Click here for Full Issue of EIR Volume 31, Number 18, May 7, 2004

Enron, Parmalat, Shell Oil: Who Will Be Next?

by Lothar Komp

"Shell shock" has hit the British Isles. The almost 100-year-old British-Dutch oil giant, Royal Dutch Shell, with 115,000 workers worldwide and an annual turnover of 35 billion euros, has had to acknowledge, in a series of reports, that it has pulled the wool over the eyes of its shareholders and creditors for years.

About one-fourth of the oil and gas reserves which have been reported in Shell's books, have existed only in the fantasy of the members of the board. And each barrel of estimated reserves represents an imputed income stream for the company in the future, which influences the stock value of an oil concern even today, and at the same time serves as collateral for credits and other financial transactions.

Already back in January, Shell Chairman of the Board Sir Philip Watts was sent into the desert, after the company's first admission: that it had vastly overestimated its own oil and gas reserves. The chief of exploration for Shell, Walter van de Vijver, was also fired at that time. At the end of March and again on April 19, Shell had to correct its reserves downward again. With the third such event, finance director Judy Boynton lost her job.

But the real shocker, which also came on April 19, was something else: The American law firm Davis Polk and Wardwell published excerpts from the 463-page report, concerning the background to Shell's faked reserve estimates, which Shell's new leadership had commissioned in January. And even the few excerpts of this report which were made public, hit the British media like a bombshell. So great was the shock, that even the continuing sex scandals of Britain's leading soccer idol, David Beckham, had to be pushed back to the inside pages for a few days. It became clear, that the Shell board of directors had had full knowledge that the figures were faked, for at least two years.

'Sick and Tired of Lying'

A series of e-mails between the exploration department head and the company's chief executive were cited in the report. In November 2003, Walter van de Vijver sent an e-mail to chairman Philip Watts, saying: "I am becoming sick and tired about lying about the extent of our reserves issues and the downward revisions that need to be done because of far too aggressive/optimistic bookings."

Other documents show that van de Vijver already in February 2002 was fully aware that Shell's reserve estimates were far too high. It has also been revealed that top executives at Shell had destroyed certain documents in an attempt to cover up the fraud.

But appearances had to be kept up. According to the report, Shell's executive was playing for time. They hoped that somehow, sometime, a miracle would occur to provide all those missing reserves. As is now known, the amount of new explorations of oil and gas reserves per year at Shell, in Angola and elsewhere, had fallen to only 61% of annual production in recent years. Up to the last minute, chairman Watts wanted to keep this secret from the firm's financiers. On May 28, 2002, he had written to van de Vijver, to do whatever was necessary—obviously including faking the figures—to come up with an exploration/production ratio of at least 100% in Shell's official reports.

The dimensions of Shell's fraud, even after those of Enron, Parmalat, etc., are enormous. The faked oil and gas reserves, according to the latest tally—further corrections are not to be excluded—amount to 4.5 billion barrels. If one assumes, for a rough estimate, that the fraud only concerns oil reserves, and not production, and takes $35 per barrel as the basis for calculating Shell's "accounting errors," then this yields a sum of a good $150 billion. By comparison, the cur-

© 2004 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.

Nothing but empty liquidity out there? Shell Oil's reserves fakery, only as exposed in the first three "corrective" reports, amounts to 4.5 billion barrels of claimed oil reserves in the North Sea and elsewhere, which don't exist. These admissions of speculative fakery undoubtedly have had more effect on oil and gas spot prices staying very high, than any announced production targets of OPEC.

rent total market value of Shell shares, which imploded at the beginning of the year, is 140 billion euros.

The rating agencies have already reacted by downgrading Shell. American shareholders' groups have already presented a class action suit. American attorneys are preparing charges against Shell, for criminal machinations.

Empty Promises, Not Production

Whatever the further destiny of Royal Dutch Shell might be, the significance of the "British Enron" goes beyond the destiny of the company itself, in two ways.

First, the incident at Shell is a symptom and a symbol of the condition of the worldwide financial and economic system: As a result of insufficient real economic re-investments, the real value of operating, productive capacities in the "formerly industrialized" countries is being burned out. Financial values are promises on future income, which at least in part must be paid for through real economic activity. As soon as it becomes apparent, however, that a large portion of the financial values are only "empty promises," then a financial collapse, of a firm or a financial system, is inevitable. In the meantime, one can buy time, through the central banks, which print money and pump it into the financial markets—and through companies adopting the practice of falsifying their books.

On the other hand, Shell is no more a unique case than were Enron, WorldCom, or Parmalat. Hundreds of big companies, not least in the financial sector, are presently in a precarious state, which is at least as bad as Shell's. It is just that no one has noticed it yet.

One indicator for the alarming situation of financial markets, is the developments in the now-huge field of financial speculation known as credit derivatives contracts.

The dimensions of the worldwide credit derivatives market have exploded in the last years. In the *Le Figaro* "Economy" report on April 21, economics editor Muriel Motte noted that credit derivatives markets—in particular the contracts called "credit defaults swaps" (CDS)—are actually the best indicators for coming corporate collapses.

When a bank lends money to a company at high risk, and wishes to protect itself from that risk, it buys a CDS from an insurance company or a hedge fund—a product which guarantees the bank full reimbursement in the case of default. Therefore, investors take a close look at these sophisticated financial instruments "in the search for advanced indicators of coming financial catastrophes," *Le Figaro* wrote. In the recent period, due to the increasing indebtedness of companies, this market has "exploded," stated Motte, citing estimates that it represents more than $3.5 trillion today.

It's this "highly liquid" market which signals the great bankruptcies ahead of time, as was the case with Parmalat and Enron. There was clearly a scramble for credit derivatives swaps in the weeks prior to the failure of those large companies. Motte underlined the fact that at this point, 350-400 European corporations already have default swaps attached to their debt.

It is all too well known that numerous companies can achieve the promised increase in quarterly gains only if they massage their figures, through the usual criminal accounting methods. Other companies, including the so-called "industrials" on the market indices, have in the past made a significant part of their profits through speculative earnings on the side,

through purely financial transactions. Since, however, the growth of various financial bubbles has begun to flag—now even the huge U.S. and British housing-market bubbles are hitting their limits—these profits suddenly are no longer there.

No one knows who will be the next, of what one former U.S. administration official recently referred to as "several LTCMs waiting to happen at once" (referring to the Long Term Capital Management hedge fund failure of 1998, which nearly caused a systemic meltdown). But it will probably soon be found out.

Derivatives Time Bomb

It is certainly no coincidence that the German Bundesbank, precisely at this point in time, published a special study on credit derivatives. Thus, in its monthly report for April 2004, the Bundesbank included a 20-page feature headlined "Instruments for credit risk transfer: its use by German banks and aspects of financial stability."

First, the Bundesbank welcomes the use of credit derivatives and the securitization of credit risks through special "Asset-Backed Securities," as in this way, existing risks, at least in theory, are divided up to be borne on many shoulders. Unfortunately, in practice, things look a bit different, as the Bundesbank report showed.

What are credit derivatives? The Bundesbank explains: "Through the offer of credit, a creditor runs the risk that the debtor may not be able to fulfill the future obligations from the financing. The creditor can insure himself against the effects of such an event, in that he, for example, signs an insurance contract and takes the position of a buyer of insurance. The contract removes the credit risk from the original financing and transfers it to a third party, the insurance seller."

The predominant type of credit derivatives are the credit default swaps referred to by the *Le Figaro* survey. They relate, usually, to the debt obligation of a single company. If that company cannot pay back the credit covered by the CDS, then the insurance seller has to jump in and take over the full amount of the loan. Otherwise, the insurance provider makes a profit in the form of a risk premium, which the insurance buyer (the lender) pays him.

One could also say, a credit derivative is a bet between a loaning bank and an investor, a bet on the outcome of a credit deal.

Actually, one should have expected most of the credit derivatives providers to be insurance companies, funds, or investors who take over credit risks from banks against premiums; naturally in the hope that everything works out well. However, according to the study by the Bundesbank, this is not the case. It reports that in fact, four-fifths of all credit derivatives in which German banks are involved, are contracts between two banks.

In all, it is a total volume of 566 billion euros. Only 263 billion euros are related to contracts in which German banks have transferred their credit risks to a counterparty. The remaining 303 billion euros are in contracts, where German banks have actually taken over additional credit risks from other banks, usually abroad.

What the Bundesbank is particularly worried about is the high concentration of German credit derivative business, held by a small group of financial institutions. "According to the inquiry of the Bundesbank, for example, the four biggest banks account for about 78% of all the positions in credit derivatives of the banks involved in the poll."

The situation is similar throughout the world. Already, a "sudden change in behavior of one of the biggest intermediary banks," for whatever reason, could "move the market significantly. Any losses which ensue, could force single market players to sell securities in order to fulfill the payment obligations of others. Due to this selling pressure, the disturbance could spill over to other financial markets and other market actors. The high concentration, which also characterizes other derivatives markets, is unfavorable from the standpoint of financial stability." It increases the "systematic damage potential" of disturbances in a single market, the report concludes.

The Bundesbank hopes that the banks will accompany their derivatives trade with adequate "risk management." Otherwise, the report says, credit derivatives could "endanger financial stability."

Electronic Intelligence Weekly

EIW

An online almanac from the publishers of **EIR**

Electronic Intelligence Weekly

gives subscribers online the same economic analysis that has made *EIR* one of the most valued publications for policymakers, and established LaRouche as the most authoritative economic forecaster in the world.

EIR Contributing Editor, Lyndon H. LaRouche, Jr.

Issued every Monday, *EIW* includes:

- Lyndon LaRouche's economic and strategic analyses;
- Charting of the world economic crisis;
- Critical developments ignored by "mainstream" media.

$360 per year Two-month trial, **$60**

For more information:

Call **1-888-347-3258** (toll-free)

VISIT ONLINE:

www.larouchepub.com/eiw