Derivatives: 'Ticking Time Bombs'

In an article headlined "Ticking Time Bomb in Structured Credit Products," Switzerland's conservative financial daily *Neue Züricher Zeitung* on May 19 pointed to the precarious situation in the so-called "structured credit" market. This includes the use of capital structure arbitrage (CSA) contracts, combined bets on the stock price and debt titles of the same corporation. The daily states that the purchase of GM stocks by Kerkorian caused a "brush fire" on the bond market, which then, in particular, hit funds specialized in CDAs. The funds faced "painful" losses when the risk premiums on GM bonds "exploded" and the prices of related derivatives plunged, while GM stocks, because of the Kerkorian move, jumped by 20%. Overall, the downgrading of GM, in spite of "the fact that it didn't came as a full surprise, triggered a chain reaction on the bond market," centered around collateralized debt obligations (CDO). These CDOs fueled the "sudden explosion" of the GM risk premium. Trying to escape from their CDO adventure, investors "at some point engaged in panic selling, which then derailed the credit derivatives market."

—Lothar Komp

This means piling up even more losses, which in turn—once investors recognize it—will further intensify withdrawals.

One indicator for the ongoing "distress selling" is the average price of credit-default swaps (CDS), which on May 18 hit the highest level since records started one year ago. For every outstanding corporate bond, an investor can buy a CDS contract, by which the default risk is transferred to the counterparty of the contract. In exchange for this kind of protection, the investor pays a certain fee to his counterparty, which works like an interest rate deduction on the nominal return of the bond. Within ten days leading to May 18, the average CDS rate has jumped up by one third, from 42 to 60 basis points (from .42% to .6%). The sharp increase reflects not only the rising fear for corporate bond defaults, but even more, a sudden drop in the number of hedge funds that are willing, or able, to take over additional default risks. The surprising rise of the U.S. dollar and the fall of commodity prices, including oil, are also being attributed to hedge fund emergency sales.

Beyond LTCM

Andrew Large, the deputy governor of the Bank of England, issued a strong warning on credit derivatives on May 18. Speaking at an international conference of financial regulators in Turkey, he noted, "Credit risk transfer has introduced new holders of credit risk, such as hedge funds and insurance companies, at a time when market depth is untested." Large said the growth of derivative instruments has "added to the risk of instability arising through leverage, volatility, and opacity." Regulators should therefore act and, in particular, search for credit concentrations.

Among the many voices warning against a repeat of the LTCM debacle or worse, is non other than Gerard Gennotte, former senior strategist at LTCM, and now working for another hedge fund called QuantMetrics Capital Management. In statements picked up by London's *Financial Times* on May 18, Gennotte pointed to the rising risk of a liquidity crisis triggered by hedge fund blowouts, which then could lead to a 1998-style collapse. He emphasized: "You could expect something similar to 1998, with people starting to liquidate their positions. It starts with one position, but then they are afraid of getting withdrawals, and it spreads across strategies."

In private discussions with *EIR,* an international financier confirmed LaRouche's notion, that the downgrading of General Motors and Ford debt was just the beginning of a much larger crisis hitting the grossly over-extended global financial bubble—in particular the derivatives scam. The financier said that the international financial system is, in fact, facing a derivatives crisis "orders of magnitude beyond LTCM." He observed that one can be certain that the Federal Reserve, the President's Commission on Financial Markets (the so-called "plunge protection team"), and the relevant departments of major central banks around the world, are all on "emergency red-alert mobilization."

Hedge funds and banks are, of course, all publicly denying reports of a major derivatives blow-out. Any bank or hedge fund that admitted such losses without first working a bail-out scheme, would instantly collapse. Such implausible protestations of solvency are another source of instability. The source further said that there is no doubt that the Fed and other central banks are pouring liquidity into the system, covertly. This would not become public until early April, at which point the Fed and other central banks will have to report on the money supply.

Regulating Hedge Funds

In response to the GM and hedge funds crises, Lyndon LaRouche issued a statement May 14, "On the Subject of Strategic Bankruptcy," in which he called for "new governmental mechanisms" for dealing with these "strategic bankruptcies, bankruptcies with which existing mechanisms of governments are essentially incompetent to deal." LaRouche also renewed his call, from the early 1990s, for a transaction tax on all derivatives trades, to regulate hedge funds. By such a transaction tax, government authorities, for the first time, could get an insight into the hedge fund activity. Currently,