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Betting the System and Beating the House? Gillian Tett's Story of the Financial Crisis: "Fool's Gold—How Unrestrained Greed Corrupted a Dream, Shattered Global Markets and Unleashed a Catastrophe"

Review Essay

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Betting the System and Beating the House? Gillian Tett's Story of the Financial Crisis: Fool's Gold—How Unrestrained Greed Corrupted a Dream, Shattered Global Markets and Unleashed a Catastrophe, London: Little, Brown, 2009, xiv+338pp, £18.99.

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It all seemed so simple. If risk were dispersed around the globe, throughout the financial system, boom and bust would be a phantom of the past. The finest minds from finance, statistics, and law applied themselves to converting the ideal into reality. This “new dawn” of finance would embrace new technologies that would shrink financial risk into sufficiently small slices that no single bit could be responsible for a major eruption in the system. Alan Greenspan and Gordon Brown were in the vanguard of promoting the market's freedom to innovate with the lightest touch of regulation. “Groupthink” opined that once counterparty risk was fully dispersed the financial system would never be rocked by crises like the Great Depression. Of course, it didn't work and we are in one of the worst financial crises ever. How deep and long it will be is, *pace* Rumsfeld, an unknown unknown.

I recall I was to give a paper at the Berlin Law & Society Association meeting in 2007 on how new secondary debt markets were removing the threats of large-scale bankruptcies. I aborted the presentation: by the time of the conference the financial system was imploding and my paper was redundant. In the two years since the credit crisis has rolled through our lives, I have been surprised by the lack of response by socio-legal scholars in analysing this phenomenon. Elsewhere, for example, one of the recent issues of *Accounting Organizations and Society* contained a series of articles on accounting research and the crisis. No socio-legal journal has (yet?) published anything akin to this. I suspect the reasons are located in the difficulty of understanding the causes of the crisis and what, if any, lawyers' roles in it were. Nevertheless, a small number of social scientists have been delving into these dark complex areas. Donald MacKenzie and Karin Knorr Cetina are two that come to mind. But to get the big picture we have to leave the academy and migrate to the *Financial Times*.

In 2005 the *FT* gave a social anthropologist, Gillian Tett, the post of capital markets editor. This was generally situated at the back of the newspaper. Capital markets were arcane and seemed to exist in a shadowy world. One of her first tasks was to attend a banking conference in Nice with the topic of credit derivatives. Tett was completely baffled as she saw that finance “was presented as an abstract mathematical game that took place in cyberspace” replete with concepts such as “Gaussian copula”, “delta hedging” and “first-to-default basket”. She applied her anthropological skills to studying the tribe of financiers who made up the credit world and gradually acquired an ethnographic understanding of their rituals and rites. At the conference she asked her neighbour who the speakers were: “They all used to work at J.P. Morgan...It's like this Morgan mafia thing. They sort of created the credit derivatives market”. Four years later Tett has written one of the clearest expositions of the causes of the financial crisis. She takes us gently through a frighteningly complex world in a gripping story based around a young group of investment bankers who were to devise a complex method of taking risk off the balance sheet and selling it on to investors for high fees.

Tett's story is told in part through the lives of J.P.Morgan's credit derivatives department. In the mid-90s it generated half of the bank's revenues. Its swaps team helped companies and banks reduce risk in currency markets but they wanted to innovate, find the next generation of financial products that would captivate the markets. These came through the imaginative use of derivatives, which despite the Orange County-type scandals associated with their use, had managed to evade regulatory oversight. And with the concept of Value at Risk, to which major financial institutions subscribed, precision could be attained in calculating risk.

A risk attached to loans is that the borrower will default. Under Basel I banks held 8% capital reserves on their books. For every \$100 lent there had to be \$8 in the reserves. Because Morgan lent to high-quality corporate clients the default rate was low so that the Basel requirements seemed wasteful. And it restricted its business growth. Morgan didn't want to sell loans since that would harm client loyalty. The solution was to pay a fee to another entity to bear the risk of loan default—a credit-derivatives contract—a form of insurance. The trick for Morgan was how to do this in “industrial” quantities. Having first persuaded the Federal Reserve (Fed) to permit the deployment of credit derivatives as a way of reducing capital reserves, the bankers looked to securitization as the means to crank up their scale.

Securitization is the bundling of large numbers of loans into packages of securities which are then sold on in the market. Morgan's big idea was to package and divide the credit derivatives into different tranches (slices) with different levels of risk and return. Junior tranches would carry the greatest risk and highest return up through the mezzanine to the lowest-risk, the senior tranche. If defaults occurred then the junior would take the first hit and up the chain. But the senior tranche was hardly ever expected to suffer a default. The final piece was to sell these securities to a shell company called a special purpose vehicle, which was off the balance sheet, usually set up in offshore jurisdictions such as Bermuda. The SPVs sold the securities in smaller slices and insured losses in case of defaults in return for Morgan paying fees. The credit derivatives team had big ideas. They identified 307 companies for which Morgan was carrying \$9.7 billion of risk and the SPV would only need to sell \$700 million of notes to cover any payouts it might need to make to Morgan—“around 8% of the risk insured”. Morgan persuaded Moody's, a rating agency, to stamp two-thirds of the notes AAA with the rest Ba2. Within days the \$700m notes were sold and “Bistro” (a synthetic collateralized debt obligation) was hailed a great success. Other banks jumped on board and within a few months \$300 billion such deals had been done. Here was the solution to insuring against risk and making money.

Yet the regulators weren't happy that all risk had been moved off the books; some was still unfunded. This was the top-drawer risk that was “beyond triple-A” (some erroneously called it quadruple-A) and for which effectively there was no market because the returns were too low—super-senior risk. Morgan approached AIG, an insurance company, and in return for a small fee AIG signed credit-derivatives contracts insuring Morgan against this loss. Insurance companies were not subject to the same regulatory requirements on capital reserves as banks and, moreover, were regulated at the state level so the pressures were much lighter for them. The Fed then had a change of mind that the super-senior risk did not have to be removed from their books as long as the issued credit derivatives received AAA ratings. But if they kept it then they would have to post reserves of 20% of their capital reserves. Under Basel banks had to hold \$800 million

reserves for every \$10 billion of loans they held. With credit derivatives that figure went down to \$160m. Even though other banks held on to their super-senior risk the Morgan team thought it judicious to keep insuring theirs. Thus the levels of super-senior risk grew. And as the credit derivatives deals exploded in number, their returns diminished. New outlets were sought.

An advantage of corporate debt as a basis for credit derivatives is the amount of data available about defaults. This meant that the correlation of defaults in a package of loans could be predicted with some certainty and as long as the correlation was low (about 0.3) the risk was tiny. But when a German state bank asked Morgan to use CDOs to remove the risk of \$14 billion of US mortgage loans it had made, the bank initially balked.

¹ Whereas corporate loans were tied to identifiable institutions whose histories were known, mortgages were essentially anonymous. How then was the risk/correlation of default to be calculated? The statisticians didn't know. They had some estimates based on patchy data which enabled them to take on the task. Morgan eventually left the field of mortgage-backed derivatives as the correlations could not be calculated with any accuracy, although other banks saw this as the way to reap extraordinary profits.

Once CDOs became standardized bankers looked for other ways to capitalize on their new financial technologies. Institutions such as pension funds and municipalities were also seeking new means of obtaining greater returns on their investments. The realm of credit derivatives expanded as single-tranche CDOs took hold. Only one class of notes was offered so the structured investment vehicle (type of SPV) had to hold more of the risk on its books. Then CDO-squared emerged where SIVs would buy not loans but debt issued by other CDOs financing the purchases by issuing notes to investors.

The rise in credit derivatives chimed with the boom in the housing market as the Fed capped interest rates. The big growth was in subprime mortgages—loans to homeowners who didn't conform to conventional standards—so that in 2000 subprime mortgage bonds sold amounted to \$80 billion but by 2005 the figure was \$800 billion. Subprime mortgages attracted huge interest and the business of repackaging mortgages into bonds for sale became mass production. And bond sales became the driver of mortgage lending. Mortgage bonds were rebundled as CDO of ABS (asset-backed securities) with one of the most popular being mezzanine CDO of ABS which contained pools of subprime mortgage loans. New CDOs were being formed by constantly taking out the risky bits and reforming them and issuing new notes. The appetite for these CDOs was enormous. Yet, as the Morgan team had spotted, no one could predict what would happen to these CDOs if there were a decline in house prices.

Although CDOs were created and notes sold market information and default predictability were scarce. One model, the Gaussian copula, in 2000 became the market standard for interpreting the value of a CDO. It did it through not examining historical default data but by using market data on the pricing of credit default swaps (a form of insurance against default). It simplified calculations by providing a single correlation figure, low or high. But, as was pointed out by some observers, models are real life approximations, not life itself. Felix Salmon in *Wired* wrote, "The effect on the securitization market was electric." Balance sheets looked healthy with the

risk “removed”, profits were rising and London and New York were thriving. There was a massive co-expansion in the market for CDOs and CDSs. Plus bankers could book the profits immediately instead of piece by piece over the term of the CDO.

By 2006 the housing market was showing signs of slowdown and mortgage defaults were rising. Banks and investors were nevertheless hungry for CDOs and CDSs which were still being churned out. The one area of ignorance in the market was how much super-senior risk banks held on their balance sheets. Some canny hedge funds began shorting (selling to anticipate price falls) these banks and super-senior tranches. Even the G8 criticised the role of the hedge funds despite being warned the real problem was that no one knew how much risk the banks held.

In 2007 two Bear Stearns funds faltered as the mortgage market downturned. Banks demanded the return of their loans which had enabled the hedge funds to make their bets. This was the spectre of leverage: how much debt had been taken on to fund investments? Next was a German bank with an SIV invested primarily in mortgage-related securities that couldn't sell its notes because main investors in such notes, money market funds, stepped away from anything related to the mortgage market. These events triggered a rise in the US overnight borrowing rate making it prohibitively expensive for other SIVs to continue to finance their portfolios. These vehicles borrowed money short term typically from money market funds to purchase longer-term assets. No one thought the markets would become illiquid. Moreover, the SIVs were not bound by Basel requirements nor were they regulated. Investors' concerns that billions of assets from liquidating SIV portfolios were soon to hit the markets made the market illiquid. The opacity of SIV holdings and lack of dependable asset valuations created an aura of mistrust and with that nobody wished to lend except at extortionate rates. Central bankers were divided with the US tending to want to assist banks and the Bank of England letting them stew.

When Northern Rock was pictured on TV with queues of people demanding their money regulators and politicians could no longer stand by. Mortgage defaults exacerbated cash-flow problems for CDOs and banks. Governments were forced to action by guaranteeing deposits, buying toxic assets, and recapitalizing the banking system. Some banks were forcibly merged with others; some, notably Lehman's, fell bankrupt with catastrophic consequences; and some were (unimaginably) nationalized. The downward spiral of de-leveraging was now snaking its way through the system creating an acute lack of liquidity. The insurers couldn't manage their CDS losses and failed. The correlation of default risk was fast approaching the undreamt of figure of 1.0: total collapse. Two years after the beginning of the collapse unemployment is rising, public debt is soaring, homelessness is growing, and banks are wondering if they can restart paying bonuses. Losses will run around \$3 trillion.

Not everything in Tett's book is uncontroversial in its telling. Take two examples. Some believe super-senior wasn't risky and unwanted. Relative to the returns on the scarce universe of AAA-corporate debt, super-senior return was high and so bankers were meeting demand from investors. Or, with mortgage-backed securities the available statistics were well-identified since the MBS market in the US had a 30-year history making correlation easier, not more difficult, to model. Yet Tett is a well-written entree into the financial world and its tribes. She introduces us to its kinship structures (how bankers move from one bank to another; the revolving door

between finance and regulators), its status hierarchies (how bankers earn bonuses and achieve promotion), and its beliefs (the Gaussian copula as sacred; the sanctity of triple-A). She shows us that understanding numbers is only a small part of the story whereas the people creating and interpreting the numbers are far more important. Economics alone cannot explain the crisis; we must look to social explanations.

What Tett's story tells us is that our faith in espoused systems should be sceptical and full of suspicion. Snake oil salesmen are still with us though they are selling different things. When lenders allow borrowers to take out mortgages for 125% of the property value on a multiple of 5 times their income at low starting interest rates that ratchet up quickly, we are in earthquake territory—it's not if but when. When banks pay enormous bonuses for illusory profits written on their books with risks inadequately covered, we are being blinded by sunspots. When regulators and politicians let themselves be courted by the financial industry with promises of boom and no slump, of dispersed risk and wealth for all, we are without any moral compass whatsoever.

Maybe regulation could have been better synchronised. Splitting it between institutions—both in the UK and the US—doesn't create harmony or coherent planning. Would tighter regulation have worked? It's difficult to say. The US had rules-based regulation while the UK deployed principles. Neither proved effective. Two points emerge from Tett on this. One is that the industry was extremely effective at lobbying against regulation in favour of supposed self-control. We could almost imagine the reprise of the corporatist state. The second is that regulators themselves take positions on what they consider properly within their purview (because they are captive?). And the intellectual and social complexity of the issues involved might help push some areas beyond this prospect. Thus we ought to be educating our regulators (and raters) more eclectically to expand and enhance their vision.

Credit derivatives themselves weren't at fault. Their use was—the way Morgan distanced itself from mortgage-backed CDOs was indicative of their good sense. Bankers' abandonment of good sense, of moral stewardship, raises questions about the roles of those in this business. How accountable are the credit rating agencies in awarding AAA to risky products? What were accountants doing in their audits of SIVs? And what were the lawyers doing who put these beautiful structures together? For us the role of lawyers in this debacle is an empty space. They remain in the background. Were they merely technicians, the underlabourers, doing the bidding of the bankers? Who decided that covenants in agreements would be "lightened"? The Bank of America-Merrill merger case in the US has shown that in the shadows lawyers took vitally important decisions about what was to be omitted—namely \$3 billion of bankers' bonuses—from important public merger documentation. There is an entire field of research here that relates to lawyers' roles, client relationships, education, and ethics. Because, despite all that has occurred, the role of ethical responsibility in bringing about this crisis has not been raised. As Tett says the root of the word credit comes from the Latin *credere*, to believe. And even Moody's has above its entrance: "Credit is men, trust in men." Has the re-engineering of risk rendered it impossible for us to believe and recapture some kind of ethics? I would hope not.

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¹ For an illustration of how CDOs work see <http://www.portfolio.com/interactive-features/2007/12/cdo/>