

Derivatives Managed by Mega-Banks Threaten Your Bank Account. All Depositors, Secured and Unsecured, May Be at Risk

Winner Takes All: The Super-priority Status of Derivatives

By [Ellen Brown](#)

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[Web of Debt](#)

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Cyprus-style confiscation of depositor funds has been called the “new normal.” Bail-in policies are appearing in multiple countries directing failing TBTF banks to convert the funds of “unsecured creditors” into capital; and those creditors, it turns out, include ordinary depositors. Even “secured” creditors, including state and local governments, may be at risk. Derivatives have “super-priority” status in bankruptcy, and Dodd Frank precludes further taxpayer bailouts. In a big derivatives bust, there may be no collateral left for the creditors who are next in line.

Shock waves went around the world when the IMF, the EU, and the ECB not only approved but mandated the confiscation of depositor funds to “bail in” two bankrupt banks in Cyprus. A “bail in” is a quantum leap beyond a “bail out.” When governments are no longer willing to use taxpayer money to bail out banks that have gambled away their capital, the banks are now being instructed to “recapitalize” themselves by confiscating the funds of their creditors, turning debt into equity, or stock; and the “creditors” [include the depositors](#) who put their money in the bank thinking it was a secure place to store their savings.

The Cyprus bail-in was not a one-off emergency measure but was consistent with similar policies already in the works for the US, UK, EU, Canada, New Zealand, and Australia, as detailed in my earlier articles [here](#) and [here](#). “Too big to fail” now trumps all. Rather than banks being put into bankruptcy to salvage the deposits of their customers, the customers will be put into bankruptcy to save the banks.

Why Derivatives Threaten Your Bank Account

The big risk behind all this is the massive \$230 trillion derivatives boondoggle managed by US banks. Derivatives are sold as a kind of insurance for managing profits and risk; but as Satyajit Das points out in [Extreme Money](#), they actually increase risk to the system as a whole.

In the US after the Glass-Steagall Act was implemented in 1933, a bank could not gamble with depositor funds for its own account; but in 1999, that barrier was removed. Recent congressional investigations have revealed that in the biggest derivative banks, [JPMorgan](#) and [Bank of America](#), massive commingling has occurred between their depository arms and their unregulated and highly vulnerable derivatives arms. Under both the Dodd Frank Act and the 2005 Bankruptcy Act, [derivative claims have super-priority over all other claims](#),

secured and unsecured, insured and uninsured. In a major derivatives fiasco, derivative claimants could well grab all the collateral, leaving other claimants, public and private, holding the bag.

The tab for the 2008 bailout was \$700 billion in taxpayer funds, and that was just to start. Another \$700 billion disaster could easily wipe out all the money in the FDIC insurance fund, which [has only about \\$25 billion in it](#). Both JPMorgan and Bank of America have over \$1 trillion in deposits, and [total deposits covered](#) by FDIC insurance are about \$9 trillion. According to an [article on Bloomberg](#) in November 2011, Bank of America's holding company then had almost \$75 trillion in derivatives, and 71% were held in its depository arm; while J.P. Morgan had \$79 trillion in derivatives, and 99% were in its depository arm. Those whole mega-sums are not actually at risk, but the [cash calculated to be at risk](#) from derivatives from all sources is at least \$12 trillion; and [JPM is the biggest player](#), with 30% of the market.

It used to be that the government would backstop the FDIC if it ran out of money. But section 716 of the Dodd Frank Act now precludes the payment of further taxpayer funds to bail out a bank from a bad derivatives gamble. As summarized in [a letter from Americans for Financial Reform](#) quoted by Yves Smith:

Section 716 bans taxpayer bailouts of a broad range of derivatives dealing and speculative derivatives activities. Section 716 does not in any way limit the swaps activities which banks or other financial institutions may engage in. It simply prohibits public support for such activities.

There will be no more \$700 billion taxpayer bailouts. So where will the banks get the money in the next crisis? It seems the plan has just been revealed in the new bail-in policies.

All Depositors, Secured and Unsecured, May Be at Risk

The bail-in policy for the US and UK is set forth in a document put out jointly by the Federal Deposit Insurance Corporation (FDIC) and the Bank of England (BOE) in December 2012, titled [Resolving Globally Active, Systemically Important, Financial Institutions](#).

In [an April 4th article in Financial Sense](#), John Butler points out that the directive does not explicitly refer to "depositors." It refers only to "unsecured creditors." But the effective meaning of the term, says Butler, is belied by the fact that the FDIC has been put on the job. The FDIC has direct responsibility only for depositors, not for the bondholders who are wholesale non-depositor sources of bank credit. Butler comments:

Do you see the sleight-of-hand at work here? Under the guise of protecting taxpayers, depositors of failing institutions are to be arbitrarily, de-facto subordinated to interbank claims, when in fact they are legally senior to those claims!

. . . [C]onsider the brutal, unjust irony of the entire proposal. Remember, its stated purpose is to solve the problem revealed in 2008, namely the existence of insolvent TBTF institutions that were "highly leveraged and complex, with numerous and dispersed financial operations, extensive off-balance-sheet activities, and opaque financial statements." Yet what is being proposed is a framework sacrificing depositors in order to maintain precisely this complex, opaque, leverage-laden financial edifice!

If you believe that what has happened recently in Cyprus is unlikely to happen elsewhere, think again. Economic policy officials in the US, UK and other countries are preparing for it. Remember, someone has to pay. Will it be you? If you are a depositor, the answer is yes.

The FDIC was set up to ensure the safety of deposits. Now it, it seems, its function will be the confiscation of deposits to save Wall Street. In the only mention of “depositors” in the FDIC-BOE directive as it pertains to US policy, paragraph 47 says that “the authorities recognize the need for effective communication to depositors, making it clear that their deposits will be protected.” But protected with what? As with MF Global, the pot will already have been gambled away. From whom will the bank get it back? Not the derivatives claimants, who are first in line to be paid; not the taxpayers, since Congress has sealed the vault; not the FDIC insurance fund, which has a paltry \$25 billion in it. As long as the derivatives counterparties have super-priority status, the claims of all other parties are in jeopardy.

That could mean not just the “unsecured creditors” but the “secured creditors,” including state and local governments. Local governments keep a significant portion of their revenues in Wall Street banks because smaller local banks lack the capacity to handle their complex business. In the US, banks taking deposits of public funds are required to pledge collateral against any funds exceeding the deposit insurance limit of \$250,000. But derivative claims are also secured with collateral, and they have super-priority over all other claimants, including other secured creditors. The vault may be empty by the time local government officials get to the teller’s window. Main Street will again have been plundered by Wall Street.

Super-priority Status for Derivatives Increases Rather than Decreases Risk

Harvard Law Professor [Mark Row maintains](#) that the super-priority status of derivatives needs to be repealed. He writes:

. . . [D]erivatives counterparties, . . . unlike most other secured creditors, can seize and immediately liquidate collateral, readily net out gains and losses in their dealings with the bankrupt, terminate their contracts with the bankrupt, and keep both preferential eve-of-bankruptcy payments and fraudulent conveyances they obtained from the debtor, all in ways that favor them over the bankrupt’s other creditors.

. . . [W]hen we subsidize derivatives and similar financial activity via bankruptcy benefits unavailable to other creditors, we get more of the activity than we otherwise would. Repeal would induce these burgeoning financial markets to better recognize the risks of counterparty financial failure, which in turn should dampen the possibility of another AIG-, Bear Stearns-, or Lehman Brothers-style financial meltdown, thereby helping to maintain systemic financial stability.

In *The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended) Consequences*, [David Skeel agrees](#). He calls the Dodd-Frank policy approach “corporatism” – a partnership between government and corporations. Congress has made no attempt in the legislation to reduce the size of the big banks or to undermine the implicit subsidy provided by the knowledge that they will be bailed out in the event of trouble.

Undergirding this approach is what Skeel calls “the Lehman myth,” which blames the 2008

banking collapse on the decision to allow Lehman Brothers to fail. Skeel counters that the Lehman bankruptcy was actually orderly, and the derivatives were unwound relatively quickly. Rather than preventing the Lehman collapse, the bankruptcy exemption for derivatives may have helped precipitate it. When the bank appeared to be on shaky ground, the derivatives players all rushed to put in their claims, in a run on the collateral before it ran out. Skeel says the problem could be resolved by eliminating the derivatives exemption from the stay of proceedings that a bankruptcy court applies to other contracts to prevent this sort of run.

Putting the Brakes on the Wall Street End Game

Besides eliminating the super-priority of derivatives, here are some other ways to block the Wall Street asset grab:

- (1) Restore the Glass-Steagall Act separating depository banking from investment banking. Support [Marcy Kaptur's H.R. 129](#).
- (2) Break up the giant derivatives banks. Support [Bernie Sanders' "too big to jail" legislation](#).
- (3) Alternatively, [nationalize the TBTFs, as advised in the New York Times by Gar Alperovitz](#). If taxpayer bailouts to save the TBTFs are unacceptable, depositor bailouts are even more unacceptable.
- (4) Make derivatives illegal, [as they were between 1936 and 1982](#) under the Commodities Exchange Act. They can be unwound by simply netting them out, declaring them null and void. [As noted by Paul Craig Roberts](#), "the only major effect of closing out or netting all the swaps (mostly over-the-counter contracts between counter-parties) would be to take \$230 trillion of leveraged risk out of the financial system."
- (5) Support [the Harkin-Whitehouse bill to impose a financial transactions tax on Wall Street trading](#). Among other uses, a tax on all trades might supplement the FDIC insurance fund to cover another derivatives disaster.
- (5) Establish [postal savings banks](#) as government-guaranteed depositories for individual savings. Many countries have public savings banks, which became particularly popular after savings in private banks were wiped out in the banking crisis of the late 1990s.
- (6) Establish publicly-owned banks to be depositories of public monies, [following the lead of North Dakota](#), the only state to completely escape the 2008 banking crisis. North Dakota does not keep its revenues in Wall Street banks but deposits them in the state-owned Bank of North Dakota by law. The bank has a mandate to serve the public, and it does not gamble in derivatives.

A motivated state legislature could set up a publicly-owned bank very quickly. Having its own bank would allow the state to protect both its own revenues and those of its citizens while generating the credit needed to support local business and restore prosperity to Main Street.

For more information on the public bank option, see [here](#). Learn more at the [Public Banking Institute conference](#) June 2-4 in San Rafael, California, featuring Matt Taibbi, Birgitta Jonsdottir, Gar Alperovitz and others.

Ellen Brown is an attorney, chairman of the Public Banking Institute, and the author of eleven books, including [Web of Debt: The Shocking Truth About Our Money System and How We Can Break Free](#). Her websites are [webofdebt.com](#) and [ellenbrown.com](#).

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