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Out of Control Derivative Trade Threatens the U.S. Economy

Congress Never Fixed the Financial System … And Is About to Make It Even Worse

By Washington's Blog
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Washington's Blog

Out-of-control derivatives were *largely* responsible for the 2008 financial crisis … and still pose a massive threat to the economy.

Unchecked derivatives are so harmful to the economy that:

- Warren Buffet called them "weapons of mass destruction"
- A Nobel prize winning economist who helped develop derivatives pricing said some of them were so dangerous that they should be "blown up or burned"
- Newsweek called them "The Monster that Ate Wall Street" after the financial crash

This is especially true since the big banks are manipulating the *hundred trillion* dollar derivatives market.

No, the big "financial reform" bill passed in the wake of the financial crisis didn't fix anything. We noted last year:

> No, there have not been any reforms or attempts to rein in derivatives, and the Dodd-Frank financial legislation was really just a p.r. stunt which didn't really change anything.

Indeed, the derivatives "reform" legislation previously passed has probably actually weakened existing regulations, and the legislation was "probably written by JP Morgan and Goldman Sachs".

In fact:

> Harold Bradley – who oversees almost $2 billion in assets as chief investment officer at the Kauffman Foundation – told the Reuters Global Exchanges and Trading Summit in New York that a cabal is preventing swap derivatives from being forced onto clearing exchanges:
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> > There is no incentive from the moneyed interests in either

> Washington or New York to change it…I believe we are in a cabal. There are five or six players only who are engaged and dominant in this marketplace and apparently they own the regulatory apparatus. Everybody is afraid to regulate them.

> *** Moreover, the big banks are still dumping huge amounts of their toxic derivatives on the taxpayer. And see this.
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> Indeed, the U.S. has agreed to backstop potential trillions in derivatives in the U.S. … and abroad.
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> If the big banks are manipulating the derivatives market, they could manipulate every other market on the planet.   Given that the size of the derivatives market dwarfs the entire global economy, and given that derivatives are – by definition – not real assets, but paper abstractions loosely based upon real assets, manipulation of derivatives can drive asset prices up or down at whim.
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> Of course, the big banks own Washington D.C. politicians, lock stock and barrel. See this, this, this and this.
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> So don't expect anything to change without a huge public outcry … or worse (and see this).

There *wasn't* a big enough public outcry. So the boys are at it again.

Huffington Post notes:

> A bipartisan cadre of House lawmakers will move on legislation to deregulate Wall Street derivatives Wednesday ….
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> "The road to hell is paved with these bills," said Rep. Alan Grayson (D-Fla.), an advocate of financial reform.
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> The House Agriculture Committee will mark up several derivatives bills on Wednesday despite opposition from a coalition of public interest and consumer advocacy groups ….
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> In a statement provided to The Huffington Post, [Senator] Levin expressed exasperation at the House efforts.
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> "Last year, some members of Congress supported watering down Dodd-Frank derivative safeguards, but abandoned those efforts after the world learned that JPMorgan Chase had lost billions of dollars on derivative trades made out of its London office," Levin said. "It is incredible that less than a week after new JPMorgan Whale hearings detailed how the bank's London office piled up risk, hid losses, and dodged regulatory oversight, that some House members are again supporting the weakening of derivative safeguards."
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> Derivatives were at the heart of the 2008 financial collapse. The preferred financial vehicle for a host of risky bets on the U.S. mortgage market, they created artificial demand for subprime mortgages, encouraging banks and mortgage brokers to extend loans to doomed borrowers. Derivatives pushed insurance giant AIG to the brink of bankruptcy and proved a hotbed for abuse on Wall Street. Goldman Sachs famously settled with the Securities and

> Exchange Commission for betting against the very derivatives it created and sold to its clients.
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> Yet in an era of partisan gridlock in the nation's capital, Democrats and Republicans have come together to repeal or weaken those rules. Although Obama may not want to sign a standalone package of Wall Street deregulation into law, bipartisan legislation could be inserted into a broader bill that the president might find difficult to reject.
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> Exempting such trades from oversight could also help foster tax avoidance, however, since companies have used sham derivatives transactions to dodge the Internal Revenue Service. Such activity is usually illegal, but the IRS has been short on resources to investigate and combat it. Requiring companies to post monetary guarantees creates an upfront cost to sham transactions that may serve as a deterrent.
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> The bills to be considered Wednesday also include legislation from Rep. Jim Himes (D-Conn.) — another Goldman alum — that would roll back Dodd-Frank's ban on taxpayer support for some kinds of derivatives trades.
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> Another bill would force the Commodity Futures Trading Commission, a regulator with derivatives responsibility, to conduct economic cost-benefit analyses for new agency rules using guidelines that would be more favorable to Wall Street banks.

Yves Smith explains the latter bill:

> The third bill, HR 1003, is a more straightforward "throw sand in the gears" operation. It seeks to neuter the CFTC by requiring it to make more than twice as many cost-benefit assessments of proposed decisions, which will undermine enforcement actions. It effectively subjects regulation to a second screen, by requiring regulators to jump through another hurdle and prove that rules already passed by Congress don't impose an undue cost relative to the supposed benefits. But that logic is heinous. First, recall that that sort of reasoning led to exploding Pintos. It was cheaper for Ford not to fix its cars and merely pay off the bereaved relatives of people who got fried. Second, the banks will always argue that tail risks, which is what a good deal of regulation is intended to reduce, are lower than they appear. But the cost of tail events, as in financial crises, are so great that it is imperative to be overinsured, since (as Nassim Nicholas Taleb has stressed) is inherently hard to measure and established approaches lowball it. And most important, he has described how complex derivatives risks are inherently unsuited to statistical measurement.
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> So it isn't just that the CTFC will be snowed under with busywork to justify its efforts, but that they are also likely to be shoehorned into a statistical template which will give the banks the upper hand. Well played!

Smith explains that it is still possible to kill these horrible bills:

Please contact your Senator and Representative and tell them you are firmly opposed to these bills since they are all "gimmie my bailout and leave me alone" proposals from the banks. One bit of good news here is that at least on paper, Republicans are not happy about the fact that Dodd Frank resolutions aren't likely to work even before the launch of this effort to assure they won't ever be attempted. Spencer Bachus issued a paper last year criticizing the inadequacy of the Dodd Frank resolution provisions. So it can't hurt to tell Democrats that they need to stand behind Dodd Frank, and remind Republicans that they've stood for "no more bailouts" and they need not to allow those sneaky ex Goldman Democrats to allow Wall Street to suck resources away from Main Street. This sort of bill depends on the complacency and indifference of the public to get passed, and correctly painting its as an egregious piece of pro-bailout pork might make some Congresscritters loath to be associated with it.