How Banks Loot Nations 'Legally'

by David Malone via reed - Golem XIV *Saturday, Dec 17 2011, 11:39pm*
international / imperialism / other press

Is there an emergency plan B? But let's first be CLEAR about Plan A.

The privately owned Federal Reserve Bank

Plan A is to enforce an era of long-term austerity cuts to public services, in part to cut public expenditure so as to free up money for spending on the banks, but perhaps more importantly to further atrophy public services so that private providers can take over. A privatization of services which will bring great profits and cash flow to the private sector and to the banks who finance them, and a further general victory for those who feel that private debts rather than public taxes should be what underpins our national life and social contract.

Plan A therefore requires that governments convince their populace that private debts should be taken on to the public purse and that once taken on, the contracts signed by governments on behalf of the tax payers/citizens, are then sacrosanct and above any democratic change of mind. If governments can hold their peoples to this,then the banks are 'saved' with the added bonus that democracy and the 'Rights' it once guaranteed will all have been redefined as subordinate to finance and its contracts, and our citizenship will have become second to one's contractual place in a web of private debts. Debts to the private lenders will become more important than taxes to the public exchequer. And as they do the State will wither away, leaving free-market believers and extreme libertarians exactly where they have always wanted to be – in charge – by dint of being rich. It is, in my view, a bleak future which I once described as A Toxic Debt Wasteland.

BUT it does all depend on governments being able to suppress discontent and to outlaw opposition in the sense of saying to people you may disagree but we have now declared these debts and their repayment to be outside democratic control and immune to any attempt to rescind or repudiate the agreed debt contracts. As the severity of the austerity cuts to social services (health, education, pensions etc) becomes painfully clearer to people and the 'necessity' for them is 'regretfully' extended year after year, it will become harder and harder to justify, let alone impose, such suffering. We will enter an era of vicious sectarian blame. We are already in it, but it will get much darker.

The banks and those whose wealth and power is tied to them, would obviously prefer Plan A to succeed. It makes governments do all the dirty work and it would profit the banks far more in the long run. If you want to bleed a man – kill him and you get about 5 litres/quarts. But strap him to a gurney with a catheter in his arm and a drip feed in his nose, and he will bleed for you for as long as his system can stand it. That is Plan A. But what if it fails?

I cannot believe the banks, with everything at stake, have not thought it prudent to have a plan B. So here are my thoughts on what that plan could be. Let me say now, I do not think this plan was a long term conspiracy. I do not think the end game was in mind when the first elements were put in place. It has, I think, been constructed opportunistically. But the end result is no less dark and threatening.

What I offer from here on is thinking out loud. I obvioulsy have no proof at all that there is a plan B. All I can hope to do is show you the elements which I think could make a Plan B for the banks. Then my argument is that if the mechanism I describe could work, if I have not simply misunderstood something, then I think the banks will surely have thought of it before me. And so it either already exists or it will. I think there are scraps of information that suggest it does exist and the collapse of MF Global might even be the first example of Plan B in action. The MF Global case certainly contains all the clues.

MF Global imploded when it could not get the short term funding it needed. There were two kinds of funding MF Global relied upon for its liquidity/cash flow: repo and hypothecation. For those not familiar, Repo is when a bank or brokerage 'sells' an asset for cash but with the agreement that it will re-purchase – hence 'repo' – the asset at an agreed date for an agreed price. It is not really a sale but a loan. Repo is the oxygen the financial world breathes. Repo is a $10 Trillion market.

The other main source of the essential short term funding was Hypothecation. This is when a bank or brokerage pledges an asset to a 'lender' in return for cash but the asset remains in the possession of the borrower. What the 'lender' gets is hypothetical control of the asset. Although the asset never actually changes hands, the new 'owner''s' hypothetical control of the asset allows her to do what she wishes with the asset. Including re-hypothecating the asset to another bank or brokerage. If she does so then the hypothetical control passes to yet another 'owner'. Even though physically it remain where it started.

Like repo – hypothecation and re-hypothecation are truely massive parts of modern debt-based banking. So the first thing the MF Global case tells us is that what happened is not due to some peripheral, parochial rogue trader-esque, isolated problem. What happened was as a result of a mechanism right at the very heart of the financial system.

In the MF Global collapse what ZeroHedge, and following them, I and others wrote about, was the way in which not only did MF Global go bankrupt, but so also did some of their clients when they found the money they thought MF Global was holding for them, went unaccountably missing. Client's money went missing because it was 'mingled' with the brokerage's money when it should not have been. Brokers should keep them separate. But it seems in the 're-hypothecation' of assets it was mingled. Former CEO of MF Global, Mr Corzine has sworn under oath he knew nothing about his co-mingling nor the irregularities with his company's re-hypothecation. It has been rumoured the client's money may now be, possibly, in the hands of JP Morgan.

This hint of illegality has grabbed everyone's attention. But I think it is actually the legal part of the story not the possibly illegal part which is by far the more important.

In my opinion the key to the bank's Plan B is in understanding why any money/assets were taken from MF Global after it had gone bankrupt and how exactly it went under in the first place. We all know MF Global had huge holdings of dicey European sovereign debt. But those debts have not become worthless so what caused MF to collapse? .

The answer to all these questions lie in a change to Bankruptcy laws that happened around the world between 2002 and 05. This might seem like a detour into nerd city but it is not. It is the key.

When a company declares bankruptcy there is what the Americans call an ‘automatic stay’, which means all the assets left in a company at the moment it goes bankrupt are protected from the rush of creditor’s demands until appointed auditors can sort out who should get what. The automatic stay prevents a first come first served disorderly looting where those with the most muscle getting everything and everyone else getting nothing. As we are all painfully aware now, there is a legal pecking order to who gets paid before who, with Senior bond holders at the top. But, in America culminating in 2005 with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) the order was changed. And that change is the crucial event.

At the time the law was being passed few were aware of this change and even fewer were aware of how important it would become. At the time the furore was all about changes to personal bankruptcy. The Credit Card industry (AKA Banks) had spent more than a decade and its rumoured as much as $100 million lobbying to make bankruptcy much harder and more punitive for ordinary debtors.

An article from 2005 in the Boston Globe quoting a very senior Republican Senator, gives a flavour of what was then being said about ordinary people who fell into debt.

> Senator Orrin Hatch (R-UT) has said that millions of Americans are bankrupt or near-bankrupt because “they run up huge bills and then expect society to pay for them.”

After 4 years of bailing out banks who did exactly that the irony is enough to gag on.

But what was not talked about was an amendment which was put into the bill and, as far as I know little debated. Don’t let the word ‘amendment’ mislead you. Amendments are generally not there as refinements and improvements on the original idea. Whenever a bill goes through Congress every lobby group and industry with something it wants done, gets their tamed/owned/ political friends to tack on the change in the law that suits them in return for supporting the original bill. The bill emerges from this process festooned with ‘amendments’ to other vaguely related laws. Amendments are the price of getting the original bill passed. They are often little understood, written by and for the benefit of the sponsoring lobby group and can be far more influential than the bill they are smuggled in on. This is certainly the case here.

According to a scholarly article in the American Bankruptcy Law Review,

> “the provisions [in the amendment] were derived from recommendations from the President’s Working Group and revisions espoused by the financial industry”

The President at the time was Bush and one of the most vociferous sponsors of the amendment was none other than Senator Leach whose other claim to fame was the Gram-Leech-Bliley Act which repealed most of the Glass Steagal Act of 1933 whose repeal virtually assured that the present debt crisis would happen. When bankers play pocket billiards, Senator Leach is what they prod their balls with. Ribaldry aside Senator Leach can certainly be described as one of the principle architects of our present global misery. But I digress.

What was this ammendment? The ammendment exempted repos (and hypothecated and re-hypothecated assets) and a whole range of derivatives from the automatic stay. It also allowed lower quality assets to qualify for the exemptions.

Which means,

> The special bankruptcy treatment given repos and derivatives means that repo lenders and parties to derivative contracts can keep the collateral if their trading partner becomes insolvent. This exempts them from the "automatic stay" rule in bankruptcy, which prohibits most creditors from trying to collect ahead of others.

Or as the official report from the US Financial Crisis Inquirey Commission said,

> under a 2005 amendment to the bankruptcy laws, derivatives counterparties were given the advantage over other creditors of being able to immediately terminate their contracts and seize collateral at the time of bankruptcy. (p. 48)

So when a bank goes bankrupt, BEFORE even the most senior bond holders, the repo lenders and derivatives traders can remove, or keep all the assets pledged to them.

This amendment which was touted as necessary to reduce systemic risk in financial bankruptcies also allowed a whole range of far riskier assets to be used, making them too immune from the automatic stay in the event of bankruptcy. Which meant traders flocked to a market where risky assets would be traded and used as collateral without apparent risk to the lender. The size of the repo market hugely increased and riskier assets were gladly accepted as collateral because traders saw that if the person they had lent to went down they could get your money back before anyone else and no one could stop them.

It also did one other thing. Because the repo and derivatives traders ran no risk – they could get their money out of a failing bank before anyone else, it meant they had no reason at all to try to stop a bank from going under. Quite the opposite.

All other creditors – bond holders – risk losing some of their money in a bankruptcy. So they have a reason to want to avoid bankruptcy of a trading partner. Not so the repo and derivatives partners. They would now be best served by looting the company – perfectly legally – as soon as trouble seemed likely. In fact the repo and derivatives traders could push a bank that owed them money over into bankruptcy when it most suited them as creditors. When, for example, they might be in need of a bit of cash themselves to meet a few pressing creditors of their own.

The collapse of both Bear Stearns, Lehman Brothers and AIG were all directly because repo and derivatives partners of those instituions suddenly stoppped trading and 'looted' them instead.

According to Enrico Perotti, professor of international finance at Amsterdam Business School speaking at the London Conference on The Future of Bank Funding, held in June of this year, 2011,

> The financial crisis happened when repo lenders and derivative parties lost confidence in the mortgage-backed securities they'd accepted as collateral for repo loans and credit default swaps. They demanded to be paid, forcing their troubled trading partners into fire sales of their holdings to raise cash. They were unconcerned that they might drive their trading partners into bankruptcy, because they were exempt from the automatic

stay.

Professor Perotti went on to say,

> As often in financial regulation, this leads to unintended consequences. As a default leads to repossession of collateral for all safe harbor claims, repossession accelerates fire sales, resulting in a disorderly resolution, with a rush to sell collateral ahead of others, creating a downward spiral in valuations. The timing of the jumps in risk spreads on Lehman, two days after the default, demonstrates this effect, as does AIG.

Should the bankers and their political fluffers like Mr Leach have known? Well they were warned at the time. In 2005 a paper entitled "Derivatives and the Bankruptcy Code: Why the Special Treatment?" by Franklin R. Edwards and Edward R. Morrison, in the Yale Journal of Regulation http://www1.gsb.columbia.edu/mygsb/faculty/research/pubfiles/1666/Morrison%20%26%20Edwards%20Yale%20Rev

> VI. Conclusion
> ... the Code's special treatment of derivatives contracts cannot be justified by a fear of systemic risk.... Indeed, exempting derivatives counterparties from the automatic stay may make matters worse by increasing systemic risk....Our analysis, however, should worry members of Congress and legislators in other countries. They have been lobbied heavily by special interest groups (such as ISDA) to expand the special treatment of derivatives on grounds that such legislation is necessary to prevent a systemic meltdown in OTC derivatives markets should a derivatives counterparty suffer financial distress.
>
> Our analysis casts serious doubt on this proposition. Systemic risk may be a real threat, but bankruptcy law has no role to play in addressing it."

The same changes to the bankruptcy laws were also adopted in the UK and throughout Europe. In fact they may well have preceded them. I simply have not done that research yet. And the changes in the UK and Europe were also lobbied for and sponsored by the banks via among others the ISDA (International Swaps and Derivatives Association). Most of the Big banks are ISDA members.

OK all of that was the back-ground to show you how we got here and that it is all 'legal'. On the basis of laws sponsored by the banks of course. Now lets come to the present.

MF Global is where I started. There was something about its collapse which did not seem right to me. Mr Corzine's claim that he 'didn't know' where his clients' money had gone might be true, but I was and am still, left with the feeling that there is a deeper story here. When I wrote about MF Global and the renewed crisis of bank lending, I came across the fact that in the six months to June 2011 the global trade in Derivatives increased by 18% to an astonishing $707 trillion in nominal value (the face value of all the contracts). And remember the Repo market is $10 trillion.

Somehow MF Global's collapse and the huge increase in derivatives trading felt related. For me it was not the huge exposure to risky European bonds which MF Global had deliberately amassed, it was the nature of its demise, the trigger, and what happened to its assets afterwards, which were key. MF Global collapsed because it could not get short term funding. It could not get other financial institutions to accept its assets as collateral for Repo agreements nor hypothecate tham any longer.

When MF Global went down it did so because its repo, derivaitve and hypothecation partners essentially foreclosed on it. And when they did so they then 'looted' the company. And because of the co-mingling of clients money in the hypothecation deals the 'looters' also seized clients money as well. The co-mingling story is what brought the whole thing into the light but also provided a wonderful distraction.

The important point is that the change in the Bankruptcy laws. The change, as illustrated by Bear Stearns, Lehman Brothers and AIG has made the markets more not less systemically unstable. Yet the banks have defeated all attempts to reform these unwise laws. The Dodd Frank financial reform act in eth US did nothing to address them AT ALL. Mr Dodd was lobbied very hard to make sure of this.

Why?

Here, finally, is my answer.

Let us say you are a bank or broker that has bought up a lot of European bank and sovereign bonds from Italy, Spain and Greece for example. You would be very exposed to great losses should those countries or their banks default. You are relying on the politicians forcing their tax payers to bail out you and the other banks you trade with. What if they don't?

One solution would be to sell as many of those bonds as you could accepting the inevitable losses as being better than a much larger loss if the banks or nations or both, defaulted. The other solution, counter-intuitively, would be to do more business with them. But make sure it is repo lending and derivative trading. Specifically offer the banks in troubled nations CDS insurance on their own bad debts and currency swaps. How would this help?

First, lets keep in mind that the trade in both these types of derivatives did increase by 18% in the first 6 months of 2011 precisely as the Euro crisis has worsened.

If a bank or nation was to default on you as a mere bond holder, you would have to wait in a the queue of creditors to see what you were going to be given back. And some 'hair cut' would be likely. But if you had done rather a lot of derivatives trading (CDS insurance and currency swaps are both derivative trades) then you would not have to wait. You would seize all the collateral the bank had pledged to you for repo lending or derivative trading and walk away. Now you will say that if you had done CDS insurance then you might well have to pay back out the money you had seized. Except that possession is nine tenths of the law. While lawyers set about arguing about what you owe, the critical fact is that in the mean time, in the height of the crisis you HAVE the money. JP Morgan allegedly has MF Global money while other people's lawyers can only argue about it.

This will also be true if you have also rather wisely been on the right side of lots of re-hypothecation deals and repo deals with the collapsed bank. In both cases if the collapsed bank had pledged to you assets for Repo or hypothecation then you get to keep all those assets in the case of the bank going bankrupt. We have the clear proof of this already. As Zerohedge reported some days ago, "HSBC Sues MF Global Over Disputed Ownership Of Physical Gold". It seems HSBC's gold may have been hypothecated or re-hypothecated. Someone else, some other bank, has their gold and all they have are lots of lawyers charging them fat fees.

So what we have, courtesy of the change in the bankruptcy laws is the means for banks to loot each other. Simply become a major short term funder via repo or hypothecation or a major counterpary in derivatives deals with the ailing bank and in both cases should the bank you are lending to go bankrupt, you will keep all the assets it pledged to you before any other creditor get a chance.

If I am right then MF Global was the first hint of Plan B in action. The bankruptcy laws allow a mechanism for banks to disembowel each other. The strongest lend to the weaker and loot them when the moment of crisis approaches. The plan allows the biggest banks, those who happen to be burdened with massive holdings of dodgy euro area bonds, to leap out of the bond crisis and instead profit from a bankruptcy which might otherwise have killed them. All that is required is to know the import of the bankruptcy law and do as much repo, hypothecation and derivative trading with the weaker banks as you can. To me, this gives a possible answer to why there has been such a surge in derivatives trading.

If I am right about all this, I think this means that some of the biggest banks, themselves, have already constructed and greatly enlarged a now truly massive trip wired auto-destruct on the banking system. If they have and they have explained any of this to our politicians then it would explain why our governments have been so abjectly willing to bail out any and all of the biggest banks and sacrifice anything else in the process. Any hint of relucatnace and the banks can make veiled reference to the extreme 'risk' of systemic 'panic' and forced liquidations. None of which is really a panic, since they have engineered it.

Are the banks threatening us? No, no, good lord no! Just pointing out the reality of the state of the system. There just happens to be a gun pointed at our head and the banks just happen to find their finger on the trigger. All they ask is that we do nothing to make them feel that their best interests are served by pulling it. And all we have to do to avoid that is stick to plan A. Simple.

But now I come to the really ugly part.

For the last four years who has been putting money in to the banks? And who has become a massive bond holder in all the banks? We have. First via our national banks and now via the Fed, ECB and various tax payer funded bail out funds. We are the bond holders who would be shafted by the Plan B looting. We would be the people waiting in line for the money the banks would have already made off with.

It is the money we have been putting in to bail out the biggest banks which they have then been using as collateral for offering weaker banks in weaker nations, repo loans or hypothecation. And the money or government bonds the weaker banks are using to pledge as assets and collateral for those loans or in derivative deals with the bigger banks is also from us. We have and are funding both sides of the deal.

The result is that the assets which the big banks would be legally allowed to seize and keep in the event of the failing bank actually going under would be ours.

To give a concrete example. Spain or Greece puts its tax payer money in to one of its insolvent banks.That bank then uses that money to get a short term repo or hypothecated it for loan. Or it uses it to hedge its currency problems via a currency swap or buys CDS insurance on assets it is deeply worried about. If the weak bank then goes down all those assets are seized by the big bank who was lending or was the counter-party to the derivative deals. The tax payer gets zero. And there is no redress. It was legally done. And the money the Big bank would have used to get themselves into this position would be the bail out money we had earlier given to the mega banks. They would have used that money against us – again.

The largest banks, those with the greatest exposure to bank and sovereign bonds from the most indebted euro nations, have the most to gain from doing derivative. repo and hypothecation deals with the troubled euro area banks and nations. The more assets the weak banks and nations have pledged in deals with teh Big banks, the more theBig banks will walk away with in the event of a crash. I suggest this is why, even as this crisis has worsened, the Big banks have been increasing by 18% their trade in derivatives and why Repo and hypothecation is as large or larger than even before the crash.

I am sorry this has been such a long piece but I wanted you to see exactly how I came to this because I hope you can show me how I am wrong. Please do so politely and I will go downstairs and celebrate my stupidity with a cup of tea, before apologizing to you all. I would very much like to be wrong.

But if I am not wrong, then the banks have created a financial Armageddon looting machine. Their Plan B is a mechanism to loot not just the more vulnerable banks in weaker nations, but those nations themselves. And the looting will not take months not even days. It could happen in hours if not minutes. Our leaders would have only a few hours to decide who they would side with: the banks or us. The past four years give me no faith they would chose us.

http://www.golemxiv.co.uk/2011/12/plan-b-how-to-loot-nations-and-their-banks-legally/
