High finance — a game of risk:

Subprimes, ninja loans, derivatives and other financial fantasies*

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Two centuries after Hegel deplored the chronic failure of states to learn the lessons of history, financial capital seems to be caught in a similar loop, condemned to repeat the same errors, trapped in a recurring crisis. The instruments involved may be new but the current crisis on the credit markets has enormous potential for disaster, and offers another reason to re-examine the "benefits" of capital market liberalisation.

There is something of a religious cult about finance. It sees itself as reality and insists that businesses justify themselves according to the standards of financial reporting, by their quarterly results and longer-term performances. Yet it remains stupidly ignorant of what its own recent history teaches
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Financial liberalisation has a mixed record. Since it began, there has rarely been more than three years without a serious incident, usually of historic significance. After the 1987 stock markets crash (Black Monday) came the junk bonds scandal and the Savings and Loans crisis, both in 1990, and the 1994 US bonds crash. A financial crisis started in the Far East in 1997 (Thailand, Korea, Hong Kong), before spreading in 1998 to Russia and Brazil. After 2001 the internet bubble burst.

Globalisation, according to a devotee, Pierre-Antoine Delhommais, is "a blessing, but an erratic one" (1). He is astonished by its ability to bounce back, stronger than ever, from potentially fatal disasters. Of course he overlooks the fact that every time the financial markets go wild, ordinary workers have to pick up the tab. The collapse of the markets hits the banks, then has a knock-on effect on credit, investment, growth and employment. Maybe he would like to see his own newspaper taken over by a hard-nosed investment fund. First-hand experience of downsizing might make him more sensitive to the consequences of the financial world's practices. Maybe the knocks he suffered from globalisation's erratic progress might outweigh its blessings.

The current crisis in the US credit market is an ideal opportunity to examine the fatal consequences of unregulated speculation. We can observe distinct stages leading from unfettered speculation to catastrophic collapse and central bank intervention.

Ponzi market tendencies

The best account of the blindness to disaster that characterises the interlinked finance markets was given by Hyman Minsky (2). He examined the activities of Charles Ponzi, a speculator during the 1920s, who separated suckers from their savings by promising incredible returns. Ponzi had no assets and rewarded his initial investors not with the dividends that were never there, but with the capital paid in by subsequent victims. The sustainability of the edifice depended on sustaining the flow of new participants. Apart from this fraudulent element, all bubbles that depend upon a constant inflow of liquidity to sustain a rising market and the illusion that everybody is a winner use a similar mechanism. The trick is

to keep recruiting new investors; and once the initiates have signed up, more ordinary, and less astute, punters are enlisted in greater and greater numbers.

For the US property market to keep growing (ideally for ever), more households have to be press-ganged into mortgages. The appeal of the US property dream made it easy to enlist them, particularly since households damaged by the bursting of the internet bubble were looking for fresh investments. But the reservoir of healthy borrowers was quickly exhausted and brokers began to look further afield for recruits to sustain the market. Problematic borrowers were pronounced fit. House prices exploded. Borrowers and brokers agreed that in the event of default the property could be sold, yielding a profit for borrowers and commission for brokers. They had faith in the indefinite expansion of the market: everyone was fit to borrow. The floodgates of credit burst open, feeding a speculative rise that seemed to justify the process. The result was subprime mortgages: loans to aspiring owners with no credit record or creditworthiness, typified by “ninja” loans (no income, no job or asset).

Inadequate risk evaluation

Everyone assumes that the financial industry has the reserves and expertise to handle risks. It certainly isn’t short of ingenuity. It has a secret weapon: derivatives. The problem with any credit, particularly a risky one, is that it stays on the lender’s books until it ends well or badly. But in the early 1990s banks realised that they could merge different credits into a line of negotiable bonds. The major advantage of this process, known as securitisation, lay in the fact that these securities could be sold in bundles to enthusiastic (institutional) investors, and risky loans could be wiped off the balance sheets of the issuing banks.

But why were investors so keen to buy something that banks were desperate to get rid of? Partly because they acquired them in smaller quantities; but mainly because the bonds were negotiable and could be sold on. The line of securities derived from the original credits was sliced up into tranches of equal risk. According to their profile and aversion to risk, individual institutional investors could buy their tranche of choice, safe in the knowledge that there would always be some institution (like hedge funds) prepared to take on the most risk-laden, and most profitable, tranche. Assuming everything went according to plan.

Obviously all the rights (financial flows) and risks (of default) attached to the original credits were transferred to these new residential mortgage-backed securities (RMBS), dispersed among many constantly changing bearers to spread the risk globally. The originating bank was no longer left to face the consequences of default on its own; instead, the risk was fragmented among many institutions, each responsible for only a minimal part, just a fragment of its portfolio.

Securitisation had apparently solved the problem of high-risk credit. The process was taken a stage further with the development of a special instrument to dispose of the most unappetising tranches of the RMBSs. Collateralised debt obligations (CDO) are a new form of negotiable security, derived from securities, whose issue redistributes the relevant fraction of the RMBS portfolio into different tranches. The senior, investment grade, tranche shelters its bearers from the first 20-30% of defaults on the original mortgage loans. There is an intermediate, mezzanine, tranche and, at the bottom, an equity tranche that takes the first hit from any default. This tranche is known in the markets as toxic waste: appropriate for

vulnerable CDO products derived from the most risky tranche of RMBSs, which are drawn from the portfolio of original credit. While the housing market soared and households kept up their payments, there was always a taker.

Hedge funds, with their ability to raise money at fairly low rates, have invested in high-risk securities, convinced that they can resell freely in a liquid market. The enormous profit margins turned toxic waste into gold. But the profits concealed objective risks that everybody ignored for fear of killing the goose that laid the golden egg. Meanwhile the mortgage brokers kept adding new recruits.

Structural vulnerability and failure

The illusion that securitisation had dispersed risk to the point of extinction provoked rash behaviour. Having managed to lay off their riskiest loans, mortgage lenders believed they could do anything. At the other end of the chain, the liquidity of the derivatives market persuaded hedge funds to pick the juiciest, but most rotten, CDOs. The dilution of risk encouraged the uncontrolled growth of its overall volume. The situation drifted into the critical zone.

By now, the structural fragility of the edifice had made it vulnerable to environmental changes that would normally seem insignificant. Individual quarter-point rises in the US Federal Reserve's interest rate might seem insignificant; but in August The New York Times reported how one woman had seen her mortgage rate rise from 6.3% in 2005 to 11.25%, and her monthly repayments from $414 to $691, more than she could afford to pay (3). She was one of the 14% of subprime borrowers who defaulted in the first quarter of 2007.

Central bank interest rate rises, however modest, have a twin effect. With new buyers excluded from the housing market, prices fall. Those already on the property ladder face unsustainable repayments; if they realise their asset, they lose financially and increase the bearish pressure on everybody.

In financial crises, there is always a specialised institution whose collapse signals a general turnaround. This time, two failures at the opposite ends of the chain brought the markets down to earth. The US investment bank Bear Stearns was forced to shut down two of its dynamic (perhaps too dynamic) funds after they binged on CDOs.

More alarmingly, since it is not particularly involved in the subprime sector, at the beginning of August the lender American Home Mortgage had to seek Chapter 11 protection from bankruptcy (4).

Catastrophic reassessment of risk

There began to be a whiff of panic. The toxic waste bonds already stank and there was a growing suspicion that even top-level investment grade CDO bonds could not be trusted. How could the industry have committed such monumental errors of judgment? The complexity of evaluating derivative products had something to do with it; credit rating agencies had been assessing CDO and RMBS tranches by the hundred. But there was more to it than honest workers struggling under the weight of the task. The agencies were raking in

money because financial institutions were madly issuing securities for assessment – in 2006, the rating agency Moody's derived 40% of its income from evaluating structured products. There was an obvious incentive to approve products in order to encourage new business.

The rating agencies were supposed to curb the worst excesses of the market; instead they allowed themselves to be infected by it. It is difficult, so close to and dependent upon the financial industry, to warn it, especially with everybody filling their pockets. The agencies, procyclical when they should have been countercyclical, encouraged the bubble, only to make panic revisions as soon as the turnaround kicked in, thus helping precipitate a collapse.

The crisis is probably only beginning. The US home mortgage industry has used attractive teaser rates to lure more borrowers towards the precipice. On a 2/28 mortgage, borrowers repay at a lower interest for the first two years, then revert to the damaging full rate for the remaining 28. We have yet to see the full impact of this on people who took out mortgages at the peak of the property bubble, in 2005 and 2006. But, as with the derivative-stuffed hedge funds, there are bound to be fireworks.

Finance is global; likewise its accompanying idiocies. With hedge funds across the world being tempted by derivative securitisation, the delirium gripping the US mortgage market was unlikely to remain confined to one country. Germany's retail banks, long derided as unimaginative and boring, decided to modernise and to become more active in the markets around 2000. After the Russian financial crisis of 1998 and the internet crash of 2001, over-exposure to the sub prime market has brought the bank IKB to the brink of collapse.

Lateral contagion

Global markets are vulnerable. Derivative products can maintain their delicate balance as long as nobody calls them out – as long as everybody pretends to believe the market is still liquid. But it takes just one institution to try to bale out by selling its CDOs for buyers to disappear. Once liquidity evaporates, the formal negotiability of the bonds becomes meaningless and their value plummets.

In August the French bank BNP-Paribas announced the suspension of three 'dynamic' funds: "The complete evaporation of liquidity in certain market segments of the US securitisation market has made it impossible to value certain assets fairly regardless of their quality or credit rating" (5). Yet only a week previously Baudoin Prot, the bank's CEO, had guaranteed the liquidity of the three funds.

As risky products collapsed and supposedly safe ones wobbled, the contagion spread to other, unrelated, market sectors that had participated in the orgy of lending, specifically the private equity sector.

These investment funds have been the stars of the finance industry over the last few years. They buy up promising companies whole, withdraw them from the stock market, restructure them and sell them on at a huge profit after a few years. They invest little of their own capital, relying instead upon debt, which they repay by milking the companies they purchase. The profits are so staggering that banks, convinced they can't lose, have fallen over themselves in the race to finance these operations. The terms offered include covenant-

light loans, exempt from all the limits on basic financial ratios normally imposed upon borrowers – "whatever you do, we're behind you".

Then there are PIK (payment in kind) and IOU loans, where the interest and principal are not paid in cash, but added to the original debt. As a result, private equity funds have stacked up astronomical levels of debt. But problems can arise when illiquid assets are sold, not as blocks of shares but as entire companies. All it could take is a single problem – for resale to be impossible, delayed or at a loss – for the entire private equity sector to be compromised.

Recent fund-raising operations have struggled because the banks, hitherto relaxed and complicit, have suddenly got cold feet. It is typical of financial crises that the sudden discovery of risks in one sector should raise anxieties in others. Just as Mexico's difficulties in 1994 generated doubts in Thailand — hardly a next-door neighbour — because both were emerging markets, so anxieties about the housing market have spread to the private equity market, although they have nothing in common except dangerous excesses.

Overexposed banks

The fact that the banks managed on the whole to offload their portfolios of property credits through securitisation didn't protect them from trouble. By letting their funds fill up with derivative products, they created a new exposure to mortgage risk. And they came under threat from lateral contagion, particularly through private equity, to which they were directly exposed.

The banking regulations require every bank to maintain a solvency ratio between its capital and its liabilities. If actual or even potential losses loom, something likely now that the credit rating agencies have woken up and started to revise all their evaluations downwards, the banks must make corresponding provision in their accounts; to maintain their ratios they must reduce the denominator (credits granted) in proportion to the contraction of the numerator (the bank's own capital, reduced by the provisions they have made). As always, it is those involved in the real economy, businesses and workers far removed from the evils of speculation, who face credit restrictions they have done nothing to deserve.

Nanny to the rescue

As long as the markets kept rising, the financial masters of the universe despised the nanny state and said so. Now they want and need her comfort. A central bank, which rescues the financiers by lowering interest rates to restore general liquidity, is not a state itself; but it is public institution, outside the market, rejected while profits flood in, appealed to when things turn bad.

Jim Cramer is a no-holds-barred financial pundit on the US business news channel CNBC. On 3 August he was seen screaming at Ben Bernanke, the chairman of the Federal Reserve: "Cut! Cut!" (6). Infuriated by the Fed's delay, Cramer claimed that Bernanke understood nothing because he was an academic (he is a former economics professor). Other fund managers interviewed on the same channel were more soberly dressed and less hysterical. But they all agreed: the readiness of Alan Greenspan, Bernanke's predecessor, to

cut rates rapidly was the mark of a practical man, unencumbered by academic preconceptions, who could read a situation and recognise that it was time to make concessions.

Saner analysts are beginning to recognise that this long monetary tolerance of the financial world's excesses must take some of the blame for the risks now threatening us. Until 17 August, when he did cut the Fed's primary discount rate, Bernanke seemed happy to let the most foolhardy operators take the consequences of their own stupidity. But that was unsustainable once failures spread to constitute a systemic risk. That is the worst thing about the financial system. It is always encouraged to swim further and further out until the authorities can no longer ignore its misfortunes and have to dive in to the rescue. It holds the world hostage.

Notes

(*) This article originally appeared in *Le Monde diplomatique*,

(1) Pierre-Antoine Delhommais, "Une mondialisation heureuse mais heurtée", *Le Monde*, Paris, 9 August 2007.

(2) Hyman P Minsky, *Stabilising an Unstable Economy* (Yale University Press, 1986).

(3) Gretchen Morgenson, "More Home Foreclosures Loom as Owners Face Mortgage Maze", *The New York Times*, 6 August 2007.

(4) Chapter 11 keeps businesses afloat by offering them protection from over-impatient creditors (a moratorium on company debts). It releases employers from their commitments and allows them to renegotiate wage agreements.

(5) Press release; see http://www.bnpparibas.com/en/news/p ...

(6) That is cut interest rates. For the clip see http://www.youtube.com/watch?v=GKZg...; and for a transcript, http://latimesblogs.latimes.com/ la...

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