What Caused the Economic Crisis?

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Warren Buffett called them "weapons of mass destruction" in 2003.

President Bush said they had to be regulated.

So did the chairman of the Securities and Exchange Commission, and the current head of the Federal reserve.

As did the G-20 group of the world's 20 richest nations.

Former Federal Reserve Chairman Alan Greenspan – after being one of their biggest cheerleaders – now says they are dangerous.

And a Nobel prize-winning economist said they should be "blown up or burned", and we should start fresh.

What Are They Talking About?

What are the above-listed folks talking about?

A financial instrument called "credit default swaps" (CDS for short).

CDS are like an insurance contract, where the purchaser buys "insurance" that a company won't go out of business from a seller. If the company stays in business, the purchaser pays premiums to the seller, but if the company goes belly up, the seller has to pay the face value of the CDS "policy".

Why are CDS so dangerous?

According to the experts, CDS were largely responsible for bringing down Bear Stearns, AIG (and see this) and other giant financial companies.

Indeed, many leading experts say that CDS were the main cause of the financial crisis. As just 3 examples:

- Newsweek called CDS "The Monster that Ate Wall Street"
- Former SEC chairman Christopher Cox said "The virtually unregulated over-the-counter market in credit-default swaps has played a significant role in the credit crisis"
- And – as mentioned above- a Nobel economist is so concerned about them that

> he thinks that existing CDS contracts must be "blown up or burned"

I'll explain the reason that CDS are so dangerous in a future post (basically, they let the financial players to pretend that they had less risk, less stretched-too-thin leverage, and more stability then they really did). But for now, just keep in mind that some of the world's top financial experts say that they *are* extremely dangerous. They are not the only cause of the financial crisis, but they are one of the main causes.

But At Least the Risk from CDS is Over, Right?

But at least the risks from CDS are over, right?

Not exactly . . .

Credit default swaps continue to bring down large companies, partly because they make it less likely that the companies can restructure.

And one of the main reasons that banks have been hoarding the bailout money instead of lending to consumers it because of CDS.Wall Street firms and banks have been hoarding cash. As the Financial Times wrote on October 7th:

> Banks are hoarding cash in expectation of pay-outs on up to $400bn (£230bn) of defaulted credit derivatives linked to Lehman Brothers and other institutions, according to analysts and -dealers.

And as Fox News put it:

> Massive positions are just starting to be unwound in the credit default swaps market as tens of billions of dollars worth of these contracts are now getting settled in the aftermath of several high-profile flops.
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> Banks are hoarding cash in expectation of expected payouts on anywhere from $200bn to $1 tn–no one knows the amount, adding to volatility–for defaulted credit derivatives linked to the collapse of Lehman Brothers, the government's seizure of mortgage giants Fannie Mae and Freddie Mac, the government's rescue of American International Group, and the failure of Washington Mutual.

And guess where most of the AIG bailout went? Yup – to corporations which bought CDS from AIG. $13 billion dollars worth of the bailout money paid to AIG went to Goldman Sachs for CDS contracts. $40 billion dollars worth of AIG's bailout money (and see this) went to foreign banks for CDS contracts. (Even AIG's former chief said that the government used AIG "to funnel money to other institutions, including foreign banks").

Unless something is done to change things, taxpayers may have to continue shelling out bailout money to keep bailing out CDS contract-holders.

Well, At Least the Regulators are Bringing CDS Under control so That They Can't Cause Damage Indefinitely. Right?

Unfortunately, regulators have so far caved into lobbying pressure from those in the CDS industry, and have failed to take any decisive action to reign CDS in.

As Newsweek writes:

> Major Wall Street players are digging in against fundamental changes. And while it clearly wants to install serious supervision, the Obama administration—along with other key authorities like the New York Fed—appears willing to stand back while Wall Street resurrects much of the ultracomplex global trading system that helped lead to the worst financial collapse since the Depression.
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> At issue is whether trading in **credit default swaps** and other derivatives—and the giant, too-big-to-fail firms that traded them—will be allowed to dominate the financial landscape again once the crisis passes. As things look now, that is likely to happen. And the firms may soon be recapitalized and have a lot more sway in Washington—all of it courtesy of their supporters in the Obama administration…
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> The financial industry isn't leaving anything to chance, however. One sign of a newly assertive Wall Street emerged recently when **a bevy of bailed-out firms, including Citigroup, JPMorgan and Goldman Sachs, formed a new lobby calling itself the Coalition for Business Finance Reform. Its goal: to stand against heavy regulation of "over-the-counter" derivatives**, in other words customized contracts that are traded off an exchange…
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> Geithner's new rules would allow the over-the-counter market to boom again, orchestrated by global giants that will continue to be "too big to fail" (they may have to be rescued again someday, in other words). And most of it will still occur largely out of sight of regulated exchanges…
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> The old culture is reasserting itself with a vengeance. All of which runs up against the advice now being dispensed by many of the experts who were most prescient about the crash and its causes—the outsiders, in other words, as opposed to the insiders who are still running the show.

Credit default swaps may continue to deepen the economic crisis and prevent a recovery – and cause future crises – unless regulators stand up to the lobbyists and take *real* action to reign them in.

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