

**Oligarchs of the Banking System: Why They're So Powerful and How They Got Us Into the Financial Crisis** By Loren Kole

**Abstract**

The United States economy, facing a downturn of grand scale, can lay much of the blame on both the big names on Wall Street and the politicians in Washington who allowed such a stray from the regionalized banking of the post-Depression era. The lack of regulatory measures also led to an interconnectedness in banks, the likes of which our financial sector had never experienced. Credit default swaps allowed banks to hyper-leverage themselves and keep the risk of their toxic assets off of the books. Culturally, Americans have a confidence in Wall Street that has faltered since the onset of the crisis, but was so prevalent that it begs the question as to whether the banks can be broken down. Simon Johnson's article "The Quiet Coup" urges the need for nationalization and then regionalization of banks, but given this cultural standpoint, it is unclear whether this action is likely to happen.

There is no way to sugar coat the fact that the banks are in trouble. There are three fundamentally flawed aspects of the banking system that got us into this mess- credit default swaps, hyper leveraging and toxic assets. The nature of the credit default swap is such that problems could've been addressed before this collapse, but the market itself is not the reason for all of the US financial woes. Hyper leveraging would have been less of an issue had the assets remained in one institutions control. Similarly, toxic

assets would have been eliminated from the system after a few years had they not been divvied up and sold from their respective owners. These three interconnected issues are what plague our system, and what regulatory action may have been able to avoid.

As Simon Johnson points out in his article “The Quiet Coup”, over the past decade, the attitude has taken hold that what was good for Wall Street was good for the country. This attitude is what allowed these oligarchs to gain so much power and gamble themselves into financial ruin. There was a trust in these corporations that allowed for measures to be passed that were absolutely appalling in hindsight- the ban on regulation of credit default swaps, the repeal of commercial and investment banking regulations, and ability of individual banks to evaluate their own risk. Too much trust was given to these powerhouses; it became a cultural norm to have tremendous confidence in Wall Street.

The idea of a strong Wall Street has existed in the United States since the Depression, but so much has changed between then and now, it is surprising the two systems are at all connected. Banking in the post-Depression era was conservative- no outlandish leveraging, no backroom dealing between giant corporations- the system was too regulated for that. The pillar of investment can be summed up by the phrase “practical returns on practical investments”. This regulated system lasted until the Reagan era, when deregulation came into style and Wall Street was handed over the reins and told to do what they do best. This deregulatory environment led to banks merging to take advantage of new financial innovations. Thus the small regional banks of the past became the powerful oligarchs of today, taking advantage of the newest opportunities deregulation provided.

Credit default swap markets have existed since 1994, when a group of bankers from JP Morgan first developed them on an “Off-Site Weekend” in Boca Raton<sup>1</sup>. It started out as a plan to free up the huge amount of capital JPMorgan was required to have on hand in the event of corporations and foreign governments defaulting their share of on the tens of billions of dollars JPMorgan had lent out. The solution was a form of insurance on these loans. A third party would assume all of the risk of the loans in exchange for steady payments from the bank, creating a profitable new market for the third party and freeing up the banks reserves to be used at their discretion. It was an enormous step for the system, and soon the credit default swap was the “hot new financial instrument”<sup>2</sup>. Mark Brickell, then a managing director at JPMorgan, said of the development, “I’ve known people who worked on the Manhattan Project. And for those of us on that trip, there was that same kind of feeling of being present at the creation of something incredibly important.”<sup>3</sup>. The comparison to the creation of the atomic bomb, here is especially apt. In fact, investing titan Warren Buffet has referred to the credit default swap market as a “financial weapon of mass destruction”<sup>4</sup>. The deception lies in the perceived ease of the removal of risk.

But they were not always rogue nukes, with no central reporting mechanism with zero government regulation. Early in CDS dealing JPMorgan took about 300 loans to large businesses, bundled together the near 10 billion they were worth and sold the loans in “tranches”, first identifying the riskiest tranche. Terri Duhon, who put together

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<sup>1</sup> Phillips, Matthew. "The Monster That Ate Wall Street; How Credit Default Swaps --an insurance against bad loans-- Turned from a Smart Bet to a Killer." Newsweek 06 Oct 2008

<sup>2</sup> Erman, Boyd. "Counterparty Risk and Credit Default Swaps." The Globe and Mail (Canada) 17 Sept 2008

<sup>3</sup> Phillips, Matthew. "The Monster That Ate Wall Street; How Credit Default Swaps --an insurance against bad loans-- Turned from a Smart Bet to a Killer." Newsweek 06 Oct 2008

<sup>4</sup> Rappoport, Alan. "Systematic Risk Haunts Credit Default Swaps." CFO.com 18 Sept 2008

the Broad Index Securitized Trust Offering where these tranches were sold said of the process, “we made it possible for banks to get their credit risk off of their books and into non-financial institutions like insurance companies and pension funds.”<sup>5</sup>. But then the credit default swap market took on a life of it’s own. Investors bought into risky emerging world market places, like Russia and Latin America, by insuring their national debts. Then investors went further, using the credit default swap as means to protect against big company implosions like that of the Enron and WorldCom. Companies were leveraging themselves beyond what they could be responsible for and selling that risk to banks. The market was growing out of control, skyrocketing in value from 1997 to 2005 and reaching a staggering 62 trillion dollar worth<sup>6</sup>.

The failure in the system, as proved by the failure of Lehman, was that widespread loss was not the main issue plaguing market, but rather the risk that a big dealer could go under was what would do the market in. American International Group (AIG) is further evidence to back this claim. The credit protection they had sold was heavily weighed down by corporate debt and mortgages, and worse yet, they had sold this protection on over 440 billion dollars<sup>7</sup>. These swaps hid the credit risk, the leveraging, the toxic assets they held and the possibility that the parties involved would be unable to hold up their end of the deal. The Federal Reserve Bank was quoted as saying that credit default swaps “give banks a opaque means to sever links to their borrowers, thus reducing lender incentives to screen and monitor”<sup>8</sup>. So instead of taking

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<sup>5</sup> Phillips, Matthew. "The Monster That Ate Wall Street; How Credit Default Swaps --an insurance against bad loans-- Turned from a Smart Bet to a Killer." Newsweek 06 Oct 2008

<sup>6</sup> "But Will it Work?; Rescuing the Banks." The Economist 18 Oct 2008

<sup>7</sup> "The Great Untangling: Credit Derivatives." The Economist 08 Nov 2008

<sup>8</sup> "The Great Untangling: Credit Derivatives." The Economist 08 Nov 2008

a huge risk in a transparent way, such as borrowing heavily to buy mortgages, they took the quicker and less visible route and put their faith in the credit default swap market.

AIG was flat out over committed. They bought credit default swaps, but didn't get them on their own assets, in an atypical approach from the rest of the market. They insured houses and then insured the mortgages on those houses until they held 440 billion in credit default swaps at the time of the bailout. And as is typical with bonds and derivatives of this nature, once one defaults the risk of others following suit increases tenfold. The environment of fear makes investors overly cautious in their actions and the big companies all feel the hurt of one failure. Investors sell, credit pulls back and the market crumbles. And in the case of our economy, this process was exacerbated by the fact that all of the big players in the credit default market were linked. Lehman had an additional 700 billion worth of swaps, and many were backed by AIG<sup>9</sup>. So when Lehman fell, AIG was stuck trying to scramble to save itself. This was made even worse when mortgage-backed securities went bad, when AIG needed to make good on billions of credit defaults swaps and simply did not have the funds to cover their losses<sup>10</sup>. The Dow felt the effect of this failure and the drop in the Dow's average contributed to the fear of investors, perpetuating this cycle.

This crisis has put the government in the position of having to choose between letting all of the oligarchs fail, or saving many through costly legislation. If one of these big players fails, the ripple effect is enormous, and the credit default swaps connecting all of the banks makes it impossible to let one corporation fade into obscurity.

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<sup>9</sup> Phillips, Matthew. "The Monster That Ate Wall Street; How Credit Default Swaps --an insurance against bad loans-- Turned from a Smart Bet to a Killer." Newsweek 06 Oct 2008

<sup>10</sup> Phillips, Matthew. "The Monster That Ate Wall Street; How Credit Default Swaps --an insurance against bad loans-- Turned from a Smart Bet to a Killer." Newsweek 06 Oct 2008

Lehman's defaults will be felt for years to come, not just by other banks but also in the taxpayer's pockets.

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