

Banks, Bonuses, Goldman Sachs and Swaps

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The surrealism of the Greek tragicomic around Goldman Sachs abounds. After all the damage that the Greek debt management agency has done to erode not just the public confidence in Greece but ruin the green shoots of recovery, it was under pressure to replace its head. That replacement has now been effected, lo and behold, by whom - none other than Petros Christodoulou, who till then was head of Private Banking and Group Treasury at the National Bank of Greece (reporting directly to the CEO of the National Bank of Greece). So what is odd? Mr. Christodoulou worked not only as head of derivatives at JP Morgan but also held comparable posts at Credit Suisse, and... wait for it, Goldman Sachs... Uh, say what? Here is the cv courtesy Forbes:

Petros Christodoulou, born 1960, is the General Manager of Treasury, Global Markets and Private Banking. Before joining the Bank in 1998, he worked in various positions in Global Markets for Credit Suisse First Boston and for Goldman Sachs. Additionally, at JPMorgan he led the derivatives desk, followed by the short-term interest-rate trading and emerging markets division in London as Managing Director. He is a member of the Investment Committee of EH and the Foundation for Economic and Industrial Research. He holds a BSc from the Athens School of Commerce and Economics and an MBA in International Financial Markets from Columbia University.

In its first issue of Corporate Governance Journal last year the lead story titled "From Wall Street to Crawl Street" showed how the explosion of credit default swaps – at one stage valued at \$64 trillion by the International Swaps and Derivatives Association, aggressively offered by Wall Street investment bankers such as Goldman Sachs led to the global economic downturn never witnessed since the great depression. Despite the severity of the global meltdown as a direct consequence of these resulting in millions of job losses and hundreds of thousands of homes being repossessed, no lessons seem to be having been learnt. That the history repeats, not just rhyme, is now evident from the revelations of Goldman Sachs involvement in Greek maelstrom. They made a killing by first arranging these swaps back in 2001 and then shorting them.

Goldman Sachs arranged swaps that effectively allowed Greece to borrow 1 billion Euros without adding to its official public debt. While it arranged the swaps, Goldman also sought to buy insurance on Greek debt and engage in other trades to protect itself against the risk of a default on those swaps. Eventually, Goldman sold the swaps to the National Bank of Greece.

CDS – an insurance contract

A credit default swap is, essentially, an insurance contract between a protection buyer and a protection seller covering a corporation's or sovereign's specific bond or loan. A protection buyer pays an upfront amount and yearly premiums to the protection seller to cover any loss on the face amount of the referenced bond or loan. Fundamentally, this kind of derivative serves a real purpose - as a hedging device. The actual holders, or creditors, of outstanding corporate or sovereign loans and bonds might seek insurance to guarantee that the debts they are owed are repaid.

Lord Turner's remarks on the uselessness of some banking operations delivered some 6 months ago that have since garnered support from several quarters including the British prime minister refer to these swaps. It is now widely believed that while Greek finances have always remained in a mess it was the financial engineering devised by Goldman Sachs that disguised it from the public for such a long time.

Germany's chancellor Angela Merkel said, "It is scandal if it turned out that the same banks that brought us to the brink of the abyss helped to fake the statistics."

Goldman's \$500m on arranging Greek swaps and a further killing by shorting it

The terms of the swap meant that Goldman essentially made an upfront payment to Greece in exchange for a revenue stream later. If Greece defaulted on its obligation to keep that revenue stream flowing, Goldman stood to lose money. Goldman also sought to buy insurance on a Greek debt and engaged in other trades to protect itself against the risk of default on those swaps. These swaps were eventually sold to the National Bank of Greece. Despite its role in creating swaps that allowed Greek government to mask its growing debt Goldman has no net exposure to a default on Greek debt. It will be recalled that many Americans, both democrats and republicans, believe that the TARP was primarily designed to benefit Goldman Sachs. In fact the bailing out of Bear Sterns and the tranche of \$65 billion in the rescue package of AIG was designed to benefit Goldman Sachs. Goldman first put the Greek swaps in place in 2001. It immediately sought to hedge its risk to the Greek obligations by making side deals with other parties and eventually sold the entire swap to the National Bank of Greece. Later it tried to entice Greek government to about a similar deal that would delay their debt obligations.

CDS gives incentive to burn down your house

It is this kind of swaps that prompted Franklin Keyes, a prominent Wall Street lawyer to say in 1902: "Wall Street speculation fosters a ring of idle gamblers, parasites upon society, who prey upon the fortunes of the honest and industrious; such people are a menace to the legitimate business interests of the country and an element of danger to the republic."

As James Richards, Director of Omnes and former General Council of long term capital management says, "For over 250 years insurance markets have required buyers to have an insurable interest; another name for skin in the game. Your neighbor cannot buy insurance on your house because they have no insurable interest. Such insurance considered unhealthy because it would cause the neighbor to want your house to burn down and may be even light the match. When the CDS market started in 1990s the whiz-kid investor have neglected the concept of insurable interest. Anyone could bet on anything creating a perverse wish for the failure of companies in countries by those holding side bets but having no interest in the underlined bonds of enterprises. We have given wall street huge incentives to burn down your house."

In the aftermath of one of history's worst meltdowns, the governments specially in the western world have emptied their chests bailing out businesses. Britain itself has the third worst deficit in the world after Iceland and Greece. Faced with large scale unemployment these countries are naturally reluctant to take drastic measures to put their house in order. It is here that CDS's become the proverbial weapons of mass destruction and need to be regulated lest they seriously impinge on the sovereignty and stability of countries under debt.

Did Godman Sach's Rule the Fed?

It is important to realize that the investors are getting increasingly wary of the shenanigans of bankers. The arrogance of Goldman Sachs stems from his strong connections. In the financial industry it is difficult to find someone with sufficient experience of finance and banking who has not been worked for Goldman Sachs. There was a general perception before Tim Geithner took over as Treasury Secretary that Goldman Sachs ruled the Fed. After he took over there are insinuations that Goldman Sachs rules the White House.

During the nomination of Tim Geithner last year in January when it was discovered Mr Geithner had not accounted his taxes properly there was huge congressional outcry to his nomination. Commenting on the issue Christopher Whalen, Managing Director and Co-founder of Institutional risk analytics had said "I am not just sure Tim Geitner is the guy we should have driving the bus". It

was found that Tim Geithner had not only been shy of his tax dues but also asked AIG to remain silent about the rescue package that it received from the government.

Volcker's Rule shifts the power away from Tim Geithner

All this controversy has been put to rest by the Volcker Rule that takes the power away from Tim Geithner. The spectacle of a beaming Volcker standing at Obama's right as the president endorsed his proposal and branded it the "Volcker Rule" with Geithner standing somewhat at a distance showed that the two had exchanged places.

The moment was the product of Volcker's persistence and a desire by the White House to impose sharper checks on the financial industry than Geithner had been advocating, according to some government sources and political analysts. It was Obama's most visible break yet from the reform philosophy that Geithner and his allies had been promoting earlier.

Volcker had been arguing that banks, which are sheltered by the government because lending is important to the economy, should be prevented from taking advantage of that safety net to make speculative investments.

To make his case, he met with lawmakers on Capitol Hill and gave numerous speeches on the subject, traveling to at least nine cities on several continents to warn that banks had developed "unmanageable conflicts of interest" as they made investments for clients and themselves simultaneously.

Advocates of Volcker's ideas were delighted. Obama officials were growing concerned that government guarantees designed to spur lending by letting banks borrow cheaply were instead funding banks' speculative investments and fueling soaring profits.

"This is a complete change of policy that was announced today. It's a fundamental shift," said Simon Johnson, a professor at MIT's Sloan School of Management. "This is coming from the political side. There are classic signs of major policy changes under pressure . . . but in a new and much more sensible direction."

President Obama has clearly checkmated the bankers with Volcker's Rule. What Britain is going to do? There is no doubt that a Tobin like tax will affect the revenues of City of London in the short run. A proposal to cut down the volume of the trade in City that will reduce income is naturally bound to create adverse reactions. No doubt it is the job of the London Mayor to oppose a tax of this nature that truncates the City's stature as the global financial hub. But this argument has to be weighed by the danger that looms in a democratic society if the likes of Goldman Sachs use their financial innovations as weapons to destabilise and disrupt governments and abet terrorism for a few pieces of silver. .

A case for Tobin tax type levy in whatever form is clearly made out. It has two benefits. It not only stabilizes the markets. The money thus earned can be used for making this world more equitable. In fact the City of London will not be the only one who would suffer from this tax. France has a similar proposals and Brazil has already levied a similar tax to discourage hot money entering the country with no adverse consequences. Finally it is a great relief to know markets have an instrument that has the ability to help governments wipe out tears from millions of young faces and save lives in calamities such as in Haiti.