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"Getting Tough" with Predator Financial Institutions
AIG, Larry Summers and the Politics of Deflection

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Finally the US authorities have gotten 'tough' with the predator financial institutions. The world has been waiting for such decisive intervention since an unending series of Government bailouts of financial institutions began early in 2008 amounting to now trillions of taxpayer dollars. Now, with the world's largest insurance giant, AIG, the White House Economic Council chairman, Larry Summers has expressed 'outrage.' President Obama himself has entered the fray to promise 'justice.' US Senators have threatened a law to change the injustice. The only problem is they are all exercising 'politics of deflection,' taking attention away from the real problem, the fraudulent bailout.

The issue is over AIG announcing it was obligated to pay its traders in its high-risk London unit a sales bonus totaling $165 million for the year. Obama Treasury Secretary, Tim Geithner has announced a novel strategy for 'justice.' AIG will 'reimburse' the taxpayers up to $165 million for bonuses the company is giving employees. AIG will pay the Treasury an amount equal to the bonuses, and the Treasury will deduct that amount from the $30 billion in government (taxpayer) assistance that will soon go to the company. But he said that the Obama administration hasn't given up on efforts to recoup the money from the employees who got the bonuses. Good luck.

Larry Summers is the man directly responsible for the mess. As Clinton Treasury Secretary from 1999-January 2001 he shaped and pushed the financial deregulation that unleashed the present crisis. He was Treasury Secretary after July 1999 when his boss, Robert Rubin left to become Vice Chairman of Citigroup, where Rubin went on to advance the colossal agenda of deregulated finance directly.

As Treasury Secretary in 1999, Summers played a decisive role in pushing through the repeal of the Glass Steagall Act of 1933 that was instituted to guard against just the kind of banking abuses taxpayers now are having to bail out. Not only Glass-Steagall repeal. In 2000 Summers backed the Commodity Futures Modernization Act that incredibly mandated that financial derivatives, including in energy, could be traded between financial institutions completely without government oversight, 'Over-the-Counter' as in where the taxpayer is now being dragged. Credit default Swaps, at the center of the current storm, would not have been possible without Larry Summers and the Commodity Modernization Act of 2000. He is now the White House Economic Council chairman, mandated to find a solution to the crisis he helped make along with Tim Geithner, his friend who is Treasury chief. Foxes should never be asked to guard the henhouse.

Theatre of the absurd or deflection?

This all makes great food for tabloid headlines and popular outrage. They can write that elected politicians are finally acting in taxpayer interests. Until we look a bit more closely. Paying $165 million in employee bonuses or any amount for a company that is in the middle of a multi-trillion dollar fraud that is bringing the world economy down with it is 'outrageous.'

The problem is the tax bailout haemmorrhage will go on. The reason is the Obama Administration like its predecessor refuses to take consequent action with AIG, despite the fact today the US Government owns at least 80% of AIG stock, bought for $180 billion of, yes, taxpayer dollars. To demand AIG 'pay back the government' is absurd as the government is in effect demanding it pay itself back with its own money. The latest claim that the Treasury will subtract the $165 million bonus money from the next $30 billion tranche it will give AIG says it all.

Preserving the CDS bubble

The political 'outrage' expressed by the Obama Administration is an example of 'perception management.' The population is being slylyduped into believing their officials are working in their interest. In reality the officials are channeling growing popular outrage over endless bank bailouts away from the real problem to an entirely tertiary one. The US Government has injected $180 billion since September 2008 to keep the 'brain dead' AIG in business and honoring its Credit Default Swap obligations. In effect, they are propping up the casino to continue endless gambling with taxpayer dollars.

The rise of a market in derivatives or 'swaps' contracts supposedly to 'insure' against a company going into default and not being able to honor its debts, the Credit Default Swaps market, is at the heart of the global financial catastrophe. The market was 'invented' by a young economist at JP MorganChase, interestingly enough one of the few big banks recording profit today.

As noted, CDS trading was created free from US Government regulation by President Clinton when he signed the Commodity Futures Modernization Act of 2000 that mandated that financial derivatives not be under government regulation scrutiny. Enron crony and UBS bank adviser, Texas good 'ol boy

Senator Phil Gramm helped pass the laws at a time his wife, Wendy headed the putative regulator, the Commodity Futures Trading Corporation (CFTC). That gave the green light to a derivatives market nominally worth more than $62 trillion in 2008. No one knows the exact size because this is a ‘phantom banking market’ completely private and between banks, so-called OTC for Over-The-Counter, ‘just between us.’

Michael Greenberger who headed the CFTC Division of Trading and Markets in the late 1990’s at the time of the financial deregulation acts, says that banks and hedge funds"were betting the subprimes would pay off and they would not need the capital to support their bets." The unregulated Credit Default Swaps, he says, have been at "the heart of the subprime meltdown. In 1998 Greenberger proposed regulating the growing derivatives market. At the prospect, he says, "all hell broke loose. The lobbyists for major commercial banks and investment banks and hedge funds went wild. They all wanted to be trading without the government looking over their shoulder."

The confidence between banks, the ‘just between us,’ collapsed after the ill-conceived decision by the US Government on September 15 2008 not to save the world’s fourth largest investment bank, Lehman Brothers. By then, there was no alternative but to nationalize and then sort out the mess. Bankruptcy, as the world now realizes, was not an option. But neither was the Henry Paulson TARP ‘casino rescue plan’ and Geithner’s continuation any option.

At the point the Government let Lehman Bros go down only months after saving the far smaller Bear Stearns and also AIG, not even a bank, there was no clear idea who would be saved and who not. No bank could afford to trust any other bank not to be holding just as risky loans as they. The crisis became a global systemic crisis. Notably, the man who participated in the decision to let Lehman Bros fail ‘to teach a lesson’ was then President of the New York Federal Reserve, US Treasury Secretary Tim Geithner.

The US Government has stated that AIG cannot be allowed to fail, that, to use the jargon, AIG is ‘too big to fail.’ The reason the Government says it can’t let AIG fail is that if the company defaulted, hundreds of billions of dollars’ worth of Credit-Default Swaps (CDS) would ‘blow up,’ and US and European banks whose toxic assets are supposedly insured by AIG would suddenly be sitting on immense losses. Quite the contrary, AIG is ‘too big to save’ under current rules of the game that have been written by Wall Street and the privately-owned Federal Reserve, Treasury Secretary Geithner’s former employer.

The CDS fraud

Credit Default Swaps purported, in theory, to let banks remove loan risk from their balance sheet onto others such as AIG, an insurer. It was based on a colossal fraud using flawed mathematical risk models.

AIG went big into the selling Credit Default Swaps with banks around the world, from its London ‘Financial Practices’ unit. AIG in effect issued pseudo ‘insurance’ for the hundreds of billions of dollars in new Asset Backed Securities (ABS) that Wall Street firms and banks like Citigroup, Goldman Sachs, Deutsche Bank, Barclays were issuing, including Sub-prime Mortgage Backed Securities.

It was a huge Ponzi scheme built by AIG that depended on the fact the world’s largest insurance company held a rare AAA credit rating from Moody’s and S&P rating agencies. That meant AIG could borrow more cheaply than other companies with lower ratings

AIG issuing of CDS contracts acted as a form of insurance for the various exotic Asset Backed Securities (ABS) securities being issued by Wall Street and London banks. AIG was saying ‘if, by some remote chance’ those mortgage-backed securities suffered losses, AIG would pay the loss, not the banks.

Then it got really wild. Because credit-default swaps were not regulated, not even classed as a traditional insurance product, AIG didn’t have to set aside loss reserves! And it didn’t. So when housing prices started falling, and losses started piling up, it had no way to pay off.

AIG then issued of hundreds of billions of dollars worth of CDS instruments to allow banks to make their balance sheets look safer than they really were. Banks were able to get their loan risk low not by owning safer assets. They simply bought AIG’s credit-default swaps. The swaps meant that the risk of loss was transferred to AIG, making the bank portfolios look absolutely risk-free. That gave banks the legal illusion of BIS minimum capital requirements, so they could increase their leverage and buy yet more ‘risk-free’ assets.

How could that be allowed? The level of venal corruption in the Clinton and then Bush Administration rivals that of the last days of Rome before its fall from the internal rot of corruption. Banks invested billions in lobbying Washington politicians to get their way.

What can be done?

Fortunately there is a simple way out of the AIG debacle. The US Government can step in and fully nationalize AIG, 100%, kick out responsible management, declare AIG's CDS contracts null and void and let holders sue the US government to regain value for what were in reality lottery gambles not loans to the real economy. They own 80% so the step is small to 100%. Doing that would end the global market in CDS and open the door for countless legal challenges. But AIG's counterparties, as we begin to learn, were exactly the big Wall Street players like Goldman Sachs, Citigroup, even Deutsche Bank. They have gotten enough taxpayer bailouts to cover their risk in CDS. Let them recognize risk is the heart of banking, not the opposite.

Myron Scholes, the 'father' of financial derivatives, who won a Nobel Prize in economics in 1997 for inventing the stock options model that led to financial derivatives back in the 1970's, has declared that derivatives and Credit Default Swaps have gotten so dangerously out of hand that authorities must 'blow up' the market.

Scholes says derivatives traded over the counter should be shut down completely. Speaking at York University Stern School of Business recently, he said the "solution is really to blow up or burn" the over-the-counter market and start over. He included derivatives on stocks, interest rate swaps and credit default swaps that should be then moved into regulated markets.

The idea is simple and not that radical. A US law banning OTC derivatives and moving them to regulated exchanges would end a colossal 'shadow banking' fraud. Banks would not lose much more than already, but the world financial system would get back to 'normal.' OTC derivatives are unregulated precisely to hide risk and enable fraud by the banks. It is past time to end that. There is where the US Treasury and other Governments must focus, not on meaningless 'transparency' calls or trading bonus 'justice.'

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