Do Credit Default Swap Derivatives Add or Reduce Risk?

Further, are these particular derivatives yet another illusion and moral hazard in the context of "Austrian Enginomics"? The answer is YES!!

May I Borrow $20 billion for Clunkers, Inc.?
One day I needed to borrow $20 Billion to keep my Clunker, Inc. company afloat because I was getting pressure from my employees and pesky suppliers who all wanted payment for the labor and raw materials they supplied. I also wanted to implement some product turnaround ideas that would require incremental capital.

Fortunately I had a friend, Muffy, who managed the State School and Police Pension Fund and was under similar pressure to earn at least a 9% return on the Fund's investments. He knew his job was at risk, if he did not perform. Muffy was restrained by nuisance policy and regulatory requirements that stated investments must carry an AAA rating. Teachers and cops, who were dependant upon future proceeds from the fund, had guns and pitchforks, and they were not friendly to fund managers who might squander their collective nest egg on risky "investments".

I approached Muffy about a loan for $20 billon. Muffy said the bond credit rating agencies assigned a rating of CCC to my existing debt because they determined the securities are "highly speculative" and a "substantial risk". Consequently, he could not make the loan today. I told Muffy that the President of the United States was "hoping" Clunkers Inc. would be just fine in a few short months because **government** was going to make the economy improve somehow. Muffy was impressed, but had a better idea.

The Credit Default Swap
Muffy had a brother, Buns, who enjoyed a credit rating of AAA on his hot dog stand business. Muffy said Buns would be willing to insure the $20 billion loan. So, if I ever defaulted on it he would pay Muffy $20 billion and keep the pesky old teachers and cops happy. This "insurance" is referred to as a Credit Default Swap (CDS), which is designed to reduce Buns' and my risk. I asked Muffy, if Buns had $20 billion or access to $20 billion. He said no, but the Credit rating agency didn't perform any due diligence on Credit Default Swap counter-parties as long as Buns' company carried an AAA rating. Buns always pays his wiener and bun suppliers on time, but Muffy and I wanted some more assurance in case the worst happened to my Clunker car business and Buns did not come through. With the assistance of an Investment Bank friend, Viper (from Goldman Sucks), we enlisted our other brother, Kool, to write a Credit Default Swap "Squared" contract on Buns in case Buns could not come up with the $20 billion on the outside chance my Clunker, Inc. business went kerplunk.

Kool owned a Kool-Aid stand in Baghdad that was VERY profitable, so certainly that would ease the risk concerns of all parties. Viper was very helpful in arranging all of the financing and putting everyone at ease. He suggested I pay an interest of 20% annually ($4 billion) to Muffy. Muffy would pay 8% ($1.6 billion) to Buns annually, and Buns would pay Kool 3% ($600 million) annually.

Everybody Was Happy…

- I received $20 billion ($21 billion loan less $1 billion to Viper) to turn around Clunker, Inc.
- Muffy will receive an impressive 12% net return (20% less the 8% going to Buns) on the investment in Clunker's, Inc. with the resourceful Buns and Kool backups.

- Buns will receive a 5% net return (8% less the 3% going to Kool).
- Kool will receive 3% from Buns as compensation for his risk.
- Viper will receive a small brokerage fee, approx. $1 billion, for organizing things.

UNTIL….
The crusty old executive management team at Clunker didn't like my turnaround ideas. They said it was unrealistic to build a 5-passenger sedan that would travel 1,000 miles on a gallon of salt water and 500 grams of carbon dioxide, then emit pure oxygen to reverse the decades of abuse the environment has experienced from all the fossil-fuel burning clunkers to date. So, I fired them all and hired some young academics flush with innovative ideas. Soon they learned they could not change the laws of physics even with a congressional mandate. So, clunker, Inc. went kerplunk. I either defaulted on my loans or needed a government bailout.

Result…
The entire country financial system was under tremendous stress. So, to prevent a cataclysmic collapse, Santa Sam (read Taxpayers) came to the rescue and paid Muffy the full $21 billion plus interest due for part ownership of Clunkers, Inc. Muffy and Kool were paid interest due them. Viper was a proactive cheerleader encouraging Santa. Viper was depending upon Santa to indirectly back the next deal he was working.

Could This Really Happen????
A recent article in Bloomberg described how the government and Central Bank **forced** AIG to pay Credit Default Swap investors **par** (100 cents on the dollar) to retire the Swaps that were valued up to **40% less than par**. These, "investors" were other banks who were "too big to fail" including Goldman Sachs. Following is an excerpt from the article:

Bloomberg.com Oct. 17, 2009…. By Sept. 16, 2008, AIG, once the world's largest insurer, was running out of cash, and the U.S. government stepped in with a rescue plan. The Federal Reserve Bank of New York, the regional Fed office with special responsibility for Wall Street, opened an $85 billion **credit line** for New York-based AIG. That bought it 77.9 percent of AIG and effective control of the insurer.

The government's commitment to AIG through **credit facilities** and investments would eventually add up to $182.3 billion.

Beginning late in the week of Nov. 3, the New York Fed, led by President **Timothy Geithner**, took over negotiations with the banks from AIG, together with the Treasury Department and Chairman **Ben S. Bernanke's** Federal Reserve. Geithner's team circulated a draft term sheet outlining how the New York Fed wanted to deal with the swaps -- insurance-like contracts that backed soured collateralized-debt obligations.

Subprime Mortgages

CDOs are bundles of debt including subprime mortgages and corporate loans sold to investors by banks.

Part of a sentence in the document was crossed out. It contained a blank space that was intended to show the amount of the haircut the banks would take, according to people who saw the term sheet. After less than a week of private negotiations with the banks, the **New York Fed** instructed AIG to pay them par, or 100 cents on the dollar. The content of its deliberations has never been made public.

The New York Fed's decision to pay the banks in full cost AIG -- and thus American taxpayers -- at least $13 billion. That's 40 percent of the $32.5 billion AIG paid to retire the swaps. Under the agreement, the government and its taxpayers became owners of the dubious CDOs, whose face value was $62 billion and for which AIG paid the market price of $29.6 billion. The CDOs were shunted into a Fed-run entity called Maiden Lane III.

Habayeb, who left AIG in May, did not return phone calls and an e-mail.

Goldman Sachs

The deal contributed to the more than $14 billion that over 18 months was handed to Goldman Sachs, whose former chairman, **Stephen Friedman**, was chairman of the board of directors of the New York Fed when the decision was made. Friedman, 71, resigned in May, days after it was disclosed by the Wall Street Journal that he had bought more than 50,000 shares of Goldman Sachs stock following the takeover of AIG. He declined to comment for this article.

In his resignation letter, Friedman said his continued role as chairman had been mischaracterized as improper. Goldman Sachs spokesman **Michael DuVally** declined to comment……..

How Large is the Credit Default Swap Derivative Monster?

The **total** notional amounts of Over The Counter (OTC) Derivatives as of June 2009 was **$605 trillion** up from **$94 trillion** at the end of June 2000[(1)]. Credit Default Swap (CDS) derivative contracts have been declining from a high of about $60 trillion in 2007 down to $36 trillion in June 2009. Keep in mind the CDS's are a newcomer to the derivatives OTC market. Blythe Masters was credited with inventing[(2)] Credit Default Swaps in 1997 at the tender age of 28 working at the London branch of JP Morgan Chase. I have asserted for some time that they would likely not even exist within a sound monetary system. They do not add Real Wealth to the economic system. It's another gaggle of financial predators that consume rather than create real wealth.

Conclusion.

Today most CDS contracts represent a mirage of insurance coverage rather than a sound time-tested resource that could readily pay claims under extreme economic shock conditions. If those issuing CDS contracts passed a rigorous capital requirement test, we would likely find that the cost of the contracts is prohibitive, and they never would have gotten off the ground in the first place. Hence, rather than reduce risk these contracts represent one of the greatest moral hazard risks of our times.

By Russell Randall 1-12-2010

References:

(1) BIS press release Nov. 13, 2000.
(2) "The Woman Who Built Weapons of Mass Destruction" by David Teather, The Guardian Sept. 20, 2008