In 2004, I and other non-governmental organisation (NGO) colleagues went to a meeting with UK government officials. The purpose was to discuss the UK’s presidency of the upcoming July 2005 Summit of G8 leaders – the heads of government of the eight leading industrialised countries. One item on the Summit agenda was export credit agency (ECA) reform. I was familiar with the UK’s agency, the Export Credits Guarantee Department, from our solidarity work with communities around the world affected by the dams, pipelines, power plants and other infrastructure projects that this Department had funded. NGOs at the time were pressing for ECAs to adopt mandatory environmental, human rights and development standards.

The UK government officials had other proposals in mind, however. In particular, they seemed keen to expose the extent to which ECAs were subsidised by the taxpayer. This was (to say the least) surprising. That’s been the NGO line more than the government’s. In fact, the ECGD and other ECAs have consistently and vehemently denied any element of subsidy in their operations. But the officials seemed to think that, once the subsidies had been exposed, the rationale for continued government backing for export credit agencies would be removed. “New instruments”, they said (they were not more specific), would enable the private sector to provide cheaper export insurance cover than official agencies could. The days of publicly supported ECAs would soon be over: they would, as one official put it, “wither on the vine”. The UK’s ECA proposals for the G8 were not accepted: other countries were not so keen to admit that ECAs receive and dispense subsidies.

But the talk of “new instruments” did not go away. What exactly were they? How did they work? Were they already impinging on the activities and influence of ECAs? Would they make any difference to our work supporting people affected by infrastructure development that had been backed by ECAs?

Fast-forward a couple of years to November 2006. I was in Rome with Antonio Tricarico of the Italian group, Campagna per Riforma della Banca Mondiale, a long-time colleague in the international ECAdWatch coalition, attending a conference on export finance. This time, there were no other NGOs – only bankers, export credit agency...
officials, insurers and hedge fund managers. Some ECA officials, whom we knew from elsewhere, were none too pleased to see us: “This isn’t an NGO meeting. You shouldn’t be here.”

This time, the “new instruments” made it into every presentation. The problem was that the talk was utterly incomprehensible: a jumble of acronyms (IOs, POs, WACs, WAMs, TACs, SLABS and TTEs) and bizarre “in-crowd” phrases (“haircuts”, “black boxes”, “bullets”, “hard bullets” and “dead cat bounces”). What was clear, however, was that those who had drunk this acronym-laced Kool-Aid had little time for official ECAs. “We don’t need you any more”, said one banker candidly. Exporters had a new best friend: the Special Purpose Vehicle or SPV (also known as a Structured Investment Vehicle [SIV] or Special Purpose Entity [SPE]).

Acronymed-out during the conference, Antonio began to sift through the piles of reports picked up from exhibition stands. “Look at this”, he said, pointing to an article about SPVs and ILSs (decoded: “Insurance Linked Securities”). The article discussed how insurers were using these instruments to spread the risks throughout the world’s financial markets of claims after severe climatic events such as Hurricane Katrina that flooded New Orleans in August 2005. One paragraph in particular stood out:

“The typical structure would include the creation of a special purpose vehicle (SPV), usually a Cayman Islands or Bermuda exempt company whose common shares are held by a charitable trust in order to shelter it from potential bankruptcy . . . The ILS will be issued by the SPV and sold to investors, the proceeds from which will be invested in high quality securities and held in a collateral trust.”

I didn’t know it at the time, but this was a double blind date: my first encounter with securitisation (the process of placing assets in an SPV) and with derivatives (the asset-backed bonds sold by the SPV) – the process and instruments that have caused the “credit crisis”, financial meltdown, and social and economic hardship for millions of people for years to come.

At first, what caught my attention was the use of a charitable trust to avoid bankruptcy. Great! That’s what charity and trust had descended to. Slowly, however, some of the broader implications began to dawn on me. What would “spreading risk” through SPVs mean for efforts to persuade insurers to increase their insurance premiums against global-warming related damage? If the tab for paying out claims was now being spread among hundreds of thousands of investors around the world, rather than concentrated in a few companies, would potential pressure points for change be similarly diffused and thus rendered ineffective? Besides insurers, how many other businesses were using SPVs? Flipping through all the conference reports, we came across dams, toll roads, bridges and oil pipelines that had all been funded through SPV-like arrangements.

How did it all work? If alphabetised acronyms were confusing, the spaghetti-like diagrams that filled the various reports created yet further bewilderment. We were not alone: a partner at accountants PricewaterhouseCoopers has candidly admitted:

“Insurance securitisations remain difficult to understand not only for investors, but also for regulators, rating agencies, bankers and lawyers – few of whom even begin with background knowledge of the insurance industry.”

The credit crisis and financial meltdown has been caused by securitisation and derivatives . . .

. . . two things that have been difficult for regulators, rating agencies, bankers, lawyers and investors to understand.
Given that securitisation and derivatives have been touted as the “most important innovations in modern finance”, such lack of understanding was (and remains) scary. Even officials at the Bank of England are reported to have had trouble grasping the many different derivatives and their combinations. John Moulton, a prominent UK private equity investor, recalls having a breakfast meeting with senior Bank of England officials in the wake of the September 2007 bankruptcy of the UK’s fifth largest bank, Northern Rock, at which he had to explain how derivatives worked.\(^6\)

What we learned (and what we didn’t) at this export finance meeting in Rome prompted ECAWatch and other coalitions to dig deeper into the world of securitisation and derivatives. Some key questions emerged: How were these new instruments affecting communities on the ground? Were they helping or hindering companies’ ability to fund potentially destructive projects? Were ECAs themselves using these new instruments?

From asking and talking around, we discovered that other colleagues had had their own “brief encounters” with this alphabet spaghetti and were just as puzzled and alarmed. Roger Moody of Partizans, a group that has long monitored mining companies, had noticed the wave of mergers and acquisitions in the mining sector. He discovered that many of the new, sometimes major, shareholders in mining companies were hedge funds that were betting on share prices falling (“short selling”) to generate profits from risky new mining ventures, or were speculating on the outcomes of the mergers and acquisitions themselves.\(^7\) Other colleagues, such as Kavaljit Singh with Public Interest Research Centre in India, were puzzled by the huge mergers and acquisitions taking place among big and small companies alike. He went on to research the extent to which these new financial instruments were enabling private equity companies to buy out their target companies.\(^8\) Wiert Wiertsema of the Dutch group, BothENDS, uncovered the use of derivatives by Atradius, the Dutch ECA.\(^9\)

All our collective further research yielded more information about the mechanics and history of securitisation and derivatives, and answers gradually began to emerge to some (but by no means all) of the many questions that the Rome meeting had raised about SPVs, derivatives and the “spreading of risk” (see Box: “Questions and Answers”, pp.8-9).

There were some questions that we didn’t know how to answer in 2007. What happens when the gambling stops? When a derivative doesn’t pay up? When the bet goes very wrong? We made some guesses, based on what had happened after Barings Bank collapsed in 1995 when the bets of its trader Nick Leeson went wrong, or when Enron’s gambling finally brought the oil company down (and its employees’ pensions with it). The events of the past 12-18 months have answered some of those questions, but further responses are still unfolding daily.

As banks, mortgage lenders and insurers now collapse like dominoes, the irony is that exporters (and their supporting government officials) are now desperately tending the vine of ECAs that they were allowing to wither. With credit on the open markets drying up, the talk now is not of “new instruments” but of a resurgence of public export credit agencies as exporters flee the commercial market for what they believe is the safe haven of government-backed insurance. Just as the bankers are now doing. But if exporters and bankers get public money, it should come with conditions that need to be set through public debate and decision-making rather than simply being a blank cheque.
Bricolage: Derivatives and Securitisation

The French have a word for it: *bricolage*\(^{10}\) – the use of whatever happens to be at hand (regardless of its original purpose) to create something that has a strikingly new use or meaning.\(^{11}\) Examples include: the punk rocker’s transformation of safety pins into fuck-off, anti-jewellery jewellery; the use of pots and pans, discarded industrial oil drums, biscuit tins and metal rubbish bin lids as musical instruments by the first Caribbean “steel bands”;\(^{12}\) or the cobbling together of furniture out of bits and pieces of wood retrieved from skips or picked up at junk yards and rummage sales.

Today’s bankers, accountants and financial fund managers are not obvious *bricoleurs* – their pinstripes and Porsches fit uneasily with the gobby rebelliousness of punks or the “do-it-yourself” pragmatism of shantytown musicians. But *bricolage* is not confined to the marginalised or the thrifty.\(^{13}\) On the contrary, the opportunistic recombining of “whatever is at hand” to overcome a particular obstacle or to achieve a given objective – in this instance, massive and rapid personal capital accumulation – is as much a feature of the many sub-cultures that people the major financial markets as it is of society’s myriad other, less privileged, sub-cultures.\(^{14}\)

The financial *bricoleurs* have seen and exploited money-making opportunities thrown up by the liberalisation of financial markets over the past two or three decades or so – for example, the removal of controls on the free flow of capital between countries – and by a period of low interest rates\(^{15}\) and of weak oversight by the financial authorities.\(^{16}\) Academics, insurers, bankers and fund managers have joined together to transform investment practices worldwide by re-engineering a range of financial instruments – notably assets, known as “derivatives”, whose value depends on (or is “derived from”) the price of another underlying asset\(^{17}\) – and by creating new ways of packaging these instruments up and selling them. The recent tool of choice for such repackaging has been “securitisation” (of which more below).

These new financial instruments did not emerge from august policy discussions within the institutions that NGO activists often associate with determining the “financial architecture” of financial markets – the International Monetary Fund, the World Bank or the World Trade Organisation. They have come about through the everyday actions of individual financial *bricoleurs* using what they had to hand.

The tool of choice, “securitisation”, is a process whereby assets that generate regular streams of income (such as loans, corporate bonds,
mortgages, export credit debt, care homes, gas pipeline contracts or music rights on songs by rock stars like David Bowie are sold to a newly created company (a Special Purpose Vehicle [SPV], but also sometimes called a Structured Investment Vehicle [SIV] or a Special Purpose Entity [SPE]). The SPV then issues derivatives, the other tool of choice that was to hand, that give investors the right to the income stream from the assets. The underlying asset – David Bowie’s songs or the mortgage that has been taken out – remains with the SPV: the buyers of the derivatives have rights only to the “receivables” that the securitised assets generate. By combining risky assets (such as mortgages to low-income groups) with less risky ones (mortgages to high income groups), securitisation has been used magically to transform risky assets into attractive investments. In the process, new capital is raised to expand the businesses that sold the assets to the SPV. In addition, through establishing the securitised investment funds offshore in tax havens such as the Cayman Islands or the British Virgin Islands, the bricoleurs are able to enhance their returns through tax avoidance.

In particular, the bricoleurs have used derivatives and securitisation to devise ways to make money by evading or “playing” regulations; by extending the process of commodification (derivatives have enabled virtually everything – from weather to bandwidth and risk – to be priced, commensurated, bought and sold); and by devising elaborate new financial vehicles through which they have been able either to hide their “risks” (read: their losses, actual or potential) or pass them on to less savvy or less informed retail clients (for example, pension holders) or onto the State, while ring-fencing their own profits from liabilities. Risks have indeed been “spread” (one of the main claimed benefits of derivatives) – but only in that they have been made more contagious, not in the sense that they have been reduced.

Derivatives are used within all major financial markets – to make bets against future fluctuations in interest rates, currency rates, commodity prices, share prices, and the credit-worthiness of companies and states. Their proponents argue that derivatives provide investors with a vital tool both for the efficient management of credit risks – a claim that, as will be seen (p.28), is highly questionable because much of the credit risk has been hidden rather than mitigated – and for making visible “the market’s assessment of the current and future value of certain assets”, sometimes also called “price discovery”.

Within the debt and credit markets (the focus of much of the current concern over their use), derivatives have transformed the ways in which companies raise money to finance their activities. Capitalising on the flexibility of derivative-based financial instruments, a range of opaque and largely unregulated bricoleur-created corporations, notably hedge and private equity funds, but also “boutique” investment banks, have constructed a “shadow banking system” to that more familiar one long operated by commercial and investment banks involving straightforward deposits from one group of customers and loans (with interest) to another. These new financial entities have used derivatives to both generate capital and hedge against risk by passing it on to other investors. These new players have been joined by mortgage lenders who, thanks to the relaxation of the rules governing financial services, have jettisoned their “mutual fund” status and transformed themselves into banks, aggressively raising money to “grow their businesses” through the use of securitisation. The money raised has enabled the mortgage lenders to expand beyond mortgages into other areas of finance.
Creating a Wall of Money

“A derivative is like a razor; you can use it to shave and make yourself clear and attractive to your girl friend or to slit her throat with it or you can use it to commit suicide.”

Financial Times
4 May 1995

The result has been a wall of money, in the form of cheap credit, that has fuelled a boom in mergers and acquisitions (see p.37) – concentrating economic power in the process – and provided huge sums of capital for investment in sectors where the bricoleurs saw opportunities for profit. Industries that have seen money pouring into them include mining, biotech, biofuels, private health care, oil and gas, and water supply. Projects are now underway that had been rejected for funding even by the World Bank (not generally regarded as a model of environmental friendliness), other multilateral development banks (ditto) and official export credit agencies (ditto again).

The bricoleurs have also developed new capital-raising structures, involving securitisation and derivative-based instruments such as Credit Default Swaps (see Box “Questions and Answers”, p.7), to expand private sector ownership of infrastructure – from ports and railways to motorways, hospitals and utilities. In the process, they have transformed infrastructure finance from a banking “backwater” into a multi-billion dollar business, with profound implications for corporate control over many areas of life that affect public welfare, such as health care and access to water and energy. Almost every major investment bank and many large private equity firms now have an infrastructure fund – and the sums potentially available for investment are huge. In 2006, the world’s top 60 infrastructure funds were estimated to have raised more than $150 billion in dedicated capital to buy or build “infrastructure” – a figure that, if used to “leverage” additional borrowings, could fund “a staggering $750 billion worth of transactions”. Moreover, the infrastructure bricoleurs have already begun to devise mechanisms through which the new instruments can be used to restrict the power of governments to regulate for the public good: default provisions written into project bonds, for example, have been proposed as a means of locking states into “a more investment-friendly environment” by “deter[ring] politicians’ attempts to make undesirable policy changes”.

Although some infrastructure funds have been hard hit by the credit crunch, the sector is nonetheless still viewed as a safe haven in a turbulent market, with investment analysts calculating that global demand for infrastructure over the next 20 years could reach $40 trillion (see p.44 and Box: “Infrastructure Funds – Replacing Project Finance?”).

For the bricoleurs, derivatives and derivative-based investment strategies have brought huge wealth. In 2007, Wall Street’s top five investment banks paid out over $40 billion in bonuses to their executives, top-tier management and traders – and the projected bonuses for 2008 are still a whopping $23.2 billion, despite the current downturn in the economy. Indeed, many investment banks were paying out more than half of their revenues in annual bonuses to their employees (or at least some of them). Cheques in the millions are not uncommon for a firm’s top traders (or “Big Swinging Dicks” as they like to be known on Wall Street). Managers of hedge funds, one of the main financial bricoleurs (see Box, “You Know a Hedge Fund When You See It”, p.32) have been equally (if not better) rewarded: in 2006, the world’s
top hedge fund managers – just 25 in total – earned more than $14 billion between them, equivalent to the entire annual output of Jordan or roughly one quarter of the additional annual aid flows that are estimated to be required to meet the Millennium Development Goals by 2015. The highest earner was Jim Simons (of Renaissance Technologies), who raked in $1.7 billion, followed by Ken Griffin (of Citadel Investment Group) on $1.4 billion and Eddie Lampert (of ESL Investments) on $1.3 billion. Even relatively junior portfolio managers are reported to earn over $500,000 after bonuses are taken into account. Nonetheless, despite the huge sums involved, tales abound of traders ripping up cheques that they deem “too low” or even, in one notorious incident, excreting on the floor of trading rooms in protest. There are no “claw back” arrangements to recoup bonuses paid to managers whose portfolios subsequently fall in value.

**When the Music Stops, Who’s Left Holding the (Toxic) Parcel?**

“Derivatives did not eliminate the credit risk; they simply made it invisible.”

*John Gapper*  
*Financial Times*  
*23 April 2008*

By contrast with the huge bonuses paid to financiers, the derivatives and securitisation revolution has generated a long list of casualties for the public at large. In 2006, it was estimated that some 2.2 million poorer US households – often classed by the mortgage industry (in a language resonant of eugenics) as “sub-prime” because of their low or even non-existent incomes; tellingly, loans to “sub-prime” applicants were referred to by the mortgage companies as NINJAs – “No Income No Job No Assets” – had either already lost their homes to foreclosure or would soon lose them because securitisation-driven mortgage lenders had allowed (and indeed encouraged) them to take on loans that they could not afford – loans that the companies often knew would be beyond the borrowers’ means. By the end of 2007, the estimated number of “seriously delinquent” (again, note the language) households had mushroomed to 3.6 million – and by August 2008 investment bank Credit Suisse was predicting that as many 6.5 million households could foreclose as the crisis spilled over beyond the “sub-prime” market. In the last quarter of 2007 alone, over 900,000 mortgage owners foreclosed on their loans or were in arrears on payments, the pace of foreclosures gathering pace as house prices tumbled and homeowners were driven into “negative equity”. Many had been sold mortgages by companies that were almost entirely unregulated. The Afro-American community has been worst affected (52 per cent of “sub-prime” loans in 2005 were made to Afro-Americans), causing what has been described as “the largest loss of African-American wealth in American history.”

The “sub-prime” mortgage crisis has caused the largest loss of African-American wealth in US history.
insufficient cash to pay teachers and other staff.\textsuperscript{64} One municipality – the City of Vallejo in California – has already been forced into bankruptcy by the sub-prime crisis,\textsuperscript{65} while Jefferson County in Alabama teeters on the verge after a municipal bond to raise money to repair the local sewage system run into difficulties, leaving the county $4.6 billion in debt.\textsuperscript{66}

With securitised mortgages being traded among hedge funds, banks, pension funds and other financial institutions around the world, it was inevitable that the financial impacts of the US mortgage default crisis

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**Questions and Answers:**

**What’s a Special Purpose Vehicle (SPV)?** At its simplest, it is a company set up to buy certain specified assets.

**What assets are we talking about?** Anything that has a regular stream of income associated with it. It could be a bank loan (the income stream being the repayments made by the borrower), or a mortgage (ditto) or a credit card loan (ditto) or the contract to operate a toll road (the payments made by car users providing the income).

**Why should anyone want to sell these assets to a SPV? Don’t they want that income themselves? Isn’t that why banks make loans, to get the repayments?** They want to sell them for many reasons. If you are a bank, by law you have to set aside reserves against the loans you have made, just in case the loan doesn’t get paid back – and the riskier the loan, the more you have to set aside. Selling the loan to an SPV means you don’t have to set anything aside, thereby freeing up money that would, from the bank’s perspective, otherwise remain unproductive. Likewise if you’re a mortgage lender. With other assets – a toll road, for example – the attraction is that you still get your future income but you get it in a lump sum and get it in advance.

**Who sets up the SPV?** Generally, the person or company who wants to sell the asset.

**So they sell their own asset to themselves?** Yes and no. A bank will set up an SPV to buy the bank’s loans. But the SPV is legally a separate entity from the bank, so the loans no longer belong to the bank but to the SPV. The distinction, however, is very legalistic – and a big question now exercising lawyers in the wake of the “credit crisis” is how far some banks actually remained in control of the loans, not least where they retain shares in the SPV.

**How does the SPV raise the money to buy the asset?** It issues bonds that give investors (those who buy the bonds) the right to the income off the assets that the SPV owns. But the assets themselves remain the property of the SPV. The bonds are called derivatives because their value is derived from the value of the underlying assets. A bond based on mortgages is known as an MBS (mortgage-backed security); a bond on a loan is a CLO (collaterised loan obligation); on an insurance policy, an ILO (insurance linked obligation); on a business (for example, the Priory Group, best known in the UK for its alcohol and drug treatment centres favoured by celebrities, recently securitised its rehab centres), a WBS (whole business securitisation); and so on. Collectively these various derivatives are known as Collateralised Debt Obligations or Asset Backed Securities – CDOs or ABSs.

**Is that it?** In what financiers call “plain vanilla” securitisations, yes. But new “derivatives of derivatives” have been created to sell on the basis of the securitised assets. And these have greatly increased the riskiness and complexity of the deals.

**Can you give an example, please?** One that has got a lot of publicity is called a Synthetic Collaterised Debt Obligation (S–CDO). Instead of the SPV buying a loan, owning it and selling bonds that give an investor the right to the income, the SPV sells a bet – a Synthetic Collaterised Debt Obligation – on the loan defaulting. If the loan does default, then the investors in the S–CDO have to pay up. Until it does so, the investors get the income stream from the loan.

**Why would anyone want to buy these CDOs and S–CDOs? If they’ve got the money to buy them, why don’t they just...**
How Does Securitisation Work?

**Give out loans like the banks and sit back and wait for the income streams?**

There are many reasons why someone might buy them. Like any bond, they provide an income – and for some investors, that may be reason enough. But for hedge funds and private equity funds, that income itself generates further investment opportunities. The key lies in the low interest rates that banks have charged in recent years. So long as the income from the CDO was higher than the interest paid on a loan from a bank, the CDO could be used to fund further borrowing.

The maths is relatively simple. At an interest rate of 3 per cent (the rate in May 2006), the annual interest paid on a £1,000,000 loan would be £30,000. If the return on one million pounds worth of S-CDOs was 15 per cent – often the case – then an investor would earn £150,000. So an investor would spend their initial (unborrowed) million pounds on the S-CDO, and then, using the S-CDO as collateral, go to a bank and borrow £5 million, the interest on which would be £150,000 (which the bank knows can be paid from the S-CDO income stream). The investor then invests the borrowed £5 million in some more S-CDOs, which would then generate £750,000 in income . . . which could then be used as collateral to leverage another £25 million in loans . . . and so on, to infinity. This is how many private equity buy-out firms raised the money to purchase companies in their mergers and acquisitions spree of the past few years.

**But aren't the CDOs and S-CDOs and all this pyramid borrowing rather risky?**

The risk depends on the underlying assets. In many cases, the income stream in a CDO is secure: most loans are in fact repaid. But, as securitisation has freed up more and more money for more and more loans, and as banks have scented the easy profit to be made from making new loans but then shovelling them out of the door as soon as possible, many riskier assets have been recruited into service, such as so-called “sub-prime” mortgages.

**Why do investors buy CDOs and S-CDOs based on these risky assets?**

Well, ignorance is one answer. The banks have not advertised their risks. Another is that a portfolio based exclusively on high-risk assets wouldn’t find many takers – except the occasional high stakes gambler with money to burn. But what SPVs have done is to combine high-risk assets with lower-risk ones to create a portfolio that has an overall lower risk (or so the theory goes). To make the CDOs issued on the portfolio still more attractive to investors, the SPVs introduced a “waterfall” structure, whereby the whole portfolio is “sliced and diced” or “tranching” into different risk portions. As repayments come in, they are allocated to the senior tranches first, so the junior tranches lose out first when some of the borrowers (for example, “sub-prime” borrowers) stop repaying their loans. With Synthetic CDOs (the bets on the credit-worthiness of the underlying assets), the waterfall structure means that the owners of the riskiest tranches take the first “hit” if the loans default, while the lower-risk tranches are last in line to cough up and pay out.

**So the risks have indeed been spread?**

Well, yes and no, again. Initially, financial commentators assumed that this was the case – that was the theory combining securitisation and synthetic derivatives. But the credit crunch has proved otherwise, as one bank after another has run into difficulties. The answer, it now appears, is that securitisation did enable banks and mortgage brokers to shed their loans, but they did not always shed the credit risk. On the contrary. When the banks set up the SPVs that bought their loans, they often kept shares in the SPV. And it is the equity holders that take the first hit on any default on the SPV’s portfolio. And the equity chickens are now flocking home to roost.
a slow-motion multiple pile-up began on Wall Street as one bricolaged financial vehicle smashed into another, littering the financial highway with broken deals and critically-damaged hedge funds, insurance companies and banks. Hedge funds, which had borrowed heavily against the mortgage-based derivatives (known as collateralised debt obligations or CDOs – of which more later) that they had bought when the housing market was booming, found that the banks were no longer prepared to lend against such CDOs, sending their value tumbling. A fire sale ensued as hedge funds sought to raise the money they needed to service the debts on the considerable sums they had borrowed to “leverage” their deals.

As the value of the mortgaged-based CDOs fell, other non-mortgaged-based assets (such as derivatives based on commercial bonds) were thrown into the sale. But the banks discovered that many of these, too, had been issued by vehicles that had been holding “sub-prime” mortgages and whose credit-worthiness was thus suspect. Moreover, the banks themselves “discovered” what they had blithely ignored in the credit boom – namely that they still had liabilities attached to the loans they themselves had securitised (see Box: “Questions and Answers”, pp.8-9). Panic set in and the major banks stopped lending to each other,69 spooked by the prospect that their potential creditors might not be as “bankable” as they had previously assumed.70 Liquidity (a measure of “the ease with which one can sell an asset at the expected price”)71 dried up – causing a number of banks to fail (starting with Britain’s Northern Rock72 and Germany’s IKB Deutsche Industriebank,73 both subsequently nationalised or bailed out by governments). Within a year of the credit crunch first biting, some $476 billion had been knocked off the value of the world’s major investment banks.74 Globally, losses from the “sub-prime” market alone are predicted to reach anywhere between $420 billion75 and $3 trillion76 (and that is just in the financial sector: losses in the “real” economy outside of Wall Street and the City of London may be far higher).77

By the end of September 2008, the roll call of bank fall out was mounting: Lehmann Brothers (the fourth biggest investment bank in the USA) had gone under; American International Group (AIG), one of the world’s biggest insurer of derivatives (and principal sponsor of Manchester United football team), had been rescued under a government bail-out; Bear Stearns, one of the largest US investment banks, received a government injection and was then bought out by another bank, JP Morgan; and the US government had nationalised (or, as government officials coyly put it, “put into conservatorship”) the two biggest mortgage insurers in the US, known as Freddie Mac78 and,79 bringing three-quarters of America’s mortgage industry under public control80 – the largest nationalisation in recent history.81 The Freddie Mac and Fannie Mae nationalisation promptly caused a convoy of other bricolaged financial vehicles – derivatives known as credit default swaps (CDSs, see p.18ff) – to slam into the back of the paramedics seeking to save the mortgage market. The CDSs had been taken out by investors as an largely unregulated form of insurance on the bets they had placed on the credit worthiness of mortgage loans made by Freddie Mac and Fannie Mae. The bail-out triggered default clauses in many of the CDSs that had been issued, prompting fears that the $62 trillion credit derivatives market could face meltdown.82 Within days, the US government had announced further nationalisations – this time intervening to pump government money into a $700 billion fund designed to take “toxic” mortgages into public ownership.83 Such has been the extent of government intervention in the crisis that it is estimated that 70
per cent of all new credit issued between the summer of 2007 and April 2008 has been public money.\textsuperscript{84}

No one knows the full extent of the damage yet to come — rumours of impending bankruptcies outside of the mortgage market are rife, with some commentators putting the probability of one or more of the major US car manufacturers defaulting within the next five years at “well over ninety per cent”\textsuperscript{85} (a slam-dunk bet, some would say, given Chrysler’s failure to refinance \$6 billion of credit in August 2008).\textsuperscript{86}

For years, the \textit{bricoleurs} have been “hiding risk” — and raising credit in the process — by parceling up high-risk loans with less risky loans and selling the “securitised” package on to investors, including the banks, who then sold the riskiest packages on to others.\textsuperscript{87} The sub-prime crisis pulled the plug on the music and the game of “pass the parcel” is (temporarily) over. Only this is “pass the parcel” with a difference: the parcel contains not a present but billions (and maybe trillions or even quadrillions) of dollars of “toxic” debt; and no one knows who is holding it or insuring it.\textsuperscript{88} Nor is it just defaulting mortgage loans that lie behind the crisis: credit card loans (whose defaults are on the increase),\textsuperscript{89} car and other leasing agreements, future income from private care homes and gas pipelines, premiums on climate-related insurance, and a range of other income streams have also been securitised. The risk is that they too will turn out to be “toxic”.\textsuperscript{90}

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**Who Knew What and When . . . ?**

UK taxpayers may be thankful that Alistair Darling, Britain’s Chancellor of the Exchequer, likes to read the \textit{Financial Times}, even when on holiday. Were it not for the FT, who knows when he would have learnt about the imminent collapse of the UK bank, Northern Rock. As he tells it:

“\textit{I remember I picked up the FT in the supermarket [in summer 2007], as you do, and it had the European central bank starting to put money into the economy. I phoned the office to ask why they were doing quite so much. It didn’t surprise me that money was going in — there was concern going around — but it was the sheer scale of it. I said, what about our institutions? This was when Northern Rock started to figure.}\textsuperscript{91}

Nor was the Chancellor alone. Senior bankers recall that the first they knew of the impending credit crunch was when their Blackberries went crazy, interrupting their sunbathing.

And as anxious customers queued in long lines in September 2007 to withdraw their deposits from their local Northern Rock branches, so the extent of ignorance about the exotic new financial instruments that had caused the collapse of the mortgage society-turned-bank began to emerge. Leading private equity investor John Moulton recalls that during a breakfast meeting with Bank of England officials:

“It became clear they did not know what a CLO [collateralised loan obligation] was. I had to show a senior man [by drawing a diagram] on the back of a napkin.”\textsuperscript{92}

Journalists found that they had to learn a whole new vocabulary, although the more perceptive had a head start. \textit{Financial Times} columnist John Gapper announced in March 2007 (a good six months before Northern Rock collapsed) that he had spent “some time last week” discovering what sub-prime mortgages were.\textsuperscript{93}

Yet there were voices that had been expressing concern. A regular reader of \textit{The Economist} or Gillian Tett’s prescient articles in the \textit{Financial Times} would have picked up that not all was well in the mortgage market — and that the consequences of borrowers defaulting might be all the more severe thanks to derivatives’ \textit{bricolage}.

Bad news, however, was not what the “Big Swinging Dicks” and their champions in government or in the boardroom\textsuperscript{94} wanted to hear. As Gillian Tett notes:

“From 2003, senior officials at the BIS [Bank for International Settlements] in Basel . . . repeatedly warned that risk dispersion might not always be benign. However, such warnings were largely kept out of public view, partly because the US Federal Reserve was convinced that financial innovation had changed the system in a fundamentally beneficial way.”\textsuperscript{95}

Within banks, too, disquiet was expressed at senior level about the complexity of the risk models being used. As one senior risk manager wrote (anonymously) to Gillian Tett:

“Upfront we did express to senior management that we lacked the analytical skills . . . and highlighted deep concerns about the approach colleagues in the market risk area had taken . . . I feel responsible for not doing more, but I really did push my views, risking my immediate career.”\textsuperscript{96}

It was a risk that all too many others were unprepared to take.
“Times like these are cathartic. Bubbles of overpriced assets collapse along with the egos of many investors. The wannabe stars in, say, hedge funds and private equity will go to the wall but the genuinely talented will survive. Some senior banking heads have rolled – and more will no doubt need to roll – but the danger is that the banks learn nothing, only to repeat it all in a few years’ time. So when you are having a conversation and some banker tells you that this time there is a new paradigm, you know it is just moral hazard on the horizon. And you should run for the hills. You have been warned.”

Ian Morley
Chief Executive of Dawnay, Day Brokers
12 June 2008

Meanwhile, the *bricoleurs* have been hard at work once again re-engineering their investment strategies to profit by trading their way around the crisis. Now that the market for loans to back buy-out deals has collapsed, for example, the leading private equity firms are “looking to buy bombed-out debt at discount prices with the hope that a recovery will generate their customary big profits”. As the markets have fallen, hedge funds have similarly made millions by betting on equity and bond prices falling or “short selling” as it is termed. Fortunes have also been made by those who anticipated the US mortgage crisis and used derivatives to bet on mortgage defaults.

Others, recognising that the European and US credit markets have lost their previous money-making fizz, are turning to Asia and other markets. (In the first half of 2008 alone, 104 new private equity funds focussing on emerging markets were launched, with a combined value of $35 billion.) Still others are sizing up the money-making potential of bespoke new infrastructure funds (see p.44ff and Box: “Infrastructure Funds – Replacing Project Finance”, pp.46-47), or carbon trading (see p.45ff). Hedge funds have also been active in “playing” commodities, making huge sums from betting first on rising metal and oil prices and then on their decline. Lured by the prospect of rising food prices, many funds have also plunged into agro-industries and land (see Box: “Food Prices and Speculation”, p.42).

And as the pile-up continues in the financial markets, so the *bricoleurs* have devised new derivative-based instruments to hedge against the risk of other associated derivatives going sour or, with inflation hotting up, to bet on consumer price rises – and thus to profit from the credit crunch and its aftermath. As one senior banker observes:

“It’s a strange business. First you make money by creating products no one understands, then you make money by cleaning the mess up.”

Indeed, a year after the credit crunch hit, hedge funds have more under investment than ever before, despite having their worst year on record; the use of derivatives is on the up as investors bet on future volatility in the market, and the world’s super-rich have increased their wealth by more than 9 per cent to $40,700 billion.

Investment strategies have been re-engineered once again to make profit out of the financial crisis.
Bricolaged Ancestry: The Faux Historicism of a Speculative Tool

“This decade, financiers have invented so many brilliantly clever mathematical tools to repackage risk that the industry has slipped, almost unthinkingly, into an assumption that ‘credit’ is a collection of abstract equations, stripped from any human context . . . Yet, as any Latin scholar knows, the word ‘credit’ hails from credere: ‘to trust’ . . . And bankers forget this human dimension to their cost – no matter how impressive the abstract numbers might seem.”

Gillian Tett
Financial Times
17 March 2008

Both financiers and politicians initially portrayed the credit crunch as the result of a few bad decisions by a few over-exuberant or inexperienced bankers (notably those who were new to banking, such as the board of Northern Rock). Slowly, however, it has had to be acknowledged that the crisis is deeply systemic. The blame is largely being placed on a lack of regulatory oversight, obscuring the key role played by bricolaging derivatives and securitisation, which has largely gone unanalysed.

Since 1970, the derivatives market has grown from insignificance to the largest market in the world. In June 2007, the notional “marked to model” value of outstanding derivatives contracts amounted to $516 trillion – a level of risk that is just under 10 times the entire output of the world economy. The actual value of the market (what the derivatives would be worth if they were sold today, rather than their theoretical value when trades come due in the future) was estimated in 2007 at $11 trillion – almost equivalent to the entire economic output of the United States and 8 times that of the United Kingdom.

Although the credit crunch has severely dented the profitability of some areas of the derivatives market, overall net turnover continued to increase – standing at $600 trillion in September 2008.

The construction of that market has not come about by accident (see p.20f) – and certainly not through the supposedly politically-untainted, vested-interest-free operations of the laws of “supply and demand”. Rather it has involved patient political lobbying and the intensive use of elite social networks to create a demand for derivative products – their supply effectively preceding demand. It has also involved the bricolage of a narrative that casts the modern derivatives market as essentially unproblematic, a socially benign and prudential way of handling risks, creating liquidity and boosting efficiency that has an ancient pedigree. The real history of derivatives is not so romantic; and the bricoleur version is more notable for what is omitted than what is included.

In much the same way that proponents of biotechnology argue that genetically-engineered products are simply an extension of time-honoured (and, thus it is implied, harmless and natural) plant and animal breeding methods, derivative bricoleurs and their apologists work hard at constructing a long and respectable ancestry for themselves and for derivatives as financial instruments. Reference is often made to the ancient Greek philosopher-mathematician, Thales of Miletus. In order to prove that his poverty arose out of choice rather than an
assumed inability of philosophers to make money, Thales made a fortune 2,500 years ago by *bricolaging* a “financial device” that enabled him to establish a monopoly over the olive crop in Miletus and neighbouring Chios. Anticipating a bumper harvest, Thales negotiated to pay local olive growers a small deposit in return for the right to have first use of their olive presses after their olives were harvested. Thales’s bet paid off: the harvest was bigger than usual and demand for the presses was huge, enabling Thales to clean up by charging growers considerably higher sums to use their own presses than he was himself paying them in rent. Had the harvest failed, all that Thales stood to lose was the deposits he had advanced – the deposits conferred no obligation on Thales to rent the presses if ultimately he chose not to do so. The contract is said to be a derivative because the value of Thales’s contract depended on, or is derived from, the value of the olive crop: if the crop was poor, there would be little demand for the presses and the scheme would be a money-loser; but with an abundant crop, Thales stood to gain what another Greek philosopher, Aristotle, described as “a quantity of money”.

No mention is ever made of what happened to the olive growers, who, alongside Thales’s distinctly unworldly motives, are conveniently airbrushed out of history. Appropriated by the derivative *bricoleurs*, Thales becomes the first known derivative trader, a canny entrepreneur rather than a philosopher out to prove that philosophy was not incompatible with making money. Using modern parlance, Thales is said to have invented what is now called an *option*. In return for a small down-payment, he had bought the right – but not the obligation – to buy a given good or asset (in this instance, the rental rights to olive presses) at a specified time in the future (the date at which the local olive crop was harvested) for a specified price (known today as the *strike price*). Had Thales’s contract involved an agreement to actually buy the right at this future time (rather than simply an option to buy), it would have been what is now called a *forward* contract. If the agreement had been arranged through a formal, regulated exchange, rather than privately between Thales and an olive grower, then the contract would have been a *futures* contract. An option always gives a right to the buyer and an obligation to the seller. Forwards and futures confer obligations on both parties. Purchasing the right to buy is known as a *call* contract; purchasing the right to sell is a *put* contract. Those who “call” hope to make money by prices in the market rising by more than the price agreed in their contract: those who “put”, by market prices falling. And one final bit of jargon: those betting that the market prices will go up (the buyers) are said to be “long” on the commodity they are trading; those betting on prices falling (the sellers) are said to be “short”.

Thales is not the only historical character to feature in the *bricolaged* pedigree of the modern derivatives market. Seventeenth century Japanese rice farmers, 13th century monks, 16th century Dutch herring fishers, and even biblical figures such as Joseph and Jacob also pop up using derivatives to protect their livelihoods against the vagaries of the market, all cast in the role of homely ancestors to Wall Street’s modern hedge fund managers. Or as one US farm website would have it:

“There is a lot that farmers have given the world, and in the world of high finance, farmers taught Wall Street how to trade the future.”

Indeed, the relatively simple “vanilla deals” that were genuinely used

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**Derivatives are usually portrayed as an ancient, socially benign and prudent way of handling risks that creates liquidity and boosts efficiency.**

**Derivatives have a long history of helping farmers and manufacturers insure against risk, but are only one strategy for doing so.**

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October 2008

The Corner House

Briefing 39: A (Crumbling) Wall of Money
historically by farmers to insure themselves against rises or falls in the prices they might get for their crops are now frequently cited by apologists and critics of derivatives alike to explain the workings of complex derivative deals that involve hedging. Iowa corn farmers appear frequently in these stories.

In a hypothetical example, a corn farmer seeks to ensure that the price she gets for her harvest will not fall below a specified price. When she plants the corn in the spring, the price is, let’s say, $3 a bushel. But the harvest will not take place until October – by which time the price may have fallen. To guarantee her costs of production, the farmer enters into 10 contracts, each of which commits her to sell 5,000 bushels of corn to the local grain dealer on a specified date in October at a strike price of, say, $3.20 a bushel – the grain dealer gambling on the market price rising higher than this and thus on his being able to buy the corn cheap but sell on at the market price. If the market price of corn falls below $3.20, however, the farmer is “in the money”, since she has a guaranteed buyer at a strike price that is above the market price. If, on the other hand, the market price rises above the strike price, she is in danger of losing out. But because derivative contracts establish an obligation to the trade rather than to a person, she can always liquidate her own position should the price of corn start to rise in, say, July. She does this by buying another 10 contracts – but this time the contracts are to buy grain in October at the price she had agreed to sell in her first 10 contracts – the two sets of contracts cancelling themselves out. While she might lose some money on this, her aim – to ensure that she will receive a specific price for her crop – will still be achieved, since she can sell her crop on the rising open market in October. Meanwhile, the grain dealer adopts the opposite strategy, offsetting his contracts should the market price look like falling. Options work in a similar manner – the main difference being that the purchaser of the option does not have to exercise the right to buy or sell and stands to lose only the premium they pay for the option right should they let their option expire.

There is no question that derivatives have a long history nor that, in the simple form described above, they play a useful role in insuring against risk, not only for farmers but also for manufacturers (seeking, for example, to ensure that they can buy steel or other commodities at a price for which they have budgeted in contracts to which they are committed). But the bricoleurs’ narrative leaves out much that is important. For instance, farmers and other producers have long followed other strategies in addition to their farmer-trader futures and options to manage their risks – planting a wide range of crops, for example, to protect against the failure of any one crop or sharing the risks of bad times by building social institutions such as co-operatives. Anonymous futures and options contracts disembed farmers from these social networks that are also directly affected by the risk – and they change whose interests can be taken into account when risk is being assessed.

Likewise, the bricoleurs’ truncated historical account of the emergence of futures contracts (in which farmers appear but the bureaucracy on which futures markets depend does not) obscures the centralising tendencies inherent in the standardisation of contracts and their underlying assets – and the ways in which such standardisations have enabled speculators to extend their global reach by operating “at a distance” in markets across the world, buying low in one and selling high in another. And entirely missing from the bricoleurs’ narrative is

Today’s derivatives are for speculation more than insurance and benefit financiers more than farmers.
the long list of Greek, Dutch, English, Japanese and other historical speculators who used options and futures to cream the markets, leading governments in many jurisdictions (often unsuccessfully) to prohibit such trading.\textsuperscript{147}

**Derivatives, Hedging and Speculation**

“Like matter, which astrophysicists have learned creates space as it expands, speculative capital creates profit opportunities as it moves across borders. But the opportunities are also traps that can lead to losses.”

\textit{Nasser Saber}  
\textit{Institutional Investor’s Alpha}  
\textit{July/August 2007}\textsuperscript{148}

Indeed, the narrative of “hedge-fund-manager-as-homely-hedging-farmer” almost entirely obscures the role of derivatives, both historically and in the modern era, as tools not of insurance but of speculation – and the degree to which such speculation is now a primary means through which companies raise the capital they require for their expansion, blurring the differences between “speculative capital” and “portfolio capital” (of which more later). Far from using derivatives for conventional insurance purposes (where it does not much matter if the deal makes money, merely that it minimises the risk of losing it through a declining market),\textsuperscript{149} the “hedging” undertaken by hedge funds (in so far as they hedge at all)\textsuperscript{150} is entirely driven by the requirement to profit from \textit{betting} on price fluctuations. If the bet goes wrong, the hedge fund, unlike the prudent farmer, stands to lose everything unless other bets have been made to offset the risk, each bet enmeshing the hedge fund in further offsetting gambles.\textsuperscript{151} Nasser Saber, a lecturer on derivative risks at New York University’s Institute of Finance and Banking and author of \textit{Speculative Capital and Derivatives},\textsuperscript{152} puts this clearly:

“In their modern incarnation, derivatives are the functional form that speculative capital assumes in the market. Finance textbooks are fond of beginning the discussion of derivatives with the reminder that futures existed in ancient Greece or in 16\textsuperscript{th} century Japan. This faux historicism fails to see that while the derivative structure, in the form of a bet, might be ancient, the function of derivatives as the tool of speculative capital is an entirely modern development.”\textsuperscript{153} Hedge funds do not hedge their bets merely to cover their costs (unlike the farmer seeking to ensure her costs of production): they hedge in order to accumulate. Moreover, their clients demand more than the run-of-the-mill “beta” returns achieved by conventional money market funds where the return on assets comes solely from the movement of prices in the market (so, if the asset is up 7% during a particular time period when the market is up 10%, “beta” is judged to be 0.7%).\textsuperscript{154} No, hedge funds are after “alpha” – the higher than market returns that (supposedly)\textsuperscript{155} come from active management; they are “alpha hunters for hire”.\textsuperscript{156} Their target is returns – typically 15-20% – that are uncorrelated to movements in the market. This is achieved by betting not only on the price of assets going up but also on them going down. The hedging undertaken by hedge funds is against under-performing on “alpha”, not “beta”, let alone against simply preserving the value of the initial portfolio. It is about insuring \textit{above}-market returns, not break-even or humdrum market tracking.
The speculative power of derivatives, the opportunities they provide for speculation, and the scale on which they are created and marketed has been greatly enhanced in recent years – to the point where modern derivative instruments, though by no means new in their basic structure, would be unrecognisable to Thales and previous generations of derivative traders. The *bricoleurs* have taken what was “at hand” – forwards, options, swaps and futures – and cross-linked the different instruments, embedding them within other contracts or financial vehicles and applying them to all sorts of different assets. Take conventional *bonds*, for example, which are securities issued by companies and governments in order to raise finance, the bond holder loaning money in return for an undertaking by the issuer to repay the amount initially loaned plus interest, known as the *coupon*, at a specified date in the future. Bonds have been reengineered into complex derivatives known as *structured notes*, the repayments to the bond holder no longer being paid on specific dates but instead on uncertain dates should specific events occur – a rise in the Nikkei (Japan’s stock exchange index) or a fall in US interest rates or, even the number of victories won by the Utah Jazz basketball team. Opportunities for speculation have been created that would not otherwise have been available, derivative traders betting on the likelihood of the linked event happening (or not) or the timeframe in which they might occur.

Another example is a simple *interest rates swap*, under which two parties exchange interest rate obligations, generally swapping a fixed rate for a floating rate obligation. Like bonds, these have been similarly restructured by derivative *bricoleurs* by linking their returns to highly complicated mathematical formulae that greatly increase profits if the bet goes well – but lead to skyrocketing losses if it doesn’t. One swap negotiated for Gibson Greetings, a US greeting cards manufacturer, entitled Gibson to be paid a fixed rate interest of 5.5 per cent in return for paying “a floating rate, squared and then divided by 6 per cent”. If the interest rate was 3 per cent, “then Gibson would be obligated to pay just one and half per cent (the maths was 3 times 3 divided by 6 per cent)” – bringing the company massive savings in its interest payments. But if interest rates increased, its losses increased exponentially. In the 1990s, many other companies were making similar highly geared interest rate swap bets, with some – such as Gibson and Proctor & Gamble, another US company – losing billions of dollars.

**Alphabetising the Derivatives: CDOs**

“[M]any new financial markets . . . essentially operate as bookmakers accepting differing bets on future prices. Underneath their technical names – monoline insurance, derivatives, debt securitisation – lies little more than bookee principles and practices.”

*Will Hutton*

*Chief Executive of the Work Foundation*

*27 January 2008*

Bonds and interest rate swaps are just two examples. The *bricoleurs* have taken other financial instruments, such as securitised assets, and restructured them so as to make high-risk investments appear low risk (see Box: “Questions and Answers”, pp.8-9). Key to this development was the creation of *collaterised debt obligations* or CDOs. A CDO is
a totally new derivative that, anecdote has it, emerged after a group of Bank of America’s mortgage securitisation experts met by chance in the office canteen with a group of the Bank’s derivative traders. By combining the securitisation of debt with another financial tool, structured finance (of which more below), the derivative bricoleurs devised a means of “magically creating value” out of otherwise low value or valueless products.

This is how it works. In a standard CDO, a financial institution – say a bank or a mortgage lender – bundles up high risk loans it has made with lower risk ones ("sub-prime" mortgages, for example, with "prime" ones) and sells the package of debt to a Special Purpose Vehicle (SPV), a company generally registered offshore that the financial institution controls. The SPV buys the debt by issuing bonds that entitle investors to the revenue stream from the loans. As a single package, the debt would be rated high risk, because it includes the “sub-prime” loans, and the bonds could not be sold to institutional investors, such as pension funds, which are prohibited from investing in bonds with a low credit rating.

In effect, the debt would be next to valueless to the SPV because no one would buy it – or, at the very least, of interest only to the most high-risk speculators. Ever resourceful, however, the bricoleurs overcame the problem by splitting (or “structuring”) the package of loans into tranches – the technique that constitutes structured finance. The bonds for the high risk “junior” tranches, known as “nuclear waste” because of their low credit rating, are sold to hedge funds and other investors who are not precluded from taking riskier investments; the supposedly low risk “senior” tranches, which get a higher credit rating, go to pension funds and other more risk-averse institutional investors. The parts can thus be sold for more than their sum: a high-risk package is transformed, through an act of financial alchemy, into an attractive investment. As derivatives expert and trader Satyajit Das comments:

“CDO tranching is the black art of dissimulation. Investors are told that they are getting access to a ‘diversified’ portfolio of credit risk and are promised highly customised credit risk. It’s all very clever spin.”

As a result of the creation of bricolaged debt vehicles such as CDOs, the liabilities of holding high-risk debt have been spread throughout the financial system. But if the loans underpinning these high-risk tranches of an SPV default (as “sub prime” mortgages did), the value of the other tranches will be affected as well. Investors (including pension funds, insurance companies, local councils, manufacturing companies and others on whom the public may rely for their livelihoods) may thus find their investments massively downgraded – as Swiss bank UBS found to its $50 billion cost when the triple-A-rated CDOs it held lost 30 per cent of their value in the wake of the credit crunch. And because of the global nature of modern markets, the collapse of any given SPV can affect investors all over the world. British and European pension holders are thus affected by the US “sub-prime” crisis as much as US pension holders.

Closely associated with the development of CDOs are credit default swaps (CDSs), derivatives that provide cover in the event that a loan or a bond defaults. Although often described as “insurance”, CDSs are not insurance in any sense that the mainstream insurance industry would understand. First, those who do the “insuring” frequently do not hold a licence and are unregulated under insurance rules (As
TUAC, the trades union body with representation at the Organisation for Economic Co-Operation and Development [OECD] notes: “The collapse of the US giant AIG was precipitated not by its core activities in the highly regulated life insurance business, but by ‘AIG Financial Products’, the derivative trading subsidiary that the parent company of AIG had set up in the late 1980s.” Second, the person buying the “insurance” often has no “insurable interest” in what is being insured. And, third, there is no duty on the person seeking the “insurance” to disclose all possible risks to the insurer.

CDSs are in effect bets on the credit-worthiness of a company. Under the most straightforward CDS, the issuer of a loan (let’s say a bank but it could equally well be a mortgage company or other lender) enters into a contract with an investor (often another bank or a hedge fund or a mortgage company) under which the investor agrees to indemnify the bank against losses on the loan in return for periodic payments. This enables the bank to shed the risk of the loan (in theory) while retaining it as an asset on its books. The investor takes on the bank’s risk – but gets paid for doing so. Whether the gamble turns out to have been worth taking depends on whether or not the loan goes into default. If the loan defaults, the investor has to pay the bank the value of the loan and in return gets the defaulted bonds or loans. The investor then hopes to recoup some of its losses by selling the defaulted loan to “vulture funds” (buyers of distressed debt) at a discounted price. But what happens when there are no buyers? In the case of Enron, the energy derivatives multinational that went spectacularly bankrupt in 2001, Citigroup used CDSs to raise $2.4 billion of protection on its loans to the company. When Enron went bust, Citi’s CDS counterparties were left with worthless Enron shares. Similarly, AIG collapsed in September 2008 when the credit crunch led to calls on the billions of dollars of CDSs that the insurer had issued. The US government stepped in with a $85 billion bail-out loan to rescue AIG, fearing that its bankruptcy would have a domino effect, placing trillions of dollars of CDS “insurance” at risk worldwide.

But it gets still more convoluted. The CDS market – which now forms the largest part of the credit derivatives market with an outstanding gross value of $62 trillion – does not just consist of such “plain vanilla” swaps. The bricoleurs have been at work to take advantage of a key difference between conventional insurance and the protection offered by CDSs. Unlike with a regular insurance policy, neither of the parties to a CDS is required to have a direct interest in the loan itself. So long as any two parties agree to a swap, they can enter into one – an analogy would be two people agreeing to insure someone else’s house. The bricoleurs have been quick to seize the opportunities this offers. Investors seeking to raise capital, for example, have bought CDSs to capture the “carry” (supposedly risk-free money) that can be earned by exploiting the difference between the cost of buying derivative-based “insurance” on a corporate bond and the interest that the bond itself pays out. Where the premium for a CDS is less than the interest paid by the bond, one investor recently told the Financial Times, “You can buy protection and hold no credit risk, while pocketing the difference between the cost of paying for protection and what the bond pays out.”

One default can trigger another in a domino effect that leads to financial meltdown, with profound social and economic implications globally.

When a securitised loan or bond goes into default, the ramifications are not restricted to the original lender and borrower, but extend throughout the financial system.
the loan itself many times over. Moreover, even these swaps have been *bricolaged* still further with increasing sophistication. Most are now linked to an index of a hundred or so selected companies: so long as the majority of these stay solvent, the CDO is profitable; but if more than a handful default, then “investors begin to take a hit on the coupon payments and sometimes their capital too”. A further refinement has been the creation of *synthetic CDOs* (now a mainstay of corporate finance) in which credit default swaps are themselves bundled together, as in a CDO, and then tranched and sold on.

Consequently, when a loan or bond now goes into default, the ramifications are not restricted simply to the original lender and borrower, as they would have been in a traditional banking system, but extend far and wide throughout the financial system. In 2004, for example, when the Michigan-based car parts manufacturer, Delphi, went bankrupt,

> “It wasn’t just lenders and bondholders who suffered. Their exposure was a mere $5.2 billion. Market participants had another $28 billion of notional exposure to Delphi embedded in scores of credit derivatives. That triggered pandemonium too, as the market tried to assess the residual value of those derivatives.”

The use of CDSs to hedge against the credit crunch threatens a similar debacle – but on a far deeper scale. With banks running into difficulties in the wake of the credit crunch, the volume of CDSs being bought and sold has greatly increased as the *bricoleurs* bet on which bank will be the next to go under. In the months following the bankruptcy of UK bank Northern Rock in September 2007, the volume of CDSs traded rose from a gross value of $721 billion in June 2007 to $2,002 billion in December 2007. The worry is that one default could trigger another in a domino effect that could lead to financial meltdown, with profound social and economic implications globally.

Thanks to derivatives’ *bricolage*, risk management no longer involves just avoiding risky investments: it has been transformed into a cynical game of pass the parcel in which almost any risk is acceptable so long as it can be “contained” by foisting it onto someone else. Indeed, it is above all the scale of *imposed* risks (risks of which the pension holders or company employees, whose livelihoods are actually gambled on, are unaware and which they had no opportunity to assess and to refuse) that differentiates earlier derivative trading from the computer-mediated, speculation-at-a-distance that modern derivative *bricoleurs* have engineered. Whatever speculation the prudent Iowa farmer or the bearded, fatherly figure of Thales might have engaged in, it is of a completely different order, riskiness, scale and motivation from that of their modern Wall Street counterparts. The new *bricoleurs* have not simply re-invented what was already there: they have re-engineered it to create entirely new forms of finance. The result has been a transformation of the credit industry from “a dull backwater into a financial market blockbuster”.

And to a frightening extent, it is the whole of society that bears the risk they have commodified and globalised.

**Creating a Derivatives Market**

> “[There is] an escalating cycle in which regulatory initiatives inspire financial innovations that trigger further regulations that in
The financial bricoleurs might have taken what was at hand to create their alphabetised instruments, as described above – but who was going to buy and sell them? And how? Once again, using what was around, they set about creating their market.

For many years, trading in financial derivatives such as options was outlawed in most countries. In Britain, options trading was banned in 1734, although the ban was not enforced, while the French government prohibited it in 1806. Outside of the major capitalist economies, the trade was also widely prohibited: post-independence India, for example, banned the use of options in 1956, a ban that was lifted only in 1995. Indeed, the world’s very first option on a futures contract was not traded until 1982, while the first currency swap (between IBM and the World Bank) took place in 1981.

In the USA, until the late 1970s, derivatives trading was considered gambling unless (as in the case of futures and forwards) “a futures contract could be settled by physical delivery of the underlying commodity, for example grain.” Investors were not permitted to buy securities entirely on credit – the essence of an option, which grants the right to purchase in the future in return for a small advance payment in the present – and short-selling (betting that equity and bond prices will fall) was constrained by law. It was not until 1970 that the New York International Commerce Exchange launched its first currency futures markets (it failed), and it took a further two years before the Chicago Mercantile Exchange’s International Monetary Market opened for business, with the passive acquiescence of the authorities. A year later, the Securities and Exchange Commission officially sanctioned the opening of the Chicago Board of Trade Option Exchange.

These new markets did not arise organically – as free market theory would dictate – to facilitate the supposedly obvious marriage between supply and demand. They were born out of active lobbying, nurtured through a period of near-death by calling in social favours, legitimised through alliances with academics and dependent on the engineering of demand for a product that few initially wanted. As ever, the bricoleurs used what was at hand: dinner-party colleagues, political contacts, ideologues for hire and the persuasive power of mutual back-scratching.

The story is elegantly related by sociologist Donald MacKenzie in his book *An Engine Not a Camera: How Financial Models Shape Markets*. Rather than directly challenging US laws against trading options, the early US derivative bricoleurs sought ways around them. Leo Melamed, a leading Chicago futures trader, realised that most options would not pass the “physical deliveries” test, but believed that currency futures might make it past the regulators, since currencies involved a “real cash settlement . . . a delivery process.” Backed by the Chicago Mercantile Exchange, which he chaired, Melamed began to plan for a currency futures exchange in the late 1960s. But Melamed recognised that he needed to build a “public interest” argument for options trading if he was to overcome the legislative and other...
difficulties in getting the market up and running. To obtain “the stamp of authority from someone who counts”, Melamed therefore arranged to meet the free market guru Milton Friedman over breakfast at New York’s Waldorf Astoria hotel on 13 November 1971. As MacKenzie reports:

“The Friedman was instantly enthusiastic: ‘He said, “That’s a terrific idea. It’s a wonderful idea. You must do this.”’ Melamed asked ‘if I [Friedman] would be willing to write a paper for them on the case’ for a currency futures exchange. Friedman replied ‘I’m a capitalist first,’ and I [Melamed] said, ‘How much?’ I immediately knew what he meant and he liked that. He liked that. He said ‘$5000’. I said, ‘It’s done,’ Just like that.”206

It proved to be money well spent. Armed with Friedman’s report, Leo Melamed went to see his political contacts in Washington, including George P. Schultz, then Secretary of the Treasury. Melamed told Schultz that the Mercantile Exchange’s plan for a new Exchange had the backing of Friedman. Schultz replied: “If it’s good enough for Milton, it’s good enough for me”.207 The Exchange was duly opened in May 1972.

Similar bricolage ad hoc alliances with academics served the Chicago Board of Trade equally well in efforts to overcome the regulatory obstacles to setting up an options market. When first proposed, in the late 1960s, the idea faced considerable hostility from established traders and officials at the Securities and Exchange Commission, the then chairman comparing options to “marijuana and Thalidomide”.208 Thwarted, the Board of Trade turned to an economics consultancy firm, which in turn sought out a group of financial economists who were commissioned to set out the “public interest” case for introducing options.209 The report, which argued that options were desirable because they extended the repertoire of strategies available to investors in the same way that an umbrella was a useful added accessory for pedestrians,210 was used to mobilise support, recruiting among others Milton Cohen, a lawyer who had the respect of the new head of the Securities and Exchange Commission. Following a meeting between the two men, the SEC agreed to issue the necessary permits for the Board of Trade’s Option Exchange to open.

But the bricolage did not end there. In the early days, there was little appetite for using the derivatives traded in the Mercantile Exchange’s International Monetary Market (IMM). “Once the novelty wore off”, one trader recalls, “the market liquidity completely dried up . . . For most of the day . . . we just sat around playing chess and backgammon.”211 Melamed, acting as, in his own words, “a one-man enforcer”, had to beg the Mercantile Exchange’s members to take part – “coercing, cajoling, admonishing, pleading” with traders to participate in order to ensure that the market remained liquid. “Everyone had to lend a hand”, Melamed subsequently wrote, “And for the most part, the floor responded to my pleas. These were, after all, my guys.”212 Melamed’s social networks would also be called fully into play in October 1987, when it looked as if the Exchange would go bankrupt after a spectacular crash in the US stock markets. Only a 7am telephone call to a colleague at Continental Illinois Bank (“Wilma, you’re not going to let a stinking couple of hundred million dollars cause the Merc to go down the tubes”) saved the day: Continental agreed to provide the Exchange with the money it needed to clear the outstanding trades from the previous day213 – with just three minutes to spare before the Exchange officially reopened for trading. As Melamed has subsequently reflected, a market is:

Price stabilisation, price discovery and risk mitigation are commonly cited as the “public goods” provided by derivative markets.

But this “public interest” case for derivatives ignores the ways that markets are affected by social or political influence.
“more than a bright idea. It takes planning, calculation, arm-twisting, and tenacity to get a market up and going. Even when it’s chugging along, it has to be cracked and pushed.”214

The social and political bricolage necessary to construct and maintain the US derivatives market – and the networks of power and influence that Melamed was able to tap into – are not merely of academic and historical interest. The “public interest” case for derivatives that Friedman and other free marketers have promoted – namely, that derivatives serve to stabilise markets by arbitraging away price differences215 and by enabling the mitigation of risk,216 the proof of their contribution to social welfare being the willingness of people to pay for them217 – rests on the assumption that markets operate entirely unaffected by social and political influence.218 Self-interest and self-interest alone, devoid of collective considerations, characterises the Homo economicus beloved of economic textbooks – and it is this self-interest, if given a free rein, that supposedly operates to everyone’s benefit.

Collective action by derivative traders to protect “their” market – evident in the way traders came to the aid of the Mercantile Exchange – is therefore something of a paradox. As MacKenzie notes:

“The very markets in which Homo economicus, the rational egoist, appears to thrive cannot be created (if they require the solution of collective action problems, as in Chicago) by Homines economici.”219

It is a paradox that strikes at the heart of free market theory. The derivatives market is revealed not as the outcome of the self-interested matching of seller and buyer, responding to the gradgrind laws of supply and demand, but as one of many “publics” whose rules, structures, daily practices220 and collective purpose are directed, in this instance, at its own continuation for the money-making benefit of its members. Its claim to represent the interests of the “public” writ large is exposed (if there was ever any doubt) to be as partial, self-serving and contestable as that of any other interest group. For activists outside financial markets who are affected by the activism of bricoleurs within markets, exposing the social networks to which the derivatives markets respond may thus provide a powerful tool for puncturing the public interest claims of free market theory – and indeed the theory itself.221

Seven (Unstated) Uses for a Derivative

Proponents of derivatives portray derivative traders as financial paramedics acting, through the invisible hand of the market, to staunch the damage done to the efficient allocation of capital (and hence, it is assumed, the general welfare of society) by market inefficiencies. Price stabilisation (achieved through using options to arbitrage away differences in the price of the same goods in different markets), price discovery (revealing what buyers are willing to pay for a particular commodity) and, above all, risk mitigation are the three commonly cited “public goods” provided by derivative markets.222

Market “inefficiencies” – principally arising from incomplete information – are held to result in different prices for the same commodities in different markets. The classic example is that of shares in oil company Royal Dutch/Shell, a single entity formed from two companies. For historic reasons, Shell was listed on the London Stock Exchange where its shares were traded; Royal Dutch’s shares, however, were
traded in Amsterdam where Royal Dutch was listed. Even though the
London shares and the Amsterdam shares both gave investors a por-
tion in the same dividend income stream from the overall Royal Dutch/
Shell group, the shares often traded at different prices in Amsterdam
and London. Traders could make tidy profits by selling Shell shares
high in London and using the money to buy Royal Dutch at a low price
in Amsterdam, netting a tidy profit when the Amsterdam share price
rose to London levels. Market theory dictates that such trades should
eventually lead to the two sets of prices equalising themselves, since
the value of the underpriced share will be driven up as arbitrageurs
seek to profit by buying low.

But the speculative, rent-seeking enabled by derivatives explains
why, despite arbitrage, prices do not equalise in the most profitable
trades. Derivative traders do not hang around to ensure, as good
economic paramedics would, that the prices have indeed stabilised – to
do so would be to lose out on the profit opportunities. They are con-
stantly on the move; and that very speculative shiftlessness creates
endless volatility that undermines their purported role as price stabilis-
ers. Indeed, without volatility, hedge funds would have nothing to
speculate on. It is their bread and butter. In that sense, the derivative
bricoleurs are ambulance chasers, not paramedics.

The claim that derivatives benefit society as a whole by allowing
better pricing and management of risk is equally flawed. Certainly, de-
rivatives are widely used to disperse risk – but this does not mean that
they necessarily benefit society or lead to more “efficient” markets.
Most derivatives, for example, are never priced through the market:
their valuation on the books or accounts of banks or in investor portfo-
lios is based on “complex mathematical models and other non-market
techniques”.

Moreover, the majority of derivatives are sold “over the counter”
(OTC) through private trades that never feature on any public exchange.
The prices reached are secret and therefore offer other investors little
information that would help them price risk. Nor, as apologists assume,
are the risks spread only to those, in the words of Alan Greenspan,
former Chair of the US Federal Reserve, “willing and presumably able
to bear them”. Many investors are simply ignorant of the risks – an
ignorance that traders have ruthlessly preyed upon. In this context,
“risk management” is just a euphemism for imposing risk on others,
without their knowledge or consent. In addition, as the recent crisis
makes clear, the pricing models cannot take account of the nature of
the risks they are imposing on the entire financial system.

Indeed, the driving force behind financial innovation in the deriva-
tives market has not been the prudent and socially responsible man-
agement of risk (assessing it, ensuring that it is not imposed on others
without their understanding and agreement, pricing it, reassessing
whether it justifiable and, if so, seeking to share the cost with equally
informed colleagues). On the contrary, what has driven innovation has
been the bricolaging of ways to disguise risk; to hide it; and to avoid
regulations that have been introduced specifically to control risk con-
tagion in financial markets. Moreover, that drive to evade regulation
is also reflected in the institutional form that derivative bricoleurs have
evolved to capitalise on derivative-based investment strategies: hedge
funds and private equity (see Box, “You Know a Hedge Fund When
You See It”, p. 35).

Seven examples of the bricolaging of specific derivative deals to
avoid regulation illustrate this point.

“Risk management” is a euphemism for imposing risk on
others, without their knowledge or consent.

The mathematical models used to price
“risk” cannot take account of the nature of the risks they
impose on the entire financial system.
Using What is at Hand – Permitting the Impermissible

In the early 1990s, Japanese investment regulations forbade insurance companies from investing in stocks and shares. Consequently, insurance companies were unable to cash in on the lucrative arbitrage opportunities available on the Nikkei, Japan’s stock market index, that traders were seizing and making millions by buying undervalued stock low and selling it high. As Frank Partnoy, a former investment banker and now Professor of Law at San Diego University, reports, the derivative *bricoleurs* had a solution:

“[US banking organisation] Bankers Trust came up with an ingenious solution, a kind of cross-continental *ménage a trois*, which gave the Japanese insurance companies exactly what they wanted, while addressing the needs of two other clients: Canadian banks and European investors.”

The Canadians would borrow yen from the Japanese insurers, in return for an option on the Nikkei 225 stock index. The insurers could not, legally, invest in stocks, but they were permitted to lend money, so the deal did not break Japanese regulations. To hedge against the risks for the Canadian clients, Bankers Trust sold the Canadians a further option that mirrored that sold to the Japanese – so, if the Nikkei went in a direction that resulted in losses for the Canadians, the second option (based on a bet in the other direction) would cover these losses. A third leg, in which European investors were sold options that covered the hedging option sold by the American Bankers Trust to the Canadians, completed the deal.

In effect, “a Nikkei 225 gamble was being passed from European investors to Bankers Trust to Canadian banks to Japanese insurance companies”. The Japanese insurance companies were thus enabled, via complex derivatives *bricolage*, to load up “with stock market bets they should not have been making”.

Japanese regulators and citizens discovered the deals only when the Nikkei crashed in the early 1990s, the deals having been hidden from the public because they were undertaken “over the counter” – and thus outside of official exchanges.

In the USA, *bricoleurs* seeking to speculate on commodities have also used derivatives – in the form of swaps – to bypass rules that limit the size of speculative positions on commodity markets. Rather than buying commodity futures directly on commodity exchanges, the *bricoleurs* place their bets through dealers who belong to the International Swaps and Derivatives Association (ISDA). Because the bets are offset by swaps, they are exempt from any limits on their size. In March 2008, nearly $9 out of every $10 of the money used to buy commodity futures through index funds was reportedly being placed using ISDA traders as a conduit. According to Michael Masters, a hedge fund manager, the effect of such *bricolage* has been to open “a loophole for unlimited speculation”.

Using What is at Hand – Disguising Risk

Structured notes – in which the payment on a bond is linked to another financial instrument or index – were one of the first derivative instruments to be *bricolaged* in the early 1990s. The team behind the notes was based at investment bank Credit Suisse First Boston (CSFB). One of the first structured notes involved a bond linking payment to the

The driving force behind financial innovation has not been the prudent and socially responsible management of risk...

...It has been to disguise and hide risk and to avoid regulations introduced to control contagion in financial markets.
relative rise and fall of the Thai baht against a basket of other currencies. The note was specifically designed to enable investors to evade rules that prevented certain investors – pension funds, for example – from speculating directly in Thai baht, since the trade was too risky. Issued by a top triple-A-rated bank, it “was a perfectly legal instrument, and it would look safe to a regulator, a shareholder, or even a boss . . . ” The structured note was bought widely by major mutual funds, insurance companies, pension funds and corporations, and its appearance encouraged others to issue similar notes of their own. By 1993, almost half of the medium-term borrowing of GE Capital (the financial arm of General Electric) consisted of structured notes: the company used the notes to borrow at a cheaper interest rate than it could borrow from a bank, the payouts being lower than the (then) interest rate. Shareholders in the banks and companies issuing structured notes were kept in the dark, despite their risks, because the US laws governing securities did not require disclosure. Many investors lost billions from such structured notes when the market for them collapsed in the early 1990s as it became clear just how risky they were, despite their triple-A-rated status. One – the treasury of Orange County, California – went bankrupt in 1994, while the Louisiana state pension fund lost $50 million and City Colleges of Chicago almost its entire portfolio of $96 million.

3. Using What is at Hand – Beating Basel

To safeguard against banks going bankrupt in the event of borrowers defaulting on their loans, banks are required under internationally-agreed banking rules – known as the Basel Accords – to set aside reserves equivalent to 8 per cent of their “risk-weighted” assets. Under the 1998 Basel rules – known as Basel I – all loans to the private sector carried a 100 per cent risk weighting – meaning that a bank had to set aside a minimum reserve of 8 per cent of the full value of the loan. For mortgages, however, which the international committee setting the rules deemed less risky (no kidding . . . ), the weighting was set lower – at 50 per cent. So the amount a bank had to set aside on a mortgage loan portfolio of £100 million would be 8 per cent of £50 million.

From the outset, the 8 per cent rule prompted “a drum beat of protest.” The bankers argued that the rule made no sense: some loans were so low risk as to be virtually “bullet proof” and the capital set aside against them could be put to better use if released. Lobbying by the banks resulted in more flexible weighting rules being adopted in 2004 – under the Basel II Accord – but the 8 per cent reserves requirement remained unchanged. The bricoleurs, however, had already devised financial instruments that could circumvent the new rule.

Their mechanism of choice has been securitisation, the banks moving loans “off balance sheet” by selling them to Special Purpose Vehicles (SPV) that the banks set up in offshore tax havens and whose shares they often sell on to others such as hedge funds. Typically, the SPV buys the loans by selling Collaterised Debt Obligations (CDOs); investors in CDOs buy the right to receive the interest from the loans (which have been tranched into high, medium and low risk segments) and any repayment of principal – but they do not buy the loans themselves (see pp.8ff and 17ff for further explanations). So long as the banks provide a legal opinion vouchsafing that the sale of the loans constitutes a “true sale” (a key test being that the banks and their
creditors do not have any recourse to the assets of the SPV), the banks no longer needed to put aside reserves against the loans. As for the SPVs, the Basel rules do not apply since such vehicles are almost entirely unregulated.

It has been openly admitted that CDOs were created primarily to evade the Basel rules. The American International Group (AIG), which went bankrupt in September 2008 as a direct result of the Credit Default Swaps (CDSs) it had issued, revealed in its 2007 financial report filed with the US Securities Exchange and Commission (SEC) that it had issued over US$300 billion worth of credit insurance to European banks “for the purpose of providing them with regulatory capital relief rather than risk mitigation in exchange for a minimum guaranteed fee”. Such CDSs have allowed European banks to borrow up to 50 times the value of their reserves.

Billions of dollars of bank loans – from “sub-prime” mortgages to credit card and corporate debt – have now been placed off balance sheet through SPVs and CDOs: Citibank alone is reported to have created about $100 billion worth of SPVs. Credit Default Swaps (CDSs) have also been used widely to “protect” any tranches of the CDOs that the banks have themselves bought. Evasion of regulation is also “the most powerful driver” behind securitisation in the insurance industry. The financial logic is simple. On a bundle of private sector loans worth, say, $1 billion, a bank would need to put aside $80 million in reserves (8% of the 100% weighted risk) if the loans were kept on the balance sheet. Once the loans have been shifted to an SPV, however, this figure is dramatically reduced. No capital needs to be kept in reserve against the loans because they no longer belong to the bank. The only capital that is required to be set aside is against the equity that the bank holds in the SPV – perhaps 2 per cent of the total loan portfolio value, translating into a $20 million reserve requirement. The difference – $60 million – can thus be released to make new loans. Moreover, the bank also gets repaid the value of the loans it has sold to the SPV, enabling new lending and thus more fees, fees . . . and (of course) bonuses.

The banks claimed that, through securitisation and CDOs, the credit risks of their loans have been shared more widely, thus reducing the risk to the financial system as a whole and to individual banks in particular. Critics respond that securitisation has primarily been about the banks reducing their capital requirements – and that there has generally been no commensurate reduction in their asset risk. The critics have been proved right. As the ongoing fallout from the credit crunch testifies, many of the highest credit risks have in fact remained with the banks. One reason is that it is the equity holders in the SPVs who take the “first hit” on any default on the loans underlying the CDOs that have been issued. And who often remain the SPVs’ main equity holders? Why, none other than . . . the banks.

Indeed, far from reducing risk, the banks’ bricolaged response to the Basel rules has massively increased the likelihood of a major economic depression by reducing the reserves that they should have set aside against the loans whose credit risks, despite all the talk to the contrary, they frequently retain.

4. Using What is at Hand – Avoiding Law Suits

Special Purpose Vehicles (SPVs) have not only proved vital tools in the bricolaging of new ways to evade regulation: they have also been

If a bank’s loans are shifted to a Special Purpose Vehicle, the bank does not need to keep reserves against them.

Circumventing international banking rules has massively increased the likelihood of a major economic depression.
critical to ensuring that banks escape legal liability to buyers of their derivative products. Following a number of lawsuits by disgruntled investors who claimed that they had been misled into buying derivatives (such as swaps) that they did not understand, the banks turned to SPVs as a way of protecting themselves against charges of making “unsuitable” sales, particularly where these sales involved deals of such complexity that the investors had arguably been kept in the dark as to their risks. Under US law, the bank might be held liable if it had failed to disclose key information to the buyer. By placing the SPV between the bank and the investor, however, the bank could disclaim responsibility for the swaps and other derivatives sold through SPVs. Instead of buying a swap directly from the bank, the buyer would purchase it from the SPV. As former investment banker and derivatives broker Frank Partnoy explains: “Economically, the bank was the seller, but on paper it was merely a swap counterparty to an [SPV], who was a swap counterparty to the buyer.” If the deal went sour, the banks could argue that there was no relationship between the buyer and the bank – and therefore no duty of care on the bank’s part.

5. **Using What is at Hand – Inflating Profits, Hiding Debt**

Derivatives have also proved a powerful tool for inflating company profits by hiding losses and hence the risks of company operations – practices directly undermining claims that derivatives improve market efficiency (see p.23ff). Taking advantage of particular accountancy rules, the now bankrupt US multinational Enron (which projected itself as an energy company – building power plants such as that at Dabhol in India but was in reality a derivatives trading company) used derivatives to make itself “look bigger and better than it was”. The trick lay in creating special purpose partnerships through which it was able to borrow money without the debt showing up on the company’s balance sheet – accountancy rules only required disclosure where Enron owned more than 50 per cent of the special purpose partnership. Any debt belonged to the partnership, not Enron, and “were disclosed only as footnote to Enron’s financial statements, not in the balance sheet.”

By hiding such debts, Enron was able to make itself look more profitable than it really was – keeping its share price and credit agency ratings high.

Enron also used over-the-counter (that is, unrecorded) derivative swaps to raise money without recording the debt, including borrowing some $8 billion from investment banks JP Morgan Chase and Citigroup through pre-paid swaps. On the face of it, the deals were straight loans – the banks agreed to pay Enron upfront in return for Enron repaying the money over time – but because the loans were wrapped in swaps, the accountants were able to keep them off the balance sheet. An email from a JP Morgan Chase employee was candid about their purpose: “Enron loves these deals because they are able to hide debt from their equity analysts ... they can bury it in their trading liabilities.” Partnoy reports that “when one Chase employee expressed surprise that Enron had billions of dollars of prepaid swaps, another employee wrote in response: ‘Shut up and delete the e-mail’”. When Enron collapsed in December 2001, it emerged that such “tools” – going under acronyms such as FELINE PRIDES (“Preferred Redeemable Increased Dividend Equity Securities” – don’t ask how the feline comes in) – were widespread within corporate finance. Other companies

**US multinational Enron projected itself as an energy company but was really a derivatives trading company.**

**By hiding its debts, Enron looked more profitable than it was, and so kept its share price and credit agency ratings high.**
using them included Kerr-McGee (the energy giant), Phillips Petroleuim and Duke Energy.  

Outside of the USA, derivatives have also been used to hide corporate losses and misrepresent the true financial position of companies. In Japan, investment bank Credit Suisse First Boston was hauled over the coals by the country’s Financial Supervisory Agency in 1999 for marketing derivative trading strategies to help banks conceal their losses. In Italy, the collapse of the Parmalat food company in 2003 revealed the extensive use of SPVs “to hide money that was being siphoned out of shareholders’ funds”. As the Financial Times reports:  

“Parmalat abused the capital markets for years by raising money under false pretences. Money was siphoned off for family purposes and the whole mess hidden in a complex structure of 200-plus subsidiaries and special purpose vehicles scattered across the globe, including tax havens such as the Cayman Islands, the Dutch Antilles and Cyprus.”  

So widespread has been the use of derivatives to “massage” the figures that, in the wake of the collapse of Enron, some 250 large US corporations had to restate their accounts.  

6. Using What is at Hand – Evading Maastricht  

Under the Maastricht criteria – introduced under the 1992 Maastricht Treaty on European Union (EU), which laid down rules for the introduction of the Euro – EU countries seeking to adopt the Euro as their currency are required to ensure that annual government borrowing is below 3 per cent of their GDP and that the ratio of government debt to GDP does not exceed 60 per cent. Under the EU’s so-called “Growth and Stability Pact”, these criteria must be maintained if the country is to remain in the eurozone. EU governments have thus turned to derivatives and securitisation as a means of both removing debt from the public accounts and of raising capital without increasing their official debt burden. Pension payments held by governments on behalf of former state employees, export credit agency debts and government real estate have all been put out to the market. In Germany, the government securitised post office and telecom workers’ pensions, raising $7 billion against the future income from the workers’ pension pot, a strategy that is also being followed by France. In Italy, the Treasury is busily securitisising the government’s vast real-estate holdings, “effectively trading future rent income for immediate cash”. In Greece, securitised “assets” have even included the future income from funds that Greece expects to receive under the European Union’s Community Support Framework and expected future dividends from the national lottery. Export credit agency (ECA) debt is one revenue stream that some governments have sought to securitise. SACE, for example, Italy’s ECA, has securitised $1.17 billion of debt owed by “emerging market” countries in Africa, the Caribbean, the Middle East, Asia, Eastern Europe and Latin America. Britain’s Export Credits Guarantee Department (ECGD), France’s COFACE, Germany’s Hermes and the USA’s ExIm
bank are also reported to be seeking to securitise $1 billion of Russian
debt, although this is denied by the ECGD. The deal, which was
reportedly postponed in July 2007 due to the credit crunch that followed
the collapse of the US sub-prime mortgage market, is expected to be
revived with a “significantly larger” portfolio: it would be the third of its
kind to be handled via a SovRisk, a vehicle especially set up for the
purpose.

For campaigners working to cancel illegitimate third world debt, such
securitisation of ECA debt is of considerable concern. As Francesco
Martone, formerly of Eurodad, the European debt campaign, points out,
by spreading risk, the claims that are transferred through securitisation
to Special Purpose Vehicles (SPVs) are often disposed of without in-
forming – and much less obtaining agreement from – the debtor coun-
try. Moreover, once transferred to an SPV, ownership of the debt be-
comes disbursed and it becomes difficult for the originating govern-
ment to restructure or cancel claims. Securitisation therefore runs the
risk of making it more difficult – if not outright impossible – to negotiate
a restructuring of debt payments in the event of a debtor country run-
ing into economic difficulties because of the loss of control over the
claims. Argentina has already experienced such difficulties when it
sought to renegotiate its debt repayments.

7. Using What is at Hand –
Circumventing Stock Market Rules

All major stock markets have rules requiring investors to declare what
is termed their “beneficial ownership” in a company – for example,
shares held on their behalf by a nominated proxy. The rules are in-
tended to “out” anyone who is secretly trying to acquire a company. In
the USA, nominee holdings over 5 per cent must be declared. In the
UK, the threshold is 3 per cent.

Derivatives known as “Contracts for Difference” (CFDs) – in
which the seller typically agrees to pay the buyer the difference be-
tween the current value of a share and its value on a specified date
– have been used widely to get around these rules, enabling companies
to build up undisclosed beneficial interests prior to making a takeover
bid. The bet is simply on the difference in the share price on two differ-
ent dates, so neither party need actually own shares. In practice,
however:

“The broker selling the CFDs will almost always seek to hedge its
position by buying shares in the company if the CFD holder is
betting on the share price going up or by borrowing stock if the
CFD holder is betting on it going down.”

If the CFD contract is settled through the physical exchange of shares,
its purchase must be declared. But if the settlement is paid in cash,
there is no such requirement. A predator company can therefore buy
CFDs to build up a “virtual position” in companies, without actually
purchasing the company’s shares itself. Such “virtual ownership”
gives the CFD holder considerable influence.

An example is the acquisition in 2004 by BAE Systems of Alvis, a
UK tank manufacturer, against a rival bid by General Dynamics:

“[H]edge funds holding a virtual position in Alvis persuaded BAE
Systems to announce a competing takeover for Alvis because
they were unhappy with the terms being offered by General
Dynamics. Despite not owning the underlying shares in Alvis, those
hedge funds gave Alvis irrevocable commitments to request

Securitisation of export credit agency debt makes it impossible for a
debtor country to renegotiate its repayments if it runs into difficulties – the agency no longer controls the debt.

Companies have used derivatives to get around stock market rules, enabling them to build up “virtual ownership” in a target company before making a takeover bid.
physical settlement of the CFDs. The hedge funds knew that the broker who sold the CFDs to them would tender the underlying Alvis shares (acquired by the brokers to hedge their position) in accordance with their clients’ wishes as the hedge funds, rather than the broker, had the economic exposure in the outcome of that bid.”

CFDs currently account for almost one third of UK equity trading. In Britain, they were first used by the construction conglomerate, Trafalgar House, in 1995 to build up a covert stake as part of its campaign to takeover Northern Electric. Since then, they have featured prominently in other takeover battles, including Joe Bloggs Jeans’s 2002 bid for men’s outfitter Moss Bros; millionaire retailer Philip Green’s abortive attempt to take over Marks and Spencer in 2004; and investment company Laxey Partners’ build up of a 22 per cent holding in Swiss building services company Implenia – a move that led to legal action by the Swiss regulators.

How long the CFD loophole will remain open, however, is questionable. New rules have been introduced in Australia to require disclosure of beneficial holdings via derivatives and the UK authorities are also recommending changes to the regulations. In the US, where the Securities and Exchange Commission (SEC) is resisting changes to the rules, a US Federal Court recently ruled that a British hedge fund, The Children’s Fund, should have disclosed its involvement with US railway operator CFX. The Court held that The Children’s Fund, which had built up a 14 per cent covert holding in CFX in preparation for a takeover bid, had used its equity swaps “as part of a plan or scheme to evade the reporting requirements” of US law. The ruling has left the US equity derivatives market in considerable confusion. More grist, no doubt, for the bricoleurs’ thrill.

Bricolaging Institutions: Private Equity and Hedge Funds

“Hedge funds were designed to loot shipwrecks.”

Karl Miller
senior partner
Miller, McConville, Christen, Hutchinsen & Waffel
June 2003

“Private equity funds have developed extreme forms of financialisation beyond the scrutiny of public stock markets, while hedge funds have invented new ways of speculating in everything related to the world of finance, day by day increasing the pace, volume and leverage of such speculation.”

International Trade Union Confederation
2007

The side-stepping, trampling and mince-meating of regulation are not restricted to the use of specific instruments – SPV, swaps, PRIDES or whatever. The institutional forms that the derivative bricoleurs have engineered to carry out their operations – hedge funds and private equity funds – have also been bricolaged with the evasion of regulation uppermost in mind. Under US law, companies that have fewer than 100 “beneficial owners” and that do not trade securities publicly are exempt from the majority of the legislation governing financial services. Hedge funds and private equity funds have taken advantage of...
“You Know a Hedge Fund When You See It”

Regulation requires regulators to know what they are regulating. Those who prefer to live and operate in the shadows, however, exploit their largely unregulated status to morph into whatever form best suits their immediate needs. They are understandably reluctant to be too precise about what they are and what they do. Hedge funds are no exception.

Small wonder, then, that the UK’s newly created Hedge Fund Standards Board – a body that should be able to define a hedge fund – is coy about doing so:

“You know a hedge fund when you see it”  

The International Monetary Fund noted almost a decade ago that:

“Defining and describing hedge funds is further complicated by the fact that other investors engage in many of the same practices. Individuals and some institutions buy stocks on margin. Commercial banks use leverage in the sense that a fractional-reserve banking system is a group of leveraged financial institutions whose total assets and liabilities are several times their capital. The proprietary trading desks of investment banks take positions, buy and sell derivatives, and alter their portfolios in the same manner as hedge funds. For all these reasons, any line between hedge funds and other institutional investors is increasingly arbitrary.”

The Financial Times has also pointed out the increasing use of hedging strategies by companies:

“Whereas companies once might have simply crossed their fingers, and ‘hoped’ that commodity prices, interest rates, foreign exchange or credit markets did not move in an adverse way, these days many companies are taking active steps to protect themselves from adverse events.”

Whatever their definition, hedge funds now control some $2.9 trillion in assets under management – one billion more than the 2007 level despite the credit crunch and some high profile bankruptcies. (A little over a decade ago (1996) hedge funds managed just $1.3 billion in assets. By the end of 2004, the figure stood at $1 trillion, and at the end of 2006, $1.5 trillion – if not more.)

To put the 2008 sum into perspective, $2.9 trillion is almost equivalent to the entire annual output of the United Kingdom, over 100 times the annual disbursements of the World Bank, and enough to meet the Millennium Development Goals’ entire projected budget several times over.

Although hedge funds were once two-bit organisations that operated on the fringes of Wall Street and the City of London (think Mickey Rourke’s arbitrage dealer in the 1986 Hollywood film 9 1/2 weeks), they have been billed as “the vanguard of a financial revolution”. In the decade from 1996 to 2006, the number of hedge funds grew from just 130 to an estimated 9,000 – a period that has also seen a ten-fold increase in their assets under management.

Among many hedge funds, the culture of doing business from home (or the beach), rather than from an office in the main financial districts, persists. In the USA, such is the profusion of ‘hedges’ around Greenwich, Connecticut, that the area has been dubbed “Upper Hedgistan”, with a further enclave in the Upper Eastside of New York (or “Lower Hedgistan” to insiders). Forty per cent of the world’s 351 funds, with more than $1 billion in assets, are based in one or other of these two locations.

In the UK, Hedgecity is centred on London’s Mayfair (notably the area around the old red light district of Shephards’ Market).

The first recorded “hedge fund” dates back to the 1940s, when a US investor, Alfred Jones, set up a fund to combine “long” and “short” positions – offsetting bets on the prices of some stocks and shares rising (“going long” in the jargon) with bets on other stocks falling (“going short”). Today, however, very few hedge funds actually hedge their positions.

Indeed, far from having a common, identifiable investment strategy, it is the diversity of their “market plays” that is most striking. Some combine long and short strategies; some invest long only; some focus on specific asset classes, such as stocks or bonds, while others have broader portfolios.

Moreover, these strategies are not exclusive to hedge funds. Many of the bigger investment and commercial banks now have hedge funds of their own or “are increasingly resembling hedge funds” or “have proprietary trading desks that are – in essence – internal hedge funds”. Barclays, for example, runs Barclays Global Investors, which is “among the world’s biggest hedge fund managers”, while Goldman Sachs itself is often said to be a big hedge fund dressed up as an investment bank.

Private equity firms, such as Blackstone, also have hedge fund divisions, or are part hedge fund, part private equity, like US group Cerberus Capital. Meanwhile, many companies listed on publicly traded stock exchanges have adopted hedge fund strategies to raise capital and “spread risk”. Enron, though often thought of as an energy company, was primarily a derivatives trading operation that used hedge fund style strategies.

Hedge funds initially drew their funds from High Net Worth Individuals – private investors with more than $1 million in liquid assets, excluding their home. But, as with hedge funds’ investment strategy, this is no longer a defining characteristic. Attracted by the high returns, pension funds have invested heavily in hedge funds, as have other institutional investors, notably university endowments – in 2007, Yale University had one quarter of its endowment money in hedge funds while Harvard University was also a major investor.

All this leaves just two features of hedge funds that most help in defining them. First – and most important of all – they are largely unregulated. And, second, they pay their managers huge fees. Indeed, Bill Gross, a bond fund manager at Pimco, a leading global investment management firm, is candid: hedge funds, he is reported as saying, are “a remuneration strategy, not an investment strategy.”
this loophole to evade reporting and registration requirements that, in common with much of corporate America, they deem onerous and time consuming. As “pooled, privately organised investment vehicles”, they are not required to register with the US Securities and Exchange Commission (although recent changes in the law have attempted to tighten up on this) and are exempt from having to disclose their financial dealings. Because their capital is drawn from “high net worth” individuals and institutions, which are deemed to be well enough versed in finance not to need protection, they are also exempt from the US Investment Company Act. Similar lax regulation applies in the UK.

The bricoleurs have also discovered the advantage of “taking companies private”. The majority of the biggest companies in the US and elsewhere are “public” companies – that is, they are listed on and trade their shares and securities through public stock exchanges. As such, they are subject to strict reporting and auditing requirements. Unlisted “private” companies, however, are not subject to most of the requirements of securities laws. In particular, they have no obligation to disclose financial information, other than a basic set of accounts. Private companies also avoid the more onerous corporate governance and accountancy requirements introduced in the USA in wake of Enron’s bankruptcy – notably through the 2002 Sarbanes-Oxley Act. Hedge funds and private equity funds have not only themselves adopted “private” status: they have de-listed companies they purchase in order to restructure them behind closed doors, without the scrutiny of shareholders or the broader market.

Such “regulatory arbitrage” brings added profit for the hedge funds, not least through fewer transaction costs. But it also places the public – particularly savers and pension holders – at greater risk and with fewer legal avenues for redress should things go wrong. Equally important, decision-making power is now concentrated in a handful of funds whose investment strategies are entirely beyond any form of public scrutiny or accountability. Just 9,000 hedge funds now account for 30 to 60 per cent of the daily global turnover in financial markets – deals which are not subject even to the minimum oversight that institutional shareholders provide for public companies – while private equity is presently involved in between one quarter and one half of all major mergers and acquisitions in the US and the UK – all behind closed doors. In the process, many of the strategies developed by human rights and environmental activities to influence corporate decision-making – shareholder resolutions, for example, or corporate social responsibility policies (many of which have teeth only because they are grounded in the reporting requirements for listed companies) – no longer have any purchase.

Bricolaging a Shadow Banking System

“The heroes of the past 20 years have been the financial market wizards, and all of a sudden it’s so obvious that the emperor has no clothes. The lionising of the money men was ‘ideology and special interests, cloaked in ideology’.”

Joseph Stiglitz
Nobel Prize economist
13 April 2008

The use of derivatives to avoid regulation, to offload risks and to tap the “liquidity factory” created through securitisation is now so widespread
A “shadow banking system” has emerged out of the interwoven deals and counter-deals to avoid regulation, offload risks and raise capital.

Derivatives and securitisation have massively shifted assets away from traditional banks towards hedge and private equity funds.

Many companies now look to hedge funds – not banks – to raise capital or to loan them money.

that the cumulative effect of the interwoven deals and counter-deals bricoleured by derivative traders has been the emergence of what the Financial Times has called a “shadow banking system.” Just as shanty towns grow unacknowledged on city maps by the authorities until they become so established that they can no longer be ignored, so the bricoleurs’ shadow banking system has grown higgledy-piggledy alongside the more formal financial architecture of established financial institutions such as banks and pension funds: everyone has known it exists but few have ventured to acknowledge its presence or power. Initially just tolerated, and occasionally clamped down on, it is now as much a feature of the landscape as the august facade of the Bank of England. Indeed, by 2007, the largely unregulated shadow banking system was estimated to be worth $5,900 billion, compared with $9,400 billion for regulated banking – “no minor appendage on the mainstream financial world”. Ironically, given the credit crunch and its aftermath, central banks have in many instances aided and abetted the development of the bricoleurs’ new financial shanty town: with the big banks’ balance sheets bloated with debt in the late 1970s and early 1980s, the central banks viewed the newcomers as a welcome means of spreading the risk and thus avoiding their greatest fear – a domino collapse of the bigger banks and forced nationalisation of the banking sector.

A “plethora of opaque institutions and vehicles” – from hedge funds to private equity funds – have thus been allowed to take root “untouched by regulation yet free to magically and mystically create and then package [high-risk] loans in [ways] that only Wall Street wizards [can] explain.” While their institutional focus differs – some invest long-term, some hedge, some invest for milliseconds – the new shadow bankers have one feature in common: they all use derivatives to generate the leveraged finance that has fuelled their growth over the past decade. The result has been a massive shift of assets away from traditional banks to new bricoleur-created institutions, with many companies – particularly those that are distressed – looking towards hedge funds, not banks, to raise capital or to loan them money directly. By 2007, for the first time in the history of banking, banks provided less than 50 per cent of the leveraged (or borrowed) finance sought by investors and companies – down from 95 per cent at the start of the decade. In 2007, non-bank institutions owned “just over 50 per cent of all lending to risky European companies – pushing banks into a minority role in this sector for the first time.” Hedge funds had even graduated to originating their own securitised credit derivatives – a practice that was, until recently, the exclusive province of banks. Indeed, as The Economist notes:

“The cosy, often inefficient, relations between its [Europe’s] banks and their corporate clients are being supplanted by cheaper, but more opportunistic, debt practices of the sort that fuelled the takeover boom in America in the 1980s. With investors searching for alternatives to low-yielding bonds and shares, buy-out merchants can raise astonishing sums astonishingly fast.”

Even after the credit crunch, which has dented the leveraging power of hedge funds, the shadow bankers still remain a first port of call for many distressed companies, including the banks themselves, with hedge funds proving a prime source of “rescue capital to prop up the ailing corporate world”. The experience has been described as borrowing “from the local thug with a baseball bat”.

Indeed, the derivatives market has proved so responsive to corporate
needs – and so lucrative\textsuperscript{342} – that the majority of corporate finance departments are now heavily immersed in derivatives trading in one form or another, either through hedge funds or on their own account. Nine out of every ten of the world’s top 500 companies use derivatives or one kind or another.\textsuperscript{343} In an indication of the extent to which derivatives are now a major source of finance for manufacturers, carmaker DaimlerChrysler has “earned half of its profits not from the sale of cars but from foreign currency trading”.\textsuperscript{344} Such corporate profits – as with Enron’s derivative-derived investments in the power generation and water sector – are now a major source of “portfolio” investment. Speculative capital can no longer be neatly divided off from “beneficial” portfolio capital.

Pension funds have also plunged into derivatives,\textsuperscript{345} investing heavily in private equity and hedge funds, while commercial banks have expanded their own proprietary derivatives trading operations to the point where many now more closely resemble investment banks than traditional lenders, making their money on arranging deals rather than taking deposits and originating loans. The World Bank, through its private sector arm the International Finance Corporation, is also involved, promoting (and investing in) the securitisation of “low income” group mortgages and other derivative products,\textsuperscript{346} while governments, export credit agencies, municipalities and a range of other institutions now routinely use currency derivatives and interest rate derivatives to hedge against volatility in the markets.\textsuperscript{347} Likewise, the Asian Development Bank now has $650 million invested in some 40 private equity funds (domiciled for the most part in tax havens or secrecy jurisdictions) despite an internal report revealing in 2007 that the Bank’s private equity holdings “breached its capital allocation limit for private equity funds of 5 per cent”.\textsuperscript{348}

Indeed, there are those who would argue “a type of ‘tipping point’ has been reached where the use of derivatives has become so prevalent that it is almost impossible for any investor to stay out of the fray.”\textsuperscript{349} As Professor Paul Merton, the Nobel laureate who jointly invented the formula currently most widely used for pricing options, comments: “Asking whether the world today wants to use derivatives or not is like asking whether we want to use cars. They are an integral part of the financial system”.\textsuperscript{350}

### Derivative Bricolage and “Financialisation”

The growth of the shadow banking system and the increasing role of derivatives within markets has profoundly changed relationships of power within the formal global economy. With growth in the financial sector now far outpacing growth in manufacturing in many western economies,\textsuperscript{351} and with companies increasingly reliant on derivative-based strategies for raising finance, the bricoleurs in hedge funds, investment banks and private equity funds have come to dominate decision-making in large areas of the economy – dictating, via the power they increasingly exert within markets, how companies organise themselves, what they invest in and how. Policies that increase returns to shareholders in the short term are pushed at the expense of long-term profitability; assets are no longer held but quickly securitised against their future income to raise lump sums to finance short-term growth; “value” is created for shareholders through mergers and acquisitions rather than increased production.\textsuperscript{352}
Such “financialisation” of the economy, as the International Trade Union Confederation notes, now means that “financial concerns, and those who voice them, are ever more influential in setting corporate strategies”. In effect, satisfying the needs of the “speculative economy” has become a driving force in shaping the behaviour of companies and in deciding which sectors of the economy receive finance. The impacts on the ground – for employees, for pensioners, for householders, for the sick and for those who livelihoods stand in the way of profit – have been profound. Two areas where derivative-based strategies of accumulation have been particularly evident in recent years – leveraged buyouts, and mergers and acquisitions – are illustrative:

**Leveraged Buyouts**

Enhancing the value of “undervalued” companies through leveraged buyouts – a specialty of private equity funds – has been a prime force driving the growth of financial markets in the past decade. Typically, a private equity fund will use derivatives to raise debt finance to take over “undervalued” companies, which it then de-lists from the stock exchange (if they are a publicly quoted company), strips of their non-core assets, closes non-profitable operations and sells the restructured company back onto the market, making large profits in the process. In 2005, the number of buy-out deals surged to 2,677 (with a value of about $326.5 billion), up from about 1,200 deals (worth about $108 billion) in 2002. In the following year, 2006, buy-outs in the USA alone hit $410 billion – a new record being set for a single deal by the buyout of the Texas utility company TXU for $45 billion. Although most deals took place in the US and Europe, the practice has spread, with a wave of such takeovers taking place in Argentina, Brazil, Japan and South Africa.

Cheap derivative-generated debt has been a key driver of this leveraged buyout boom. Because debt finance is tax-deductible, the private equity companies have been able to structure the deals so that they end up paying minimal tax on their profits – and sometimes no tax at all. Derivatives, such as Collaterised Debt Obligations, have enabled hedge funds to buy tranches of triple-A-rated debt cheaply, against which further loans can then be leveraged. The hedge funds (or the hedge fund departments of private equity companies) then provide the debt for the takeover, profiting along with the private equity funds when the company is sold back on to the market. The money made has tended to outstrip by far ordinary returns on investments. The Carlyle Group (one of the world’s top private equity firms that is now in trouble following the sub-prime collapse) made a return of 128 per cent after buying the Hertz car company in 2005, restructuring it and returning it to the market through an Initial Public Offering (IPO) a year later. Another top private equity firm, Blackstone, “made 368 per cent in just seven months on a quick-flip of Celanese, a German chemical company; and Bain Capital has earned more than four times their initial investment in Burger King while still retaining a share of the now re-listed company.”

Sectors in which buyouts have been prevalent include retailing (Boots, the UK chemist chain, being an example), health care (Hospital Corporation of America, HCA, the largest private hospital chain in the US being bought out in 2006), public utilities and defence (such as the purchase of US defence contractor IAP by Cerberus Capital Management).

For workers in the companies that fall prey to such buyouts, the consequences have often been dire. In the UK, 4,000 workers in Gate

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**Satisfying the needs of the speculative economy has become a driving force in corporate behaviour and in deciding which sectors of the economy receive finance.**

**The impacts on employees, pensioners, householders, the sick and those whose livelihoods stand in the way of profit have been profound.**

**Because debt finance is tax-deductible, private equity companies pay minimal or no tax on their profits.**
Gourmet, a catering firm that supplies airlines, lost their jobs after a buy out by TPG. Many of the workers were informed by text on their mobiles. In the case of Airwave, the company that provides the digital radio network for the emergency services in the UK, the new private equity owners announced that they were scrapping the existing, guaranteed benefits pension scheme within an hour of taking over. Subsidies captured through tax breaks also affect wider society, depriving the public exchequer of income that could be used to fund schools and hospitals and other public goods.

**Mergers and Acquisitions**

Derivative-based instruments – primarily equity swaps and debt swaps – have also played a critical role in facilitating the Mergers and Acquisitions (M&A) boom of the last two decades, generating huge profits for hedge fund speculators and huge fees for the banks that arranged the deals. The impacts of such M&A activity have been profound, concentrating market power in fewer and fewer hands – and driving corporate managers to adopt strategies that enhance short-term investor returns in an effort to avoid being the next M&A target.

The number of M&A deals sky-rocketed in recent years – from less than 200 a year worldwide in the early 1980s to over 40,000 a year in the late 1990s, US deals alone being valued at over $1.7 trillion. Although the trend declined briefly in the early 2000s, it picked up again soon after, with the number of mergers and acquisitions reaching $4.06 trillion in 2006, an increase of 36 per cent on 2005. Europe recorded a 47 per cent increase in 2005, with several high-profile deals – such as Italian bank UniCredito’s purchase of Germany’s HVB (HypoVereinsbank) for $18.6 billion – helping push volumes up to $463.5 billion. In the wake of the credit crunch, M&A deals have again declined – but are by no means over. Private equity groups (which have been among the biggest players in the market) still have “money burning a hole in their pockets”, having raised some $500 billion in 2007, and wealthy private investors continue to invest in private equity. Smaller companies or companies in the Asia-Pacific region are now favoured targets for buyouts.

Because over-the-counter derivative trades are not public, equity derivatives have proved a critical (and much used) tool for takeover bricoleurs, enabling them to circumvent, quite legally, stock market rules on the disclosure of “beneficial interests” in a company (see pp.30ff). Influence over a target company can therefore be built up by stealth. Derivative deals can also increase flexibility for the buyer in an M&A deal. For example, equity swaps, for example, feature prominently, both because they offer a lower cost means of acquiring holdings and because they enable the buyer to stagger the backdoor acquisition of shares while ensuring that the purchase will take place at a given price or following a given event (which may be critical to the acquisition strategy). Under such swaps, the predator company (or a hedge fund seeking to speculate on a takeover deal) buys rights to the income stream from the target company’s shares, which it then agrees to swap at an agreed date with a company that has actual ownership of the targeted shares. Where finance for the takeover involves syndicated loans or bridging finance, credit derivatives are also widely used to hedge against the credit risks. Oil giant BP made use of repackaged equity-linked derivatives in its 2003 acquisition of the Russian oil firm TNK.

Because over-the-counter derivative trades are not public, financiers have been able to use them to circumvent stock market rules when taking over a company.
and repackaging. But the social and economic consequences extend beyond additional Ferraris in the garages of investment bankers, or extra Krug champagne sales in the lap-dancing clubs favoured by city brokers. M&A deals have profoundly restructured power within markets, concentrating decision-making power and the control of assets. Market share in such industries as iron and agrochemicals is now concentrated in a handful of companies – with other sectors, such as pharmaceuticals and banking, tending in the same direction. The result, argues Steve Hannaford, author of Market Domination, is the emergence of new oligopolies, with fewer and fewer companies dividing up specific markets between them. Fearful that a rival may snap up remaining takeover targets, each new round of acquisitions encourages another, the power of the acquiring companies growing with each successful purchase. Hannaford illustrates the dangers:

“Take an industry like soybean processing. With essentially three global competitors, the industry leaders (Cargill, ADM, Bunge) have power over prices for feed, food, or chemicals (whether they illegally collude or not) and the costs (what they pay to farmers). These companies compete, but within certain levels of trust and mutual benefit, so that none of them is likely to engage in a price war.”

A further consequence of M&A deals has been the entrenching of a “short-term” culture within the investment community, where quick returns are favoured over improving long-term prospects. Speculation by hedge funds – betting on the prospects of M&A mergers – has been a critical factor in determining the outcome of many deals. The chief executive of the UK-Swiss mining giant Xstrata (the world’s biggest exporter of thermal coal and a company with a much criticised environmental record) has candidly admitted, for example, that its successful 2006 bid for Canadian copper and nickel miner Falconbridge was almost entirely the result of hedge fund backing: “The hedge funds – if they didn’t exist, we might not have won.” But, as the Toronto Globe and Mail commented on the deal:

“The prevalence and firepower of the hedgies and the arbs [arbitrageurs] makes a mockery of the term ‘investor’, at least in the classic sense of the term . . . Hedgies and arbs have absolutely no interest in long-term value. To them, long-term is the end of the quarter, when they have to show their clients returns that are high enough to justify their outrageous fees.”

The ruthless pursuit of such returns is reflected in the scant regard that hedge fund investors have historically shown for the environmental, human rights and development impacts of the companies they back. A case in point is the reaction of UK-based RAB Special Situations Company Ltd to the shooting of protestors against a planned open-pit coal mine in Phulbari, Bangladesh, being promoted by Global Coal Management (GCM), a company in which RAB then had a holding. Five people, including a 14-year-old boy, were killed and a further 100 injured. In its 2006 annual report, RAB stated:

“Sadly our two largest holdings, Oxus Gold and Global Coal Management (formerly Asia Energy, now GCM Resources) lost US$85 million . . . between them, due to extreme local political difficulties which can be judged by the fact that people were shot in both locations. We have bought more of both stocks and believe we will make good returns in the future . . .” (emphasis added).
Although M&A activity has declined dramatically since the credit crunch, it may well increase again as surviving banks snaffle up distressed former rivals — in the USA, Bank of America has already acquired Merrill Lynch, whilst in Europe Spain’s Santander has bought much of the UK’s bankrupt Bradford & Bingley (although the UK government has taken on the most toxic of Bradford & Bingley’s mortgage assets). Hedge funds and private equity are also “cannibalising” each other, as those who have funds seek to scoop up cash-strapped rivals. The result is likely to be still further concentration in the financial sector.

A Wall of Money – Impacts on the Ground

“When the capital development of a country becomes a byproduct of the activities of a casino, the job is likely to be ill done.”

John Maynard Keynes
1965

Financialisation – a direct political and economic outcome of the speculative success of the derivatives bricoleurs’ “shadow banking system” – has undoubtedly changed the landscape of market power in western economies. But it would be a grave mistake to conceive of the “speculative economy” as existing entirely separately from the “real economy” of manufacturing and services. The two feed off each other and are intimately entwined. Instruments that are vehicles for speculation to a hedge fund – securitised assets, for example, or an initial public offering (IPO) of shares when a company goes public – are also the means by which many “real world” companies raise capital, speculation often increasing their value and realising higher than expected finance. Likewise, by raising the price of given commodities, speculation in the commodity markets influences the choices made by companies on the ground: an oil field that was uneconomic to develop when oil was $20 a barrel may become financially viable if the oil price goes over $100 a barrel. And because the wall of money that derivative bricolage has generated must be “reinvested” if further profits are to be made, each new round of speculation profoundly affects the productive economy, providing finance to areas where hedge funds and other speculators gamble on the likelihood of high returns, while potentially starving others of funds.

Here are some examples from health care; mining and food; mills and dams; infrastructure; and climate and weather.

Securitisation and the Expansion of the Private Sector Health Care

Securitisation “works” (for those not left holding the toxic parcel when the music stops) because its structured tranches of debt (senior, mezzanine and junior) can be sold not only to hedge funds and other speculators seeking high-risk but high paying securities but also to pension funds seeking triple-A-rated investment grade bonds that pay above market returns (at least in theory). And because securitisation is specifically structured to appeal to both types of investors – risk averse and risk addicted – it has proved a powerful vehicle for raising capital to “grow” businesses. One rating agency alone, Standard & Poor’s, reports rating some £59.4 billion worth of European corporate securitisations in the eight years from 1998-2006, finance that was used

The “speculative economy” does not exist separately from the “real economy” of manufacturing and services.

Speculation in commodity markets raises the price of food, oil and timber and influences the choices made by companies in these sectors.
to fund private sector roads, hospitals, nursing homes, oil and gas development and airports. In the UK, corporate securitisations totalled £11 billion in 2005, 20 per cent of which was accounted for by a single transaction that securitised Scotia Gas Network’s gas supply in two regions of the country. The actual amount of money raised for the corporate sector through securitisation may, however, have been higher still, since many companies preferred to raise funds through securitising commercial property rather than using cash flows from their business or a given project (the strict meaning of “corporate securitisation”). Moreover, the use of securitisation is spreading, with $7 billion raised (including residential mortgages) in the “new” markets of Russia, Central Eastern Europe and the Middle East. And, in a new trend, securitisation is now being used to guarantee export credit loans, one Brazilian steel company reportedly using securitised receivables to back a loan by JBIC, the Japanese export credit agency.

In the health care sector, securitisation (justified as a means of “plugging the gaps in national health services”) enabled the UK’s largest operator of private hospitals, the General Healthcare Group, to raise £975 million in 2001. Capitalising on the decline of local authority care homes (due in large part to reduced public sector funding) and with the UK’s “ageing population” providing what Barclays refers to as a “positive effect on occupancy rates”, private health companies have also used securitisation to finance expansion in the care homes sector: almost one fifth of all private care homes in the UK are now funded through securitised future income streams. Private equity firms, such as The Blackstone Group and 3i, have recently made huge windfalls from selling their care home businesses – and others are now rushing into the market, with city analysts predicting a boom.

But while securitisation might provide easy finance, its speculative origins – built into its design – bring real risks of default, potentially putting some of society’s most vulnerable citizens at risk. In 2002, one major US private health care provider – National Century Financial Enterprises, Inc., which raised more that $4.8 billion using securitised healthcare receivables, primarily expected Medicare and Medicaid payments that were sold to hedge funds and other investors – went bankrupt on the back of a securitisation deal that went sour. Were such a bankruptcy to occur in the care home sector, the consequences for those living in care homes could be dire. Trade unions and organisations such as Help the Aged have also expressed concern over the low pay, inadequate training and long hours that are often a feature of care home jobs in the private sector. Patients who run into difficulties with paying the high fees for private homes – which now constitute 90 per cent of the care homes in the UK – could also face eviction, with none of the legal protections they would enjoy in a publicly funded home, the Human Rights Act only applying to government agencies.

Gambling on Commodities – Mining and Food
Securitisation is just one in a range of speculative derivative instruments that companies are now using to raise finance, not only in the North but also increasingly in the South. The speculative use of options to gamble on commodity prices has also proved a major mechanism through which “productive finance” that might otherwise not have been available has been ploughed into specific sectors. Hedge fund speculation, for example, is cited as playing a major role in fuelling the recent commodities boom, “exaggerating” (to use hedge fund tycoon George Soros’s phrase) the upswing in prices – and, latterly, the
As prices rose, metal producers cashed in on the boom to close new projects – from the Chukotka gold and silver mine in Russia (a deal arranged by Germany’s HVB and France’s Société Générale) to the San Christobel project in Bolivia (with investment banks Barclays Capital and BNP Paribas taking the lead). In agriculture, too, hedge funds – scenting huge profits in agriculture from “the fight to feed people, cattle and cars” – have contributed to rising prices of corn, soyabeans and tree crops, fuelling a rush by companies to buy or lease land and to invest in food production and biofuels, both seen as sure-fire alpha bets.

George Soros (whose philanthropic foundation, the Open Society Institute, is a major funder of non-governmental organisations) recently invested $900 million in ethanol production in Brazil, demanding that the United States and European Union open their markets for the biofuel produced. Other hedge fund managers are following his lead. The ethanol is produced from sugar cane, whose production is associated with widespread damage to rainforests, pesticide pollution and, in many areas of Brazil, the use of bonded labour.

With land values rising faster in the USA and elsewhere than property in London’s trendy Notting Hill, hedge funds and private equity are also pouring money into the purchase of land. In January 2007, Pergam Finance, a Paris-based hedge fund, announced that it would be doubling the size of a fund it manages to buy farms in South America, particularly Argentina. The $100 million fund, known as Campos Orientales, is to receive a shot of $60-80 million in further finance. In the USA, according to Bloomberg News, Hancock Agricultural Investment Group in Boston purchased $100 million of farmland in 2006, increasing its holdings by 13 percent to $865 million. Macquarie Bank, Australia’s largest securities firm, plans to spend as much as 1 billion Australian dollars, or $787 million, on ranches in Australia for a new agricultural fund. In Britain, a £100 million hedge fund was launched by Blackrock, one of the world’s largest asset management funds and at the time part owned by Merrill Lynch, with £1.3 trillion under management, to buy into wheat futures and to purchase farms.

Indeed, many analysts expect a substantial proportion of the $200 billion that flows annually into hedge funds to be shifted towards agriculture in the wake of the credit crunch. “The best bet going forward is agriculture”, Charles Gradante of the Henessee Group, told Commodity Risk magazine in 2008, “because it cannot be replaced by other by-products, but we can replace oil with solar or other products.” Others describe wheat as “the new gold”. Meanwhile, the speculation-driven rise in food prices has sparked food riots in Morocco, Yemen, Mexico, Guinea, Mauritania, Senegal and Uzbekistan, and forced the government of Pakistan to reintroduce food rationing. The World Food Programme’s supplies of emergency food aid have also dwindled to dangerously low levels because it is unable to afford to replenish its stocks.

Buying into Water, Mines, Timber and Dams

At the project level, the widespread use of derivatives is also acknowledged to have played a critical role in transforming many “hitherto marginal or unproductive projects into highly profitable concerns.” And although project finance (whereby a consortium syndicate makes loans to a project that is secured against the project itself but without rights of recourse to the assets of the companies developing it) remains the vehicle of choice of banks for financing new infrastructure projects.
Food Prices and Speculation

In May 2008, UK investment bank Schroders invited rich investors to put their money into a new fund aimed at making above market returns from agricultural commodities and companies. The same month, at least five people were shot during riots that erupted in Somalia over the soaring cost of basic foodstuffs; prices for rice, maize, sorghum and other cereals had risen by between 100 and 400 per cent over the previous year. One month earlier, in April 2008, food riots had left a swathe of wounded demonstrators, burnt out buses and cars, and smashed storefronts from Egypt to Haiti. According to the World Bank, rising food prices had left 100 million people around the world facing severe hunger.

The new fund – Schroder Alternative Solutions Agriculture – had been launched in October 2006 and already had $6 billion in assets under management. All the figures, Schroders argued, suggested that now was the time to invest in agriculture: demand for food was rising against a backdrop of “constrained” supplies; food reserves were at a 40-year low; the availability of arable land was “shrinking”; gains in yield were “fading out”; commodities were “under owned” as an asset class (just 856 funds investing in commodities compared to 36,366 investing in equities); and liquidity in the agricultural sector was “good”.

Other funds have also been promoting the investment potential of agriculture. Some, like the Schroder agriculture fund, are committed to a “long only” strategy (betting on prices going up) and make a point of stressing that they eschew “complex derivatives” (although “50–100 per cent” of the Schroder portfolio is allocated to commodities futures). Others, however, have adopted investment strategies that bet on prices going down as well as up, using one to hedge against the other. For such funds, volatility in the markets is a bonus.
the *bricoleurs* have been hard at work engineering hybrid packages that combine traditional project finance with derivative-based products, using the derivatives to “de-risk” the project finance loan portfolios of the arranging banks.335 Such hybrid finance has been used to fund water sector projects throughout Britain (through structured utility bonds) and road projects in Portugal (through securitisation of the project contracts). In 2007, the Franco-Belgian Dexia bank securitised a portfolio of infrastructure bonds to raise £1.4 billion from seven previously-financed Public Finance Initiative (PFI) projects and 21 electricity, water and other utility contracts. Although the original debt remained on Dexia’s balance sheet, the risk was “transferred” via two credit default swaps. The deal enabled Dexia “to free up its balance sheet for further activity” in the sector436 (and in September 2008, Dexia was bailed out by the Belgian, French and Luxembourg governments to keep it afloat).

Other examples of similar hybrid deals include Ireland’s Depfa Bank’s 2004 securitisation of its UK public-private-partnership infrastructure finance portfolio – a deal hailed as a “path-finder for future transactions” and “one small step for securitisation, a giant leap for project finance”.437

Recently, the HSBC Infrastructure Company (the first infrastructure fund to be listed on the London Stock Exchange) also fused “project finance” with “infrastructure fund-financed” funding to develop a new London office accommodation block for the Home Office.438 One infrastructure fund was used to build the building, while another (also backed by HSBC) bought the completed building. The bonds used to finance the project were guaranteed by Ambac Assurance.439

Speculative funds also make their way directly to mining companies through direct equity investment – examples being RAB Capital’s investments in Global Coal Management (see p.38) and in Cameco and Aflease, respectively Canadian and South African uranium miners.440 Hedge funds have also been active in buying bonds issued by gold mining companies and others in the minerals sector (almost $60 million of a 2003 convertible bond issue for gold mining company Durban Deep being bought by hedge funds441) or in making direct loans to companies. Recently, the Canadian mining company, TVI Pacific, negotiated a bridging loan for $15 million with the LIM Asia Arbitrage Fund and the LIM Asia Special Situations Master Fund.442 TVI is the operator of the controversial Canatuan sulphide project in the Philippines, which has been the site of long-standing protest by affected Subanon indigenous communities who charge violation of their human rights and the pillage of their sacred lands.443 In Indonesia, Abax Global Capital, a Hong Kong-based hedge fund, recently purchased $25 million in convertible bonds for a pulp mill in Kalamantan being developed by United Fiber Systems, and is reported to be considering the purchase of a further $200 million worth of structured notes for the project.444 The project, which threatens to cause widespread social and environmental impacts, including accelerated deforestation, had previously been refused finance by the World Bank’s MIGA (Multilateral Investment Guarantee Agency), OECD member export credit agencies and financial institutions such as Deutsche Bank and JP Morgan. Abax’s shareholders included North American pension funds and institutional and private investors from the USA, Italy, UK, France and Hong Kong, while investment banks Goldman Sachs and Merrill Lynch acted as its prime brokers.445

Private equity, too, is becoming increasingly involved in backing individual infrastructure, mining and other projects. In Uganda, the
private equity firm, The Blackstone Group, has invested in the controversial Bujagali dam, a project that has struggled to find finance in the face of strong local opposition. Blackstone will provide $110 million towards the $872 million project, which will be “spearheaded” by Sithe Global Power, a power development company that Blackstone owns. Barclays’ South African affiliate Absa Capital will act as a hedging bank for the project.

London-based private equity companies, boutique investment companies and hedge funds – such as RAB Capital, City Capital Corporation (3C) and CD Capital – have invested heavily in companies before they are listed on a stock exchange in an Initial Public Offering (IPO). CD Capital’s sector of choice is mining – investing “privately alongside owners of natural resource companies, when they are highly undervalued and then they either get listed or sold out via a trade sale to either the big caps, to the Chinese groups, Indian groups or whoever”. The IPOs that 3C have brought to issue have similarly involved mining companies, particularly in the Russian Far East, such as Highland Gold, but also what is now Russia’s largest timber processing company, Tynda Forest Holdings (now The Russian Timber Group), which exports logs to China and Japan, the two largest timber importing countries in the world. RAB Capital has also invested heavily in the mining sector. The deals have seen the offered companies’ coffers swell by millions of dollars.

Hedge funds and private equity will now be using derivatives and securitisation to finance infrastructure.

Infrastructure, Infrastructure, Infrastructure

The direct and indirect involvement of hedge funds and private equity in infrastructure development looks set to grow, as speculative capital “retreats to quality” in the wake of the sub-prime meltdown. The use of derivatives and securitisation in financing for infrastructure development has, to date, been largely focussed on infrastructure in the North. But the indications are that interest in their use is growing in the South. Whetting the appetite is a recent report by the Organisation for Economic Cooperation and Development (OECD), a club of the world’s largest free market countries, which predicts that annual investment requirements for telecommunications, road, rail, electricity and water taken together are likely to “total around an average of 2.5% of world gross domestic product (GDP)” until 2030; the figure is higher still (3.5%) if electricity generation and other energy-related infrastructure investments in oil, gas and coal are included; and even higher if account is taken of other infrastructure such as ports, airports and storage facilities. Already, massive schemes, such as the Plan Pueblo Panana, which aims to interlink the countries of Central America, are coming off the drawing board and seeking finance.

Unsurprisingly, investment bankers, hedge funds and private equity firms have scented new opportunities for profit. In 2007, 3i, the UK-based venture capital group, announced a strategic partnership with India’s India Infrastructure Finance Company (IIFC) to invest together in infrastructure projects on a case-by-case basis, with 3i providing equity and IIFC providing debt finance. The partnership with 3i followed an earlier announcement that the IIFC is setting up a separate $5 billion fund with Citigroup, Blackstone and another state-run organisation, the Infrastructure Development Finance Company. Specialist investor journals already list key slabs of Indian infrastructure considered ripe for possible takeover.

3i (which plans to invest $1 billion in Asia over the next three years) and Blackstone are just two private equity funds that are moving into
infrastructure finance; The Carlyle group, Kohlberg Kravis Roberts and Terra Firma are others. Attracted by the prospect of earning huge arrangement fees, the major investment banks are jostling to get on the bandwagon: indeed, by 2006, almost every large investment bank had raised – or was in the process of raising – an infrastructure fund. Pioneers in the field include specialist investment funds, such as Australia’s Macquarie bank (which now owns Thames Water, the UK’s biggest water company, and the UK national grid’s Wales & West Utilities gas distribution network) and Ontario Teachers Pension Plan, which have been buying up airports, water companies, roads and hospitals. Although Macquarie’s infrastructure funds have been hit by the credit crunch, the sector continues to attract investment, with many investors bricolaging their own vehicles to make direct investments in infrastructure projects, rather than buying a stake via a publicly-listed infrastructure fund (see Box: “Infrastructure Funds – Replacing Project Finance”, p.50.) The use of hedging and derivative-based financial vehicles (such as Credit Default Swaps and inflation swaps) have proved key to this new generation of infrastructure funding, which has already shown itself adept at bricolaging new hybrids forms of finance. In the UK, the new instruments build in particular on the experience gained in financing the 700-plus Private Finance Initiative (PFI) deals that have been signed by the UK government since 1994.

Carbon and Weather – New Sources of Alpha
Hedge funds have been involved in the nascent carbon market since it was first bricolaged together though the misplaced pragmatism of “the-market-is-the-only-game-in-town” green policy wonks and politicians fearful of the electoral impacts of adopting carbon-cutting policies. Indeed, a recent analysis by Citigroup places hedge funds as the biggest winner “by far” from the largest carbon market to date, the EU Emissions Trading Scheme (EU ETS) – with nuclear and coal companies coming second and electrical utilities third. Consumers were listed as the clear losers.

Today, the carbon market is being touted as the future Holy Grail of alpha returns. Some $12.5 billion is currently invested in carbon funds globally, with the largest fund to date (worth some $800 million) being managed by Climate Change Capital (CCC), a UK-based investment bank that focuses on carbon finance. Maik Neubauer, the chief operating office of the European Energy Exchange (EEX), set up to trade carbon credits, confidently predicted that the European ETS market will grow by at least 25 per cent a year from 2008-2012. In the US, banks and hedge funds are also piling in to the Chicago Climate Exchange. “They smell the coffee,” Peter Fusaro, chair of Global Change Associates Inc., a consulting firm, recently told Dow Jones’s Market Watch. “They’re going to make money doing this. Energy is a $4 trillion business and this is a great investment opportunity. You have two markets – developed countries and developing nations. That’s why there’s so much capital in this sector.” The coffee is still smelling enticingly good despite the credit crunch: in August 2008, Dow Jones Indexes and the Chicago Climate Exchange launched two new emissions indexes amid predictions that the carbon market would be worth more than $100 billion in 2008.

Speculation lies behind the dash to carbon trading – few energy traders believe the carbon market will do anything to tackle global warming.
Infrastructure Funds – Replacing Project Finance?

Brazil’s hydroelectric company Furnas Centrais Elétricas is now constructing a controversial $10 billion dam on Brazil’s Madeira River. ICA Panama is the owner of the Corredor Sur toll road in Panama City. Lima Airport Partners operates Peru’s Jorge Chavez airport. What do these three have in common (other than being involved in Latin American infrastructure)? Answer: they have all raised the money to expand their businesses (or to pay off their debts) by securitising the income streams from their existing assets (see pp.4, 8, 26) – in Furnas’s case, generating some $500 million in the process. Securitisation of infrastructure assets – road, dams, power plants, airports, ports, hospitals and schools – is big business – and, unlike mortgage securitisations, much of the market for “infrastructure” has (so far) remained relatively unscathed by the credit crunch (although there have been some casualties). Returns on investment are down, but many institutional investors, notably pension funds, continue to view infrastructure as a safe haven in troubled times. And, although the cost of borrowing has risen, bank lending within the infrastructure sector is still flowing, whereas it has all but frozen for asset classes such as real estate, private equity and retail. Fund managers are also reported to view the long-term outlook for “leveraging” infrastructure loans as “stable”, particularly in “areas such as water, waste water and energy regarded as low risk”. Unsurprisingly, perhaps, infrastructure has become “flavour of the month” for investors, with “infrastructure investment companies” storming the markets. The emergence of infrastructure as an “asset class” is relatively recent. Until the 1980s, governments were largely responsible for funding infrastructure investment. But, as governments have adopted (or been forced by the International Monetary Fund to adopt) “free market” policies, state spending has been slashed – and the private sector has taken an increasingly prominent role in infrastructure finance, either because nationalised industries (such as railways) have been privatised or because the private sector has been encouraged to build and develop infrastructure through “public–private partnerships”. The private sector now provides an estimated 22 per cent of global infrastructure finance, with official development programmes providing 8 per cent and national governments the rest. The use of derivatives and securitisation in financing for infrastructure development has, to date, been largely focussed on infrastructure in the North. But the indications are that interest in their use is growing in the South. Increased private sector involvement in infrastructure development has dramatically changed the nature of infrastructure financing, bringing in new actors and new financing mechanisms. As Piers Constable, a Director in the Structured Trade and Export Finance team at Deutsche Bank, notes: “Traditional (infrastructure) financing structures have been supplemented by a dazzling array of new techniques over recent years – private equity, credit default swaps, hedge funds and securitisations are now commonplace in infrastructure projects, along with local currency lending and Sharia’h compliant finance.”

To capitalise on the boom in private sector–financed infrastructure development, specialised infrastructure funds have emerged to enable investors to gain exposure to portfolios of infrastructure assets, such as shares in infrastructure companies or collateralised debt obligations (CDOs) issued on securitised infrastructure revenue flows. Such funds come in two forms: unlisted and listed.

- **Unlisted funds** are privately arranged, with investors directly approaching (or being approached by) companies to buy infrastructure securities.
- **Listed funds**, which were pioneered by Australia’s Macquarie Group, comprise a basket of different infrastructure investments – from roads to dams and airports – that are managed on behalf of investors, with the securities traded openly on public exchanges. Macquarie itself holds $174 billion in all the various infrastructure funds it manages.

Other examples of listed funds include:
- Goldman Sach’s $6,500 million Infrastructure Partners Fund;
- Citigroup’s $3,000 million Infrastructure Investors Fund;

of energy traders by the magazine *Energy Risk* revealed that few believe that the market would do anything to tackle global warming (they are right), while 40 per cent admitted that they foresee using the carbon market. Twenty-one per cent saw a huge scope to make money. To that end, the derivative *bricoleurs* are busy taking whatever profits are to be made – while the utilities whose emissions are supposed to be curbed by the market are *bricolaging* instruments that will cut the costs of compliance and ensure that, as far as possible, business continues as usual.
“Power generators emit CO₂ when generating electricity and therefore have to surrender allowances in respect of these emissions. As there is a link between the weather and levels of energy generation, and thus electricity generators’ obligation to surrender emissions allowances, trades may be structured in a way that combines carbon and weather derivatives. For example, power generators could enter into a temperature-based weather swap that would pay out in CO₂ allowances, which would allow them to satisfy any increased obligation to surrender emissions allowances that results from above normal power generation due to unexpectedly hot or cold weather conditions.”

Unsurprisingly, the weather derivatives market is enjoying a boom period, weather-specific hedge funds like Cumulus making returns of 25%

- The Carlyle Group’s $1,000 million Carlyle Infrastructure Fund; and
- 3i’s $1,200 million Indian Infrastructure Fund, which raised 20 per cent more than targeted, despite the credit crunch.

As of July 2008, over 70 private equity firms had launched infrastructure funds, with an aggregate value of $89 billion. Specialist funds have also been started to invest only in specific infrastructure developments – Canada’s Criterion Water Infrastructure Fund (“Tap into a Trillion Dollar Opportunity”) focuses exclusively on the water sector.

Institutional investors, such as pension funds, are attracted to infrastructure funds because they appear to offer steady, stable investments: returns are respectable and the funds provide a hedge against inflation because the revenue flows from securitised projects such as toll roads are inflation-linked.

Projections of worldwide “needs” for infrastructure investment, in both “developed” and “emerging” markets, have further encouraged investors into the sector. Worldwide, more than $34 billion was raised by infrastructure funds in 2007 – nearly double 2006’s level – and nearly seven times the $5.2 billion raised in 2005. The world’s 20 largest funds now have nearly $130 billion under management, 77 per cent of which was raised in 2006 and 2007. The total amount invested, however, is likely to be far higher, since many investments (particularly by pension funds and state-owned sovereign wealth funds) are unlisted. If leveraged – and recall that, as of September 2008, banks were still reportedly lending for infrastructure, despite the credit crunch – one billion dollars of equity funding could, in some situations, pay for up to $10 billion in projects.

Although listed funds have been declining in popularity since 2006 – reflecting, in part, investor resentment at the high fees charged and, in part, a preference for doing business outside of regulated exchanges and “all those pesky rules” – unlisted deals continue to prosper. The future of listed funds, however, which have been hard hit by the recent turmoil in the markets, is less certain.

An economic downturn in the US and Europe would certainly dampen the demand for infrastructure development in the North – but investors hope that continued growth in Asia and Latin America will keep infrastructure funds buoyant. Indeed, as infrastructure securitisation becomes more common in developing countries, some predict it will take over from project finance as the norm for funding projects. (Project finance involves funding projects through equity and debt, with the debt gradually being repaid from the project’s earnings. With securitisation, in contrast, the earnings are available in advance through their sale to investors.) Companies in Chile are already looking to securitisation rather than more complex project finance schemes to develop new dams and other power projects.

Securitisation is also being promoted in some quarters as a superior route for financing alternative energy projects.

With many governments, particularly in the North, likely to be strapped for cash in the wake of the credit crunch – not least because of the costs of bailing out or nationalising whole swathes of the “regulated” banking system – infrastructure funds could provide the private sector with the finance it needs to gain even greater control over infrastructure development. But note: the state will not lose its role entirely. Where projects are structured as public–private partnerships, governments (or rather a country’s taxpaying citizens) are likely to remain the ultimate guarantors of at least part of the revenues that are securitised, even if the guarantees do not feature on the government’s own balance sheet. And, in increasingly uncertain times, exporters are more likely to seek out export credit agencies for guarantees and insurance than they have been in recent years.

The use of derivatives and securitisation in financing infrastructure suggests that, for activists, the effectiveness of campaigns to democratisethe infrastructure investment might be enhanced by not only looking at who is in investing in specific projects but also at how those investing are raising the money in order to invest; how this influences where the money goes and how deals are structured; and how companies themselves are using securitisation and derivatives to raise capital, which then provides the leverage for yet more new projects.
per cent during 2007 despite the post-sub-prime credit crunch. UBS’s Global Warming Index (GWI) has enjoyed a return of over 40 per cent since its launch in May 2006, weather derivatives being viewed as an increasingly attractive “asset class” in a turbulent market.

But while money is certainly to be made from the carbon and weather markets – the bricoleurs already exploring the scope for super-hybrid derivatives, using carbon and weather to link markets – the public whose climate is being traded will derive few benefits. Far from being a solution to global warming, carbon trading perpetuates it – and even threatens to make it worse. As Kevin Smith of Carbon Trade Watch points out:

“The problem lies in the fact that carbon trading is designed with the express purpose of providing an opportunity for rich countries to delay making costly, structural changes towards low-carbon technologies. This isn’t a malfunction of the market or an unexpected by-product: this is what the market was designed to do.”

Instead of cutting emissions – the only means of reducing the risk of adverse climate change – tradable carbon credits grant the worst polluters the right to continue to pollute. Moreover, most of the carbon credits being sold to industrialised countries come from polluting projects, such as schemes that burn methane from coal mines or waste dumps, or from large-scale dams and monoculture tree plantations. They do little to wean the world off fossil fuels. In addition, many are associated with human rights abuses or with severe adverse environmental impacts. Yet it is these projects – and the polluting industries in the North that are perpetrated by them – that the huge sums now being generated by speculation in the carbon markets are financing.

**Bricolaging a “Policy Response”**

“Self-regulation stands in relation to regulation the way self-importance stands in relation to importance.”

*Willem Buiter*

*Professor of European Political Economy*

*London School of Economics*

*April 2008*

“Few industries at first glance appear more disconnected from the national security of the United States than does financial services. In reality, financial services are the foundation upon which all other economic functions and industries are built and rely . . . The financial services industry provides the underlying mechanisms that remove the nation’s wealth from under its figurative mattresses and allocates it across the breadth of the economic landscape to create growth . . . For the US, national wealth underwrites the nation’s ability to project power.”

*Industrial College of the Armed Forces,*  
*US National Defense University*

*2007*

As the credit crunch careers destructively through Wall Street and the City of London, with markets crashing and rebounding only to crash again, the uncertain search for survivors – “Are CDOs dead? Yes (*Financial Times*, 2 April 2008). No (*Financial Times*, 26 May 2008). Well, maybe (*Financial Times*, 31 May 2008). . . or, then again,
maybe not (Financial Times, 1 July 2008)⁵¹⁸ – is giving away to a realisation, even amongst the staunchest supporters of laissez-faire capitalism, that “The System” (with a capital ‘T’ and a capital ‘S’) cannot survive as it is.

In the lobby of the London office of investment bank Lehman Brothers, now in receivership, ex-employees have daubed parting messages on a giant photograph of Lehman’s CEO Dick Fuld, known on Wall Street as the “Gorilla”. Most are uncomplimentary and many tell of behaviour that redundant traders now regret. On the blogsphere, sneer and loathing are to be found in equal measure:

“I like dick fuld. He has all you idiots debating whether or not he is good or bad. He lost 650m. True. But over his tenure he made 450m+. dick will enjoy the rest of his life. Will you?”⁵¹⁹

“Put the people who wrote these loans in prison. Ban the investment bankers who sold their snake oil from working in financial services”⁵²⁰

“To all of the vindicative [sic] posts – what a bunch of useless drivel. Everyone keeps on talking about all of the ‘greed and corruption’ of Wall Street. Let’s get down to brass tacks, this whole crisis is the result of ‘middle’ America taking out loans that they couldn’t afford and buying houses and cars they had no right owning. That’s where the heart of this greed lies. Stop blaming Wall Street for your own inability to be fiscally responsible”⁵²¹

“This guy should be executed for high treason and fraud. What these CEO’s and the rest of their cronies are costing this country so he can have 4 multi million dollar homes is unimaginable”.⁵²²

Calls for regulation of the banking sector now dominate the airwaves and print media. In private, even the International Monetary Fund (which, if the crisis had unfolded in a developing country rather than the USA, would, on past form, have been using its iron fist to impose widespread deregulation, not least of the banking sector)⁵²³ is reported to favour the regulation of the sale of Credit Default Swaps (but not other derivatives) by shadow banks⁵²⁴ – a proposal that is as remarkable for its failure to take on board how limited and partial regulation is likely to encourage the very regulatory arbitrage that lies at the root of the current crisis⁵²⁵ as it is for its apparent break with IMF dogma. Others, such as the European Parliament’s Economic and Scientific Policy Department, propose forcing the originators of CDOs to retain some of the credit risk of the underlying loans⁵²⁶ (good idea – except that many banks never actually shed this credit risk, retaining it even though the loans had been placed off balance sheet . . . which is why they are now going bust).⁵²⁷ And still other proposals are striking less for their misconceived analysis than for their

**Depression Now . . .**

“[A]s the current credit turmoil now mutates into ever-more virulent forms, it is faith – or rather, the lack of it – that has turned a sub-prime squall into what is arguably the worst financial crisis in seven decades.”

Gillian Tett
*Financial Times*
March 2008 ⁵²⁸

**. . . and Then**

“I remember ’29 very well. We had it made (I didn’t but most people did). I remember the drugged and happy faces of people who built paper fortunes in stocks they couldn’t possibly have paid for. ‘I made ten grand in ten minutes today. Let’s see – that’s eighty thousand for the week.’

“In our little town bank presidents and track workers rushed to pay phones to call brokers. Everyone was a broker, more or less. At lunch hour, store clerks and stenographers munched sandwiches while they watched the stock boards and calculated their pyramiding fortunes. Their eyes had the look you see around the roulette table.

“I saw it sharply because I was on the outside, writing books no one would buy. I didn’t even have the margin to start my fortune. I saw the wild spending, the champagne and caviar through windows, smelled the heady perfumes on fur-draped ladies when they came warm and shining out of the theatres.

‘Then the bottom dropped out, and I could see that clearly too because I had been practicing for the Depression for a long time. I wasn’t involved with loss.’

‘I remember how the Big Boys, the men in the know, were interviewed and re-interviewed. Some of them bought space to reassure the crumbling millionaires: ‘It’s just a natural setback’; ‘Don’t be afraid – buy – keep buying’. Meanwhile the Big Boys sold and the market fell on its face.

‘Then came panic, and panic changed to dull shock. When the market fell, the factories, mines, and steelworks closed and then no one could buy anything, not even food. People walked about as if they had been slugged . . .

‘Then people remembered their little bank balances, the only certainties in a treacherous world. They rushed to draw the money out. There were fights and riots and lines of police-men. Some banks failed; rumors began to fly. Then frightened and angry people stormed the banks until the doors clanged shut.”

John Steinbeck
“A Primer of the ’30s
June 1960 ⁵²⁹
banality and sense of paralysis: who could dispute the need to strengthen “prudential oversight over capital, liquidity and risk management” – one of the main conclusions of the Institute of International Finance, the trade association for the UK’s financial services sector?

Nonetheless, a bricolaged package of (limited) reforms is slowly beginning to emerge amongst mainstream commentators. These reforms would include:

- **Requiring the financial sector to be more transparent**, not only about the risks inherent in new financial products but also about the risks held by banks and the sums set aside to cover them.\(^{530}\)

- **Bringing hedge funds and other shadow banks under the same regulatory umbrella as regulated banks.**\(^{531}\)

- **Requiring banks to hold larger capital reserves.**\(^{532}\)

- **Forcing the originators of collaterised debt obligations (CDOs) to hold some of their credit risk.**

- **Standardising derivatives** or, at the very least, reducing their complexity.

  “Excessive complexity is a significant source of lack of clarity. It is particularly damaging, as we have seen, to the originate-and-distribute model, because markets in complex securitised products may, at times, seize up, forcing central banks to become ‘market makers of last resort’, with all the difficulties this entails. One possibility then is to insist that all derivatives be traded on exchanges.”

  Martin Wolf, *Financial Times*\(^{533}\)

- **Changing the incentive structure within banks** so that bankers are not rewarded for taking high risks.

  “Simply put, the best way to prevent a recurrence of these systemic seizures . . . is once and for all to break this one-sided incentive system by cutting back banker pay and making a portion of it contingent on the longer-term outcome of their deals or trades. In effect, use a fraction of the excessive compensation to pay the premium on an insurance policy that will, hopefully, encourage less reckless behaviour.”

  William Cohan, financial commentator\(^{534}\)

- **Ensuring through international action that all countries adopt the same reforms**, in order to reduce the opportunity for regulatory arbitrage.

  “While the idea of a global financial regulator – or a global financial ‘sheriff’ – is for the time being a bit far-fetched, a much stronger degree of coordination of financial regulation and supervision policies is necessary to avoid a race to the bottom in financial regulation and supervision and to prevent excessive regulatory arbitrage. Such international coordination of financial policies is currently occurring on a very limited scale and will have to be seriously enhanced over time.”

  Nouriel Roubini
  New York University’s Stern School of Business\(^{535}\)

Quite an agenda. And, after two decades in which policymakers have systematically sought to **deregulate** markets, many, including proponents of free markets, have concluded that the “Age of Thatcherism and Reagonomics” are over, or at least waning.\(^{536}\) Certainly the wholesale nationalisation of the US mortgage sector in September 2008\(^{537}\) is a departure (to put it mildly) that, if it had been undertaken as premeditated policy, would indeed signal a sea change in US politics (one senator denounced the nationalisation as “un-American” and “financial socialism”\(^{538}\)). But there at least five reasons to be sceptical of claims...
that neoliberalism is in willing (or even unwilling) retreat.

First, no measures (beyond what has been necessary to rescue the banking sector from imminent collapse) and no regulatory reforms of any long-term significance have been taken by any of the major industrialised countries in the wake of the credit crunch. Short-selling of shares in banks has been (temporarily) banned to protect banks from the very instruments they have been promoting as essential to “price discovery”, but no similar bans have been instituted to protect ordinary people from the shorting of shares in the companies they work for. Little action has been taken to assist the vast numbers of people who go hungry because of speculation in foodstuffs, nor to protect mortgage holders from having their homes taken away from them. And, while steps have (rightly) been taken to protect those with deposits in banks, those with no savings remain at the mercy of the market. Meanwhile, hedge funds remain largely unregulated, and no measures have been taken to ban the use of more complex derivatives. Indeed, on present form, whatever wider new regulations are eventually introduced to rein in the financial sector – and there will be some – they are likely to be carefully crafted to ensure that the recent nationalisations that governments have undertaken do not threaten broader structural change in US and European society.

Second, calls for regulation should not be taken as inevitable harbingers of change. Deregulation is certainly a hallmark of neoliberalism – but so is regulation. Indeed, the free market “reforms” of the past twenty years have always been accompanied by regulation, designed more often than not to “lock in” neoliberal policy changes (the EU’s Maastricht Treaty is a case in point, making it illegal under European Union rules for member governments to borrow more than a fixed percentage of their Gross National Product; the World Trade Organisation’s General Agreement on Trade in Services [GATS] is another). The prospects that the regulatory fallout from the credit crunch will “reverse” neoliberalism, without accompanying social organising, should not be taken as inevitable, the more so when the proposed reforms are intended to “save” the free market – and, even, unashamedly, to “make Wall Street more profitable.”

Third, while blind faith in free markets may now be under question, the emphasis amongst mainstream policy makers is on “blind”. Despite isolated calls to “learn from our mistakes and act pragmatically to regulate markets as they exist in fact, not theory”, the proposed reforms are underpinned by the belief that markets are the most efficient means of distributing resources within society – and that economic actors, from bankers to consumers, act rationally in all their economic transactions. All that is required to prevent future “market turmoil” is to provide more information and a little more policing to catch those who break the rules. Yet, as Jeremy Grantham comments in the Financial Times, if the current crisis has shown anything, it is that “Efficient Market Theory” is a “complete illusion”. Economic actors do not always act rationally or assess risks for themselves: they follow the crowd, and try to keep in with colleagues and to clinch a deal.

Fourth, the financial services industry has powerful allies and, internationally, constitutes one of the best-organised political lobbies in existence. Regulation will undoubtedly follow the bail-out of the banks.
Without public pressure for the state to intervene in the economy in the public interest, politicians will not stand up to financiers’ demands.

If the financial system is not to trigger further meltdown, a different moral economy must prevail based on solidarity and prudence rather than greed and fear.

in the USA and Europe – but it is likely to be the weaker precisely because the bail-outs have been agreed in advance of the regulation. It is worth recalling that there were calls to regulate derivatives following the financial “blow up” of 1994 when many derivative contracts went sour after interest rates suddenly changed. For a while “everyone hated derivatives”\(^{548}\) but, after lobbying by the International Swaps and Derivatives Association and a recovery in the markets, regulatory pressure died away and the derivative bricoleurs went back to their old ways. Given that those being called in to advise on or draw up new regulations are often the very people who played a major role in creating or profiting from the derivatives and securitisations that lie behind the mess, the prospects for radical overhaul of the financial system would appear slim.\(^ {549}\) Moreover, with the private sector now financing much that the state used to finance (from railways to many previously state-run industries) – and securitisation being one of the principal ways in which they raise the funds to do so\(^ {550}\) – the bricoleurs have governments over something of a barrel: regulate us too hard and you will need to increase taxes to make up for what your new rules prevent us from raising on the capital markets. Absent public pressure on government for the state to take a more interventionist role in the economy, it will be a brave politician that resists such arguments.

Fifth, even if the proposed regulations were introduced, they are unlikely to contain the risks of future collapse in the absence of deeper structural changes within society more widely. Whatever new measures are introduced, the bricoleurs will seek a way around them – and engender new risks (and new profits) in the process. Moreover, the bricoleurs are currently better equipped to circumvent the rules than the regulators are to enforce them. As The Economist dryly notes:

“Naive faith in regulators’ powers creates ruinous false security. Financiers know more than regulators and their voices carry more weight in a boom. Banks can exploit the regulations’ inevitable blind spots.”\(^{551}\)

Moreover, talk of international action to close the loopholes that regulatory arbitrage exploits frequently ignores the profound constraints that neoliberal-inspired international regulations have already placed on the ability of national governments to act. Moves such as banning options trading in key commodities, which India introduced during the commodities boom of mid-2008, will not be available to many countries if current proposals under the latest round of the World Trade Organisation’s negotiations on the General Agreement on Trade in Services (GATS) go through.\(^{552}\) Given international organising, such agreements could be undone – but this is not even remotely on the official agenda for reform of the financial services industry. The obituaries of neoliberalism, it would seem, have not yet reached the World Trade Organisation.

If neoliberalism is indeed to be laid to rest – and risk in the financial system not to trigger further meltdown – the challenge surely goes beyond formulating new rules for the financial sector, necessary as this undoubtedly is. Where risk is viewed at a distance and reduced to number-crunching and complex mathematical models, the impacts of specific decisions on people and their lives and livelihoods are merely abstract. “Repopulating” risk assessment so that parties to a contract know through personal contact who will be affected by any given action and how brings a different view of risk – and builds a different moral economy to that which currently dominates finance, one based on a different calculus of what is acceptable and unacceptable. Greed
and fear are not given as the drivers for market behaviour as they have been – unless markets are organised to allow them to become so: solidarity and prudence are equally possible moral underpinnings. Those who make deals do not have to behave as sociopaths once they cross the threshold of their workplace: rooting economic behaviour in different social institutions and relationships could produce very different outcomes. Bankers know this, which is one reason why new recruits must be “socialised” into abandoning behaviour towards others that would be required in the outside world. The elaborate rituals and initiation rites that accompany bank training programmes – and which have been well described by ex-bankers⁵⁵⁴ – testify to the “unnaturalness” of the “Greed-is-Good”, “Big Swinging Dick” culture of today’s investment banks.

A Bricolage of our Own: Some Reflections for Activism

“Greed is what drives much of the modern financial world – combined with fear of getting sacked.”

Gillian Tett
Financial Times
March 2008⁵⁵⁴

Environmental and social justice activists may have different reactions to the emergence of the derivative bricoleurs’ shadow banking system and its unfolding collapse (and partial rebuilding) in the wake of the post-sub-prime credit crunch. Those who, like me, came late to SPVs, CDOs, FELINE PRIDES and the rest of the alphabetised jargon, arriving long after the bricoleurs had pieced together their new world of finance, undoubtedly have much to learn from others who were quicker to recognise the deep changes that derivatives have brought about within financial markets.

What follow are thus no more than initial reflections – in no particular order – prompted by what I have learned to date from my briefest of brief encounters with derivatives.

First, where activists (but also “ordinary” citizens) are willing to become “literate” in complex financial instruments, they may be in a stronger position to challenge some of the underpinnings of the financial sector. Financial literacy is not a pre-requisite for mounting such challenges – far from it – but it is a discipline that may help in enhancing effectiveness. As sociologist Donald MacKenzie puts it at the end of his “Philosophical Investigation into Enron”:

“[The] fate [of Enron’s employees] should . . . remind us that numbers matter. We need to understand how they are constructed, and perhaps to start to imagine ways in which they can be re-constructed to better ends.”⁵⁵⁵

Second, the construction of modern derivatives markets and their daily operation provide many insights into the clear disjuncture between free market theory and its practice. Revealing the social networks that underpin such markets and their influence on market behaviour might provide activists with powerful tools for unpicking many of the assumptions that underpin neoliberal theories of market efficiency. Building such arguments is often undervalued as a form of resistance – but it would seem to be a key task if free market theory is to be dislodged from its current hegemonic position and if the market is to be regulated...
on the basis of how it actually works rather than on how free marketeers say it works. There would seem to be much potential scope here for collaboration between activists and activist academics, building new networks that may assist in depriving free marketeers of a tool for claiming that their *bricolage* is in the “public interest”.

**Third**, unless policy reform is rooted in wider grassroots mobilisation for change, regulation of the financial sector (though a necessary task) will do little in and of itself to undermine the structures of power that the derivative *bricoleurs* have constructed through derivative trading. On the contrary, for the *bricoleurs*, each new regulation is a new opportunity for arbitrage and accumulation. This is not a reason for eschewing regulation. Far from it. But it is a reason for placing it in context, for recognising its limits and for prioritising movement-building that might contribute to deeper structural change – and which, alone, will create the political pressure to ensure that regulations are not weakened by the financial services industry or restricted just to measures that provide bail-outs for the banks. Opportunities for such movement-building include stronger linkages with those affected by the sub-prime fall-out, with communities affected by volatility in the commodity markets, and with those affected by the predatory actions of private equity and hedge funds.

**Fourth** (and closely related to the above), all of the institutions constructed by the derivative *bricoleurs* have their vulnerabilities. Many are financed by public institutions or public monies – pension funds, university endowments and municipal funds – which are potentially vulnerable to public pressure (albeit pressure that needs to take into account the changing rationale of public funding). Campaigns against the investments of such institutions in hedge funds and private equity could provide useful political space for those directly affected by the investments made. But, drawing on the experience of other campaigns directed at single institutions, hanging banners on yet another set of buildings will not in itself challenge the power of those within. Institution-focussed campaigns may shake financial power, embarrass it, even force it relocate elsewhere, but, unless they are geared to wider movement-building, their successes may prove short-lived or even Pyrrhic, trapping activists in years of restricted “engagement” that at best contains the most flagrant excesses of an institution and at worst enables its expansion. Yes, single hedge funds may be forced out of a specific investment. Yes, they may be forced to adopt environmental and human rights standards. But campaigns that are not rooted in a drive for wider institutional change – and that do not build new alliances among social movements – are unlikely to be able to move towards closing down the space for derivative *bricoleurs* to accumulate at the expense of wider society. Campaigns need to show how hedge fund activity is tied to the withdrawal of the state from pension provision,\(^56\) for instance, and private equity to growing inequality within society.

**Fifth**, the current credit crunch offers many opportunities that have not presented themselves to environmental and social justice movements for many decades. Reports of the death of neoliberalism may be exaggerated, but the so-called free market model is certainly now being questioned – even by many who for years have passively accepted it as “the only game in town”. Moreover, with the state having now nationalised a slew of failing banks and much of the US mortgage industry, the space to push for new forms of ownership and control over the provision of credit has been considerably increased. With Britain’s...
fifth largest bank, Northern Rock, now in state hands, is it simply to be patched up before being sold back to the private sector? Or are there other possibilities that could be pursued that would benefit society at large? If so, what form of governance might work best to ensure not simply public control but the exercise of that control for the public good? And how is the “public good” to be determined? What political processes might be nurtured to encourage debate and consensus building around what constitutes the “public interest”? Here again, possibilities for new alliances present themselves – for example, alliances with those at the grassroots who are building new forms of mutual societies and credit unions that offer the opportunity to build a shadow banking system rooted in a moral economy based on solidarity rather than “fear” and “greed” – a very different one from that constructed by the derivative *bricoleurs*. At the international level, too, the credit crisis has similarly opened up space for change, dramatically unsettling the balance of power in global markets – with institutions such as the International Monetary Fund playing second fiddle to state-owned sovereign wealth funds from China and the Middle East in the bail-outs that are being negotiated. How might that space be best used?

The *sixth* – and this may apply more to professionalised NGO activists like myself than to grassroots activists – is that there is much that can be learned from the activism of the Wall Street and City *bricoleurs* (yes, Wall Street and the City have their activists as well) that has so dramatically re-engineered the institutional landscape in which investors operate. For the derivatives revolution has not been achieved through “this year’s campaign” or mass- emailed letters to Ministers: it has come about primarily through the everyday actions of traders, whose *bricolaged* “successes” have been picked up and further developed by the networks within which they work. In itself, this provides important insights into the dynamics of change within markets – dynamics suggesting that critical responses to the derivatives’ revolution that rely primarily on “policy-oriented” tactics aimed at regulating what already exists may be far less effective in reclaiming markets for the public good than other everyday grassroots acts of *bricolage* aimed at constructing – and organising around – alternatives to “The Market”. Such acts of *bricolage* might include active solidarity with those seeking to develop (or to defend) social networks that share risk consensually, such as credit unions, where savers potentially have more direct control over what gets financed and how, or community-supported farms as alternatives to derivative-based hedging in agriculture, where farmers sell directly to community members, who provide the farmer with working capital in advance, thus lowering farmers’ risks and ensuring they receive better prices for their crops. Active solidarity with movements, such as those committed to defending the “commons”, would also be critical to constructing a moral economy in which no one has the right to accumulate at another’s expense but where all have a shared right to decent and dignified livelihoods. The *bricolage* of derivatives markets suggests that, far from being insufficient to leverage structural change, such grassroots activism and self-determination is, in practice, the primary organisational form that change is based on. Having the confidence to trust in the power of grassroots activism may well be the greatest challenge facing many professionalised – and often depoliticised – NGO activists. Grasping that nettle, with its organisational implications, may be the first act of *bricolaged* resistance that is required. The French have a word for that, too: *courage*. The financial crisis offers many unprecedented opportunities to environmental and social justice movements.
Notes and References

1. Export credit agencies are government bod- ies that use public money to provide compa- nies with insurance against the main com- mercial and political risks of operating abroad.

2. For more information, see:
   —Hawley, S., “Turning a Blind Eye: Cor- ruption and the UK Export Credits Guarante- ees Department”, The Corner House, June 2003, http://www.thecornerhouse.org.uk/item.shtml?x=5 2 0 0 7 ;

3. For more information, see ECAWatch: http://www.eca-watch.org/.


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10. Export credit agencies (ECAs) sometimes have internal limits on how much insurance or credit they can provide for exports to, or investments in, developing countries – their ‘risk exposure’ ceiling for each country. The ceiling placed by Atradius DSB, the Dutch ECA, on cover for Indonesia had been set by the Dutch government at €1.5 billion. After Atradius DSB decided in June 2004 and Feb- ruary 2006 to guarantee a total value of more than €1 billion of military exports to Indone- sia from a Dutch navy shipyard (Schelde Navale), it had little scope left to support other exports from The Netherlands to Indonesia because of the country risk exposure limit. Atradius DSB went on to reinsurance some of its Indonesian exposure on these military exports with other ECAs and private insurance companies, opening up more scope to support other Dutch exporters to Indonesia – but not enough. Thus the Dutch Ministry of Finance explored other options to reinsurance the export credit exposure in Indone- sia. In August 2008, it announced in a press release that it had used derivatives known as credit default swaps (CDSs, see page 171f and footnote YY of this brief- ing) to create an additional €210 million of cover for Dutch exports to Indonesia.

11. There is no exact translation of brickelage in English. Derived from the verb bricoler, the core meaning in French is to fiddle, to tinker with and, by extension, to “make creative and resourceful use of whatever materials are to hand (regardless of their original purpose)”. The original engineering meaning of “hacker” is a similar US American term. The closest equivalent in English is “do-it-yourself” (http://en.wikipedia.org/wiki/Bricolage). “Bricolage” was first used in a metaphorical sense by anthropologist Claude Levi-Strauss to describe the practice by which, he argued, myths are created. See: Lévi-Strauss, C., The Savage Mind, Weidenfeld and Nicolson, London, 1966.


13. “Steel Pans – 20th Century Percussion”, http://www.bbc.co.uk/dna/h2g2/A1297721. The use of such instruments dates back to the 1930s; prior to that, Jamaican rhythm bands used hollow bamboo drums.


Following the bursting of the Internet or “dot.com bubble” in 2001, interest rates were kept low and did not begin to rise again until 2005. Charles Goodhart, Emeritus Professor of Banking and Finance at the London School of Economics, notes: “After the bubble burst, there was a fear of deflation in the US. Moreover, there appeared to be a world glut of savings. These two factors prompted an expansionary mon- etary policies, with nominal interest rates at low levels and accelerated monetary growth in several countries… This pe- riod of low interest rates did not lead to higher inflation. Indeed, these years saw a continuation of what is known as the ‘great moderation’. Ever since the 1990s, the de- veloped countries, with the partial excep- tion of Japan, have enjoyed a golden age. Inflation has been low and growth steady with few, if any, cycles. This benign macro- economic picture led many to believe that financial conditions were less risk-prone than in the past.”

17. In the UK, the Financial Services Authority has been criticised for its “light regulatory touch” approach to derivatives. In the USA, Robert Weisman, editor of Multinational Monitor, has identified five regulatory fail- ures from a failure to manage the US trade deficit to unchecked financial deregulation – that have contributed to the global financial crisis that has followed the derivatives-fuelled mortgage meltdown in the US.

At the international level, criticism has also been levelled at the International Monetary Fund, which issued several warnings over the past decade about the systemic risks to world markets of hedge funds and their use of derivatives but failed to act on them – per- haps because of its own increasing marginalisation within the world’s financial system. As Yilmaz Akyuz, a former divisional Director of the UN Conference on Trade and Development, notes of the IMF in 2007: “The Fund is being marginalized in the provision of international liquidity to de- veloping countries. All major emerging market economies, except Turkey, have now paid in and exited from Fund supervision, leaving only the poorest countries as its only regular clientele – barely a strong ra- tionale for an institution established to safe- guard international monetary and financial stability.”

In 1999, the IMF warned: “A further concern is that no single national regulator can know the exposure of finan- cial intermediaries as a whole to hedge funds that obtain credit from international banks based in different countries. This problem arose with LTCM [Long Term Capital Management, the US-based hedge fund that collapsed in 1998], where U.S. regulators may have known the outlines of U.S. banks’ exposure and Swiss regulators may have been aware of the exposure of Swiss banks, but they did not know the exposure of one another’s banks and therefore the risks to the international financial system as a whole. This problem is generic, applying to all large borrowers, not just hedge funds; the generic solution is for bank supervisors to share information more systematically, as recommended by, among others, the Basle Committee in their Core Principles for Banking Supervision. Hedge funds differ from other borrowers in this respect only insofar as they tend to be highly leveraged, so that when things go wrong, they go very wrong.”

In 2006, the Forum on Financial Stability, an international group convened in 1999 to brings together national authorities respnsi- ble for financial stability, similarly alerted the leaders of the G7 and G20 countries and the Presidents of the World Bank and the IMF to the systemic risks of “large, unregu- lated and opaque institutions employing a high degree of leverage in financial markets – primarily hedge funds”. Little action – be- yond further reviews and data collecting and the publication of a voluntary guidelines (with which hedge funds are expected to “comply or explain”) – appears to have been taken. See: —Weisman, R., “Deregulation and the Fi- nancial Crisis”, Multinational Monitor Edi- tor’s Blog, 22 January 2008, http://


17. For definitions of derivatives and discussions, see:

According to Levison, (p.199): “The term derivatives refers to a large number of financial instruments, the value of which is based on, or derived from, the prices of securities, commodities, money or other external variables”. Similarly MacKenzie defines derivatives as: “An asset, such as a future or option, the value of which depends on the price of another underlying asset”. Philip Augar gives a wider definition: “financial contracts based on other financial assets” (p.75).

18. David Bowie “became the first songwriter in the world’s history to use derivatives to securitise future royalties from his own song catalog when he created “Bowie Bonds” in 1997. Bowie and his business manager, the Rascoff/Zysblat Organization, sold the royalty rights to his 25 pre-1990 albums to the Prudential Insurance Company. The singer/songwriter was able to pocket $55 million immediately, while Prudential received a 7.9 percent return on bonds that were backed by Bowie’s future royalty payments.”


Charles Garnsworthy of accountants PricewaterhouseCoopers defines securitisation as follows:
“... securitisation ... gives the investor rights to a flow of income or profits in exchange for a lump sum. It is a parcelling up of assets, liabilities or rights to a set of cashflows, into securities that can be traded in capital markets.”


For more on tax havens and secrecy jurisdictions, see Tax Justice Network: http://www.taxjustice.net.

22. As Satyajit Das, a world expert in derivatives, notes of credit derivatives: “Traders want credit to become like currencies – homogenous, standardised, tradable and liquid”. He adds, presciently, given the current credit crunch: “The problem is that credit risk is not like that. It partly operates as bookmakers accepting different bets on future prices. Underneath their repackaged debt”, Financial Times, 28 June 2007, http://search.ft.com/ftArticle/queryText=Tett%2B%22Does%2Bit%2Badd%2Bup%23%22&key=false&x=12&id=070628000751c&t=0.

23. Will Hutton, Chief Executive of the Work Foundation, comments: “Financiers have organised themselves so that actual or potential losses are picked up by somebody else – if not their clients, then the state – while profits are kept to themselves. An industry that socialises losses while privatising profit, and that has the capacity to create booms and busts alike, has to be as closely regulated as any utility.” He continues: “... many new financial markets... essentially operate as bookmakers accepting differing bets on future prices. Underneath their technical names – monoline insurance, derivatives, debt securitisation – lies little more than bookie principles and practices.”


There is a long-standing debate within the banking industry as to the legitimacy of the state intervening to save financial institutions in times of crisis. “Purists” argue against intervention on the grounds that it invites investors to take unwarranted risks, knowing they will be rescued; “pragmatists” (usually, as one insider has commented, “who people are in some way profiting from the current arrangements”) hold that, when the financial system is at risk, central banks should lend freely to financial institutions against good collateral and at a suitably high penalty rate. That said, the expectation that losses would be “socialised” – that is picked up by the state – have been encouraged by past bail-outs of failing financial institutions and markets. As Charles Goodhart, Emeritus Professor of Banking and Finance at the London School of Economics, notes: “... whenever financial markets in the US have weakened sharply over the previous 20 years – black Monday in October 1987; the housing crisis in 1992; the Asian crisis in 1997-98; or the bursting of the high-tech bubble at the end of 2001 – the Federal Reserve always moved in swiftly to prevent downturn spreading more widely into the economy. Whatever the truth of this assumption, there was a general belief among bankers that if a particular bank got into trouble, its difficulties would be seen as part of a systemic problem and hence the central bank would intervene, protecting them from losses.”

Such socialisation of risk and losses is arguably a central feature of “free” markets. See:

24. Derivatives spread risk by diffusing it, so that it is no longer concentrated in any one financial institution or group of institutions but among many. The assumption has been that such diffusion would make any shock to the financial system – through a major default, for example – easier to absorb, since it would not all fall on one bank or (where a loan had been syndicated) a group of banks. See: Tett, G., “Big Freeze part 1: How it began”, Financial Times, 3 August 2008, http://www.ft.com/cms/s/0/a09f751e-6187-11dd-a94-000077670658.html.

25. The Financial Times gives an example of the use of derivative-based instruments to “hedge” against rising fuel costs: “Take Stagecoach, the UK-based operator of bus and rail networks in the UK and the US. The company is a big buyer of ultra-low sulphur diesel, so needs to have some certainty about what fuel costs will be as prices keep rising. A Stagecoach wants to hedge 1m litres of fuel over a period of 12 months. The company will buy from a bank a fuel swap contract, under which Stagecoach commits itself to pay a fixed price per litre – say, 65p in current market conditions – over the life of the contract. In return, each month the bank will pay Stagecoach whatever the market price is for that fuel; whether higher or lower than the fixed price Stagecoach had committed to paying the bank initially. While Stagecoach may find that the actual price of fuel is sometimes lower than the price it committed itself to paying to the bank – say, 50p a litre – it can offset this by October 2008
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the reduced, at-market price of fuel it is required to pay to its fuel suppliers. Irre-
spective of whether the price goes up or down, Stagecoach thus pays 60 p a litre when everything is netted out.”

See: Grant, J., “Ways to turn volatility into opportunity”, Financial Times, Corporate Fi-


ft.com/cms/s/0/42827e50-a7fb-11dc-0000779e2340.html.

In the UK, hedge funds must register with the Financial Services Authority and are bound by its codes of market conduct (ban-

ning, for example, insider trading) but “en-

joy lighter regulation and considerably greater freedom of action than the investment com-


29. In the UK until the 1980s, most mortgage societies were, as Christopher Hird reports in Red Pepper, “mutual organisations, dedicated to providing mortgages and owned by the people who saved with and borrowed from them. They needed to make profits to stay in business, but, in the words they often used, they were ‘profit makers, not profit takers’.” In the 1980s, liberalisation of the banking sector allowed these mutual societies to turn themselves into banks owned by sharehold-

ers rather than those who saved in them. Hird cautions against being “dissy eyed” about mutual societies: “Over the years, they had become large managerial organisations in which much of the original democratic im-

pulse of their founders and constitutions had been lost. Their lending policies were exces-
sively conservative, discriminating against the unmarried and the working class.” How-

ever, as Hird notes, mutual organisations do offer the opportunity of a different form of busi-

ness model – one in which profit is not the driving force and that could develop dif-

ferent types of accountability and participa-


30. In the case of Abbey National, a UK mort-
gage lender structured as a mutual society, demutualisation led to the company cutting back on mortgage lending and ploughing huge sums into “wholesale finance”, lending heav-
ily to utilities, aircraft and train leasing, and supplying consumer credit. When Luqman

Arnold took over as Chief Executive in 2002, he found that the exposure of Abbey’s whole-

sale division “to toxic, high-risk bonds was so great that, if the world’s credit markets were squeezed, the bank would be technically insolvent.”


31. Quoted in Agarwal, J.D. and Agarwal, A., “Saving concepts in Derivative Instruments”, Paper presented to 7th International Confer-

ence of International Society for Intercommu-


32. Steve Hannaford, who focuses on the interaction between technology and business, writes: “Over the past twenty years, there has been an unprecedented series of mergers and ac-

quisitions across the world in almost every industry imaginable. For the most part, these deals are part of an attempt to domi-

nate a specific market. But instead of creating monopolies, which are subject to anti-

trust action (Microsoft, for example), the preferred strategy is an oligopoly, a situa-

tion in which a small number of companies divide up the market between them. Mar-

ket share in such varied industries as iron, brewing, agricultural chemicals, airplanes, semi-

conductors, and chocolate is concentrated into two, three, or four leading companies. Even more competitive industries (bank-

ing, insurance, pharmaceuticals, steel) are tending in the same direction.”

See: Hannaford, S., “Oligopolies: A Silent Take Over”, Ethical Corporation, 20 Febru-


33. Discussing the boom in infrastructure finance, Jay Collins, head of the public sector group at Citigroup Corporate and Investment Bank-

ing, notes: “Increasingly, transactions include credit enhancements, risk sharing facilities and bonds wrapped by monoline insurers, as well as layers of debt – junior, mezzanine and convertible – that are making financings more complicated but also more efficient.”

Collins notes, however, that, despite the in-

creasing use of new market-based financial instruments to fund infrastructure invest-

ments, “development banks can play a pivotal role in taking risk that the private sector is not yet ready to take.” He goes on to com-

ment: “Development banks can provide the missing element of a financing solution that makes a transaction ‘bankable’. Many coun-

try-specific development banks, such as BNDES in Brazil, are providing term ex-

tension, currency protection and even pur-

chasing layers of mezzanine debt that im-

prove project returns.”

See: Collins, J., “Policy posers for govern-


ft.com/cms/s/0/95f7ca74-62a0-11db-0000779e2340,dw_uuid=6d3a52e6378b11dc82-0000779e2340.html.

34. Financial Times journalist Peter Larsen writes: “Until a few years ago, most investment banks looked at the business of financing infrastructure projects as a bit of a backwa-

ter. Commonly known as a subset of project fi-

nance, this sector involved in taking risk that the private sector is not yet ready to take. Over the past twenty years, there has been an unprecedented series of mergers and ac-

quisitions across the world in almost every industry imaginable. For the most part, these deals are part of an attempt to domi-

nate a specific market. But instead of creating monopolies, which are subject to anti-

trust action (Microsoft, for example), the preferred strategy is an oligopoly, a situa-

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ket share in such varied industries as iron, brewing, agricultural chemicals, airplanes, semi-

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ing, insurance, pharmaceuticals, steel) are tending in the same direction.”

See: Hannaford, S., “Oligopolies: A Silent Take Over”, Ethical Corporation, 20 Febru-


35. Examples of private equity firms include The Carlyle Group, Kohlberg Kravis Roberts and Terra Firma. See: —Hughes, C., “The light at the end of the tunnel: infrastructure assets are creating a new breed of specialist investor”, Special Report: Corporate Finance, Financial Times, 24 Oc-

tober 2006, http://search.ft.com/0/article/queryText-ChrisHughes%3C%20b+Light+at+the+end+of+Tunnel+&pye&f sleeve=11ed%06102048024ctc=0&nclick_check=1;—Larsen, P.T., “Briefing notes on how infra-

structure finance works”, Special Report: Corporate Finance, Financial Times, 24 Oc-


36. Jay Collins, global head of the public sector group at Citigroup Corporate and Investment Banking, writes: “The last three years have witnessed an explosion in the amount of long-


ft.com/cms/s/0/3505686f-62a0-11db-8faa-0000779e2340.html?nclick_check=1;—Singh, K., Taking it Private: Consequences of the Global Growth of Private Equity, Pub-

term risk capital dedicated to global infrastructure.” He adds: “With some $15,000 billion of OECD pension funds being managed as a global trend and infrastructure as an asset class, even a few incremental percentage points of infrastructure allocation will give a further jolt of capital to this space.”

37. The default would be triggered if new legislation were to be passed that was unfriendly to the bond holder.

Dr. Andrew Chen (professor of finance at Southern Methodist University’s Cox School of Business) and Jennifer Warren Kubik (a Fellow of the Next Generation Project at Columbia University) argue: “Financial innovations in the securities offering can serve as both a deterrent and an incentive. For example, including event-risk provisions in project bonds can deter politicians’ attempts to make undesirable policy changes. This can ultimately foster a more investment-friendly environment, prized by many countries.”

They also note: “The experiences to date with privatizations and securitizations suggest that a ‘market finance’ approach, which creates immediate private ownership of public investment projects among diverse groups of investors, may lead to more efficient and successful infrastructure development. Current ‘contract finance’ approaches have lead to successful projects, but also spectacular failures which have occurred with waste considerable resources. The financing of projects should be guided by global capital markets’ invisible hand to determine the economic value of an infrastructure project and provide the necessary resources for construction, operation, and maintenance.”

38. The clauses being proposed echo the stabilisation clauses commonly included in investor-state agreements, under which governments agree to compensate investors if any changes in the law adversely affect their investment. For a discussion, see Hildyard, N. and Mutti, G. “Turboring-charging investor sovereignty: investment agreements and corporate colonialism”, in Focus on the Global South, Destroy and Profit: Wars, Disasters and Corporations, February 2006, http://www.thecornerhouse.org.uk/item.shtml?id=523529.


45. In 2006, the UK’s Centre for Economics and Business Research estimated that some 4,200 people working in the financial institutions that make up “the City” (London’s financial district) would receive bonuses of more than £1m. See: Teather, D, “The bonus bonanza”, The Guardian, 4 November 2006, http://www.guardian.co.uk/business/2006/nov/04/executives_salaries.businesscomment.


47. In 2005, the average pay package for the 24,000 people who worked for Goldman Sachs, one of the world’s largest investment banks, was $520,000. As an average, however, the figure is grossly misleading concerning the earnings of top management because the total salary figure includes pay to assistants and secretaries as well.


Hedge funds are estimated to contribute “$50 billion in fees and interest to Wall Street and City investment banks”.


52. Thomas: “[A] junior portfolio manager has a mean salary of $152,744 plus a $492,819 bonus. As senior trader’s salary comes in at $152,019 with a $431,275 to boot.”

53. Will Hutton, chief executive of the UK research consultancy, The Work Foundation, recalls a consultant friend who was hired to arbitrage over a performance bonus between a hedge fund and one of its asset managers.

54. Gasparino reported that some guy in Merrill Lynch’s fixed income research group had “inappropriately relieved” himself in protest of the downsizing of his bonus. Merrill has officially explained that this was simply an unfortunate accident, and then the bank turned red and scurried to the other side of the room. We’ve been digging into this story because the way it’s told by the delicate souls at CNBC, it’s way to vague. What’s worse, the vagueness is giving rise to rumors that are totally untrue. It’s fast becoming the Wall Street equivalent of an urban legend. Here’s what didn’t happen: a guy did not urinate on his desk because he was “pissed off.” The real story is so much worse. In the first place, it wasn’t piss. It was shit. Dealbreaker can confirm this much. After that the details get a bit fuzzy. The way we first heard it is that a guy took a dump in the rest room, stomped in it, and then dragged it all over the place by walking around with it on his shoes. Merrill’s story is that there was “an unfortunate accident” in one of the stalls—which we take to mean that some guy threw his shit all over the bathroom because how the Hell could you miss the toilet—and that another person inadvertently stepped in it and tracked it all over.”


57. Thomas notes: “[A] junior portfolio manager has a mean salary of $152,744 plus a $492,819 bonus. As senior trader’s salary comes in at $152,019 with a $431,275 to boot.”
In the USA, an estimated 14 million “sub-prime” mortgages were in foreclosure, and nearly 6 per cent past due date – both sharply higher than a year ago. For sub-prime mortgages, the numbers were 13 per cent in foreclosure and 20 per cent past due. House prices have much further to fall – maybe another 20 per cent, analysts say. That will kill many more borrows into negative equity and force the pace of foreclosures still higher.


56. "At the end of last year [2007], more than one in five of the roughly 3.6 million outstanding sub-prime adjustable-rate mortgages (ARMs) were seriously delinquent, meaning they were either in foreclosure or ninety days or more past due. That rate is about four times higher than it was in mid-2005, when it initiated roughly 1.2 million foreclosures last year, up from an average of 950,000 in the preceding two years. More than one-half of the foreclosures started in 2007 were on sub-prime mortgages.”

Tellingly, Bernanke and others use the language of “delinquency” to refer only to those who have problems paying their mortgages – not to those who sold them. The language used to criticise the mortgage industry, though sometimes harsh, has no criminal overtones: instead mortgage lenders are deemed to have been “irresponsible” or “imprudent”.


57. Financial Times journalist John Gapper points out that those selling and securitising the mortgages had “a vested interest” in the loan being unaffordable and the mortgage holder thus periodically being required to refinance a loan. “The risk had been securitised away and they gained another round of fees.” He also notes: “About 70 per cent of sub-prime loans were booked by brokers who had no fiduciary responsibility to the borrowers they advised.”


58. Ben Bernanke, Chair of the US Federal Reserve (the US Central Bank), stated: “At the end of last year [2007], more than one in five of the roughly 3.6 million outstanding sub-prime adjustable-rate mortgages (ARMs) were seriously delinquent, meaning they were either in foreclosure or ninety days or more past due. That rate is about four times higher than it was in mid-2005, when it initiated roughly 1.2 million foreclosures last year, up from an average of 950,000 in the preceding two years. More than one-half of the foreclosures started in 2007 were on sub-prime mortgages.”

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59. The figure represents more than one in ten of all US mortgages.


60. “In the fourth quarter of 2007, more than 2 per cent of the country’s 46m mortgages were in foreclosure, and nearly 6 per cent past due date – both sharply higher than a year ago. For sub-prime mortgages, the numbers were 13 per cent in foreclosure and 20 per cent past due. House prices have much further to fall – maybe another 20 per cent, analysts say. That will kill many more borrows into negative equity and force the pace of foreclosures still higher.”


61. Ben Bernanke, chair of the US Federal Reserve, cites data collected under the US Home Mortgage Disclosure Act (HMDA) which show that, for 2006, “more than 45 percent of high-cost first mortgages were originated by independent mortgage companies, which are institutions that are not regulated by the federal banking agencies and that sell almost all of the mortgages they originate”.


62. Martin Eakes, chief executive of Self-Help, a US credit union, quoted in Gapper, J., “The wrong way to lend to the poor”, 19 March 2007, Financial Times, http://search.ft.com/ftArticle?queryText=The+wrong+way+to+lend+to+the+poor+&dateSlider=1&date1=1371703603&ct=0. About 80 per cent of the loans to Afro-Americans were ARMs – adjustable-rate mortgages – rather than fixed rate mortgages: the initial rates were set low to encourage the mortgage holder to take out the mortgage, but the rates subsequently went up – a rise that those in debt were encouraged to cover by taking out new loans.


Pension funds are estimated to constitute around 30 per cent of the investor base of hedge funds, attracted by the high returns and as a strategy for diversifying their holdings. Moreover, as Callari reports: “Governments are also increasingly investing their pension programme money in hedge funds. In the United States for example, the Securities and Exchange Commission (SEC) reports that about 20% of corporate and public pension funds were using hedge funds in 2002, up from 15% in 2001, and the trend is rising.”

In effect, “millions of people worldwide, both working and retired, had money invested in hedge funds and might not even know it.”


65. In June 2008, the Californian City of Vallejo had a £8.7 million hole in its budget and was unable to pay salaries of its police and firefighters or provide care for its senior citizens. There have been allegations, however, that the decision to declare the City bankrupt was politically-motivated. As The Guardian reports: “According to the police union, Vallejo’s bankruptcy is a play to dodge members out of money. Only with permission from a bankruptcy judge can Vallejo break its pay contracts. Mat Mustard, vice-chairman of the Vallejo Police Officers’ Association, says his members have made $10 million in salary concessions over six years. ‘This bankruptcy has nothing to do with financing. This bankruptcy has to do with breaking union contracts and obligates the city to has its employees,’” Clark, A., “A sign of the times in Bankruptcyville, USA”, The Guardian, 14 June 2008, http://www.guardian.co.uk/business/2008/jun/14/sub-primecrisis.usconomy.

The foreclosure of mortgages has major cost implications for municipal authorities, not only because of falling revenue from property taxes but also because of the additional bureaucratic and policing burden that serving notices on defaulting homeowners and protecting empty houses entails. A 2005 study found that the services of more than a dozen municipal agencies may be called up in each foreclosure, generating direct municipal costs that in some cases “exceed $30,000 per property.”


66. Associated Press put Jefferson County’s debt at $3.2 billion. As of September 2008, the county’s financial crisis had still to be resolved, making it one of the most indebted municipal governments in the US, owing an estimated $7,000 (£4,550) for every adult and child. As Financial Times journalists aline van Duyn and Gillian Tett reported in April 2008: “In recent years it took advantage of easy lending conditions in the municipal bond market, mainly to fix its ailing sewerage system. But since the credit crunch started last summer, funding costs have soared and investors have been less willing to lend. The county is now struggling to make its interest payments. If it cannot reach some kind of agreement with its lenders in the coming weeks, Jefferson could become the site of the largest municipal bankruptcy seen in the US – overshadowing even California’s Orange County fiasco from the 1990s.”


In 2006, Schiff predicted that the US mortgage bubble would burst. Nicknamed "Dr Doom" by CNBC (the US's Consumer News and Business Channel), he is author of "Crashproof: How to profit from the coming economic collapse". He is not alone in forecasting hard times ahead. In an unguarded moment last August 2008, the UK's Chancellor of the Exchequer, Alistair Darling, described the current credit crunch as "the worst economic crisis for 60 years" – a view which the US subsequently sought to downplay, but which has since turned out to be an understatement.


69. "Respectable, well-established banks are refusing to lend to each other for short periods unless rewarded with super-high interest rates. They have stopped trusting each other.

The reasons is that they realise that there is some £500 billion of bad debt somewhere in the system, but they don't know where it is."

See: Whittam-Smith, A., "There is a storm brewing – and it's coming this way", The Independent, 10 September 2007, http://findarticles.com/p/articles/mi_qa4158/is_20070910/ai_19513875.

70. For an interactive video explanation of how mortgage defaults in the US evolved into a global credit crunch, see: http://media.ft.com/cms/s/0/cb7a3f6e-d6f1-11dc-b8a8-000779d2ac22c5wflw.


72. Liquidity is a hard-to-define but commonly used term: "There is no universally agreed definition of this concept; best is to say you know it when you see it."

"(Full Session), The Economist, 6 January 2007, p.10) The economic definition refers to the ease with which an asset can be sold for cash at the expected price without causing any significant change in the asset's price. The term is often used simply to mean cash. Central banks (which hold official reserves) can increase the liquidity of the whole banking system's balance sheet by lending it more cash. The term has also come to be used as "a catch-all phrase to denote, variously, loose central bank policy rates, broad money supply growth, aggressive lending to private equity, yen borrowing and even the growth of debt derivative products". Concludes the Financial Times: "liquidity in its first, narrow, definition is an important economic concept. But in its more fashionable second usage, liquidity is too . . . wishy-washy to be useful" ("Defining Liquidity", Financial Times, 10 August 2007, see also "When the Rivers Run Dry: Can Bank Regulators and Central Banks Prevent Future Liquidity Crises?" The Economist, 8 March 2008).

73. For an account of the Northern Rock bankrupcy and subsequent takeover by the UK government, see: Brunner, A., The Crunch: The Scandal of Northern Rock and the Escalating Credit Crisis, Random House, 2008.


75. The biggest losses were at Citi, which has written down $556.5 billion since the beginning of 2007. Merrill Lynch came next with $51.8 billion, followed by Morgan Stanley ($44.1 billion); J.P. Morgan ($12.8 billion); Goldman Sachs ($3.8 billion) and Bear Stearns ($2.2 billion). See: Gapper, J., "Big Freeze part 2: Banking", Financial Times, 4 August 2008, http://www.ft.com/cms/s/0/c16f0464-6241-11dd-9f1f-0007077b6736.html.


77. "Credit crunch has 'sown seeds of major downturn'", Financial Times, 6 September 2007, http://search.ft.com/article?articleId=a2788-0e&jql=article%20true&q=0&jql=article%20true&q=0&id=070906000663&ct=0.

78. Martin Wolf of the Financial Times records: "Most of the losses will fall not on the financial sector but elsewhere. As Prof. Roubini [of New York University's Stern School of Business] notes, a 10 per cent fall in house prices (relative to the peak) knocks off $2,000bn (14 per cent of gross domestic product) from household wealth. The first 10 per cent fall has already happened. What he sees as a likely 20 per cent cumulative fall would wipe out $6,000bn, 42 per cent of GDP and 10 per cent of household wealth. Already, falling prices are showing up in declining net household wealth. . . . Prof. Roubini also talks of a $5,600bn decline in the value of stocks and the possibility of additional trillions of dollars in losses on commercial property. Total losses might even equal annual GDP".


86. As Martin Wolf of the Financial Times records: "Beyond housing, there are also grounds for considerable concern about consumer and automobile credit, particularly if the economy turns down big. And as yet not reported losses on commercial construction lending lie ahead. While the rate of default on corporate debt has not yet reached high levels, this is likely to change in the near future. For example, the pricing of the debt of the big American automobile companies now suggests a probability well over 90 per cent that one or more of them will go into default in the next five years - and the probability would no doubt be greater if markets did not recognise the possibility of extraordinary Federal Support."


In what many take as being indicative of a looming trend, in August 2008, the US car manufacturer Chrysler "fell $6 billion short in its attempts to refinance $30 billion worth of one-year credit lines from banks".
87. In the case of mortgages, as Charles Goodhart explains in *Prospect*, the mortgages were: “pooled together to be securitised and sold on the capital market or placed in conduits, and the pool is divided into several tranches – from the riskiest (with the highest returns) to the least risky (with the lowest). Each of these tranches can then be sold to different investors. The most risky ‘equity’ tranche, for example, may be held by hedge funds, who can afford to take such risks, particularly since the risk can be partially hedged by investing in assets whose value goes up when house prices fall. The middle tranche may be held by longer term holders, such as pension funds; and the (safest) senior tranches were largely held by these bank conduits, or SIVs” [Special Investment Vehicle]. However, when house prices actually fall, particularly at a time when effective interest rates are rising, the probability of default will rise on a non-linear, indeed possibly an exponential way. This means that there is a real credit risk, even on the senior tranches.”

Goodhart also notes: “Under normal circumstances, the probability of a default on a prime mortgage is extraordinarily low: frequently less than 0.001 per cent per year. But in the sub-prime market, even under normal circumstances, the probability of a default is substantially higher, from 5 to 7 per cent, say over the course of the first five years in which the mortgage is held.”


88. The hived off loans have not been included in the accounts of the banks that originated them. As The Observer reported in September 2007 for one UK bank, HBOS: “As the credit crunch hit last month, HBOS – the giant UK bank formed by the merger of the Halifax and Bank of Scotland – was forced to announce that it would lend money to a so-called ‘conduit fund’ called ‘Gramian’, ‘to repay maturing debt as market pricing was unacceptable’. This was code for a bailout: no other institution would lend the facility money. No mention of Gramian is made in HBOS’s 2006 annual report – an indication that the facility was held off-balance sheet. But investigations show that Gramian is a £28 billion financing facility, which appears to have been arranged with the help of leading Channel Islands law firm Ogier, which refers to the arrangement on its website.”


In September 2008, HBOS agreed to be acquired by another UK bank, Lloyds TSB.

89. Just under half of the $920 billion debt owed by US consumers on their credit cards had been securitised as of November 2007. The figure represented a $40 billion rise on that for the previous year. In Europe, securitised credit card debt amounted to just over $150 billion – with demand predicted to increase due to implementation of the Basel II Accord (see footnote XX). Such securitisation has been a prime factor in fueling the consumer credit boom of the last two decades; new finance for lending has been generated by securitising the income from old lending – the banks being paid an upfront advance on future earnings from repayments. Before 2000, total US consumer debt stood at $6,400 billion. By the end of 2006, it was more than $13,000 billion. Borrowers are defaulting on their credit cards at a significantly higher rate than last year, according to the Fitch Credit Card Index.


99. At any one time, the average FTSE 350 firm has around 4.5 per cent of its stock on loan for short selling. In 2008, the UK’s Financial Services Authority announced (and then abandoned) an investigation into the short selling of shares in HBOS, the UK bank formed by the merger of the Halifax and Bank of Scotland, after its shares plunged 17 per cent in half an hour, allegedly due to short sellers spreading false rumours in order to make profits illegally from the falling price.


100. As the Financial Times explains: “At its simplest, the objective of shorting is to profit from an anticipated fall in a security’s price. A manager borrows the security’s price. A manager borrows the security for a fee from a securities lender and sells it in the market. If the security falls in value, the manager can buy back the security, close the position by purchasing say $100, as the security’s price. A manager borrows the security for a fee from a securities lender and sells it in the market. If the security falls in value, the manager can buy back the security, close the position by purchasing say $100, as the market’s fall, and makes $5,000 net profit.”


101. A case in point is US hedge fund manager John Paulson whose company, Paulson & Co, has $33 billion under management. Anticipating the credit crunch, Paulson bet on参加了 debt in the mortgage market: his best performing fund made a 600 per cent return in 2007. Deutsche Bank has also profited from betting on sub-prime defaults.
102. Armitage J., “As takeover deals dry up in the banks are turning East”, Evening Standard, 10 Jan 2008.

With takeovers and deals down in Western Europe and North America, but booming in Asia, one banker is quoted as saying: “The mantra is ‘emerging markets, emerging deals’.” That’s all the bosses want to talk about.”

103. Davis, P., “Business falters as credit becomes scarce”, Financial Times, 28 September 2008, http://www.ft.com/cms/s/0/0f93b58e-8c03-11dd-84ae-0000779fd1fc.html. Davis notes: “The emerging market bug has even spread to Africa, where prices and valuations of private equity firms have skyrocketed from just four buy-outs valued at a combined $74m in 2003 to 24 deals last year totalling $6.4bn, according to data provider Dealogic.”

104. As McKenzie notes: “As recently as 1970, the market in derivatives such as options was tiny: indeed many derivatives were illegal.”

105. For example, see: See: Cookson, R., “Banks’ new tool to deal with counterparty risk”, Financial Times, 9 April 2008, http://www.ft.com/cms/s/0/65324696-0660-11dd-802c-e4900000779fd1ac.html. Financial Times journalists Michael MacKenzie, Gillian Tett and Aline van Duyne point out that: “Soaring prices for oil and other products might seem like bad news to many might seem like bad news to many, but according to complex models against the market in the underlying transaction. That means these contracts can be used to protect or lock in mark-to-market gains on the values of derivative contracts, as well as to protect deal- ers against counterparty risk.”

106. An example is the Contingent Credit Default Swap (CCDS), which is intended to hedge against the risk that counterparties of valuers of their assets, sharply up on last year in spite of the credit crunch and a se- ries of high-profile problems in the industry.”


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111. Davis notes: “As recently as 1970, the market in derivatives such as options was tiny: indeed many derivatives were illegal.”


119. The Bank for International Settlements explains: “Notional amounts outstanding providing useful information on the structure of the OTC derivatives market but should not be interpreted as a measure of the riskiness of these positions. While a single comprehensive measure of risk does not exist, a useful concept is the cost of replacing all open contracts at the prevailing market prices. This measure, called gross market value, increased at a considerably lower rate (74%) than notional amounts during the reporting period, to $11 trillion at the end of June.” See: Bank for International Settlements, Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in 2007 – Final results, pp.2-3, http://www.bis.org/publ/rpf07t.pdf.

120. Ibid. p.3.

This represents more than a three-fold increase since 2000 when the gross market value of derivatives was estimated by the Bank for International Settlement at $3.2 trillion (http://www.bis.org/publ/ote_hy0105.pdf). Gillian Tett of the Financial Times put the rise at fivefold but does not give the source of her figures. See: —Tett, G., “The irony is we may have created a new set of risks”, “Financial Times”, 1 May 2007, http://us.ft.com/ftgateway/weodata/download.aspx.

121. In 2007, the Gross Domestic Product (GDP), a measure of the value of all goods and services produced by a country in a given year, of the USA was estimated at $11,535 billion; that of the United Kingdom, $1.47 trillion. See: International Monetary Fund, World Economic Outlook, October 2007, http://www.imf.org/external/pubs/ft/weo/2007/02/weodata/download.aspx.


In the first quarter of 2008, six months after the credit crunch began to bite, the total net turnover was higher still – at $692 trillion.


124. As Nasser Saber, a lecturer on derivatives – was $4.2 trillion, a 75% increase on 2000 when the gross market value of OTC derivatives market but should not be interpreted as a measure of the riskiness of these positions. While a single comprehensive measure of risk does not exist, a useful concept is the cost of replacing all open contracts at the prevailing market prices. This measure, called gross market value, increased at a considerably lower rate (74%) than notional amounts during the reporting period, to $11 trillion at the end of June.” See: Bank for International Settlements, Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in 2007 – Final results, pp.2-3, http://www.bis.org/publ/rpf07t.pdf.

125. The comparison between genetic engineering and traditional plant breeding is misplaced for several reasons, not least because of the levels of risk to the public involved. Traditional plant breeding does not need a laboratory and does not involve the exchange between species of genetic materials.


128. The story of Thales was first recounted by Aristotle, who wrote in his Politics (Vol 1): “There is the anecdote of Thales the Miletian and his financial device, which involves a principle of universal application, but is attributed to him on account of his reputation for wisdom. He was re-proached for his poverty, which was supposed to show that philosophy was of no use. According to the story, he knew by his skill in the stars while it was yet winter that there would be a great harvest of olives in the coming year; so, having a little money, he bought the olive presses in Chios and Miletus, which he hired at a low price because no one bid against him. When the harvest-time came, and many were wanted all at once and of a sudden, he let them out at any rate which he pleased, and made a quantity of money. Thus he showed the world that philosophers can easily be rich if they like, but that their ambition is of another sort. He is supposed to have given a striking proof of his wisdom, but, as I was saying, his device for getting wealth is of universal application, and is nothing but the creation of a monopoly. It is an art often practiced by cities when they are want of money, they make a monopoly of provisions.” See: Aristotle, Politics (Vol 1), 350 BCE, translated by Jouret, B., http://classics.mit.edu/Aristotle/politics.1.01.html


131. The relationship between the holder of an option (the person who has bought the right to buy or sell) and the writer of the option (the person who has agreed to sell or buy, should the option be exercised) is not equal. As the Financial Policy Forum notes: “Whereas the holder of the option has the right to exercise the option in order to buy or sell at the more favourable strike price, the writer or seller of the option (known as the short options position) has the obligation to fulfil the contract if it is exercised by the options buyer. The writer of an option is thus exposed to potentially unlimited losses.” By contrast all that the holder of the option stands to lose is the premium he has paid to purchase the option. Thales, for example, could have backed out of the deal if the harvest was worse than he predicted, losing only his deposit, since he had only taken out an option to rent the olive presses rather than contracting to actually do so. The olive press owners, by contrast, were obligated to rent him the presses at the agreed price should he exercise his option. See: Financial Policy Forum, Derivatives Study Centre, “Primer – Derivative Instruments”, 2004, http://www.financialpolicy.org/dscinstruments.htm.

132. Futures and forward contracts are essentially the same: both involve an obligation – rather than just an option – to buy or sell. The distinction, however, is that futures are traded on listed exchanges – and their price is therefore public – while forwards are traded privately, their price remaining undisclosed to the market, the press or government regulators. See: —Financial Policy Forum, Derivatives Study Centre, “Primer – Derivative Instruments”, 2004, http://www.financialpolicy.org/dscinstruments.htm; —Augar, P., The Greed Merchants: How Investment Banks Played the Free Market Game, Penguin, 2005, p.77;


133. The Financial Policy Forum summarises: “A call option gives the option buyer the right to buy at the strike price, and so the option is profitable if the [market] price goes up. A put gives the option holder the advantage a stock
right to sell at the strike price, and so is profitable if the [market] price goes down. Here is a useful memory device: call up – put down”.


134. “In every trade, the two parties take opposite positions. The buyer of the contract, who agrees to receive the commodities specified, is said to be in a long position. The seller of a contract is said to be in a short position.”


135. J.D. Agarwal and Aman Agarwal note: “[The trade] was centred around Dojima, a district of Osaka and the trade was known as cho-ai-mai a kiai (rice-trade-on-book). This trade in rice grew and flourished to a stage where receipts for future delivery were traded with a high degree of standardisation. In 1730, the market received official recognition from the Tokugawa Shogunate (the ruling clan of shoguns or feudal lords). The Dojima rice market can thus be regarded as the first futures market in the sense of an organised exchange with standardised trading terms”.


136. Historians Adrian Bell, Chris Brooks and Paul Dryburgh note: “While it is commonly believed that derivative instruments are a recent invention, we document the existence of forward contracts for the sale of wool in medieval England around 700 years ago. The contracts were generally entered into by English mon- asteries, who frequently sold their wool for up to 20 years in advance to mostly foreign and particularly Italian merchants”.


137. “It is known that in Renaissance times the merchants who financed trading voyages sometimes arranged to sell wares that they expected to receive but did not yet have in hand. By the late 1550s, fish dealers in Holland were buying and selling herring that had yet to be caught, and the sale of other commodities on a to-arrive basis soon followed.”


139. Jacob is cited as the first person to default on a derivatives contract. The anonymous author writes: “It is actually amazing how far back in history you’ll find derivative-like applications...In the bible we find another early use of an option in the book of Genesis – and the first default, as well. Jacob wanted to marry Rachel. Her father made him work for seven years for the right to marry her. After the seven years he defaulted on the agreement and made Jacob marry her older sister Lea instead. He wanted Rachel, however. So he had no choice but to marry Lea, work another seven years and then he could marry Rachel. Which he did to his regret, as that liaison did not turn out to be a happy one.”


See also: “Basics – Learn more about deriv- atives”, http://www.derivativesportal.org/Misc/7d-basics.


142. “Once a trade has been completed, the participants are obligated to the exchange rather than to each other. Either party separately may terminate its contract at any point by arranging an offset, without affecting the other party’s position.”


143. Ibid.

144. For a worked example of hedging using options in the equities market, see: ibid., p.205.

145. “An engineering company signing a contract to supply automotive components at a fixed price might purchase a call on alu- minium on the London Metal Exchange, thus locking in the price of an important raw material without using its capital to amass a stockpile of aluminium”. (Ibid. p.207.)

Other examples cited by the Financial Policy Forum include banks using: “derivatives to reduce the risk that the short-term interest rates they pay to their depositors will rise against the fixed interest rate they earn on their loans and other assets” or pension funds and insurance companies using derivatives “to hedge against large drops in the value of their portfolios”.


MacKenzie writes: “The processes that made Chicago’s trading in grain futures possible were based on the disentanglement of grain from its grower that took place when transport in railroad cars and storage in steam-powered grain elevators replaced transport and storage in sacks. Sacks kept grain and grower tied together, the sacks remaining the last’s property, identified as such by a bill of load- ing in each sack, until they reached the final purchaser. In contrast, grain from different growers was mixed irreversibly in the elevator’s giant bins, and the trace of ownership now a paper receipt, a testament for an equivalent quantity of similar grain but not for the original physical substance...The standardisation of grain was both a technical and a social process. In Chi- cago, the bushel, originally a unit of vol- ume, became a unit of weight in order to permit measurement on scales on top of each elevator. A team of inspectors... checked that the scales were fair and made the inevitably contestable judgments that the contents of this bin were good enough to be classed as ‘No.1 white winter wheat’, which had to be ‘plump, well cleaned and free from other grains’, while that bin con- taining only ‘No.2’... was ‘downy and sound, but not clean enough for No.1’.”

With grains thus turned into ‘homogenised abstractions’, disentangled at least partially from their heterogeneous physical reality, it was possible to enter into a contract to buy or sell 5,000 bushels (the standard contract size) of, for example, ‘Chicago No 2 white winter wheat’ at a set price at a given future time. Such a contract had no link to any particular physical entity, and because its terms were standardised it was not connected permanently to those who had initially entered into it.”


The use of forwards and options was banned in 17th century Amsterdam, although, as Stringham shows, the proba- tion was not widely enforced.


149. Nasser Saber, a lecturer on derivative risks
at New York University’s Institute of Finance and Banking and author of Speculative Capital and Derivatives, notes: “Ownership acts as a protective cushion against price shocks and as a cover concealing the cost of hedging. If the price of corn declines, the farmer will be happy at having sold it at a higher price. If the price increases the adverse move appears to him as an opportunity cost. His practical mind sees it as pointless ‘what might have been speculation’. Under no condition, however, does he risk being ruined. He has eliminated that risk by agreeing to limit his potential profit... Now, replace the farmer in our example with an arbitrager. Suddenly, the effect of adverse price movement that for the farmer was of the ‘what-might-have-been’ kind, becomes a real one for the arbitrager. He will be long the spot and short the corn futures. That amounts to being short the basis. If the basis increases above its original value... the arbitrager has to pay the difference... The change in the basis, which was of little concern to the farmer, becomes a source of real loss to the arbitrager, especially when his position is in the cash market.”


150. Thales, a leading Canadian hedge fund, is unapologetic: “The term hedge fund is actually a misnomer because most of them do not even hedge their positions.” See: http://www.thales.ca/hedge.asp.

151. As Jim Davis notes: “Hedging and speculating are very different acts, as different as buying is from selling. Hedging is an attempt to protect the equity of a firm by maintaining the balance between assets and liabilities. It is, like insurance, the defensive act of preservation. The goal of speculation, on the other hand, is to make money.” See: Davis, J., “Speculative Capital”, Paper presented to Globalisation and Social Justice Conference, Chicago, 9-11 May 2002, http://www.gocatgo.com/texts/speccap4.pdf.


154. In very simple terms beta is the return that can be explained by market movements and alpha is the return over and above the market return which the manager is capable of generating. If the market is up 7% (beta =7%) and the manager generates a return of 10%, we say that he generated alpha of 3%. In the hedge fund industry managers are paid to produce alpha.


155. It has been reported that hedge funds “package up beta and sell it as alpha” — the implication being “that the funds in question charge high fees without delivering any form of hedge”. See: “Should investors expect more from hedge funds?”, MoneyWeek, 16 November 2006, http://www.moneyweek.com/file/21682/should-investors-expect-more-from-hedge-funds.html.


158. PriceWaterhouseCoopers partner Michael Sallu notes: “An embedded derivative is...a derivative instrument that is embedded in another contract, which is known as the ‘host contract’. The host contract might be a debt or equity instrument, a lease, an insurance contract, a normal sale or purchase contract, services agreements, loan agreements etc. Embedded derivatives are common and many companies use them on a daily basis, sometimes without their knowledge.” See: Sallu, M., “Watch out for embedded derivatives”, PriceWaterhouseCoopers, http://www.pwc.com/extweb/pwc/publications.nsf/s/dfef71194ed499d4f5174f1940035862f2f24744a4aa074a0257a0702b8fc4/SFILE/Watch%20out%20for%20Embedded%20Derivatives.pdf

159. In finance, a bond is a debt security, in which the authorized issuer owes the holders a debt and is obliged to repay the principal and interest (the coupon) at a later date, termed maturity. See: Wikipedia, “Bond (finance)”, http://en.wikipedia.org/wiki/Bond_(finance).


161. Ibid., p.52.


163. Ibid., pp.53-57.


167. Ibid., p.386.

168. Financial Times journalist Paul J Davies writes: “A CDO is an almost alchemical process by which minor substances are transmuted into investors’ gold. This can mean turning highly risky mortgages into the safest kind of investment-grade debt, taking individually low-returning investment-grade bonds and creating a higher-paying note.” See: Davies, P. J., “Turn any assets into investor gold with alchemy of CDOs”, Financial Times, 28 May 2007, http://search.ft.com/fArticle/queryText=Turn+any+assets+into+investor+gold+with+alchemy+of+CDOs&y=8&aje=false&x=13&id=9861-000077b07658.html?hlm=t1&click_check=1.

169. Dan, S., Traders, Guns and Money: Knowns and Unknowns in the Dazzling World of Inter-Bank Offer Rate (LIBOR) for firm B’s obligation to pay interest on $1m at a fixed 7.9% rate. The notional amounts themselves do not change hands, neither party is responsible for paying off the other’s loan. The value of an interest-rate swap obviously depends on the behaviour of the market rates. If rates were to decline, the swap position held by firm B would increase in value, as it would be required to make smaller payments over the next 2 years: and firm A’s fixed-rate position would lose value because the rate is now far above what the market would dictate. However, if rates were to rise, firm A’s side of the swap would be worth more than firm B’s.” See: Levinson, M., Guide to Financial Markets, Financial Times/Profile Books, London, 2005, p.220.

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In the wake of the credit crisis, credit default swaps (CDS) are proving increasingly attractive to investors, because their price has fallen. Some investors are buying them as a heavily discounted means of hedging the risks on bonds, which are also much cheaper.


185. Davies, P., “Free money to be made from swaps”, Financial Times, 4 June 2007, http://search.ft.com/ftArticle?queryText=%22Free+money+to+be+made+from+swaps+%22&y=0&aje=true&x=0&id=07060400763&ct=0.

The strategy is very popular with hedge funds, which need to put up only small sums against any potential losses they might incur. Hence the low rate premium on credit default swaps (particularly where these are covered by the interest from the bonds insured) are extremely attractive.


Frank Partnoy writes:

“Synthetic CDOs might seem like unusual or esoteric side bets, but by 2002 they were the mainstay of corporate finance. In 2001, banks created almost $800 billion of Synthetic CDOs. During 2002, even after the bankruptcies of Enron, Global Crossing and WorldCom – companies whose debts were referenced in the credit default swaps of numerous Synthetic CDOs – financial institutions still were continuing to do those deals”.


188. Frank Partnoy explains:

“A Synthetic CDO was like a standard cash-flow CDO, except that a bank substituted credit default swaps for loans or bonds. In other words, the ‘assets’ of the SPE [Special Purpose Entity, also called an SPV or SIV] were credit default swaps. As a result, the companies whose debts formed the basis of a Synthetic CDO has no relationship at all to the deal: most likely, the companies would not even know about it.”


As Financial Times columnist John Gapper comments with respect to changing lending practices by banks:

“Banks used to balance two factors in deciding whether to make a loan – how much the borrower would pay in interest and fees and how likely it was to default. They refused to lend if they thought the risk of default outweighed the reward because they would be the ones to suffer. But, as the risk that they would be hit by borrowers ran into problems receded, they became less cautious.”


In part, the scale of imposed risks arise from the globalisation of financial and other markets; and in part, from the emergence of new social networks that release speculators from face-to-face contact with individuals who are directly affected by the risks that their speculation imposes. In that respect, the issue is not one of “depersonalisation” of markets: social networks are as critical to modern derivatives trading as they were to such trading in 18th century Amsterdam or elsewhere. Today’s networks are, however, now rooted predominantly in transnational markets rather than local ones. Indeed, as sociologist Marieke de Groede notes, quoting Andreas Leyshon and Nigel Thrift:

“financial globalisation has not led to the depersonalisation and abstraction of financial activity, but, on the contrary, ‘social networking has become an even more important activity because of the increased amounts of knowledge of all kinds that now circulate [and the need to interpret this knowledge].”


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“financial globalisation has not led to the depersonalisation and abstraction of financial activity, but, on the contrary, ‘social networking has become an even more important activity because of the increased amounts of knowledge of all kinds that now circulate [and the need to interpret this knowledge].”


Stringham stresses the importance of reputation in regulating the market: cheats – or those known to “impose on their neighbours” – were at risk of being squeezed out of the market because they could not rely on the social networks that were critical to the enforcement of contracts.


195. Financial Times journalists Paul J Davies and Richard Beales write: “The single most important factor that has turned credit from a dull backwater into a financial market blockbuster is the emergence of credit derivatives. Before these instruments sprang to life in the late 1990s, buying and selling of bonds was a relatively long-winded process. It was also almost impossible to sell bonds short, meaning that expressing opinions of relative value between the debts of one company and another was, at best, difficult.”

Davies and Beales quote one broker: “It is the growth of derivatives that have made credit a tradable asset class,” says one prime broker, who considers the growth of credit funds one of the ‘megatrends’ of the past three to five years that have changed the hedge fund landscape.


199. Ibid.

200. Ibid.


202. Ibid., p.142.

203. Ibid., p.147.

204. Ibid., p.148.

205. Ibid., p.149.

206. Ibid., p.146.


208. Ibid., p.149.

209. Ibid., p.146.

210. Ibid., p.149-50. The report argued that options “enrich the investor’s repertoire of strategies by allowing him to realise a different set of payoffs than he would have realised in their absence.”

211. Quoted in ibid., p.155. The Board of Trade’s Options Exchange suffered similarly in its early days.

212. Ibid., p.155.

213. As Donald MacKenzie explains: “Every evening, after a futures exchange such as the Merc closes, the process of clearing is undertaken. Those whose trading positions have lost money must transfer cash or collateral to the exchange’s clearinghouse for deposit into the accounts of those whose positions have gained. After a normal day on the Merc in the late 1980s, $120 million would change hands. On the evening of October 19, however, those who had brought S&P [Standard & Poor’s] futures contracts owed those who had sold such contracts twenty times that amount.”


For influence on hedging on price differentials in the credit derivatives market, see: Davies, P.J., “Derivatives: Free money to be made from swaps”, Financial Times, 4 June 2007, http://search.ft.com/ftArticle?queryText=Free+money+to+be+made+from+swaps&y=6&aje=true&kce=12&id=070604000765&kct=0.

216. See, for example:—International Swaps and Derivatives Association, “A Survey of Finance Professors’ Views on Derivatives”, March 2004, http://www.isda.org/press/pdf/Academic-Survey-Report.pdf.—Melamed, L., “White Cats, Black Cats”, Keynote Address, China Seminar, Shanghai, 26 September 2005, http://www.leomelamed.com/essays/05_shanghai_seminar-WhiteCatsBlackCats.htm. Alan Greenspan in particular, former Chairman of the US Federal Reserve, the USA’s central bank, has stressed the risk mitigation benefits of derivatives: “As the market for credit default swaps expands and deepens, the collective knowledge held by market participants is exactly reflected in the prices of these derivative instruments. They offer significant supplementary information about credit risk to a bank’s loan officer, for example, who here-tofore had to rely mainly on in-house credit analysis. To be sure, loan officers have always looked to the market prices of the stocks and bonds of a potential borrower for guidance, but none directly answered the key question for them: How much is the probable net loss in a given time frame? Credit default swaps, of course, do just that and presumably in the process embody all relevant market prices of the financial instruments issued by potential borrowers.”

See: Greenspan, A., “World Finance and Risk Management,” speech presented at Lancaster House, London, U.K., September 25, 2002, http://www.hm-treasury.gov.uk/newsroom_and_speeches/speech_greenspanlancaster_02.cfm Elsewhere, in a speech to the American Bankers Association in 2002, Greenspan has stated: “Improved risk management and technology have also facilitated, of course, the growth of markets for securitized assets and the emergence of entirely new financial instruments – such as credit default swaps and collateralized debt obligations. These instruments have been used to disperse risk to those willing, and presumably able, to bear it. Indeed, credit decisions as a result are often made contingent on the ability to lay off significant parts of the risk. Such dispersal of risk has contributed greatly to the ability of bank – indeed of the financial system – to weather recent stresses. More generally, the development of these instruments and techniques have led to greater credit availability, to a more efficient allocation of risk and resources, and to stronger financial markets.”


217. Leo Melamed, who established the Chicago Mercantile Exchange’s risk management system – to weather recent stresses. More generally, the development of these instruments and techniques have led to greater credit availability, to a more efficient allocation of risk and resources, and to stronger financial markets.”
measurement, our futures markets have proved their worth a billion times over and will continue to do so.


218. Other assumptions add to the unwieldiness of economic theory. The principal model for pricing options – the Black-Scholes model – assumes, for example, that “there are no transaction costs in buying or selling the stock or option” and that it is “possible to borrow any fraction of the price of a security to buy it or hold it” at a riskless rate of interest.


219. Ibid., p.151.


Abolafia’s ethographies of Wall Street traders documents how the stock, bond and futures markets are socially constructed in situ in which the behaviour of traders is “suspected in a web of customs, norms, and structures of control”. What propels Wall Street “is not a fundamental human drive or instinct, but strategies enacted in the context of social relationships, cultural idioms, and institutions – a cycle that moves between phases of unbridled self-interest and collective self-restraint”.


227. Frank Partnoy quotes one recorded conversation between two traders at Bankers Trust discussing a highly leveraged deal with Proctor & Gamble: “‘I think my dick just fell off’. ‘Oh, my ever-loving God. Do they understand that… what they did?’ ‘No. They understand what they did, but they don’t understand the leverage, no.’ They would never know. They would never be able to know how much money was taken out of that.” ‘Never, no way, no. That’s the beauty of Bankers’ Trust’.


228. Nor is this a hidden agenda. Morton Miller, a Nobel Laureate in economics, argued in 1986 that the main impulse in financial innovation was a desire to avoid regulation. For Miller – a free marketeer to the core – such innovation could only be for the public good; regulation meant government interference in the market – and “regulatory arbitrage” was to be encouraged to rid markets of “senseless” rules. See: ibid., p.48.


231. Ibid., p.40.

232. Ibid., p.41.

Partnoy (pp.43-45) gives other examples of Bankers Trust circumventing rules designed to keep apart various sectors of the financial services industry. In the USA, for example, commercial banks were banned from acting as investment banks under rules introduced in the wake of the 1929 stock exchange crash. Commercial banks were not, for example, allowed to underwrite securities. Bankers Trust got around the rules by distributing securities – mainly bonds – through deals known as private placements. “In a private placement, the borrower did not need to register under the securities laws, and did not need to comply with generally accepted accounting practices.”

233. Commodity swaps typically involve a floating rate of payment for a commodity being traded for a fixed rate of payment, or vice versa.


234. Index funds (also known as index tracker funds) bet on the rise (long only funds) or fall (short only funds) of a particular commodity. Index funds have taken deliberate steps to allow certain speculators virtually unlimited access to the commodities future markets. Unfortunately, the CFTC [Commodity Future Traders Commission] has taken deliberate steps to allow certain speculators virtually unlimited access to the commodities future markets. The CFTC has granted Wall Street banks an exemption from speculative position limits when these banks hedge over-the-counter swaps transactions. This has effectively opened a loophole for unlimited speculation. When Index Speculators enter into commodity index swaps, which 85-90% of them do, they face no speculative position limits.” See: Masters, M., “Testimony before the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, US Senate”, 20 May 2008, http://hsgac.senate.gov/public_files/062408Masters.pdf.


236. “When Congress passed the Commodity Exchange Act in 1936, they did so with the understanding that speculation would not be allowed to dominate the commodities futures markets. Unfortunately, the CFTC [Commodity Future Traders Commission] has taken deliberate steps to allow certain speculators virtually unlimited access to the commodities future markets. The CFTC has granted Wall Street banks an exemption from speculative position limits when these banks hedge over-the-counter swaps transactions. This has effectively opened a loophole for unlimited speculation. When Index Speculators enter into commodity index swaps, which 85-90% of them do, they face no speculative position limits.”


238. If the Thai baht went down relative to the US dollar, the investor would earn huge sums because of the leverage embedded in the formula. See: ibid., p.69.

239. Ibid., p.69.

240. Ibid., p.69.

241. Ibid., p.71.

242. Ibid., p.72.

243. For an account of the bankruptcy of Orange County, see: ibid., pp.115-122.

244. Ibid., p.121.

245. The Basel Accords are recommended banking regulations issued by the Basel Committee on Banking Supervision, whose secretariat is based at the Bank of International Settlements (“a bank for central banks”) in Basel, Switzerland. The Committee is made up of representatives of the central banks or other supervisory authorities of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, The Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. Its recommendations have no formal authority but...
have been widely adopted by national gov-

- Basel Committee on Banking Supervi-
sion, Bank for International Settlements, “Basle Capital Accord – International Conver-
gence of Capital Measurement and Capi-

—European Banking Federation, “The Basel Capital Accord and the Capital Re-

—Federal Reserve Bank of Philadelphia, “International Convergence of Capital Mea-
surements and Capital Standards – A Re-

gence of Capital Measurement and Capi-

247. “Loans fully secured by mortgage on occu-
pied residential property have a very low record of loss in most countries.” See: Basel Committee on Banking Supervision, Bank for International Settlements, “Basle Capital Accord – International Conver-
gence of Capital Measurement and Capi-

248. Mehta, N., “Do the New BIS Capital Rules Make Sense?”, Derivatives Strategy, Octo-

249. Bank for International Settlements, “Inter-
national Convergence of Capital Measure-
ments and Capital Standards – A Revised Framewor-

The Basel II Accord gives more flexibility for the weighting of assets – Triple A rated private sector loans could be weighted at 20 per cent, compared with 100 per cent under the Basel I rules.


Thomas Huertas is banking sector leader and Sally Dewar capital market sector leader at the UK Financial Services Authority, the body that regulates banking in Britain. Huertas and Dewar comment: “From ‘hold what you originate’, the business model of banking is shifting to ‘underwrite to distribute and buy what makes sense to hold’: Banks still origi-
nate loans, but aim to reduce their expo-
sure, either by selling participation in the loan to other investors – not all of them necessarily banks – by securitising the loans, or by buying credit protection in the de-
rivatives market. At the same time, banks are buying exposure to credits they have not originated, so as to build an efficient portfolio – one that optimises the return on the level of risk assumed.”


252. Under the 1998 Basel rules – known as Basel I – there was no requirement for such a legal opinion. But new 2004 rules – known as Basel II – which banks are in the process of implementing, require “off balance sheet” securitised exposures to meet the requirements if they are to be excluded from the bank’s risk-weighted assessment of its assets. See: Bank for International Settlements, “International Conver-
gence of Capital Measurements and Capital Stan-

The extent to which banks retain control over “securitised” loans has already been the subject of court action. In one case, brought by US regulators in 2001, Nextbank was forced to reabsorb its securitised credit card debt after the securitisation was deemed not to be a “true sale”, resulting in Nextbank’s required capital reserves falling by 12% and thus below the legal limit. The bank was subsequently seized by the US government’s FDIC (Federal Deposit Insurance Corporation). The bank had been removing “delinquent” debt from a securitised receivables stream by reclassi-
fying defaults as frauds. This was held to be evidence that it still had an interest in the assets it had supposedly sold when they were securitised. See: Calomaris, C. W., and Mason, J. R., “Credit card securitisation and Regulatory Arbitrage”, Working Paper No. 03-7, Fed-


254. Ibid.


258. Banks charge substantial fees for each loan they arrange. Bonuses are paid at the end of each year to staff, based in part on the fees they have earned. The bonus culture preva-
lent in banks has been widely cited as a cause of the excessive risk-taking that has resulted in the credit crunch. See:

economy-britain-bonuses-fab6408.html;
—Hutchinson, S., “Revealed – the Bank Bonus Game”, 3 September 2006, thisismoney.co.uk, http://www.thisismoney.co.uk/campaigns/article.html?in-
article_id=41231&kin_page_id=163.

259. For a discussion, see:

—Calomaris, C. W., and Mason, J. R., “Credit card securitisation and Regulatory Arbitrage”, Working Paper No. 03-7, Fed-
—Roubini, N., “Ten fundamental issues in reforming financial regulation and super-

Charles Calomaris and Joseph Mason con-
clude that the charge that securitisation has not brought about a commensurate reduc-
tion in risk as held by banks is unfair be-
cause securitisation, while avoiding the capital requirements placed on banks, leads
to a more efficient use of capital. Nouriel Roubini, however, is more sanguine: “In fact, while the securitization process implied a partial transfer of the credit risk from the mortgage originators and the man-
gages of the CDOs [collateralized debt obliga-
tions] to final investors the reality is that – even with widespread securitisation –
banks and other financial institutions main-
tained a significant exposure to mortgages, MBS [mortgage backed securities] and CDOs. Indeed in the US about 47% of all the assets of major banks are real estate related; and the figure for smaller banks is closer to 67% i.e. the model of “originate and distribute” securitisation did not fully trans-
fer the credit risk of mortgages to capi-
tal market investors: rather, banks, other
financial institutions and broker dealers (for example Bear Stearns) did keep in a variety of forms a significant fraction of that credit risk on their balance sheet. Indeed, that credit risk had been fully transferred such banks and other financial intermediaries would have not suffered the coalescence of billions of dollars of losses that they have recognized so far and the many more that they will have to recognize in the near fu-
hure.”

260. Satyajit Das who is a derivatives special-
ised at the banks’ use of CDOs to “transfer risk”: “The transactions didn’t reduce the sell-
ing bank’s credit risk, it usually had to keep the equity piece. The first losses were for its account – this is ‘hurt money’ or the ‘skin in the game’. Investors want to make sure that you aren’t selling them a whole
lot of dad loans, they want you to take the first loss. Generally, the first loss piece was set at a level that was way above the anticipated level of loan losses on the portfolio. In effect, the bank was keeping most of the risk.”


261. “The tranching of CDOs not only allows leveraged investments on a basket of credits but also means investors can take exposure to the degree of correlation between defaults”


262. Even where derivative-based instruments have been kept on banks’ books, the more flexible risk weighting they have adopted under Basel II has dramatically underestimated the amounts they should set aside against such instruments. Swiss bank UBS, for example stockpiled tranches of senior CDOs (supposedly low risk). After the credit crunch, they lost 30 per or more in value, creating a $10 billion loss – but the funds set aside (on a 20 per cent risk weighting) were insufficient to cover the losses. The bank’s sub-prime-related losses had totalled $37 billion by April 2008. See:


263. In the early 1990s, for example, federal regulators sued Bankers Trust for mis-selling complex swaps to customers. For details, see: Partnoy, F., Infectious Greed: How deceit and risk corrupted the Financial Markets, Profile Books, 2004, p.249.

264. Ibid., p.249.

265. Ibid., p.250.

266. The construction of Dahbol was accompanied by numerous human rights abuses. The deal was also heavily tainted by corruption.


274. Ibid., p.339.

275. Ibid., p.339.

276. Feline Prides are a “contract to purchase Common Stock at a specified time (i.e. within 3 years) with the amount of stock required to be purchased equal to the purchase price of the unit, and with the number of shares to be received determined by a schedule based on the stock trading price prior to the specified date of purchase (i.e. the 20 days prior to the purchase date).”


Business Week reports that the sum raised from the securitisations “could amount to between 0.5% and 1% of gross domestic product.” Commenting on the factors that have spurred government securitisation, Patrizio Messina notes: “... by the introduction of the Internal Stability Pact local governments (municipalities, provinces, metropolitan cities, mountain communities, island communities and unions among municipalities), in addition to other public entities, have been asked by the central government to reduce their debt in accordance with strict provisions for controlling public borrowings.”


286. Letter from Livio Mignana, SACE, to Francesco Odone, 7 January 2008.


288. ECGD statement to meeting of NGOs with Export Guarantees Advisory Council, 10 October 2007.


295. Ibid.


299. Ibid.

300. Hughes, J. and Mackintosh, J., “FSA rules on derivatives disclosure trigger mixed reactions from hedge funds”, Financial Times,


309. Avoiding regulation is also a determining factor in where companies that are public choose to list themselves. As The Economist reports, the London Stock Exchange: "has had success in attracting listings by overseas firms, often at NASDAQ's expense, in part owing to American laws such as the USA PATRIOT and Sarbanes-Oxley acts. Greater financial disclosure and the obligation for bosses to take responsibility for accurate reporting are two examples of rules that seem onerous to many. At a time when hedge funds and other active investors are eager to move their money around the world and technology allows it to happen faster, regulators remain one of the last barriers to seamless global capital flows. Changes, meanwhile, are creating and accelerating their shift from floor to electronic trading, leaving them less tied to particular locations. 'Exchanges aren't geographic concepts any more, they're legal concepts,' says Benn Steil, an exchange expert at the Council on Foreign Relations in New York . . . Virt-x, a London exchange best known for trading Swiss blue-chip stocks, has another approach: it has a dual regulatory structure under British and Swiss authorities, and traders decide where they want transactions cleared."


330. Financial Times journalist John Dizard writes: “Hedge funds and their related speculative vehicles are now so identified with engorged private wealth that we forget that a few years ago the policy tribe saw them as a tool for the general public’s interest. In the late 1970s and early to mid-1980s, the big worry among central bankers and the like was that too much risk was being concentrated in the big banks. ‘Third World’ or ‘LDC’ (lesser-developed countries) debt, speculative real estate loans, unemployed oil tankers – they were all on balance sheets that were ultimately written down by central banks and government deposit insurance. The big question was how to avoid the risk of a forced nationalisation of the banking sector.” See: Dizard, J., “Slicing and dicing risk rebounds on the banks”, Financial Times, 22 October 2007, http://search.ft.com/ftArticle?queryText=Slicing+and+dicing+risk+rebounds+on+the+banks&key=a7a843ba-115d-11dd-a93b-0000779fd2ac.html.


332. Ibid.


334. Hedge funds account for 80 per cent of distressed debt trading. They are “increasingly buying companies themselves, competing with private equity groups, and are even bypassing banks by acting as marketmakers and lending money directly.” (Mackintosh, J., “Investors still in", Special Report: Hedge Funds, Financial Times, 27 April 2007) Ghisl Reddy, a former partner at Goldman Sachs, who now runs Prisma Capital Partners, a Jersey City-based fund of hedge funds has said: “It used to be that if you had a restructuring meeting for a distressed company, the process was driven by banks. Now if you go to a distressed company meeting, very often there are no banks present at all, just hedge funds.” (quoted in Gangahar, A., “A force for massive change", Special Report: Hedge Funds, Financial Times, 27 April 2007, http://search.ft.com/ftArticle?queryText=%22A+force+for+massive+change%22&key=a7a843ba-115d-11dd-a93b-0000779fd2ac.html?nclick_check=1.

335. Gillian Tett of the Financial Times similarly notes: “ . . . while hedge funds used to be almost non-existent in the leveraged finance sphere in Europe, they have recently entered this new territory on a large scale gobbling up leveraged loans not just in the secondary market – from banks – but participating in primary loan arrangements as well.” (Tett, G., “Funds are the banks”, Special Report: Hedge Funds, Financial Times, 27 April 2007, http://search.ft.com/ftArticle?queryText=%22Funds%20are%20%20gobbling%20up%20leverage%20loans%22&key=a7a843ba-115d-11dd-a93b-0000779fd2ac.html?nclick_check=1.


337. Leverage or “financial gearing” is a mechanism through which, by borrowing money, a small percentage gain can be transformed into a large one. Andreas Whittam Smith of The Independent explains: “Most homeowners have seen this technique in action. You purchase a property for, say, £200,000. You put up £50,000 yourself and borrow the balance, £150,000. Then suppose [house] prices rise by 10 per cent. Your home is now worth £220,000, your loan remains at £150,000 and your so-called equity in the property has risen from £50,000 to £70,000, an increase of 40 per cent. [However, the process can also work in the reverse, turning] a minor loss into a serious shortfall, or even wipe you out.” See: Whittam-Smith, A., “Why I fear a financial crisis in the offing”, The Independent, 16 July 2007, http://www.independent.co.uk/news/business/news/desperate-companies-turn-to-usurious-hedge-funds-929644.html.

338. The returns hedge funds have achieved have forced established operators to rethink investment strategies. The big banks, especially on Wall Street, have brought or linked with hedge funds to import specialist skills and improve returns.” See: Barber, L., “Forward”, Special Report: Hedge Funds, Financial Times, 27 April 2007.


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350. DaimlerChrysler sold Chrysler in August 2007 to New York-based Cerberus Capital Management in for $7.4 billion – even though DaimlerChrysler had to lend the private equity firm some cash to do so.

351. “Traditional asset managers, pension funds and insurers have been increasingly joining hedge funds, investment banks and other speculators in derivative markets of all kinds.” See: Davies, P. J., “Derivatives: Free money to be made from swaps”, Financial Times, 4 June 2007, http://search.ft.com/...
Today’s large-scale financial crises, in which the real and financial economies are interlinked, have punctuated the importance of architecture.


365. “In 1980 there were only 106 M&A deals in America and 97 in the rest of the world: in 1998, the peak year, there were nearly 12,000 in America and over 30,000 elsewhere.”


373. Risk Management quotes Thibaut de Gaudemar, head of the European equity-linked solutions group at Credit Suisse First Boston (CSFB) in London: “Derivatives are mostly used to build small positions without attracting too much attention before entering into discussions with the target.”


374. Ibid.

375. FOW: The Global Derivatives Magazine defines equity swaps as follows: “Equity swaps are primarily used as a means for acquiring or divesting equity exposure. The receiver of the total return in an equity swap receives the dividends and any increase in the value of the shares. In return, the total return receiver pays the decrease in the value of the shares. It also pays a stream of payments related to money market rates designed to compensate the payer of the total return in the equity swap for the cost of funding the underlying shares. The
376. Damian, T. and Pathak, N., “Top M&A

377. Steve Hannaford writes:

378. “Grabbing wealth by stealth: the largely

379. Ibid.

380. "Grabbing wealth by stealth: the largely

381. Reguly, E., “Hedgies, arbs, trusts – Greed

382. The Oxus Gold shooting involved an as-

383. See: Fletcher, P., “Equity derivatives: back

384. For example, in almost every branch of the

385. The Oxus Gold project, for instance, aimed to shift

386. The Oxus Gold shooting involved an as-

387. BNStory?cid=al_gam_globeedge.

388. "In 1998 and 1999, National Century cre-

389. “Securitisation in Italy”, Simmons &

390. Adams, P., “Market stands firm in chal-

391. Moody’s, “2007 Review and Outlook –

392. Adams, P., “Market stands firm in chal-

393. Frederic, O., “_secu	

394. For discussion of health care securitisation

395. For background and updates on the pro-

396. See: “Corporate application of equity

397. “Corporate application of equity

398. For example, the spin-off of the credit

399. In Chile, for example, cross-currency swaps

400. “In 1998 and 1999, National Century cre-

401. National Century Bankruptcy News

402. "In 1998 and 1999, National Century cre-

403. “In 1998 and 1999, National Century cre-

404. In Chile, for example, cross-currency swaps

405. George Soros, Interview on

406. For a discussion on the ways in which
derivative-based speculation of commodity
futures feeds through into spot prices, see:
— Masters, M., “Testimony before the Per-
manent Subcommittee on Investigations,
Committee on Homeland Security and Gov-
ernmental Affairs, US Senate”, 20 May
— Masters, M., “Testimony before the Per-
manent Subcommittee on Investigations,
Committee on Homeland Security and Gov-
ernmental Affairs, US Senate”, 24 June
Civil society organisations have condemned one Belgian bank for promising to make investors “maximum profit out of food shortages”. Myriam Vander Stichele, SOMO, personal communication, 13 June 2008.

“George Soros to invest $900 million in mining, SOMO, personal communication, 13 June 2008.


“In 2007, more than 1,000 “enslaved” workers were released from a sugar cane plantation in the Amazon owned by Para Pastoral e Agricola SA, one of the biggest ethanol producers in Brazil. Brazilian authorities said that the workers in the northern state of Para were being forced to work 14-hour days in horrendous conditions cutting cane for ethanol production. The UK bank HSBC had loaned money to the company.


“Firman from Iowa to Argentina is rising faster in price than apartments in Manhattan and London for the first time in 30 years. Demand for corn used in ethanol increased the value of cropland 16 percent in Indiana and 35 percent in Idaho in 2006, government figures show. The price of a Manhattan loft rose 12 percent, while a pied-à-terre in Islington, near London’s financial district, gained 11 percent, real estate agents said.”

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“About us”, http://www.blackrock.co.uk/uk/site/about/mlm/index.htm.


“Ibid.


“Stand back from our lands!” Subanon Leaders urge investors “maximum profit out of food shortages”. Myriam Vander Stichele, SOMO, personal communication, 13 June 2008.


451. RAB Capital was one of the biggest hedge funds using this strategy. It has been badly hit by the credit crunch and, in particular, an ill-fated investment in Northern Rock, the UK bank that needed a government injection of cash in August 2007.


453. The 30 member countries of the OECD are: Austria, Australia, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States.


459. The Financial Times explains the attraction of infrastructure funds for pension funds: “These pioneering investors first spotted what others have since found out: that infrastructure assets offer stable, long-term and inflation-proof cashflows which make a neat match for long-term pension liabilities. The business of the typical infrastructure company tends not to vary much as the economic cycle ebbs and flows, and many of the companies are monopolies working within a regulatory framework which ensures a predictable cashflow over time... The steady characteristics of the infrastructure asset class make it an attractive alternative to other forms of income investment such as bonds and property.”


460. Financial Times journalist Peter Larsen notes: “Investment banks have also been piling into the sector. Credit Suisse and General Electric recently joined forces to create Global Infrastructure Partners, a $1bn fund that will concentrate on energy, transport and water investments in the developed and developing world. It recently clinched its first deal as part of a consortium that bought London’s City Airport. Goldman Sachs is raising a fund which will include investments such as Associated British Ports, the UK group it bought earlier this year. Deutsche Bank and UBSS have launched infrastructure funds, and Morgan Stanley is in the process of raising a fund.”


462. The Ontario Teachers’ Pension Plan is one of several institutions reported to be bricolaging such deals. Unlisted infrastructure funds – which bypass public markets and access institutional investors directly – are also increasingly favoured by listed funds, in part, it would appear, to avoid the hefty management fees charged by listed funds.

463. Inflation swaps are derivatives that enable investors and companies to hedge their exposure to the risk that inflation will exceed their predictions. As the Financial Times explains: “In a typical inflation swap, two counterparties agree on a long-term contract based on an agreed inflation rate. If, at the end of the contract, prices are higher than originally expected, the seller of inflation makes a payment to the buyer. If prices turn out lower than expected, the buyer pays the seller.”

464. Because infrastructure funds are based on derivatives that are tied to revenues that are generally inflation linked (such as toll road fees), infrastructure funds have become major sellers of inflation protection.


465. Infrastructure projects – airports, roads, hospitals – generally have a useful life of 20 years or more. But, as the Financial Times notes, “nobody, apart from governments, can borrow money over such a long timeframe”. Hedging and instruments such as debt swaps are therefore key to borrowing shorter-term finance, while insuring against the risk of exchange rate and interest rate fluctuations.


467. Published by John Murray, 186 New Bond Street, London, WC1A 2AA. www.johnmurray.co.uk
Carbon markets, in which permits to emit carbon dioxide are bought and sold (traded), are the main current international response to climate change and the centrepiece of the 1997 Kyoto Protocol, the main international agreement to tackle climate change. Carbon trading has two parts. First, governments hand out free tradable rights to emit carbon dioxide to big industrial polluters. Second, companies buy additional pollution credits from projects in the South (such as coal mines, waste dumps and tree plantations) that claim to emit less greenhouse gas than they would have without the investment.


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485. Communications consultant James Spellman notes:

“The US state public pension fund, California Public Employee Retirement System, announced a plan in November 2007 to shift up to $2.5bn to a new infrastructure programme. The $12bn CK Finnish state pension fund, Valtion Elakerahasto, also announced its intent to broaden holdings in infrastructure. The world’s largest pension fund, the ABP, is committing 1 per cent of its €212bn (€165bn) in assets to infrastructure funds, with placements, for example, in ABN Amro Infrastructure Capital Equity fund and the Macquarie European Infrastructure Fund.”


487. Ibid.


489. Ibid.


In public-private infrastructure partnerships, the private sector typically raises the capital to build the project, whilst the government guarantees a minimum revenue stream for a fixed period or provides a one-off grant to make the project more attractive to investors.


495. Macquarie gives the total value of its assets under management at AS$225 billion.


The authors, who work for consulting firm Booz Allen Hamilton, report: “Booz Allen estimates suggest that in 2006, five-year returns included 11 to 13 percent for airports, 10 to 13 percent for toll roads, 8 to 10 percent for rail passenger lines, and 10 to 14 percent for wastewater plants.”


500. For overviews, see:


501. Moser, J.M. (ed), Global Infrastructure Research – The annual assessment of hydro-electricity . . . Luckily, there are ways to combat the looming energy crisis, which is partly the result of a regional drought which has affected the production of hydro-electricity . . . Luckily, there are newly-discovered capacities for generation of hydro-electricity . . . Currently, the world is getting 8 to 10 percent for rail passenger lines, and 10 to 14 percent for wastewater plants.”


507. Ibid.


509. The Legal Wire notes:

“The government [of Chile] is looking for ways to combat the looming energy crisis, which is partly the result of a regional drought which has affected the production of hydro-electricity . . . Luckily, there are newly-discovered capacities for generation across Chile. Several dams are being constructed in southern Chile, and photovoltaic panels are being built in the north of the country. Traditional project financing is giving way to collateralised syndicated loans as a means to raise capital.” Collateralised syndicated loans involve corporate loans being bundled up and their interest and principle repayments being sold to investors.”


510. Discussing alternative energy projects, lawyers Madeleine Tan and Roland Boread noted: “By creating a portfolio of assets that have proven to have relatively low correlations
with traditional portfolio assets we believe that achieving leverage through the capital markets is a viable alternative to project debt finance."


Martin Wolf of the Financial Times adds: “But there must also be greater attention to the adequacy of that other cushion: liquidity. Having assets that cannot be sold, after all, is no cushion at all.”

See:—Wolf, M., “Seven habits that finance regulators must acquire”, Financial Times, 7 May 2008, http://www.ft.com/cms/s/0/a8d59d4e-11bd-11dd-9e58-0000779f2d2a.html;—Tett, G. and Guha, K., “The cost of a lifetime: Humbled financial groups brace for the credit market turmoil... restoration of confidence requires more accessible and useful information about products and transparency on the part of firms”. More specifically, the Basel Committee on Banking Supervision recommends “regul- lar public disclosures, both quantitative and qualitative, of a bank’s liquidity risk pro- file and management”. Martin Wolf of the Financial Times also argues that greater transparency is an essential component of any reform of the banking system: “Lack of information, asymmetric information and uncertainty are inherent in financial activities. These are why they are vulnerable to swings in collective mood. The transactions-oriented financial system is particularly vulnerable, because information has to flow freely across arms-length markets. So a big challenge is to generate as much clarity as is possible. One issue is the calamitous recent role of the rating agencies and the conflicts of interest under which they operate.”


527. See: Roubini, N., “Ten fundamental issues in reforming financial regulation and supervision in a world of financial innovation and globalisation”, RGE Monitor, 31 March 2008, http://www.rgemonitor.com/redir.php?id=1&rgid=0&cid=252412;—A report by the European Parliament’s Economic and Scientific Policy Department for the Committee on Economic and Monetary Affairs recommends: “The arranger of CDO should be required to retain a proportion (say, 20%) of any CDO on its own balance sheet. This would not only encourage the arranger to assess its own exposure carefully, it would also attract a capital charge. Banks’ liabilities to SIVs should be recognised on their balance sheets, and hence in their regulatory capital.”


Robert Reoch, of Reoch of Reoch Credit Partners LLP and co-author of a report on the responses to the credit crunch for the European Parliament (see footnote X) also argues for the standardisation of CDOs: “There is scope to create a standard CDO product”.


William Cohen is author of The Last Tycoons: The Secret History of Lazard Frères & Co, and is working on a book about the meltdown of Bear Stearns.


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Martin Wolf of the Financial Times also stresses the need for global action: “Perhaps the most obvious lesson is the dangers of regulatory arbitrage: if the rules required certain capital requirements, institutions shifted activities into off-balance-sheet vehicles; if rules operated restrictively in one jurisdiction, activities were shifted elsewhere; and if certain institutions were more tightly regulated, then activities shifted to others. Regulatory coverage must be complete. All leveraged institutions above a certain size must be inside the net.”


537. See footnotes 78 and 79.


545. Jeremy Grantham, chair and chief strategist of fund manager GMO, writes: “Most academics are prisoners of the Efficient Market Hypothesis that assumes man acts rationally and efficiently in economic matters in ways that can be caught in elegant mathematical models . . . In such a convenient world, there can be no bubbles and no crashes. A related belief is that sensible, disciplined control of money supply will drive away all ills, including the madness of crowds, and, therefore, a sensible central banker is all powerful. Unfortunately, both concepts are complete illusions.”


546. For further discussion, see: Bookstaber, R., A Demon of our own Design: Markets, Hedge Funds and the Perils of Financial Innovation, Wiley, 2007.


Kay describes the financial services lobby as the most powerful in Britain. Tett cites one representative of the accountants PWC as telling a conference on securitisation in June 2008 that “that the industry had the regulators under control”, though noting the European Parliament was less malleable.


554. Tett, G., “A lack of trust spells crisis in every financial language”, Financial Times,


556. See, for example:

557. For a discussion of the UK context, see, for example, Janet Newman. “Restating a politics of ‘the public’”, Soundings, 32, Spring 2006, http://www.hwbooks.co.uk/journals/soundings/archive/soundings32.html

558. For a discussion, see:
—Raghavan, C., “Is what is good for ‘sealing’ Doha talks good for the trading system?”, Sans #6403, 30 January 2008;


559. See:
—Local Harvest, “Community supported agriculture”, http://www.localharvest.org/csa/;

Corner House Briefing 37
Taking it Private:
The Global Consequences of Private Equity
by Kavaljit Singh

www.thecornerhouse.org.uk/pdf/briefing/PrivateEquity.pdf

During the last two decades, private equity became an integral component of the world’s financial system at a time when financial markets overshadowed the productive economy. Private equity was invariably behind the multi–billion buyout deals, and mergers and acquisitions that swept across the US and Europe, creating a new type of corporate conglomerate that is reshaping the way business is conducted.

Insofar as it constitutes a new form of corporate ownership, private equity poses new challenges to labour unions, NGOs and community groups because it has a significant and distinctive influence on taxation policy, corporate governance, labour rights and public services, and thus deeply affects society, human rights and environment alike.

These challenges are especially clear in Asia, which has become more attractive for private equity firms since mid–2007 when the "credit crunch" took hold and diminished the scope for the huge deals in Europe and North America.

This paper looks at the global growth of private equity and its social, environmental and political impacts, using India as a case study of its growing importance in Southern countries. It concludes with an outline of private equity’s vulnerabilities that may provide opportunities for public concerns to be addressed.

Corner House Briefing 38
Sovereign Wealth Funds:
Some Frequently Asked Questions
by Kavaljit Singh

www.thecornerhouse.org.uk/pdf/briefing/SWFFAQs.pdf

Western politicians, business leaders and commentators seem paranoid about state–owned sovereign wealth funds (SWFs), particularly those from the Middle East and China. They fear that SWFs follow strategic political objectives — investing in Western companies and banks to secure control of strategically important industries such as telecommunications, energy and banking — rather than commercial interests.

A protectionist backlash against sovereign wealth funds is fast emerging: the US, Canada, Australia and Germany have introduced substantial legislative changes to screen and restrict investments by SWFs and other state–owned entities. European Parliament are considering regulations to curb the potential impact of SWFs on financial markets, corporate governance and security.

Are such fears based on facts or assumptions? Is the "invasion of sovereign wealth funds" real? Do SWFs pose a direct threat to financial stability? Do they have hidden agendas? Are SWFs driven by political considerations? Are governments really using SWFs to pursue nefarious foreign policy objectives? Should anyone be afraid of sovereign wealth funds? Are SWFs providing long–term investments and stability to ailing businesses and economies?

This paper examines these questions in order to understand the potential impact and implications of sovereign wealth funds in a rapidly–changing global political economy.