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Is Obama a Wall Street Puppet?

Fight the Derivatives Cancer with a Wall Street Sales Tax, Bans on Hedge Funds and Credit Default Swaps

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The Obama administration has been posturing this week about the life and death issue of Wall Street reform. Obama's predicament is that of a Wall Street puppet who has been put into the White House thanks among other things to almost $1 million of contributions from the infamous Goldman Sachs – but who now needs to make a show of fighting his own Wall Street patrons for political reasons. Of course, Obama's health-care reform was largely a bailout of insurance companies, which are themselves a key part of Wall Street. But Obama is now pretending to quarrel with Wall Street to shore up his waning credibility, partly because many House Democrats are desperately seeking anti-banker, economic populist street creds in order to avoid defeat in November. So far, the results have been largely feckless and inadequate.

The urgent problem raised by all this is the $1.5 quadrillion derivatives bubble. The financial crisis which struck the United States and the world in September and October 2008 was in fact a world a derivatives panic. This panic marked the first phase of a world economic depression caused by derivatives speculation. The second phase of this depression, which is now beginning, can also be attributed in large part to derivatives, since derivatives are the main tool being used in the speculative attacks on Greece, Spain, Portugal, Italy, Ireland, and other nations, building up towards a chaotic collapse of the euro.

Derivatives are the Cause of the World Depression of Our Time

Far from being some arcane or marginal activity, financial derivatives have come to represent the principal business of the financier oligarchy in Wall Street, the City of London, Frankfurt, and other money centers. A concerted effort has been made by politicians and the news media to hide and camouflage the central role played by derivative speculation in the economic disasters of recent years. Journalists and public relations types have done everything possible to avoid even mentioning derivatives, coining phrases like "toxic assets," "exotic instruments," and – most notably – "troubled assets," as in Troubled Assets Relief Program or TARP, aka the monstrous $800 billion bailout of Wall Street speculators which was enacted in October 2008 with the support of Bush, Henry Paulson, John McCain, Sarah Palin, and the Obama Democrats.

Asset-Backed Securities

Derivatives can be defined as any financial paper which is based on other financial paper. In other words, they are financial instruments whose value depends upon or is derived from the value of other financial instruments. Any kind of securitization results in the creation of derivatives. If individual mortgages are wrapped up and packaged together as a mortgage-backed security (MBS), that is a derivative. Any asset-backed security (ABS), be it based on car loans, credit card debt, or anything else, also qualifies as a derivative.

Beyond this, there are generally speaking two kinds of derivatives. The first type includes the derivatives which are traded more or less openly on exchanges like the Chicago Board Options Exchange, etc. These include options, futures, and indices, plus all the combinations of these. These are what expire in each quadruple witching hour in the markets. This type of derivative has generally amounted to about $600 trillion of speculation in recent years.

OTC Derivatives

Then there are the so-called over-the-counter (OTC) derivatives, otherwise known as structured notes, counterparty derivatives, or designer derivatives. These often take the form of contracts which are kept secret by the counterparties, and which are often not included on the balance sheets of banks and other institutions which enter into these contracts. This type of derivative is currently not reportable to any regulatory agency. This secrecy is a result of the successful effort by Robert Rubin, Larry Summers, and Alan Greenspan to block the modest proposal of Brooksley Born of the Commodity Futures Trading Commission to bring the OTC derivatives into the sunlight during the second Clinton administration. Since these derivatives are not reportable at the present time, we must guess at their amount, and the best guess is that OTC derivatives make up almost $1 quadrillion of ultra-toxic speculation.

CDOs, CDS, and SIVs

OTC derivatives include collateralized debt obligations (CDOs),which often represent the packaging together of large numbers of mortgage backed securities, along with other debt instruments. A CDO can also be concocted out of other CDOs, in which case it qualifies as a synthetic CDO or CDO squared (CDO^2). Notice that a synthetic CDO is not really an investment, but rather a form of gambling, in which a speculator in effect places a bet on the performance of some other financial instruments. This fact exposes the big lie inherent in the widespread reactionary myth that the current depression was caused by poor people taking out subprime mortgages on slum properties and then defaulting on these loans, thus bringing down the US and British banking systems. This fantastic story ignores the fact that derivatives were only a wager placed by speculative bettors from afar on mortgage backed securities which included some subprime notes.

Credit default swaps represent bets on whether a given asset or company will go bankrupt or not. As such, they can be used as insurance against such an eventuality, or else they can be used to make money on the insolvency. CDS are therefore a form of insurance, but they are issued by counterparties who have not registered as insurance companies and who have not met the legal and capital requirements which are necessary to function as an insurance company. It ought therefore to be clear that CDS have been totally illegal all along, and have flourished only because of an outrageous failure by state insurance regulators to enforce applicable laws against the privileged class of financiers.

Structured investment vehicles (SIVs) are another type of derivative, commonly used to wrap up masses of CDOs and synthetic CDOs and then to park them off-balance sheet, where they can be hidden from regulatory and public scrutiny.

All Derivatives Illegal under the New Deal, 1936-1982

All kinds of derivatives, be they exchange traded or over-the-counter, were strictly banned and outlawed in the United States between 1936 and 1982 thanks to a wise measure enacted under the New Deal of President Franklin D. Roosevelt. In the wake of several attempts by predatory and sociopathic speculators to manipulate the prices of wheat and corn during the First Great Depression, the Commodities Exchange Act of 1936 outlawed the selling of options on agricultural products. This law had the effect of blocking most derivative speculation, until the counterattack of free-market fanatics gathered steam under the presidency of Ronald Reagan, an ideological zealot of the Austrian and Chicago schools. The very existence of derivatives today and their resulting ability to bring on a new world depression are thus directly attributable to the reckless and irresponsible dismantling of the New Deal regulatory regime. It should be added that derivatives were also banned in many states as a result of laws prohibiting gambling or forbidding bucket shops, which were betting parlors in which side bets could be placed on stock market fluctuations.

If Obama wants to pretend to have something in common with Franklin D. Roosevelt, he ought to be proposing measures to ban at least the most poisonous types of derivatives, and to discourage the others. Notice that he does nothing of the kind. Obama's Cooper Union speech of April 22, 2010 approvingly cites Warren Buffett's remark that derivatives represent financial weapons of mass destruction. But Obama then says that derivatives nevertheless have an important and legitimate role to play. So which is it? Some years back, French President Jacques Chirac rightly referred to derivatives as "financial AIDS." What useful purpose can these toxic instruments possibly serve?

Again: in his 1936 re-election speech in Madison Square Garden in New York City, Franklin D. Roosevelt famously noted that the forces of organized money hated him, and that he welcomed their hatred. Obama, in sharp contrast, called on the Wall Street predators to join him in his efforts, compounding this with the monstrous thesis that Wall Street and Main Street are in the same boat. Nothing could be farther from the truth. The recent Goldman Sachs scandal has underlined once again that the Wall Street investment houses serve no useful social purpose whatsoever. They exist solely for the purpose of pursuing speculative profits through a process of looting and pillaging the rest of the economy. The Wall Street zombie banks are monopolizing US credit, while Main Street goes broke.

Thanks no doubt to the efforts of certain House Democrats, the reform bill is likely to contain two points which can qualify as positive half measures.

Force Derivatives Out in the Open

The first is the effort to end the secrecy of OTC derivatives by forcing these instruments to be traded on public exchanges or through clearing houses. This is a step in the right direction. But this provision needs to be strengthened by making all derivatives of any type whatsoever reportable to a central regulatory authority. This would include, for example, the derivatives held by hedge funds. In 1998, the Connecticut-based hedge fund Long-Term Capital Management went bankrupt with more than $1 trillion worth of derivatives, blowing a huge hole in the international banking system, and causing Greenspan to rush in with a crony bailout. Nobody has any idea of the amount of derivatives held by hedge funds today. Highly leveraged hedge funds are perfectly capable of causing a worldwide systemic crisis with derivatives, so they must emphatically be made to report their holdings.

This reporting requirement should also include the derivatives held by non-financial corporations, whose shareholders deserve to know if and when management is dabbling in these toxic instruments. Some years back, the Gibson Greeting Card Company took a huge loss on derivatives, so this is no theoretical danger.

In addition, all derivatives must henceforth be clearly listed ON the balance sheets of banks and all other financial institutions. The intolerable practice of hiding derivatives off-balance-sheet must be immediately brought to an end.

The other positive half measure which might survive Obama's usual quest for a "bipartisan" sellout is the so-called Volcker Rule, which specifies that commercial banks with insured deposits are not allowed to engage in proprietary speculation with their own money. Depending on how this is worded, this may include a long overdue ban on derivatives speculation by commercial banks. Senator Blanche Lincoln of Arkansas, the chair of the Senate Agriculture committee—who is fighting for her political life against a primary challenge this spring—has been backing a provision that would explicitly prohibit commercial banks from engaging in derivatives speculation. These ideas go in the right direction. But we need to do much more. We need to go back to the full New Deal regulations embodied in the Glass-Steagall Act. This law stated that a financial institution could be either or a commercial bank, or an investment house, or an insurance company, but never more than one of these. In other words, the suicidal folly of the Gramm-Leach-Bliley Act of 1999, which repealed Glass-Steagall, must be rolled back.

Outlaw Credit Default Swaps

Beyond this, we must urgently address the catastrophic effects and obvious illegality of credit default swaps. More than a year ago, Senator Warner of Virginia asked Fed boss Bernanke about the advisability of creating a "bright line prohibition" against these CDS. Remember that CDS are already illegal, because they always involve an investor masquerading as an insurance company without having fulfilled the legal and capital requirements that would be demanded from a real insurance company. Credit default swaps have cost the US taxpayer almost $200 billion in the case of AIG alone, because of the bankruptcy of the AIG London-based hedge fund which had issued more than $3 trillion of derivatives – a total greater than the gross domestic product of France.

Credit default swaps are also a clear and present danger today, since they are the principal tool being used by wolf packs of banks and hedge funds against Greece and other nations, accelerating the arrival of the dreaded second wave of the world economic depression. Unless credit default swaps are banned now, they will be increasingly used for speculative attacks against the bonded debt of American states like California, New York, Illinois, and all the others. Before long, credit default swaps will be used by international speculators to attack the value and integrity of United States Treasury securities, threatening our country with the calamity of national bankruptcy. If the United States fails to shut down credit default swaps with timely legislation now, credit default swaps will be used to help destroy the United States and human civilization in general.

Ban Synthetic CDOs

The synthetic CDO or CDO^2 must also be outlawed. These are the toxic instruments which brought down Bear Stearns, Merrill Lynch, and Lehman Brothers in the great derivatives panic of 2008. What are we waiting for to ban this kind of highly destructive derivative?

Such a ban is easy to formulate: “Any collateralized debt obligation which contains other collateralized debt obligations is hereby prohibited.” End of story. This language recalls the approach of the very successful Public Utility Holding Company Act of the New Deal. One layer of CDO is more than enough risk, and it must not be further compounded.

Another ban which is long overdue and which should be included in the current legislation is the outlawing of the Adjustable Rate Mortgage (ARM). The ARM is another catastrophic innovation of recent decades which inherently carries with it an intolerable risk for any homeowner. No American family should be deprived of a roof over their heads because of the unpredictable and volatile fluctuations of interest rates over the life of a mortgage. These ARMs shift an unacceptable risk to the mortgage buyer. Fixed-rate mortgages should be the only legal kind, and any reset or change in interest rates on a residential mortgage should be strictly outlawed. While we are at it, we also need to outlaw the high-interest payday loan, a type of devastating usury to which the poorest and most defenseless parts of our population are now exposed. The outlawing of payday loans should take the form of a de facto federal usury law establishing an upper limit of no more than 10% on any promissory note or credit card. This was the limit traditionally set by state usury laws before the coming of the Volcker 22% prime rate three decades ago, and it should be restored. This simple prohibition of adjustable rate mortgages and payday loans will be far more effective than the proposed creation of an inefficient and unwieldy consumer protection bureaucracy, especially one that is located inside the Federal Reserve. The Federal Reserve has repeatedly struck out when it comes to recognizing systemic risk, when it comes to preventing financial bubbles, and when it comes to protecting ordinary Americans. The Federal Reserve failed in the run-up to the crash of 1929, in the run-up to the banking crisis of 1933, in the run-up to the stock market crash of 1987, in preventing the dot com bubble of 1999-2000, and in regard to the financial derivatives which caused the banking panic of 2008. Locating any consumer protection bureaucracy inside the privately owned Federal Reserve is simply to guarantee that such a bureaucracy will be subject to regulatory capture by Wall Street at the earliest possible moment.

Wall Street Sales Tax of 1% on All Financial Transactions

Derivatives which escape prohibition under these blanket bans on credit default swaps and synthetic CDOs must then be subjected to their fair share of the tax burden. In a time when haircuts, bowling alleys, and restaurants are threatened with new taxation, it is simply inconceivable that the financial turnover of US financial markets should remain immune to all taxation, rather like the French aristocrats of the pre-1789 old regime. Rather than crush the US economy under an ill-advised and oppressive Value Added Tax (VAT) or national sales tax, we must institute a Wall Street sales tax of 1% on all financial transactions and turnover, including derivatives. This is the levy known as the Tobin tax, the Wall Street sales tax, the financial transactions tax, the trading tax, the securities transfer tax, or the Robin Hood tax. A low-ball conservative estimate of US financial turnover (including derivatives) in any given year might be about one quadrillion dollars. In that case, a 1% Wall Street sales tax would yield $10 trillion, $5 trillion of which could be used to confront the federal budget deficit, the costs of entitlements, and the various unfunded liabilities of the federal government. The other $5 trillion would be available for revenue sharing with the states, who could use these funds to deal with their own budget crises, which currently threaten police, firemen, health services, and other indispensable parts of the fabric of civilization itself. One of the main causes for budget deficits of all levels of government in the United States is the glaringly obvious exemption of financial turnover from all taxation, while financial speculators use various tricks to escape paying the corporate income tax. The proceeds from such a Wall Street sales tax would almost certainly decline as speculation became less attractive, but in the meantime they would provide much-needed relief for the public treasury. Needless to say, any idea of paying the proceeds of such a tax to the International Monetary Fund is out of the question. Many other countries are in the process of instituting a Tobin tax on financial turnover, so the inevitable objection that a Wall Street sales tax would represent a crippling competitive disadvantage for US financial markets is increasingly untenable.

Additional Safeguards: Bankruptcy Triage, Reserve Requirement, Hedge Fund Ban

Further safeguards against the derivatives plague are also in order. Current bankruptcy law gives special privileged treatment to derivatives. These poisonous instruments continue to exact their claims even when protection against other creditors has been provided by the federal courts. This abusive and unwarranted favoring of derivatives must be reversed. Derivatives must be made to wait their turn in bankruptcy court, and sent to the end of the line after all other creditors and claims have been satisfied. If bankruptcy triage becomes necessary, it should be at the expense of derivatives.

Another needed measure is the establishment of a reserve requirement for anyone issuing derivatives. We have seen how Goldman Sachs is accused of designing their notorious ABACUS 2007-AC1 CDO, colluding with hedge fund speculator John Paulson to load this CDO with all kinds of super-toxic paper with the intent of designing an instrument which would have the best possible chances of going bankrupt in the short run. A reserve requirement for those issuing derivatives would mean that they would have to buy and hold on their own books for the life of the investment at least 20% of any derivatives they issued. This would represent an additional deterrent against the deliberate concocting of toxic derivatives with the intention of then allowing a speculator to short them with the help of credit default swaps.

A final necessary change involves the grave risk inherent in the existence of hedge funds. Despite their name, the main business of hedge funds is pure predatory speculation. Hedge funds are currently allowed to fly below the radar of the Securities and Exchange Commission, escaping regulation because they have only a limited number of super-rich investors. It is high time that this loophole came to an end. Once a hedge fund is regulated, it is no longer a hedge fund, so the call to regulate hedge funds is for all practical purposes a call for their abolition. Hedge funds should have been subject to regulation no later than the immediate aftermath of the Long-Term Capital Management debacle of 1998. The hedge fund loophole in the SEC rules must be closed now.

Seize and Liquidate the Zombie Banks

Obama’s $50 billion resolution fund for bankrupt banks is unnecessary. What we need most of all is to have the Federal Deposit Insurance Corporation, the Comptroller of the Currency, and other regulators enforce the applicable laws. Every Friday, Sheila Bair of the FDIC shuts down a number of small town banks because of insolvency. In her interview yesterday on CNBC, Ms. Bair blatantly admitted that she has no intention of enforcing these same public laws against the large Wall Street and other money center banks. She covers this malfeasance and nonfeasance with her opinion that bankruptcy does not work for the big banks. But there is little doubt that, if their massive derivatives holdings were priced according to mark to market rules, J.P. Morgan Chase, Citibank, and Bank of America would all be thoroughly insolvent candidates for Chapter 7 liquidation. Unless and until this is done, these zombie banks will continue to block any real economic recovery in the United States. Ms. Bair's policies showed the destructive folly of the current administration's illegal policies, which are all based in the final analysis on the discredited doctrine of Too Big to Fail.

Any Wall Street reform bill should also deal with the public scandal of the ratings agencies – Standard & Poor's, Fitch, and Moody's. These agencies enjoy a quasi-governmental status when it comes to certifying the quality of certain investments. But the failure of these agencies to provide timely warnings during the onset of the derivatives panic was nothing short of spectacular. During that crisis, the ratings agencies were certifying investments as AAA investment-grade until mere hours before they collapsed. Senator Carl Levin's investigation of the ratings agencies has now unearthed horror stories of corruption and incompetence. The ratings agencies need to be stripped of any special role in relation to the United States government. Senator Levin's findings merit criminal referrals to the Justice Department for prosecution of these agencies and their executives. In short, the United States government should take this opportunity to shut down these rating agencies, before these corrupt entities join in the looming speculative assault on the US Treasury, which is being prepared by George Soros and the other hedge funds.

Wall Street speculators will certainly howl that the measures outlined here represent a vindictive policy of discrimination against derivatives, which they will attempt to portray as a beneficial innovation serving the public interest. But no serious analysis of the banking panic of 2008 can ignore the obvious role of financial derivatives as one of the principal causes of this disaster. As for the charge of discrimination, it should be clear that the proposals made here generally represent nothing more than ending the privileged special treatment which has been granted to derivatives so far. Derivatives have been exempted from the gambling laws. Derivatives have been given special status in bankruptcy proceedings. Derivatives have been made non-reportable, and carrying them off balance sheet has been allowed. Derivatives have been exempted from the usual laws governing the operations of insurance companies. Hedge funds have been exempted from the scrutiny of the Securities and Exchange Commission. Wall Street derivatives banks have been exempted from the usual bankruptcy laws and probably from the antitrust laws as well. Finally, derivatives, like all financial instruments, have been exempted from state sales taxes. This distorted treatment amounts to a systematic pattern of facilitating and fostering derivatives speculation under US laws and regulations. This pattern might be defensible if derivatives represented a public good. But all experience shows that derivatives are just the opposite – they are a public menace which now threatens to destroy our civilization and way of life.

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