

# 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<sup>1</sup> 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

## ‘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.

“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,

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.”