Derivatives 'fire accelerator' spreads banking contagion

By *Elisa Barwick*

The ongoing slide in the shares in major European banks, and the spike in the price of credit default swaps—as other banks rush to buy insurance against bank crashes—indicates a state of play in the financial system akin to mid 2007. The system is shot, but that reality has not yet been admitted.

According to *The Economist* of 13 February, "Financial stocks are down by 19 per cent in America. … Japanese banks' shares have plunged by 36 per cent since 1 January; Italian banks' by 31 per cent and Greek banks' by a horrifying 60 per cent. The fall in the overall European banking index of 24 per cent has brought it close to the lows it plumbed in the summer of 2012, when the euro zone seemed on the verge of disintegration … [Italy's] third-biggest (and the world's oldest) bank, Monte dei Paschi di Siena['s] share price has fallen by 56 per cent this year."

As *The Economist* and many other outlets are now warning, the policy of bail-in—confiscating deposits and investments to save a bank—which was invented after the 2007-08 crisis to prevent unravelling derivatives spreading contagion worldwide (p. 4), is, ironically, one of the main factors inciting panic.

The head of banking research at Italy's Mediobanca, Antonio Guglielmi, told *The Telegraph*'s Ambrose Evans Pritchard on 10 February that the sell-off in banking shares and credit seizure is the direct result of the EU's bail-in policy coming into force. "People are scared. This is very close to a potentially self-fulfilling credit crisis," said Guglielmi. "We have a major dislocation in the credit markets. Liquidity is totally drained and it is very difficult to exit trades. You can't find a buyer." Investors are "shorting" bank stocks to hedge their positions, the article says.

Guglielmi said investors fear that "bail-ins" will be "crystallised" around the fact that the European banks are sitting on €1 trillion of non-performing loans.

Also writing in *The Telegraph*, Mehreen Kahn pronounced "concerns over new EU 'bail-in' laws" (the Bank Recovery and Resolution Directive—BRRD) a key reason for nervousness. A *Financial Times* article of 11 February headlined "Bank turmoil: are Europe's new bail-in rules to blame?" agreed, saying Brussels "could hardly have imagined the political backlash would come so swiftly, or that the regime could be blamed for so much market turmoil."

Italy has been labelled a test case for bail-in, since it has been denied state aid or an EU rescue as its banks collapse. In the 13 February *Telegraph*, assistant editor Jeremy Warner reported that Italian Prime Minister Matteo Renzi "has taken to referring to the numbskulls of the European high command as like the orchestra on the Titanic." He reports that the IMF "estimates that the Italian banking sector's non performing loans amount to an astonishing 18 per cent of GDP. … If Europe's elites had consciously set out to bring the whole house of cards tumbling down, they could hardly have been more effective about it."

Bank shares crashing worldwide

Despite a statement on Monday, 8 February from Deutsche Bank that it had the means to make good on bond payment obligations, its shares fell 9.5 per cent from the previous Friday. On Tuesday morning co-CEO John Cryan emailed a statement to staff, saying that they could reassure customers that, "Deutsche Bank remains absolutely rock-solid, given our strong capital and risk position." German Finance Minister Wolfgang Schäuble got in on the act: in Paris for an EU finance ministers' meeting, he said he has "absolutely no concerns about Deutsche Bank." Financial commentators across Europe have affirmed that one of the reasons for Deutsche Bank's steep share crash is investor nervousness due to the large number of Contingent Convertible (bail-in) bonds it has issued.

A sign of the panic within Deutsche was a letter sent out by its senior credit analyst Dominic Konstam calling for bail-in to be put aside so that bail-outs can be resumed. Konstam is desperate for central banks to provide more liquidity, fast. He proposes: letting banks charge their depositors negative interest on their savings, as well as deposit and withdrawal fees to "tax" (confiscate) those savings; Basel III requirements should be postponed; let the banks raise their leverage ratios; "open the refi spigot and ease liquidity…."

Deutsche is hardly alone, however. On 11 February JPMorgan Chase CEO Jamie Dimon spent US$26.2 million buying 500,000 shares in his own bank after they fell to the lowest level in two years. Former Bank of England Chief economist and former chairman of the Independent Commission on Banking Sir John Vickers has also warned that British banks are vulnerable to "external shocks". *The Guardian* of 15 February points out that while the focus has been on the troubles of Deutsche Bank, the British banks are not much better; Standard Chartered is at 25-year lows and HSBC is at 2009 levels. Australian banks have also seen dramatic falls in their share value in 2016: Macquarie Group down 30 per cent; ANZ, 21 per cent; Westpac, 16 per cent; and NAB and CBA both down 14 per cent.

Derivatives fuel

A 10 February article in Japan's *Nikkei News* entitled "Touchy derivatives market spreading Deutsche Bank waves", warned that the derivatives market is now acting as a "fire accelerator" within the growing fire of bank panic.

This danger had been elaborated in the *Financial Times* a day earlier: "Investors flock to CDS amid fear over banks' bonds" reported a huge pile-in to credit defaults swaps (CDS), insurance derivatives against defaults by Deutsche Bank, UBS, and a number of London banks, even as the price of these CDS contracts is zooming up, showing the loss of confidence in those banks' credit. These derivatives all involve other London and Wall Street banks as counterparties. The rising risk of each others' bad loans and declining credit is spreading among these banks; contagion to Citibank, in particular, is reported.

US Fed chair Janet Yellen's 10 February Congressional testimony, which seemed to assure that the next few months would see no further rate increases, couldn't prop up the Wall Street markets for even a day; a leak from Mario Draghi's European Central Bank that it might start buying up bank stocks directly—prohibited by its charter—only temporarily sent up Deutsche Bank stock. The CDS "risk cost" of Deutsche Bank debt is now equal with Italy's Unicredit and Monte dei Paschi di Siena (MPS) as the riskiest major banks in Europe.

Heads I win, tails you lose: derivatives gamblers concocted 'bail-in'

By Robert Barwick

Under the bank bail-in regimes now in place around the world, deposits and investment savings of hundreds of millions of people are marked to be "bailed in"—stolen—while the multi-trillion-dollar derivatives gambling bets that the banks make with each other will be honoured. It is no surprise, then, that the original idea for bail-in *came from two derivatives salesmen*—executives at Credit Suisse First Boston who sold derivatives during the wild frontier days of the 1990s when that bank's derivatives division was involved in outright fraud.

Paul Calello and Wilson Ervin were both founding members of Credit Suisse First Boston's high-powered derivatives division, Credit Suisse Financial Products (CSFP), when it began in 1990. Calello, now deceased, had previously worked at the US Federal Reserve and then Bankers Trust, which pioneered the over-the-counter (OTC) derivatives trade before it went bust; Calello and a team of BT derivatives salesmen moved over to Credit Suisse to start CSFP. Ervin, now vice-chairman of Credit Suisse, had joined the firm in 1982, and spent part of the 1980s working in its Australian investment bank before he moved into CSFP.

The OTC derivatives trade was still new in 1990; worth roughly US$1 trillion in 1987, within a decade it would expand to US$70 trillion—more than global GDP. These were lawless days in the business (not that they have improved)—Frank Partnoy, a derivatives salesman who from 1993 to 1995 worked for Bankers Trust, CS First Boston and Morgan Stanley, exposed the practices and culture of the 1990s derivatives business in his 1997 book, *F.I.A.S.C.O.: Blood in the Water on Wall Street* (see box). Even then, Partnoy's revelations of outright fraud should have been enough to trigger an official inquiry that sent bankers to jail. In 1999, for instance, Japan's financial supervisors took away CS First Boston's operating license, for selling fraudulent "window dressing" derivatives to Japanese companies, which were designed to hide financial losses. At the time, the global head of CS First Boston's fixed income derivatives operations was Paul Calello!

Bloomberg noted, following Calello's death, that the Credit Suisse star "ascended the ranks as derivatives … became an increasingly important money-maker for Wall Street." He was also in the thick of coordinating the derivatives trade with other banks through the International Swaps and Derivatives Association (ISDA), as well as crisis management for the sector. In 1998, when Long-Term Capital Management (LTCM), the hedge fund run by a Nobel Prize winner, collapsed under massive losses on highly-leveraged derivatives bets, Calello participated in the frantic emergency discussions at the New York Fed which sought to stop LTCM's collapse from bringing down the entire system at that time. Describing his LTCM experience a decade later in the keynote speech to the ISDA conference in Vienna, Austria in April 2008, Calello declared he supported government "intervention" in modern global markets (read: derivatives markets) because they are "too interconnected to fail".

According to a 2015 interview with Wilson Ervin published on the Credit Suisse website, their bail-in brainwave came five months after this speech, when he and Calello represented Credit Suisse at the infamous 13-14 September 2008 weekend lockdown[1] inside the New York Federal Reserve building, where the top bankers from all the big Wall Street firms scrambled to save the global banking system from the imminent collapse of Lehman Brothers. In a 28 January 2010 column in London's *The Economist* headlined "From bail-out to bail-in"—the first time bail-in was proposed—Calello and Wilson used the Lehman case to justify their scheme, arguing, in essence: Lehman collapsed under US$25 billion of bad assets, but bankruptcy expanded its total losses to six times that, US$150 billion; if somehow Lehman's US$25 billion loss could have been passed off onto its unsuspecting shareholders and creditors, the pain would have been contained and the wider market would have escaped unscathed,

'Rip their faces off'

Former derivatives salesman Frank Partnoy's 1997 book *F.I.A.S.C.O.* exposed the primal, predatory culture and practices of the derivatives business; his revelations included:

• Derivatives trading banks overtly encouraged a vicious, primal trading culture. The banks recruited military veterans as head traders, the better to inject a killer instinct into trading rooms. The Morgan Stanley CEO when Partnoy worked there, John Mack, ordered his traders *to take advantage of the bank's own clients*, who were losing massively by buying derivatives that they had no hope of understanding. Mack exhorted his minions: "There's blood in the water. Let's go kill someone." The standard jargon of derivatives traders for earning a huge commission from a client who lost a lot of money, was "I ripped his face off". John Mack later took over CS First Boston as CEO, where he put bail-in schemer Paul Calello in charge of the firm's Asia-Pacific operations.

• Derivatives traders targeted fund managers. The easiest targets for banks to sell derivatives to, and the source of most of the massive growth in derivatives deals, is the managers of pension funds, superannuation funds, insurance funds, municipal funds etc. The fund managers are betting other people's money, mostly have no idea what they are buying, and in all likelihood get a kickback, while the bank siphons off massive commissions. The derivatives are fraudulently structured to evade regulations designed to ensure such funds only invest in reasonable and safe products.

• Derivatives are designed to hide losses, and make losses appear as profits. Partnoy explains Morgan Stanley's legendary MX missile derivative, which it sold to Japanese banks in 1995 to enable them to hide their massive losses arising from the February 1995 bankruptcy of Barings Bank, caused by derivatives losses. In 1999 Japan's financial supervisory authority caught CS First Boston selling the same so-called "window dressing" derivatives to hide losses.

1. As *Rolling Stone* reporter Matt Taibbi recorded in his 2014 book *The Divide*, "The deals the government and Wall Street worked out that weekend to save the likes of AIG, Goldman, Deutsche Bank, Morgan Stanley, and Merrill Lynch were unprecedented in their reach and political consequence, transforming America into a permanent oligarchical bailout state."