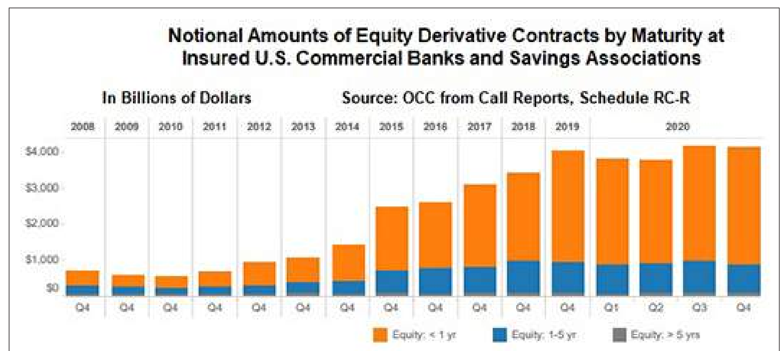
New derivatives disaster must be defused *now*!

By Elisa Barwick

The US stock market is now worth US$49 trillion, pumped up by enormous leverage. Asked about the stunning one-year rise in margin debt of nearly 50 per cent on CBS's 60 Minutes on 11 April, US Federal Reserve Chair Jerome Powell pleaded ignorance and insisted that "financial institutions are strong enough" to stand up to any risk. But the reality is that the US$814 billion worth of margin loans (up from US$545 billion year-on-year from February 2020) is nowhere near the total margin debt, much of which is being camouflaged using derivatives contracts.



The small hedge fund Archegos Capital Management which collapsed in March had highly leveraged debt with at least nine global banks, which it ploughed into bets on share movements. Archegos was exempted from having to disclose its stock holdings to the US Securities and Exchange Commission (SEC), because, due to the use of complex financial derivatives, they were lumped in with the holdings of the banks that stumped up the money. ("Archegos and financial 'black ops'", *AAS*, 14 April.)

Such derivatives on stock (equities) trades are being used to evade regulations designed to minimise risk of just such a blowout, which due to the lack of transparency, put a number of large, globally systemic banks in the firing line. All losses have not yet emerged. In a 23 April article headlined "The stock market is just one hedge fund blowup away from a crash", an investigation by financial website Wall Street On Parade revealed that similar operations to that of Archegos are taking place across the board.

Figures from the US Office of the Comptroller of the Currency reveal a dramatic increase in the face value of equity derivatives between 2008 and the end of 2020, from US$737 billion to US$4.197 trillion. The OCC shows that the contracts are "held in the federally-insured banks", wrote WSOP in a follow-up article, "not at their investment banking units. That means the US taxpayer will be on the hook if these derivatives blow up". Nearly 90 per cent of the risky contracts are held by four US banks: JPMorgan Chase, Bank of America, Citigroup's Citibank and Goldman Sachs. The first three of those banks are among the top four deposit holding banks in America.

While deposit-taking banks were prevented from running hedge funds by regulatory reforms contained in the 2010 *Dodd-Frank Act*, Archegos-type practices mean that "Wall Street banks have been effectively loaning out their balance sheets to hedge funds by writing equity derivative contracts", wrote WSOP.

Archegos proved derivatives are designed to evade the rules: with its shareholdings concealed on the banks' balance sheets, Archegos avoided SEC filings identifying large stock buy-ups and the banks evaded Dodd-Frank restrictions on gambling. They even used Archegos stock as collateral for further purchases. Until it unravelled, the arrangement also allowed evasion of limits on margin lending; skirting rules on stock concentrations; and likely evasion of capital gains taxes.

It has now emerged that Archegos utilised a derivative swap agreement for its share speculation. A 1 April article in the London *Financial Times* explained that it used a "total return swap" to disguise its share purchases. A type of credit derivative, the mechanism enables a party to "own" an asset without adding it to its balance sheet. Known as "synthetic financing", the practice is now worth more than traditional margin lending, but rules covering use of the swaps are only due to come into effect later this year! Financial consultancy firm Finadium told *FT* the instruments "developed as a natural outcome of Basel and Dodd-Frank rules that often favour [total return agreements] over cash equity financing" as they face far less regulation. They "don't appear in the Basel III filings" which require global banks to hold minimum capital against risk-weighted assets, leverage and credit risk, said Nick Dunbar of Risky Finance.

The securities that broke the system

It is widely acknowledged that derivatives were the trigger for the 2008 crisis, yet the Bank for International Settlements now puts global derivatives values back at 2008 heights, following significant declines after that event. And the very derivative that set off that crisis—the securitisation and sale of packaged mortgages—is back at centre stage.

In a 20 April article titled "The bigger short", investigative news service *The Intercept* reported on detailed studies that reveal a level of fraudulent securitisation equivalent to that which triggered the last crisis. This time it is emerging in the commercial real estate market with *commercial* mortgage-backed securities (CMBS), laced with unpayable "liar" loans, rather than the infamous 2008 *residential* ones.

Cited in the article is a University of Texas report showing that an average 28 per cent of loans contained in the securities are based on incomes overestimated by 5 per cent or more. A deep dive by CMBS advisor John Flynn into a commercial mortgage-backed fund run by a shadow bank, further revealed that many of the companies whose incomes were misrepresented are identified with different names and addresses when they are moved into different funds, suggesting "deliberate obfuscation" to prevent investors from catching on.

As in the previous experience, this is sustainable only while real estate prices continue to rise. Once the bubble is pricked, the mortgage holder and the investor are both ruined, throwing financial markets into disarray. The article notes a number of legal cases, with international law firm Quinn Emanuel Urquhart & Sullivan pointing to "a steady drumbeat of warnings regarding troubling origination and underwriting practices impacting the long-term stability of the market". The US Securities Exchange Commission has filed suit against a credit rating agency for manipulation of its ratings of CMBS tranches; a similar suit last September resulted in a US$2 million fine. Only Glass-Steagall bank separation can protect depositors; bank capital holdings will not touch the sides.

Archegos and financial 'black ops'

By Elisa Barwick

The latest puncture in distended stock and derivatives bubbles reveals yet again that the cause of financial instability is *the system itself*, a system lacking effective regulation, a problem never successfully rectified after the last global financial crisis.

While it was a little-known New York hedge fund defaulting on margin calls that sent stock markets into a spin beginning 26 March, in the firing line were some of the world's biggest banks that had backed it. Archegos Capital Management, a private wealth management fund that caters to the ultra-wealthy, used insider knowledge of the machinations of the current financial system to rake in massive profits, utilising derivatives contracts to bet on share prices. It was supplied with billions of dollars to do so by large global banks including Credit Suisse, Nomura Securities, UBS, Goldman Sachs and Morgan Stanley.

All hell started breaking loose when the stocks in which Archegos had accumulated major holdings began to fall. Archegos received margin calls from multiple brokers. When that happens, if a fund cannot increase its capital contribution it either sells some of the stocks it has bought with the borrowed money, or the broker will do so on its behalf to recover the required amount. Archegos dumped over $20 billion[1] of stocks in just one day, on 26 March, and broker banks rushed to cash in shares before they plummeted.

(The main share involved was US media group ViacomCBS, its value collapsing by half between 23 and 29 March; media company Discovery's shares lost over 40 per cent in the same period. The fund was also betting on several risky Chinese stocks.)

Some reports indicate the secretive nature of the derivatised trades meant that a number of brokers were trying to unwind trades all at once, not realising others, also brokers for Archegos, were doing the same. Other reports suggest the banks involved got together with Archegos prior to the crisis hitting the media, to plan how to unwind the trades.

In any case, unable to recoup their capital, the banks took the hit. Credit Suisse lost $4.7 billion, admitting losses would be "highly significant and material to our first-quarter results". Japan's Nomura Securities lost around $2 billion and was forced to cancel a $3 billion bond deal. Its shares plunged 16 per cent on 29 March; Credit Suisse shares were down 14 per cent, its largest one day loss since the global financial crisis. S&P Global Ratings downgraded the bank's outlook from stable to negative. Credit Suisse is also exposed to significant losses from the collapse of another dodgy operation it funded, London supply-chain finance firm Greensill.

"The crisis has rattled the City", reported the London *Telegraph* the same day. Publications invoked the memory of Long Term Capital Management, the fund which blew up in 1998 precipitating the first really big derivatives disaster. Financial derivatives allow banks to gamble with many times the amount of money they put up to invest and LTCM had leveraged $5 billion into more than $1 trillion, backed by over 50 big banks. It lost $4.6 billion in a few months following the 1997 Asian financial crisis and 1998 Russian bond default. Then-IMF director Michel Camdessus later admitted that a global financial meltdown had been narrowly

1. All figures in US dollars.

The 'tax alchemy' of hedge funds

On 7 April, the financial experts at Wall Street On Parade, Pam Martens and Russ Martens, compared the modus operandi of the Archegos family office to the New York-based Renaissance hedge fund, which was investigated by the US Senate's Permanent Subcommittee on Investigations in 2014 for avoiding tax and evading leverage limits. Renaissance made hundreds of thousands of short-term trades on a daily basis, but used complex derivatives to make them appear like longer term trades in order to take advantage of reduced tax rates. According to committee testimony from Steven M. Rosenthal, a Senior Fellow at the Urban-Brookings Tax Policy Centre in Washington, hedge funds, with the help of major banks, "wrapped derivatives around their trading strategy in order to transform their short- term trading profits into long-term capital gains. This tax alchemy purported to reduce the tax rate on the gains from 35 per cent to 15 per cent and reduced taxes paid to the Treasury by approximately $6.8 billion. I believe the hedge funds stretched the derivatives beyond recognition for tax purposes and mischaracterised their profits as long-term gains."

Summarising the committee's report, "Abuse of structured financial products", WSOP described how it was done: "The hedge fund would make a deposit of cash into an account at the respective bank. The account was not in the hedge fund's name but in the bank's name. The bank would then deposit into the same account $9 for every one dollar the hedge fund deposited. At times, the leverage could reach as high as 20 to 1.

"The hedge fund controlled the trading in the account and generated tens of thousands of trades a day using their own high frequency trading program and algorithms. Many of the trades lasted mere minutes. The bank charged the hedge fund fees for the trade executions and interest on the money loaned."

A side agreement with the bank known as a "basket option" allowed the hedge fund to collect on profits after more than a year, providing the appearance of long term trades and profits and attracting just half the normal tax rate.

In similar manner, Archegos selected stocks and directed trading on accounts technically owned by Wall Street banks. On 8 April, Chair of the Senate Banking Committee Senator Sherrod Brown released letters to the Wall Street banks engaged in the activity with Archegos, demanding answers to ten questions. Among them, Brown raised whether banks can legally shift ownership of trading accounts between themselves and Archegos.

averted; 16 major banks put up a $3.6 billion bailout under supervision of the US Federal Reserve.

The risk today is greater given the repeal of the *US Glass-Steagall Act* in 1999. Previously, deposit-taking banks insured by the Federal Deposit Insurance Corporation (FDIC) were prohibited from engaging in derivatives gambling in any capacity. Today, Goldman Sachs and Morgan Stanley—which loaned money to Archegos—both own FDIC-insured banks. This means the government is on the hook for any losses.

The *Telegraph* cited Alex Brazier, the Bank of England's executive director for financial stability strategy and risk: "[W]e've been reminded…", he said, "that the non-bank system and the banking system are not two hermetically sealed separate things. What happens in one affects the other." But that is exactly what Glass-Steagall had prevented very effectively, completely separating the banking system from dodgy financial schemes.

'Derivative deception'

And Archegos was dodgy indeed. Founder Bill Hwang rose to fame when he was hired by legendary US hedge fund Tiger Management after winning a competition. He moved from Korea to America, starting the Tiger Asia fund and in 2012 was charged with illegal trading. He was banned as a fund manager by the US Securities and Exchange Commission (SEC), but got around that by opening a so-called "family office" which as a small elite fund with 15 or fewer clients does not have to register with the SEC and is not regulated. Such was the firm's reputation that Goldman Sachs, which bankrolled its latest operation, actually blacklisted Archegos until 2018.

Archegos was leveraging its capital to generate profits for its high-stakes clients by gambling on the opening and closing price of shares that it didn't own, through derivatives contracts known as swaps and contracts-for-difference (CFDs). These contracts are "over-the-counter" transactions not traded on public exchanges, so there is little transparency—even for the bank lending them the money. Hedge funds evade the rules by trading large blocks of shares without actually owning them, meaning they need not disclose their purchase nor hold as much capital against their trades. The SEC requires purchases of more than 5 per cent of a company's stock to be publicly disclosed, and Archegos had likely accumulated "a stunning 34 per cent of the outstanding shares" of ViacomCBS, according to an account by financial watchdog site Wall Street On Parade (WSOP) on 6 April.

In addition to bypassing registration with the SEC due to its small client number, trading shares without actually owning them to avoid disclosures, and avoiding capital gains taxes via "tax alchemy" (Box, p. 6), there is yet another way Archegos evaded the rules. By law, broker-dealers can only lend up to 50 per cent on margin loans, WSOP reported on 6 April, and most brokerages require an even higher margin "if the customer is loading up on the same stock". This means trades are 50 per cent covered by the investor while the other 50 per cent is borrowed from the bank. In Archegos's case, however, Wall Street banks "were making 85 per cent margin loans ... against 15 per cent cash collateral", wrote Pam and Russ Martens, describing the "derivative deception". The use of derivatives contracts meant that the owner of the purchased stocks was not technically the hedge fund and as such, WSOP contends, the banks did not hold margin accounts for Archegos *in its name*.

Reforms introduced as part of the Dodd-Frank financial legislation following the 2008 crisis had little impact. WSOP reported 5 April that derivatives trading on shares has exploded: "According to OCC [federal bank regulator the Office of the Comptroller of the Currency] data, at the height of the financial crisis in the fourth quarter of 2008, equity derivative contracts *held by federally insured banks* totalled $2.2 trillion, versus $4.197 trillion today." (Emphasis added.)

Stunningly, JPMorgan Chase's equity derivatives contracts represent 63 per cent of the entire US market in that type of trade. Nearly three-quarters of JPM Chase's portfolio are little-regulated over the counter contracts. It also held 23.9 million shares of Discovery Inc. common stock, yet the bank has not announced any exposure to Archegos.

Fuelling the derivatives expansion, Wall Street investment houses that act as Primary Dealers for the New York Federal Reserve to disperse liquidity through short term repurchase agreement ("repo") markets—including Archegos creditors Credit Suisse, Nomura, UBS, Goldman Sachs and Morgan Stanley—have been the recipients of a mammoth flood of liquidity since September 2019 at which time they were refusing to lend to hedge funds. There was a spate of hedge fund withdrawals and closures, which prompted crash warnings from the Bank for International Settlements and an even greater expansion of Fed money pumping. The money has virtually all gone into speculation. Between the Greensill collapse, the GameStop drama and now Archegos, the cracks in the system are growing.

Change the system—with Glass-Steagall!

Andrea Cicione from research house TS Lombard told the 3 April London *Financial Times* that while the Archegos crisis may not be considered a systemic event, "There is never just one cockroach." In fact, the number of family offices grew by 38 per cent from 2017-19, reported the *Times*, and the amount under management in 2019 was nearly $6 trillion compared with $3.6 trillion in the global hedge fund industry.

Among other warnings, on 6 April New York University Stern School of Business Professor Nouriel Roubini suggested that other hedge funds and family offices would go the way of Archegos, especially if there is a fresh spike in Treasury yields. "Lots of players have taken too much leverage and too much risk and some of them are going to blow up", he said, according to Bloomberg.

Referring to Credit Suisse's current troubles as "a new episode of the permanent crisis of the financial gambling casino", the head of department of banking and finance at Zurich University, Switzerland, Marc Chesney, warned today's mix "of high debt and derivatives is the recipe for acute crises" as in 2008.

"We need smaller banks and, like previously in the USA, a separation between pure deposit banks and investment banks. Then, banks that go into high risk can go bankrupt with a minor danger for the rest of the economy. But the 30 largest world banks are principally convinced that they will never go bankrupt, because they must be bailed out. This fuels the false incentive to go into higher and higher risk at the taxpayers' cost."

Reported by Swiss financial site *Inside Paradeplatz*, economist Hans Geiger on 2 April declared that "the universal banking model is dead".