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How Greece Could Take Down Wall Street

By Ellen Brown
Global Research, February 21, 2012
Web of Debt 21 February 2012

Region: Europe, USA
Theme: Global Economy

In an article titled "Still No End to 'Too Big to Fail,'" William Greider wrote in The Nation on February 15th:

Financial market cynics have assumed all along that Dodd-Frank did not end "too big to fail" but instead created a charmed circle of protected banks labeled "systemically important" that will not be allowed to fail, no matter how badly they behave.

That may be, but there is one bit of bad behavior that Uncle Sam himself does not have the funds to underwrite: the $32 trillion market in credit default swaps (CDS). Thirty-two trillion dollars is more than twice the U.S. GDP and more than twice the national debt.

CDS are a form of derivative taken out by investors as insurance against default. According to the Comptroller of the Currency, nearly 95% of the banking industry's total exposure to derivatives contracts is held by the nation's five largest banks: JPMorgan Chase, Citigroup, Bank of America, HSBC, and Goldman Sachs. The CDS market is unregulated, and there is no requirement that the "insurer" actually have the funds to pay up. CDS are more like bets, and a massive loss at the casino could bring the house down.

It could, at least, unless the casino is rigged. Whether a "credit event" is a "default" triggering a payout is determined by the International Swaps and Derivatives Association (ISDA), and it seems that the ISDA is owned by the world's largest banks and hedge funds. That means the house determines whether the house has to pay.

The Houses of Morgan, Goldman and the other Big Five are justifiably worried right now, because an "event of default" declared on European sovereign debt could jeopardize their $32 trillion derivatives scheme. According to Rudy Avizius in an article on The Market Oracle (UK) on February 15th, that explains what happened at MF Global, and why the 50% Greek bond write-down was not declared an event of default.

If you paid only 50% of your mortgage every month, these same banks would quickly declare you in default. But the rules are quite different when the banks are the insurers underwriting the deal.

MF Global: Canary in the Coal Mine?

MF Global was a major global financial derivatives broker until it met its unseemly demise on October 30, 2011, when it filed the eighth-largest U.S. bankruptcy after reporting a "material shortfall" of hundreds of millions of dollars in segregated customer funds. The brokerage used a large number of complex and controversial repurchase agreements, or "repos," for funding and for leveraging profit. Among its losing bets was something described as a wrong-way $6.3 billion trade the brokerage made on its own behalf on bonds

of some of Europe's most indebted nations.

Avizius writes:

[A]n agreement was reached in Europe that investors would have to take a write-down of 50% on Greek Bond debt. Now MF Global was leveraged anywhere from 40 to 1, to 80 to 1 depending on whose figures you believe. Let's assume that MF Global was leveraged 40 to 1, this means that they could not even absorb a small 3% loss, so when the "haircut" of 50% was agreed to, MF Global was finished. It tried to stem its losses by criminally dipping into segregated client accounts, and we all know how that ended with clients losing their money. . . .

However, MF Global thought that they had risk-free speculation because they had bought these CDS from these big banks to protect themselves in case their bets on European Debt went bad. MF Global should have been protected by its CDS, but since the ISDA would not declare the Greek "credit event" to be a default, MF Global could not cover its losses, causing its collapse.

The house won because it was able to define what " winning" was. But what happens when Greece or another country simply walks away and refuses to pay? That is hardly a "haircut." It is a decapitation. The asset is in rigor mortis. By no dictionary definition could it not qualify as a "default."

That sort of definitive Greek default is thought by some analysts to be quite likely, and to be coming soon. Dr. Irwin Stelzer, a senior fellow and director of Hudson Institute's economic policy studies group, was quoted in Saturday's Yorkshire Post (UK) as saying:

It's only a matter of time before they go bankrupt. They are bankrupt now, it's only a question of how you recognise it and what you call it.

Certainly they will default . . . maybe as early as March. If I were them I'd get out [of the euro].

The Midas Touch Gone Bad

In an article in The Observer (UK) on February 11th titled "The Mathematical Equation That Caused the Banks to Crash," Ian Stewart wrote of the Black-Scholes equation that opened up the world of derivatives:

The financial sector called it the Midas Formula and saw it as a recipe for making everything turn to gold. But the markets forgot how the story of King Midas ended.

As Aristotle told this ancient Greek tale, Midas died of hunger as a result of his vain prayer for the golden touch. Today, the Greek people are going hungry to protect a rigged $32 trillion Wall Street casino. Avizius writes:

The money made by selling these derivatives is directly responsible for the huge profits and bonuses we now see on Wall Street. The money masters have reaped obscene profits from this scheme, but now they live in fear that it will all unravel and the gravy train will end. What these banks have done is to leverage the system to such an extreme, that the entire house of cards is threatened by a small country of only 11 million people. Greece could

bring the entire world economy down. If a default was declared, the resulting payouts would start a chain reaction that would cause widespread worldwide bank failures, making the Lehman collapse look small by comparison.

Some observers question whether a Greek default would be that bad. According to a comment on Forbes on October 10, 2011:

[T]he gross notional value of Greek CDS contracts as of last week was €54.34 billion, according to the latest report from data repository Depository Trust & Clearing Corporation (DTCC). DTCC is able to undertake internal netting analysis due to having data on essentially all of the CDS market. And it reported that the net losses would be an order of magnitude lower, with the maximum amount of funds that would move from one bank to another in connection with the settlement of CDS claims in a default being just €2.68 billion, total. If DTCC's analysis is correct, the CDS market for Greek debt would not much magnify the consequences of a Greek default—unless it stimulated contagion that affected other European countries.

It is the "contagion," however, that seems to be the concern. Players who have hedged their bets by betting both ways cannot collect on their winning bets; and that means they cannot afford to pay their losing bets, causing other players to also default on their bets. The dominos go down in a cascade of cross-defaults that infects the whole banking industry and jeopardizes the global pyramid scheme. The potential for this sort of nuclear reaction was what prompted billionaire investor Warren Buffett to call derivatives "weapons of financial mass destruction." It is also why the banking system cannot let a major derivatives player—such as Bear Stearns or Lehman Brothers—go down. What is in jeopardy is the derivatives scheme itself. According to an article in The Wall Street Journal on January 20th:

Hanging in the balance is the reputation of CDS as an instrument for hedgers and speculators—a $32.4 trillion market as of June last year; the value that may be assigned to sovereign debt, and $2.9 trillion of sovereign CDS, if the protection isn't seen as reliable in eliciting payouts; as well as the impact a messy Greek default could have on the global banking system.

Players in the future may simply refuse to play. When the house is so obviously rigged, the legitimacy of the whole CDS scheme is called into question. As MF Global found out the hard way, there is no such thing as "risk-free speculation" protected with derivatives.

*Ellen Brown is an attorney and president of the Public Banking Institute, **http://PublicBankingInstitute.org**. In Web of Debt, her latest of eleven books, she shows how a private cartel has usurped the power to create money from the people themselves, and how we the people can get it back. Her websites are **http://WebofDebt.com** and **http://EllenBrown.com**.*

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