Glossary of the Global Financial Casino

Hedge Fund: A form of mutual fund used by wealthy individuals and institutions to engage in aggressive speculative activities prohibited to ordinary mutual funds. Hedge funds are restricted by law to no more than 100 investors per fund, and these investors are presumed to be sufficiently knowledgeable to understand the risks. Most hedge funds have extremely high minimum investment amounts ranging from $250,000 to well over $1 million.

Derivative: A financial contract whose value is derived from the performance of assets, interest rates, currency exchange rates, or indexes. Derivative transactions include a wide assortment of financial contracts including structured debt obligations and deposits, swaps, futures, options, caps, floors, collars, forwards, and various combinations thereof.

Credit Derivative: A contract between two parties which uses a derivative to transfer credit risk from one party to another, in exchange for a fee. For example, an investor who owns bonds issued by General Motors might buy a credit derivative from his investment bank, which will pay off should General Motors default on the bonds. In return, the investor pays the investment bank a fee, which the bank considers sufficient to run the risk that it will have to pay. If there is no default, the bank makes a tidy profit.

Collateralized Debt Obligation: CDOs are securities backed by pools of assets, mainly non-mortgage loans or bonds. In exchange for interest charges, buyers of the CDOs bear the credit risk of the collateral, which means that if any of the loans or bonds in the pool are not repaid, the holders of the CDOs take the loss. CDOs are made up of tranches, with various maturities and risk characteristics, with the equity tranches carrying the most risk, and therefore paying the highest interest rate to the buyer.

Capital Structure Arbitrage: A form of arbitrage which exploits differences in the pricing of a company's stock price and its debt. These bets are growing rapidly because of the development of the credit derivatives market.

Over-the-Counter Derivative Contracts: Privately negotiated derivative contracts that are transacted outside of organized exchanges.

Exchange-Traded Derivative Contracts: Standardized derivative contracts transacted on an organized exchange, and which usually have margin requirements.

Off-Balance Sheet Derivative Contracts: Derivative contracts that generally do not involve booking assets or liabilities (for example, swaps, futures, forwards, and options).

Swap: A deal in which two counterparties agree to swap the cash flows from different financial instruments, such as securities paying fixed and variable interest rates. A Credit Default Swap is a form of credit derivative in which the buyer pays the seller in exchange for an agreed-upon payment should the specified "credit event," such as a default or the breaking of a loan covenant, occur.

The reader is advised that the technical descriptions above do not begin to do justice to the insanity of the processes they describe. Credit derivatives, for example, do not really provide protection against a default, since the institutions which issue them are often in precarious financial positions themselves, and sell the derivatives because they are desperate for the cash flow. In the current environment, a credit derivative is mainly used to provide the accounting fiction that certain mostly worthless assets on a company's books still have value. The derivatives market, overall, is designed to *hide* the bankruptcy of the system by providing virtual assets to paper over gaping holes in the system, as well as garnering cash flow from selling mafia-like protection to companies ravaged by market manipulations. One of the chief agencies of such manipulations are the hedge funds, which act as front men for the Anglo-American central banks and their sibling financial institutions. George Soros is a prime example of this phenomenon.—*John Hoefle*

Derivatives: 'Ticking Time Bombs'

In an article headlined "Ticking Time Bomb in Structured Credit Products," Switzerland's conservative financial daily *Neue Züricher Zeitung* on May 19 pointed to the precarious situation in the so-called "structured credit" market. This includes the use of capital structure arbitrage (CSA) contracts, combined bets on the stock price and debt titles of the same corporation. The daily states that the purchase of GM stocks by Kerkorian caused a "brush fire" on the bond market, which then, in particular, hit funds specialized in CDAs. The funds faced "painful" losses when the risk premiums on GM bonds "exploded" and the prices of related derivatives plunged, while GM stocks, because of the Kerkorian move, jumped by 20%. Overall, the downgrading of GM, in spite of "the fact that it didn't came as a full surprise, triggered a chain reaction on the bond market," centered around collateralized debt obligations (CDO). These CDOs fueled the "sudden explosion" of the GM risk premium. Trying to escape from their CDO adventure, investors "at some point engaged in panic selling, which then derailed the credit derivatives market."

—Lothar Komp

This means piling up even more losses, which in turn—once investors recognize it—will further intensify withdrawals.

One indicator for the ongoing "distress selling" is the average price of credit-default swaps (CDS), which on May 18 hit the highest level since records started one year ago. For every outstanding corporate bond, an investor can buy a CDS contract, by which the default risk is transferred to the counterparty of the contract. In exchange for this kind of protection, the investor pays a certain fee to his counterparty, which works like an interest rate deduction on the nominal return of the bond. Within ten days leading to May 18, the average CDS rate has jumped up by one third, from 42 to 60 basis points (from .42% to .6%). The sharp increase reflects not only the rising fear for corporate bond defaults, but even more, a sudden drop in the number of hedge funds that are willing, or able, to take over additional default risks. The surprising rise of the U.S. dollar and the fall of commodity prices, including oil, are also being attributed to hedge fund emergency sales.

Beyond LTCM

Andrew Large, the deputy governor of the Bank of England, issued a strong warning on credit derivatives on May 18. Speaking at an international conference of financial regulators in Turkey, he noted, "Credit risk transfer has introduced new holders of credit risk, such as hedge funds and insurance companies, at a time when market depth is untested." Large said the growth of derivative instruments has "added to the risk of instability arising through leverage, volatility, and opacity." Regulators should therefore act and, in particular, search for credit concentrations.

Among the many voices warning against a repeat of the LTCM debacle or worse, is non other than Gerard Gennotte, former senior strategist at LTCM, and now working for another hedge fund called QuantMetrics Capital Management. In statements picked up by London's *Financial Times* on May 18, Gennotte pointed to the rising risk of a liquidity crisis triggered by hedge fund blowouts, which then could lead to a 1998-style collapse. He emphasized: "You could expect something similar to 1998, with people starting to liquidate their positions. It starts with one position, but then they are afraid of getting withdrawals, and it spreads across strategies."

In private discussions with *EIR,* an international financier confirmed LaRouche's notion, that the downgrading of General Motors and Ford debt was just the beginning of a much larger crisis hitting the grossly over-extended global financial bubble—in particular the derivatives scam. The financier said that the international financial system is, in fact, facing a derivatives crisis "orders of magnitude beyond LTCM." He observed that one can be certain that the Federal Reserve, the President's Commission on Financial Markets (the so-called "plunge protection team"), and the relevant departments of major central banks around the world, are all on "emergency red-alert mobilization."

Hedge funds and banks are, of course, all publicly denying reports of a major derivatives blow-out. Any bank or hedge fund that admitted such losses without first working a bailout scheme, would instantly collapse. Such implausible protestations of solvency are another source of instability. The source further said that there is no doubt that the Fed and other central banks are pouring liquidity into the system, covertly. This would not become public until early April, at which point the Fed and other central banks will have to report on the money supply.

Regulating Hedge Funds

In response to the GM and hedge funds crises, Lyndon LaRouche issued a statement May 14, "On the Subject of Strategic Bankruptcy," in which he called for "new governmental mechanisms" for dealing with these "strategic bankruptcies, bankruptcies with which existing mechanisms of governments are essentially incompetent to deal." LaRouche also renewed his call, from the early 1990s, for a transaction tax on all derivatives trades, to regulate hedge funds. By such a transaction tax, government authorities, for the first time, could get an insight into the hedge fund activity. Currently, there exist about 8,000 hedge funds worldwide, managing about $1 trillion in capital, compared to 4,500 hedge funds and $600 billion in capital just two years ago. When LTCM was going under in 1998, for every dollar of its capital, it had borrowed $30 from banks at was running at least $400 in derivatives bets.

Allegedly, the average leverage of hedge funds today is much lower than in the case of LTCM. At least one in ten existing hedge funds, in most cases the smaller ones, are quietly being closed down every year, while at the same time many more are being set up new.

A public debate on the regulation of hedge funds has already erupted both in Britain and Germany. On top of the fears for a systemic breakdown, there is the imminent concern that private equity funds and hedge funds are, right now, taking over or manipulating the stock prices of thousands of corporations in both countries. John Sunderland, the President of the Confederation of British Industry (CBI) came out with an attack on such funds, sounding similar to German Social Democratic Party chairman Franz Müntefering's famous earlier "swarm of locusts" statements. CBI Director General Digby Jones raised the alarm bells concerning certain derivatives—"contracts for differences" (CFD)—by which hedge funds are able to secretly build up stakes in corporations.

In Germany, the chief executive officer of Commerzbank, Klaus-Peter Müller, who also heads the German banking association, raised the question: Why are we regulating small banks, while hedge funds, moving much larger capital, are not being regulated at all? Bundesbank board member Edgar Meister described hedge funds as the "white spots on the map of supervisors," which are growing at alarming speed. Even Rolf E. Breuer, who just resigned as supervisory board chairman of the Frankfurt stock exchange (Deutsche Börse) after losing a power fight with the British hedge fund TCI, has now astonished the banking scene with a surprising conversion. The same person who, as head of Deutsche Bank, had praised derivatives trading as the shortest way to paradise on Earth, and become known in some circles as Germany's "Mr. Derivatives," is suddenly denouncing the short-term speculative investments of hedge funds, that are colliding with the need for long-term productive investments and therefore could "devastate the German economy."