Financial Risk: The World turned Upside Down

William Leiss, 5 July 2011

Here's the latest from the Greek debt crisis:

> "Europe is seeking to avoid a default at all cost because it could also initiate payment of credit-default swaps, with unpredictable results. There is little public information on which financial institutions have sold credit-default swaps and might have to absorb losses if Greece defaulted, but it is likely that American banks and insurance companies have taken on the largest share. The shock to the global economy might compare to the collapse of Lehman Brothers in 2008, the European Central Bank has warned." (Jack Ewing & Landon Thomas Jr., "Europe faces tough road on effort to ease Greek debt," *The New York Times,* 4 July 2011)

Wait a minute! In credit default swaps the first party pays a premium to a second party in order to "insure" the value of an amount invested in corporate or government bonds made by the first, and the second party guarantees to make up the shortfall if that investment loses value, for example where the issuers of the bonds default on their debt.* Derivatives such as credit default swaps are a risk management strategy for investors, protecting them (for a price) against large losses. So how does this very sensible risk mitigation strategy, used by individual investors, end up *causing or exacerbating* another broad financial crisis?

> [*All you need to know about credit default swaps: http://topics.nytimes.com/top/reference/timestopics/subjects/c/credit_default_swaps/index.html?inline=nyt-classifier]

The problem is *systemic risk* – which is what led to the original global financial crisis starting in 2007/8 – and the failure of national and international regulators to solve this problem during the last three years. Systemic risk arises in the hidden interconnections involved in dealings among powerful financial institutions.* The continuing lack of transparency in these markets is one reason why governments, which provide a backstop of last resort against failures (bankruptcies) in the banking and financial sectors, still cannot estimate the level of systemic risk and take effective steps to limit the damage such risk can do to economic activity and levels of sovereign debt.

> [*Louise Story and James Kanter, "Europeans regulators investigate banks for credit swaps," *The New York Times [NYT],* 29 April 2011]

We have a never-ending global financial crisis (see http://leiss.ca/?p=365) because the core problems that originally caused it have not yet been fixed. And it's not clear that they will be fixed before much more damage has been done.

What is the scope of the current crisis?

- European governments and central banks plus the IMF now hold half of all Greek debt (~€ 165 bn);
- As of 2010, commercial banks were exposed to the following totals of debt in Greece, Spain and Portugal (all in euros): French, 229 bn; Germany, 226 bn; British and Dutch, 100 bn each; US, 54 bn; Italy, 31 bn;*
- There appears to be $616 bn (US) in swaps held by investors against debt of PIIGS countries (Portugal, Ireland, Italy, Greece, Spain);**
- Money market funds hold short-term debt issued by European banks, leading to recent large panic withdrawals;***
- If Italy starts to shake, all bets are off.****

*Jack Ewing, "Debtors' prism: Who has Europe's Loans?" *NYT,* 5 June 2010
** L. Story, "Derivatives cloud the possible fallout from a Greek default, *NYT,* 22 June 2011
***M. Mackenzie & N. Bullock, "Flight from money market funds exposed to EU banks," *Financial Times,* 24 June 2011
****Simon Johnson, "Could Italy be the next domino to fall?" (5 July 2011): http://www.bloomberg.com/news/2011-07-05/could-italy-be-next-european-domino-to-fall-commentary-by-simon-johnson.html

One of the important subtexts to the story during September 2008, when the prospect of cascading failure in the banking sector threatened to bring down the entire house of cards, was the observation of then U. S. Treasury Secretary Henry Paulson that he did not have the right kind of legal authority to take effective action to stem contagious collapse. Something similar is happening in Europe right now. Most observers would agree that the best solution to the Greek crisis would be an "orderly default" on its sovereign debt, under which holders of Greek bonds would take the usual "haircut," losing something like 50% of their investments. There would be severe pain in Greek society, to be sure; something similar has happened many times before, most recently in Argentina, and eventually nations recover from it.

But the creation of deep interconnecting webs in the global financial sector forestalls this solution. The European Central Bank and the largest Euro-zone societies fear the onset of contagion (first, a collapse in the value of Irish and Portuguese debt, then a spread to Belgium, and perhaps onwards). And if this contagion were to spread to the much larger economies of Spain and Italy, all bets would be off. *The powers that be in Europe simply do not appear to know how to prevent this from happening.* So they

have to pretend that the tools they possess will be adequate for the job. Hanging over their heads is the additional uncertainty caused by their lack of control over the derivatives markets and the fear that fallout from this market could help to destroy the viability of whatever solutions they come up with.

Citizens in North America and Europe need to understand clearly the perils they still face from the failure to fix the flaws that caused the 2008 crisis. This ongoing crisis has, quite literally, turned the global financial system on its head – meaning that solutions that worked in the past are no longer viable. The strongest sign of this change is the fact that a perfectly good risk mitigation strategy, namely paying for insurance against the risk of default of a bond held as an investment, threatens to have unintended *and unforeseeable* systemic consequences.