2007-2012: Six years that shook the banking world

Banks versus the People: The Underside of a Rigged Game! (Part 1)

Sunday 13 January 2013, by TOUSSAINT Éric (Date first published: 19 November 2012).

For the second part of this series, see on ESSF (article 27547), Financial Crisis : The ECB and the Fed at the service of the major private banks and part three (article 27546), The greatest offensive against European social rights since the Second World War

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Since 2007-2008, the major central banks (the ECB, Bank of England, the "Fed" in the USA, and the Swiss National Bank) have been making it their absolute priority to attempt to avoid a collapse of the private banking system. Contrary to what has been said more or less everywhere, the principal risk threatening the banks is not that a government will suspend payment of sovereign debt [1]. None of the bank failures since 2007 have been caused by that kind of payment default. None of the bank bailouts organized by the various governments has been made necessary by suspension of payment by an over-indebted State. What has threatened the banks since 2007 is the structured private-debt holdings they have gradually built up since the major deregulations, which began in the late 1970s and culminated during the 1990s. The balance sheets of private banks are still packed with bad assets [2] which range from completely toxic assets – veritable time bombs – to non-liquid assets (meaning they cannot be sold or shifted on financial markets), and include assets of which the value is completely over-estimated in the banks' balance sheets. The sales and depreciations of assets banks have booked until now in order to reduce the weight of these explosive assets have been insufficient. A significant number of them depend on short-term financing (either provided or guaranteed by the Public Authorities with taxpayers' money) to stay afloat [3] and handle debts that are themselves short-term. That explains why the Franco-Belgian bank Dexia, which in fact amounts to a very large hedge fund, has been on the brink of bankruptcy three times in four years – in October 2008, in October 2011 [4], and again in October 2012. During the most recent episode, in early November 2012, the French and Belgian governments provided aid amounting to 5.5 billion euros (53% of which was borne by Belgium) to recapitalize Dexia SA, a moribund financial company whose equity has melted away. According to Le Soir: "The equity of the Dexia parent company dropped from 19.2 billion to 2.7 billion euros between the end of 2010 and the end of 2011. And at group level, total equity has become negative (-2.3 billion euros on 30 June 2012)." At the end of 2011, Dexia SA's immediately outstanding debts amounted to 413 billion euros, and the amounts due under derivative contracts stood at 461 billion. Added together, those two figures amount to more than 2.5 times Belgium's GDP! And yet Dexia's senior executives, Belgian vice-prime minister Didier Reynders, and the dominant media are still claiming that the problem afflicting Dexia SA is largely caused by the sovereign debt crisis in the southern part of the Euro zone. The truth is that Dexia SA's holdings in Greece did not amount to more than 2 billion euros in October 2011 – 200 times less than the amount of its immediately outstanding debts. In October 2012, Dexia's shares were worth approximately 0.18 Euros – 100 times less than in September 2008. Despite this, the French and Belgian governments have decided once again to bail out this uncharitable organization at the cost of increasing the public debt in their own countries. In Spain, the near failure of Bankia was also caused by unsound financial packages, and not by a default on the part of any government. Since 2008, the same scenario has been replayed at least thirty times in Europe and the United States. Each time, the public authorities have come to the aid of the private banks (as they systematically do) by financing their bailouts with government debt.

Return to the beginning of the crisis in 2007

The gigantic private-debt house of cards began to collapse when the speculative real-estate bubble in the United States burst (followed by Ireland, the UK, Spain, etc.). The real-estate bubble burst in the United States when the price of homes, of which there was an oversupply, began to fall because more and more homes were without buyers.

The interpretations given by the mainstream media were dominated by partial – or deliberately fallacious – explanations for the crisis that struck the United States in 2007 and had a tremendous contagious effect, mainly on Western Europe. Regularly in 2007 and during the better part of 2008, it was explained to the public that the crisis had started in the United States because low-income people had gone into too much debt to acquire homes they were not able to pay for. Irrational behavior on the part of the poor was pointed to as the cause of the crisis. But beginning in late September 2008, after the failure of Lehmann Brothers, the dominant narrative changed and the finger was pointed at certain black sheep of the world of finance who had perverted the virtuous operation of capitalism. But the lies and partial explanations continued to circulate. Low-income families were no longer responsible for the crisis; it was the rotten apples in the capitalist class – Bernard Madoff, who put together a 50-billion-dollar swindle, or Richard Fuld, the boss of Lehmann Brothers.

The beginnings of the crisis go back to 2006, when the drop in real-estate prices began in the United States, caused by overproduction, itself caused by the speculative bubble that inflated real-estate prices and drove the construction sector to overheat and increase its activity far in excess of solvent demand. The collapse of real-estate prices is what caused the increase in the number of households unable to meet their payments on subprime mortgages. In the United States, households often refinance their mortgages after 2 or 3 years when home prices are trending upward in order to get more favorable terms (especially since, in the subprime-loan sector, the credit rate for the first two or three years was low and fixed, around 3%, before increasing sharply and becoming variable in the third or fourth year). When real-estate prices began to drop in 2006, households who had contracted subprime loans were no longer able to refinance their home loans favorably, and payment defaults began to multiply greatly starting in early 2007, causing the failure of 84 mortgage companies in the USA between January and August 2007.

As is very often the case, whereas the crisis is explained simplistically by the bursting of a speculative bubble, in reality the cause lies both in the production sector and in speculation. Of course, the fact that a bubble was created and eventually burst only multiplies the effects of a crisis that began with production. The entire rickety structure of subprime loans and structured products that had been under construction since the mid-1990s, collapsed, which had terrible repercussions on production in various sectors of the real economy. Austerity policies then amplified the phenomenon further by leading to the extended period of recession-depression in which the economies of the most industrialised countries are now floundering.

The impact of the real-estate crisis in the United States and the banking crisis that followed has had an enormous contagious effect internationally, due to the fact that numerous European banks had invested massively in US structured products and derivatives. Since the 1990s, growth in the United States and in several European economies had been supported by hypertrophy of the private financial sector and by a huge increase in private debt – household debt [5] and debts of financial and non-financial companies. On the other hand, public debt had tended to decrease between the second half of the 1990s and 2007-2008.

Thus there was a hypertrophy of the private financial sector. The volume of assets of European private banks compared to gross domestic product ballooned extraordinarily beginning in the 1990s to reach 3.5 times the GDP of the 27 member countries of the European Union in 2011 [6]. In Ireland in 2011, banks' assets amounted to eight times the country's gross domestic product.

The debts of the private banks [7] in the Euro zone also amounted to 3.5 times the Zone's GDP. Debt in the British financial sector has reached unheard-of heights in proportion to the GDP – it is 11 times greater, whereas public debt represents approximately 80% of GDP.
The gross public debt of the countries of the Euro zone amounted to 86% of the GDP of the 17 member countries in 2011 [8]. Greek public debt was 162% of Greece's GDP in 2011, while debts in its financial sector amounted to 311% of GDP – double the amount of public debt. Spain's public debt was 62% of GDP in 2011, whereas debts in the financial sector were at 203%, or three times the amount of public debt.

A little history: The implementation of strict financial regulation after the crisis in the 1930s

The crash of Wall Street in October 1929, the enormous banking crisis of 1933, and the prolonged period of economic crisis in the United States and Europe during the 1930s led President Franklin Roosevelt, and then Europe, to strongly regulate the financial sector in order to avoid the repetition of serious stock-market and banking crises. As a result, during the thirty years following the World War II, the number of banking crises was minimal. That is demonstrated by two neoliberal North American economists, Carmen M. Reinhart and Kenneth S. Rogoff, in a book published in 2009 entitled This Time Is Different: Eight Centuries of Financial Folly. Kenneth Rogoff was chief economist of the IMF, and Carmen Reinhart, a university professor, is adviser to the IMF and the World Bank. According to these two economists – to whom it would never occur to call capitalism into question –, the very low number of banking crises can be explained mainly by "the repression of the domestic financial markets (in varying degrees), and the heavy-handed use of capital controls that followed for many years after World War II." [9]

One of the strong measures taken by Roosevelt and the governments of Europe (in particular due to pressure from popular mobilization in Europe after the Liberation) consisted in limiting and strictly regulating the uses banks could make of the public's money. This principle of protection of deposits resulted in a separation between commercial banks and investment banks, of which the US's Glass-Steagall Act was the best-known example, but which was also applied, with certain variants, in European countries.

With this separation, only commercial banks could receive deposits from the public and benefit from government deposit guarantees. In parallel, their field of activities was reduced to making loans to individuals and businesses, and excluded the issuance of securities, shares, and all other types of financial instruments. Meanwhile, investment banks were required to derive their resources from the financial markets to be able to issue securities, shares, and other financial instruments.

Financial deregulation and the neoliberal turn

The neoliberal turn of the 1970s called those regulations into question. Within about twenty years, the deregulation of banks and the financial sector in general was complete. As Kenneth Rogoff and Carmen Reinhart point out, banking and stock-market crises multiplied starting in the 1980s, and also became more and more acute.

In the traditional model inherited from the long period of regulation, banks evaluate and bear risk – that is, they analyze credit requests, decide whether or not to meet them, and, once the loans are granted, keep them on their books until they come due (this is what is called the "originate and hold" model).

Taking advantage of the profound movement towards deregulation they brought about, the banks abandoned the "originate and hold" model in order to increase their yield on equity. To do that, banks invented new processes – in particular securitisation, which consists in converting bank loans into financial securities. The goal was simply to no longer keep credit and its associated risks on their books. They transformed these loans into securities in the form of structured financial products, which they sold to other banks or private financial institutions. This is a new banking model, known as "originate to distribute," also called "originate, repackage and sell." For the bank, the advantage is twofold: It reduces its risk by removing the loans it has granted from its assets, and it has additional resources to use for speculating.

Deregulation made it possible for the private financial sector, and banks in particular, to take full advantage of what is known as the leverage effect. Xavier Dupret describes the phenomenon clearly: "The banking world has accumulated large amounts of debt in recent years via what is called leverage effects. The leverage effect consists in using indebtedness to increase the profitability of one's equity. And for it to work, the rate of return of the selected project needs to be higher than the rate of interest to be paid on the borrowed amount. Leverage effects became stronger and stronger over time. Obviously this causes problems. As an example, in the spring of 2008, the Wall Street investment banks had leverage rates of between 25 and 45 (for each dollar of shareholders' equity, they had borrowed between 25 and 45 dollars). Merrill Lynch had a leverage rate of 40. That was obviously an explosive situation, since an institution that is leveraged 40 to 1 can lose its shareholders' equity with a drop of 2.5% (1/40th) of the value of the assets acquired." [10]

Thanks to deregulation, banks were able to develop activities requiring gigantic amounts of financing (and therefore of debt) without accounting for them on their balance sheet. They engaged in so much off-balance sheet activity that in 2011 the volume of the activities in question exceeded 67,000 billion dollars (which is approximately equivalent to the sum of all the GDPs of all the countries on the planet). This is what is referred to as shadow banking [11]. When off-balance sheet activity leads to massive losses, sooner or later it will affect the soundness of the banks who initiated it. The major banks are far and away the ones who dominate shadow banking. The threat of failure has prompted governments to come to the aid of these banks by recapitalizing them. Whereas banks' official balance sheets show a reduction in volume since the start of the crisis in 2007-2008, the volume of off-balance sheet or shadow banking activity has not followed the same pattern. After declining between 2008 and 2010, in 2011-2012 it returned to 2006-2007 levels, which is a clear symptom of the dangerousness of the situation of private finance worldwide. As a result, the range of action of the national and international public institutions, which are in charge of – to use their vocabulary – seeing to it that finance behaves more responsibly, is very limited. Regulators have not even provided themselves with the means of knowing what the banks they are supposed to control are really doing.

The Financial Stability Board (FSB), the entity created by the G20 forum to be in charge of financial stability around the world, has issued its figures for 2011. "The amount of the shadow banking that escapes any regulation is 67,000 billion dollars according to its report covering 25 countries (90% of financial assets worldwide). That is 5,000 to 6,000 billion more than in 2010. This 'parallel' sector alone represents half the size of the total assets of the banks. Compared to the countries' gross domestic product, shadow banking is prospering in Hong Kong (520%), Holland (490%), the UK (370%), Singapore (260%), and Switzerland (210%). But, in absolute terms, the United States remains in first place, with the share of this parallel sector representing 23,000 billion in assets in 2011, followed by the Euro zone (22,000 billion) and the UK (9,000 billion)." [12]

A large share of financial transactions totally escapes any official control. As we said previously, the volume of shadow banking represents half of the total assets of the banks! The over-the-counter (OTC) market, which is subject to no control by the market authorities for derivative financial products, must also be taken into account. The volume of derivatives developed exponentially between the 1990s and 2007-2008. While it declined a little at the start of the crisis, in 2011 the notional value of derivative contracts on the OTC market reached the astronomical sum of 650,000 billion dollars ($650,000,000,000,000), or approximately 10 times the worldwide GDP. The volume for the second semester of 2007 has been exceeded, and that of the first semester of 2008 is in sight. Interest-rate swaps accounted for 74% of the total, while currency-market derivatives accounted for 8%, credit default swaps (CDS) 5%, and equity derivatives 1%, with the rest distributed among a multitude of products.

Since 2008, bank bailouts have not resulted in more responsible behavior

With the financial crisis of 2007, the banks, despite being guilty of reprehensible actions and of having taken reckless risks, were given massive injections of funds through numerous and costly bailout plans. In a well-documented study [13], two researchers set out to verify "whether the rescue operations were followed by a greater reduction of risk in new loans made by rescued banks compared to those that were not rescued." To do that, the authors analyzed the balance sheets and the syndicated loan issues (loans granted to a company by several banks) of 87 large international commercial banks. The authors determined that "rescued banks continued to write riskier syndicated loans," observing that "the syndicated lending of banks that later received a bailout was riskier before the crisis than that of non-rescued institutions." Rather than serving as a remedy and an effective safeguard against abuses by banks, for a number of them the government bailout plans instead acted as a powerful incitement to continue and intensify their reprehensible practices. As the authors put it, "The expectation of state support may give rise to moral hazard and lead banks to engage in higher risk-taking" [14].

In short, a grave crisis of private debt caused by the irresponsible actions of the major banks prompted leaders in the United States and Europe to bail them out using public funds. It was then that the "sovereign debt crisis" tune was struck up as background music to the brutal sacrifices imposed on the people. The financial deregulation of the 1990s was the fertile ground out of which this crisis grew, with its dramatic social consequences. Until they take control of international finance, the world's peoples will be at its mercy. The struggle must be intensified, and quickly.

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The author thanks Patrick Saurin, Daniel Munevar, Damien Millet, and Virginie de Romanet for their help in writing this article.

P.S.

* Translation: "Snake" Arbusto

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Footnotes

[1] Sovereign debt is the debt of a State and the public entities attached to it.

[2] In general, the term "asset" refers to a product that has a realisable value, or that can generate revenues. In the opposite case, we speaks of a "liability" that is the part of the balance sheet made up of a company's resources (the equity capital provided by the partners, provisions for liabilities, debts). See: http://www.banque-info.com/lexique-bancaire#a

[3] Many banks depend on short-term financing because they have great difficulty in borrowing in the private sector at a sustainable (meaning the lowest possible) cost, in particular in the form of issuing debt securities. As we shall see, the ECB's decision to lend slightly over 1,000 billion euros at an interest rate of 1% for a period of 3 years to more than 800 European banks was a lifeline for many of them. Subsequently, thanks to these ECB loans, the strongest ones were again able to issue debt securities to finance their activities. That would not have been possible had the ECB not acted as lender of last resort for 3 years.

[4] On the October 2011 episode, see Eric Toussaint, ESSF (article 23029), "Krach de Dexia : un effet domino en route dans l'UE ?" ("The Dexia crash: Is a domino effect underway in the EU?"), 4 October, 2011.

[5] Household debt includes the debts American students have contracted to pay for their education. Student debt in the United States stands at a colossal 1,000 billion dollars, more than the total of the external public debt of Latin America, (460 billion dollars), Africa (263 billion) and Southern Asia (205 billion). On the debts of these "continents," see: Damien Millet, Daniel Munevar, Eric Toussaint, 2012 World Debt Figures, table 7, p. 9. Downloadable: http://cadtm.org/Les-Chiffres-de-la-dette-2012 Soon an English version will be available.

[6] See Damien Millet, Daniel Munevar, Eric Toussaint, 2012 World Debt Figures, table 30, p. 23. This table is based on data from the European Banking Federation, http://www.ebf-fbe.eu/index.php?page=statistics. See also Martin Wolf, "Liikanen is at least a

step forward for EU banks," Financial Times, 5 October 2012, p. 9.

[7] Banks' debts should not be confused with their assets; they are part of their "liabilities." See the footnote on bank' "Assets" and "Liabilities" above.

[8] See Damien Millet, Daniel Munevar, Eric Toussaint, 2012 World Debt Figures, table 24, p. 18. This table uses the Morgan Stanley research database, as well as http://www.ecb.int/stats/money/aggregates/bsheets/html/outstanding_amounts_index.en.html and http://www.bankofgreece.gr/Pages/en/Statistics/monetary/nxi.aspx

[9] Carmen M. Reinhart, Kenneth S. Rogoff, This Time Is Different: Eight Centuries of Financial Folly. Princeton University Press, 2009.

[10] Xavier Dupret, "Et si nous laissions les banks faire faillite ?" ("And what if we allowed the banks to fail?"), 22 August, 2012, http://www.gresea.be/spip.php?article1048

[11] See Daniel Munevar, "Les risques du système bancaire de l'ombre" [http://cadtm.org/Les-risques-du-systeme-bancaire-de] ("Risks of the shadow banking system"), 21 April, 2012, See also: Tracy Alloway, "Traditional lenders shiver as shadow banking grows," Financial Times, 28 December, 2011.

[12] See Richard Hiault, "Le monde bancaire 'parallèle' pèse 67.000 milliards de dollars" ("The 'parallel' banking system is worth 67,000 billion dollars"), Les Echos, 18 November, 2012, http://www.bis.org/publ/qtrpdf/r_qt1209h.htm

[13] Michel Brei and Blaise Gadanecz, "Have public bailouts made banks' loan book safer?", Bis Quarterly Review, September 2012, pp. 61-72. The citations in this paragraph are from this paper.

[14] Ibid.