The 'Next Domino' Is Biggest: Derivatives

by Paul Gallagher

The pending breakup of a $45-50 trillion bubble of financial derivatives contracts—the vast bulk of it set to fall upon banks—guarantees widespread bank insolvency and failure, unless chartered banks are quickly protected by Federal bankruptcy reorganization which freezes all these contracts and compels the banks to implement an orderly writeoff of them.

The derivatives are known as credit default swaps, and whereas they scarcely existed five years ago, their nominal "value" has ballooned by ten times in just three years, to a gargantuan $50 trillion bubble, according to a report by New York money managers, who call them "the next domino to fall." They say it will be "far more severe" than anything that has happened so far in the mortgage meltdown and otherwise. The exploded "U.S. mortgage bubble" involved claimed debt values totalling about $20 trillion.

Default swaps are bought and sold entirely in unregulated "over-the-counter" speculations, which means that there is no organized market which bears any responsibility for, or even tracks any of this huge mass of financial contracts, as there is in the case of stocks or bonds. Like the now-notorious structured investment vehicles (SIVs), the default swaps have been highly profitable speculations which are entirely "off the books" of banks and hedge funds profiting from them—until they collapse back onto those books, causing hundreds of billions of dollars in bank losses.

In the case of credit default swaps, make that trillions in losses, say these money managers.

These derivatives contracts are supposedly drawn to insure buyers of corporate bonds against the bonds defaulting; but there are only about $5 trillion in actual corporate debts "insured" by these $50 trillion in default swaps! This is the biggest pile of "leveraged debt" of all.

Default swaps are really vehicles for massive speculations on companies' ability to repay their bonds and loans—gambling games in which dozens of banks, hedge funds, and other financial firms are placing big bets on whether bonds will be repaid, or will default. And still other hedge funds are buying default swaps to bet on whether, when the bonds default, the companies *insuring* the bonds will default or pay. The speculators selling the "default insurance" buy other default swaps against having to pay. Hedge funds and banks which have sold such default swaps "insurance" to companies holding corporate bonds, collect premiums from those companies, and have *securitized* those premiums—sold them as securities to other banks and hedge funds, just as subprime mortgage payments were bundled into all manner of securities which have lately blown out.

Few speculations have made more profits, with more "leverage" and less real capital, for hedge funds in particular, in those few years, than credit default swaps. With Sir Alan Greenspan sending global short-term interest rates to rock-bottom lows, and the "yen carry trade" providing hundreds of billions of dollars of "free money" every year for global speculations, corporate defaults on bonds—even junk bonds—were almost non-existent. "Selling insurance against default" with credit default swaps exploded as a hugely profitable betting game, done almost entirely with leverage—borrowed money. There were ten default swaps "bond insurance sellers" for every corporate bond holder that might buy such insurance; so, the insurance salesmen sold the default swaps to one another, piling bets on derivatives bets for the same underlying "reference bond." And they sold the insurance premiums as "securities," piling new debts and bets on top of them.

There is currently intense fear in markets and financial media, about imminent failure of big bond insurance companies, like Ambac Financial Corp. and MBIA, which insure more than $2 trillion in government bonds, and sell credit default swaps. Merrill Lynch has just had to write off a $3.1 billion loss on default swaps with one of them. But, these sources report, 50% of all the $45-50 trillion in default swaps are potential obligations of *banks*, and 24% more are potential obligations of hedge funds, which will "all vaporize in the first wave of defaults," dumping those obligations onto the same banks, which loaned the hedge funds the money to play the default swaps betting game.

'Bank Holiday' Returns

Now, the global financial collapse since July-August 2007 is blasting the "real economy," hitting employment, manufacturing, auto and durable goods sales, credit card purchases, and of course, construction, and companies having anything to do with housing. As it does, corporate defaults have risen from below 1% to 1.5% of corporate debt, and are headed for 4-5% of corporate debt (10% for junk bonds) in the early months of 2008, according to the professionally rose-colored estimates of the ratings agencies Fitch and Moody's.

But when the sellers of default swaps contracts are required to pay for mounting defaults, they have made absolutely no provision for doing so. They believe that all of their multiple counter-bets and "counterparties" will allow them to walk away, leaving only the original bondholders to take losses of "only" $200 billion or so—"someone else" will pay.

Whether banks try to pay these obligations, or try in desperation to walk away from them, a crisis like the 1933 bank closures and "Bank Holiday" will have arrived.

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