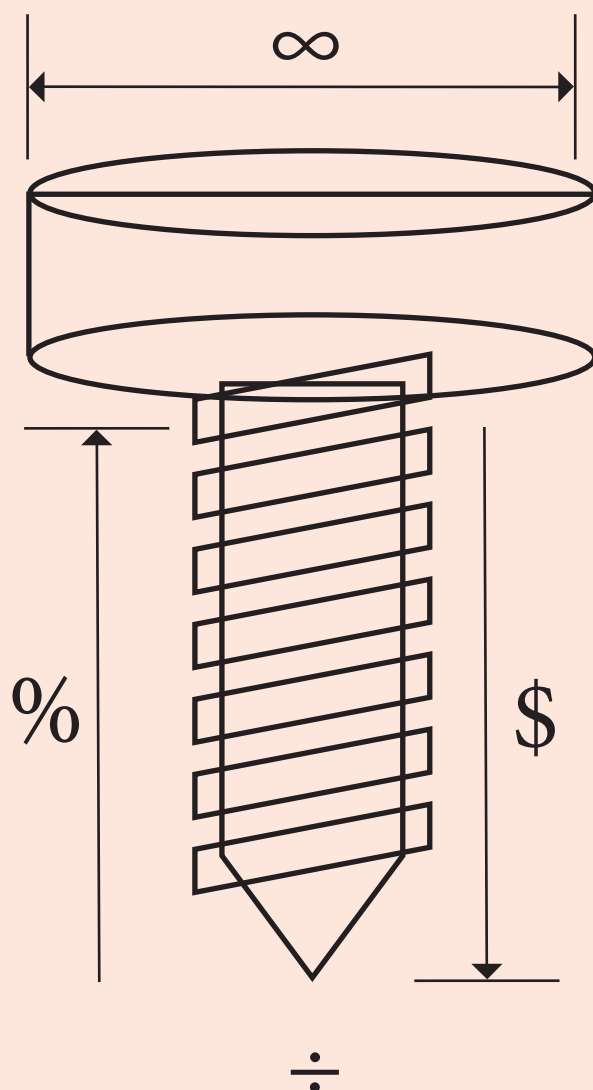
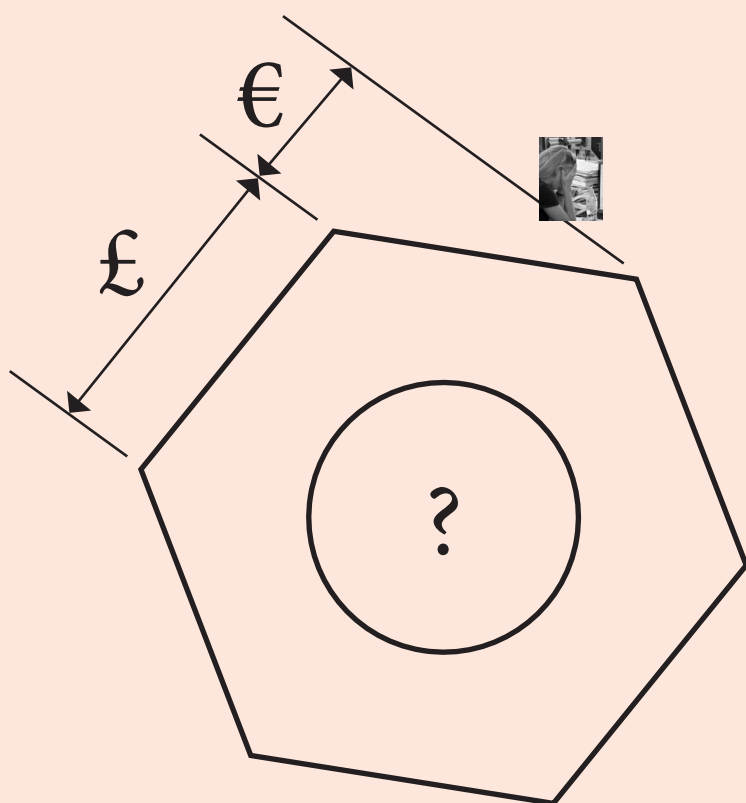


Demystifying the Financial Sector



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Introduction

“First you make money by creating products no one understands, then you make money by cleaning the mess up.”¹

Over the past three decades the financial system has exploded in both size and importance. This growth corresponds to a seismic shift in the organisation of society and the global economy, in which the world of banking and finance increasingly mediates every aspect of human activity. Global production, government spending, retirement savings and access to basic material necessities like food, housing and medicine are all now more than ever subject to the pressures of the financial markets. These markets now act as the central hub of an exploitative economic system which demands unlimited growth, stretching people and planet to breaking point. Despite triggering one of the worst financial crashes in history, which has sparked economic instability and recession across the globe, the power of financial institutions has not diminished, but rather increased. Furthermore, these markets play an integral role in the creation of some of the most destructive projects on earth, from the tar sands to cluster bombs to surveillance and repression technologies. Without finance, these socially, economically and environmentally harmful projects cannot proceed. It is therefore vital that we get to grips with the new financial forms that capital and the corporation have adopted.

Yet to most of us, the financial system appears impenetrable: a mess of jargon, institutions and economic theories; the rapid transmission of data across global communication networks; an alphabet soup of ever innovating financial products and strategies. It's easy to feel bewildered by the sheer complexity of the economy, and in the face of this difficulty it becomes tempting to resort to abstract conspiracy theories or reformist solutions. But the truth about the problems of the financial sector is far more fundamental; it is not an aberrant part of the economy or a few bad apples corrupting an otherwise healthy system. Rather finance lies at the very core of contemporary capitalism and acts as the primary organising principle of a global economy driven by the single aim of profit

maximisation – whatever the social and environmental cost. Moreover, whilst hedge funds, derivatives, and the bond markets might seem like intangible entities, far removed from our everyday lives, in truth they are rooted in the actions of normal people, not some secretive gang of elites. The worldwide financial system works through us, it cannot exist without the work we do, the things we buy and the debts we pay. It controls the resources we need to live and locks us into exploitative social relationships. Understanding how this happens is key to any struggle for social change.

This system can be broken down and understood: it operates through a global network of institutions, investors and agencies all trying to turn a profit from buying and selling a wide array of financial products. Once these key **players** and **products** are outlined, the pieces of the puzzle start to come together more clearly. This booklet lays out the nuts and bolts of the financial system: from hedge funds to pension funds, investment to retail banks, commodities to derivatives, each is defined by its core activity and which other players and products it deals with. It deconstructs the world of finance in clear, simple language, with case studies and real-world examples included throughout.

This booklet is a work in progress and forms part of an ongoing research project by Corporate Watch called *Banking on Crisis*, a series of publications and workshops aiming to contribute to a popular, critical understanding of the banking and finance sector and its role in society. For more information visit our research blog at Bankingoncrisis.org, or for questions, comments and suggestions, get in touch via: contact@corporatetwatch.org

1. Gillian Tett, *Derivative Thinking*, June 2008, <http://marketpipeline.blogspot.com/2008/06/derivative-thinking.html>

i) Banks

Overview

Banks manage the money that flows through the world economy. They act as traditional lenders and deposit holders (see ‘commercial banks’), direct market players engaged in speculation (see ‘proprietary trading’) and intermediaries helping others to buy, sell and ‘hedge’ in return for a fee (see ‘investment banks’). They facilitate almost every aspect of financing, investment and trading, as well as constantly inventing new markets and profit-making opportunities for wealthy individuals and institutions. Banks make up the core of the financial system, connecting all of the different players to each other as well as providing logistical support, financial advice and other services.

Banks have grown into global juggernauts. A few multinational banking groups now dominate the global economy, managing the movement and allocation of capital across and within national boundaries. In the UK in mid-2008, only five major banking groups controlled over 90 per cent of business banking and 75 per cent of current accounts.¹ As commercial banks have grown, building and mutual societies (co-operative banks, owned by their members rather than outside shareholders) have declined: in 1900 there were 60,000 such co-operatives operating; by 2008 there were only 59.² A similar process of centralisation and monopolisation is evident around the world. As a percentage of GDP and domestic corporate profits, banking and finance has also taken on an increasingly important position within the UK’s economy: in 2006 financial services accounted for 30% of all wealth generated in this country. The health and stability of national finance, in Britain as well as elsewhere, has become inextricably bound up with the interests of the financial sector. We’ve all heard the phrase ‘too big to fail’; as multinational banking groups teetered on the brink of financial collapse in 2008, they threatened to take the entire economy down with them. The expansion of the banking and finance sector in advanced capitalist countries has also occurred hand in hand with the contraction of what is often referred to as the ‘real economy’, primarily referring to manufacturing, industry and services produced for export as well as domestic consumption. Government policies which aggressively promoted de-industrialisation and the dissolution of Britain’s manufacturing base from the 1970’s onwards were accompanied by programs which facilitated the expansion of financial services.³ As factories in the global north closed down and production moved to



developing countries with lower wages, the expanding finance business stepped in to manage the transnational movement of capital required by these newly globalised business operations.

Historically, the different types of banking activities, most simply divided into investment and retail/commercial banking, occurred within entirely separate banks; However, the formation and development of multinational banking groups mean that these divisions are much more fluid than they were 30 years ago, with many of these operations now taking place within the same banking groups. As a result, deposits placed by ordinary people or small businesses into a high street bank enter the global money markets in the form of more risky ‘investment banking’ activities. Highly speculative forms of investment activity, which were previously taken on only by a limited section of society (i.e. the ultra-wealthy) have become generalised across a much wider public sphere, with banks acting to facilitate and manage this expansion. It is now quite normal for pension funds, insurance companies, low-income households and even nation states to plough their savings into the opaque world of derivatives in some more or less direct manner.

Banks play a fundamental role in deciding which projects, companies and individuals will receive funding and which will not, mobilising investment with profitability as the over-riding priority. They deliberately manipulate market conditions,

contributing to the creation of asset bubbles (such as the dot-com boom in the 90’s and the housing bubble of the 2000’s) and commodity price rises (such as the 2008 food crisis). Such ‘bubbles’ generate massive profits for a tiny group of savvy investors whilst they last, but inevitably contribute to the immiseration of millions when they burst. The sub-prime mortgage crisis is normally only thought of as the event which triggered the ‘credit crunch’, but in itself it constituted ‘the largest loss of African-American wealth in American history’, as millions of black homes were repossessed. On the other side of the world, the UN estimates that 130 million people were



pushed into starvation or suffered malnutrition between may 2007 and may 2008, largely as a result of the spike in food prices caused by commodity speculation.

Banks are often at the forefront of innovation in the sector – both in terms of speculation techniques and financial products (or ‘instruments’). Crucially, they do not merely operate in existing markets and deal with current products, but also actively create new markets and investment opportunities for their clients. Recent years have seen the rapid expansion of the ‘shadow banking’ sector, a network of largely unregulated small banks, investment funds and ‘special purpose vehicles’ (essentially front companies) built up to dodge national and international controls and to avoid legal and financial culpability when deals go wrong. This expansion, alongside the processes of ‘financialisation’ which have developed intensively in the last 25 years, has brought spectacular profits for some banks and correspondingly enormous bonuses for bankers. UK banks

paid out an estimated £7 billion in bonus payments for 2010,⁵ whilst paying only £5.7 billion in corporation tax for the same period. Such bonuses are by no means a direct form of investment stimulus in the British economy, as the vice-chairman of Goldman Sachs would have us believe when he instructs us to “tolerate the inequality as a way to achieve greater prosperity for all”.⁶

Furthermore, it is a structural feature of the banking industry’s excessive bonus schemes that the majority of employees, from CEO’s to floor traders, are subject to a perverse incentive to undertake riskier operations with higher yields, and to engineer price bubbles and collapses in order to generate huge profits. For instance, investment bankers continued to create and sell the toxic sub-prime mortgage based financial products which caused the 2008 financial crisis well after they knew they were essentially worthless because the fees generated by their creation and sale, paid for by hedge funds (many of whom were betting against these products), ensured they took home massive bonus packages. Whilst there is a tendency to interpret such examples as evidence that bankers are greedy and reckless individuals, it rather illuminates the structural imperative within the financial sector to maximize short-term profits whilst outsourcing risk.



1. *The No-Nonsense Guide to Global Finance*, Peter Stalker, New Internationalist, 2009, p.46
2. *Ibid*, p.46
3. David Harvey, *A Brief History of Neoliberalism*, Oxford University Press, 2005.

4. Martin Eakes, quoted in *The wrong way to lend to the poor*, Financial Times, 19 march 2007 <http://www.ft.com/cms/s/0/ed20afb2-d5be-11db-a5c6-000b5df10621.html#axzz1gbyo0bh7>

5. http://www.neweconomics.org/sites/neweconomics.org/files/How_do_they_get_away_with_it_0.pdf
6. <http://www.guardian.co.uk/business/2009/oct/21/executive-pay-bonuses-goldmansachs>

Commercial Banks

Commercial Banking is what we traditionally mean when we talk about banking. In their simplest form commercial banks take money in the form of savings, and use that money to make loans to customers, profiting from the difference between the interest rates charged on loans and paid out on savings. For example, if Lloyds pays its customers 3% interest on their savings and charges 6% on its loans, it is left with a 3% profit on its business of borrowing and lending.

Commercial banks have two arms, corporate and retail, dealing with companies and high street customers respectively. In addition to lending and borrowing, commercial banks also provide account management services, such as funds transfers and cheque processing, as well as more sophisticated products like ‘revolving credit facilities’ for large companies (essentially a credit card for multinationals). Commercial banks tend to be the biggest banks, with the largest among them operating globally.

Retail banking is the type of banking that the general public uses most regularly. It is where we have our current and savings accounts. Corporate finance is generally the type of banking involved in financing large infrastructure projects and large

multinational companies. Corporate finance involves many different types of lending and financial services, including risk assessment, ‘underwriting’ a deal (basically insurance) and arranging finance by multiple different banks (called ‘syndicated lending’).

One type of finance that is particularly important for large industrial infrastructure projects, such as a mine or mega dam, is ‘project finance’. This is a long-term form of finance which typically involves a group of banks working in a syndicate, and providing 60-70 per cent of project costs either through loans or by issuing bonds for the project. The banks are repaid with revenues generated by the financed project, and they do not have access to the borrowing company’s assets.¹ Corporations and banks involved in financing projects that they fear will face opposition, or which they want to present as ‘development’, will often seek the backing of multilateral development banks such as the International Finance Corporation (the World Bank’s private arm) or the Asian Development Bank, granting a “hybrid public-private partnership” to project finance.²

1. BankTrack & SOMO, *What is Project Finance?*, March 2005. http://www.banktrack.org/download/what_is_project_finance_/what_is_project_finance.pdf
2. *Ibid*.

Leveraging

‘Leverage’ refers to the proportion of debt a company owes relative to the assets it actually owns (called its ‘equity capital’). ‘leveraging’ means borrowing money, or using other financial instruments (*see* ‘Derivatives’) in order multiply gains, or, when things go wrong, losses. Heavily leveraged firms hold large amounts of debt compared to the liquid assets they own and so are highly exposed to the outcome of their dealings – if things go well they can make huge profits, if they go badly the firms can be suddenly faced with unpayable debts and forced to declare bankruptcy. Leveraging allows investors to get involved in much bigger deals than their cash flow would normally let them. If an investor has £1000 to play with and finds an opportunity to get a 10% return on her money, she stands to make £100. However, if she can use her original £1000 as collateral (i.e. as a deposit) against a loan of £10,000 which she then puts into the same deal, she stands to make £1000 profit with the same original sum of money. That’s ten times the returns

she would have got without leveraging; the attraction of the technique is obvious, but so are the risks. Taking on debt in order to expand business operations and increase profits is one of the most basic and commonplace practices for capitalist enterprises. But in the financial sector some firms can be up to thirty times the value of their holdings in debt, placing them at extreme risk of collapse if their trades go the wrong way. Despite various regulations designed to place constraints on the amount of leveraging banks and other financial institutions can take on (normally known as ‘capital requirements’), the complex character of many derivative products and techniques such as securitization (selling on loans to other investors) makes it extremely difficult to assess quite how exposed particular institutions are. Furthermore, the financial crisis has demonstrated the extent to which widespread use of securitization and derivatives spread risk throughout the entire financial system, meaning overleveraging was a systemic, rather than isolated, problem.

Companies

A company is a business owned by a group of shareholders and controlled by a director. Its main objective is to make profit for the shareholders.

Companies which have ‘Ltd’ after their name are ‘private’ – meaning that they are owned by an individual, family or group, and people can only buy shares by invitation. They are mostly relatively small, with a few exceptions (eg. Cargill, Virgin). When there isn’t enough private money to finance more growth, the company can raise more cash by going ‘public’ and allowing anyone to buy its shares: it ‘floats’ on the Stock Exchange and gets ‘plc’ (public limited company) after its name. The ‘limited’ refers to limited liability: if the company goes bust, directors and shareholders are only liable for a limited amount of the company’s outstanding

debts. Thus workers, suppliers (and sometimes taxpayers) take the risk for the directors and shareholders. But if the risk pays off, it’s the shareholders who get the dividends. Limited liability encourages directors to take bigger risks - and rake in bigger profits.

While a company is owned by its shareholders, day-to-day decisions are made by its directors. They can be fired by the shareholders if they don’t make enough profit. This happened at BP in 1992, when chairman and chief executive Bob Horton was sacked. His replacement, David Simon, turned the company round over the next 5 years, reducing its workforce from 117,000 to 56,000 and making it the darling of the City. In 1997 he moved to the House of Lords as Lord Simon, Minister for Competitiveness in Europe.

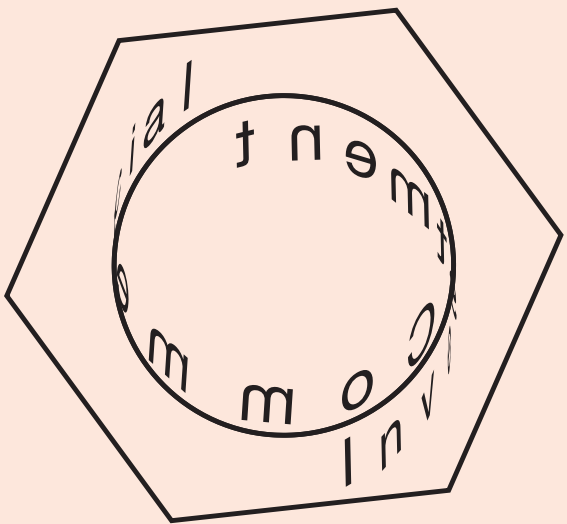
Investment Banks

Investment banks are *intermediaries*. Rather than lend directly to clients, investment banks make their profits by helping companies raise money via other means. This occurs typically by issuing and selling securities such as bonds and shares, and trading on behalf of their clients in other financial instruments, such as derivatives, and in commodities and currencies. Investment banks essentially connect corporations, entrepreneurs and governments with investors (typically other companies and rich individuals) in the ‘capital markets’. these are made up of the ‘primary’ capital markets (where new shares and bonds are first put up for sale to investors) and the ‘secondary’

capital markets (where these assets are then sold on and traded multiple times).

Investment banks are involved in Initial Public Offerings (IPOs) - when a company first issues shares. The bank will usually help, in return for a large fee, in valuing the company and setting the initial share price. With shares, as with bonds, investment banks undertake the promotion and publicity, and tend to find buyers in advance. When they are considered very profitable shares or bonds, they will contact those they do regular business with to offer them first dibs. The investment bank will also usually ‘underwrite’ share and bond offerings. This is a form of insurance in which the bank guarantees to buy up any unsold shares or bonds.

Investment banks also provide a host of advisory and financial services, including for corporate mergers and acquisitions (when companies buy other companies, or when they merge together to form a single, larger company). In this role Investment banks were central to facilitating the wave of privatisations in the 1980s and 1990s. Investment banks make their money via fees and commission levelled for these banking services, in addition to their own trading activities (*see* ‘Proprietary trading’).



Proprietary Trading

Proprietary (or ‘prop’) trading is when a bank trades shares, bonds, currencies, commodities or derivatives with its own money, rather than on behalf of a client – thus making profit for itself rather than simply earning commission. These trades are largely speculative – i.e. making money by gambling on short-term price changes.

Prop trading is a matter of degrees though, as Brett Scott has noted; “there is a fine line between dealing activities, and speculation, and the distinction gets blurred depending on how aggressive a dealing desk is in taking on risk.”¹ Furthermore, “different banks have different reputations in this regard. Goldman Sachs, for example, is known to have one of the most aggressive proprietary stances, whereas HSBC Global Banking & Markets (HSBC’s investment bank) would have a lot less, focusing a lot more on just servicing clients”². On average, Goldman Sachs, one of the world’s largest investment banks, has made around 10 per cent of its income through proprietary trading.

Such speculative trading is risky form of money making, leaving banks vulnerable to large losses. Prior to the financial crisis, many investment banks borrowed large amounts of debt in order to increase their positions in such speculative trades. By 2007 the five big independent US investment banks had borrowed 25-35 times the value of their assets to raise cash with which to gamble on the markets. As markets started to sour and lenders recalled their loans, the investment banks had nothing to fall back on, leading to the collapse of Lehman Brothers amongst others and the huge government funded bail-out programs.

Banks that undertake proprietary trading on a large scale often use automatic computer algorithms in what are called ‘high frequency trades’ (HFT). With HFT traders move in and out of markets rapidly and with a high number of trades, selling as soon as there is an advantageous difference in price. Research conducted in June 2011, found that HFT made up 35 per cent of European markets, and 55 per cent of US markets.³ Many exchanges, such as the London

International Financial Futures and Options Exchange (LIFFE), are run solely on electronic trades and so lack the classic ‘pit’ in which human traders shout at each other. HFT can contribute to volatility, destabilising markets and prices; the USA stock market ‘flash crash’ of May 2010, in which the Dow Jones Industrial Average experienced its largest ever one-day drop in value, was caused by frenzied HFT activity. An investigation into the causes of the crash declared that it was made possible by “a market so fragmented and fragile that a single large trade could send stocks into a sudden spiral”⁴.

“By 2007 the five big independent US investment banks had borrowed 25-35 times the value of their assets to raise cash with which to gamble on the markets.”

With the increasingly volatile global financial markets, and therefore greater opportunities for speculation following the 2008 financial crisis, the use of automated algorithms and HFT has increased dramatically. There have been, however, moves at both the EU and US levels to ban or limit proprietary trading by banks, particularly using HFT. Whilst some large investment banks have closed their own proprietary trading desks, they, or their former employees, are instead setting up separate hedge funds to undertake the trades. For example, over the course of 2010-11, Goldman Sachs closed its Global Macro Proprietary Trading group and its Principal Strategies department, both of which conducted proprietary trading on behalf of the bank.⁵ Following the disbanding of Principle Strategies, its former head Morgan Sze started a new hedge fund called Aventus Capital Management.

1. Brett Scott, Barclays Plc & Agricultural Commodity Derivatives, March 2011
2. Ibid
3. <http://www.ft.com/cms/s/0/bf3bd950-8f96-11e0-954d-00144feab49a.html#axzz1Sdmb2dQ5>

4. <http://www.sec.gov/news/studies/2010/marketevents-report.pdf>
5. <http://www.ft.com/cms/s/0/bd4d2d2a-3964-11e0-97ca-00144feabdc0.html#axzz1Sdmb2dQ5>

ii) Asset Management & Investment Funds

Mutual Funds (Unit Trusts)

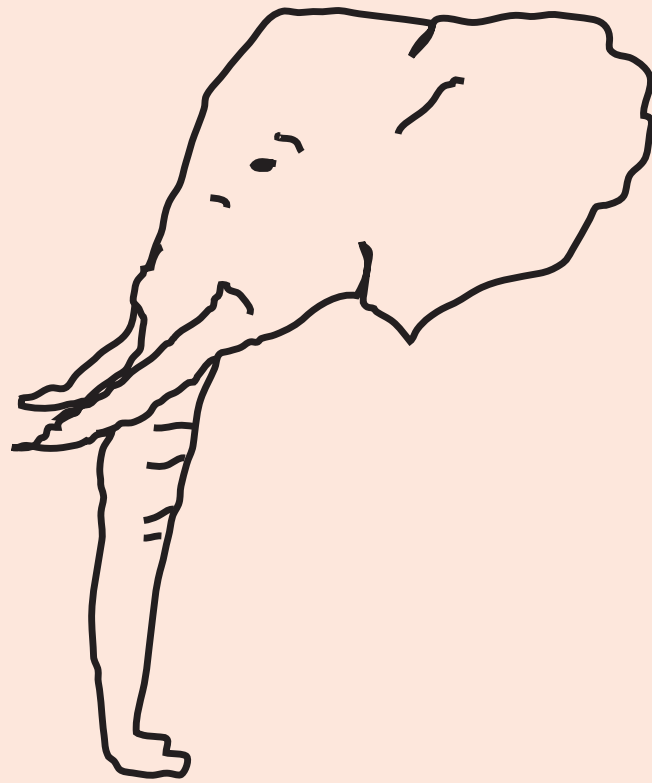
Mutual funds, also called unit trusts in the UK, pool capital from multiple investors and re-invest it in stocks, corporate and government bonds, derivatives and other assets such as money market securities like commercial paper (short-term company debt). Each fund portfolio (a collection of investments) is managed by a fund manager, who is paid a fee by investors. Investors in mutual funds are highly varied, as are the types of funds available; stakeholders range from individual households to institutional investors such as pension funds. For example, in the retail banking world, cash held in stock and share ISAs is often invested into unit trusts. Investors essentially hold shares in the mutual fund, on which they are paid a ‘yield’.¹ By pooling individual and institutional capital, unit trusts can invest larger sums, and thus increase returns.

The investment fund industry body in the UK is the Investment Management Association (IMA), representing 90 per cent of the industry.² IMA research found that, in 2009/10, IMA members were responsible for managing £3.9trn of assets, and owned 38 per cent of all shares in UK companies.³ The research also found that: “the UK funds sector as a whole has steadily grown from a specialist niche into a mainstream part of household savings”. By facilitating the investment of huge amounts of capital earmarked to support ordinary people (pensions, insurance, local government savings etc..) mutual funds represent another important way that our own interests are tied to the performance of the financial markets; depending on their profitability for our financial security and inadvertently facilitating to the financing of many destructive industries such as arms and fossil fuels. It is important to include mutual funds when researching who owns a corporation’s shares and how it generates investment.

1. http://en.wikipedia.org/wiki/Mutual_fund, <http://lexicon.ft.com/Term?term=mutual-fund>
2. <http://www.investmentfunds.org.uk/the-industry-and-ima/about-ima>
3. <http://www.investmentfunds.org.uk/research/ima-annual-industry-survey>

Hedge Funds

Whereas mutual funds and institutional investors operate with huge volumes of capital and a correspondingly large asset base, hedge funds are smaller private investment funds. They cater exclusively to wealthy individuals and institutions, and actively use derivatives and leverage to create spectacular returns on investments. The *Routledge Encyclopedia of International Political Economy* has termed this type of activity, “speculating with borrowed assets”. Their risk-based strategy permits hedge funds to engage in the kind of precarious trading activities prohibited by larger funds who are mandated to place financial security rather than sheer profits at the forefront of their concerns. Hence hedge funds are seen as nimble players with the leading edge on market trends, they habitually outwit the cumbersome institutional funds and often profit at their expense. In turn the institutional funds are increasingly turning to Hedge funds to help shore up their investments. In 2004 the FT reported that “public and corporate pension funds, universities, endowments, and charitable organisations have sharply increased the amount of money they put into hedge funds in an effort to boost their returns and diversify their holdings.”¹



Hedge funds get their name from the main investment strategy, whereby they ‘hedge’ their bets so that they stand to profit whatever the outcome of a deal. The first hedge funds started in 1940’s, betting on the value of stocks going up ‘going long’ and covering it with bets on stocks going down ‘going short’. This was a mix which ensured they would always make money. Nowadays Hedge funds cover themselves using a variety of complex techniques such as ‘short-selling’ (see box), ‘securitisation’ (packaging together debts and selling them on) as well as derivatives and other ‘instruments’ (see ‘Derivatives’).

One major criticism levelled against hedge funds is their high use of ‘leveraging’, which means taking on large quantities of debt in order to amplify the outcomes (i.e. potential profits) of a trade. In the words of the IMF “Hedge funds differ from other borrowers...insofar as they tend to be highly leveraged, so that when things go wrong, they go very wrong.”² Prior to the 2008 financial crisis, many hedge funds borrowed heavily against mortgage backed securities (CDOs), leaving them with large losses, and contributing heavily to the crazed sell-offs when the value of those securities crashed during the credit crunch. By operating with high levels of leveraged (i.e. borrowed) funds in order to undertake highly speculative trading activity, hedge funds inject significant risk into the whole financial system.

2. IMF, quoted in Nick Hildyard, A (*Crumbling*) Wall of Money: Financial Bricolage, Derivatives and Power

Like other parts of the ‘shadow banking’ sector, hedge funds saw a rapid increase in size and power with the rise of neoliberal economic policies that aggressively de-regulated the industry. Whilst there were about 130 hedge funds in 1996 managing \$130bn in assets, by 2006 there were an estimated 9,000 controlling \$2.9 trillion³, which is roughly equivalent to the entire GDP of the UK. One reason for this dramatic increase - in addition to the spectacular profits they generate - is the unique remuneration strategy of hedge funds. Personal fund managers take charge of investments and in return receive a ‘performance fee’ (typically 20 per cent of all profits generated) as well as the usual management fee paid to fund managers (around 2 per cent). This high performance fee motivates investment focused on securing the largest possible returns for investors, irrespective of the social, environment or wider economic impacts. Bill Gross, a bond fund manager at Pimco has aptly described hedge funds as “a remuneration strategy, not an investment strategy.”⁴ Over 50 hedge fund managers appear in the 2011 Sunday Times’ list of Britain’s richest 1,000 people.⁵ Given their exclusivity, London’s Mayfair district is the main home of hedge funds in the UK, whilst the legal entity is usually registered abroad in tax havens. “banks and mutual funds are lightly regulated, but the hedge funds do not have to reveal their holdings at all, and effectively escape all regulation.”⁶

3. Nick Hildyard, A (*Crumbling*) Wall of Money: Financial Bricolage, Derivatives and Power, and http://www.hfsb.org/sites/10188/files/what_is_a_hedge_fund.pdf

4. Nick Hildyard, A (*Crumbling*) Wall of Money: Financial Bricolage, Derivatives and Power. Originally quoted in <http://www.ft.com/cms/s/2/c8cbb71c-203f-11dc-9eb1-000b5df10621.html>

5. <http://www.thesundaytimes.co.uk/sto/public/richlist/article619511.ece>

6. Robin Blackburn, *Finance and the Fourth Dimension*, New Left Review 39, May-June 2006.

“Hedge funds are easier to recognise than to define. However, they tend to share certain characteristics and are generally susceptible to the elephant test: although hard to describe, you know a hedge fund when you see it.”

— The Hedge Fund Standards Board, quoted in Nick Hildyard, A (*Crumbling*) Wall of Money: Financial Bricolage, Derivatives and Power

“Millions of people worldwide, both working and retired, have money invested in hedge funds and might not even know it”

— <http://www.ft.com/cms/s/1/03d4d3b6-e088-11d8-9d75-00000e2511c8.html#axzz1hBE9mmtd>

Short-selling

Short selling is one of the oldest speculation techniques used by hedge funds. It is a bet that stands to profit from an asset falling in value. To ‘go short’, a hedge fund borrows the asset from its owner for a fee, then sells it on the market hoping the price will drop, the fund then buys the asset back at the new cheaper price and returns it to its original owner, thus pocketing the difference between what it sold the asset for and what it had to pay for it. Short selling is a notorious technique and has been banned on certain trades in the UK in recent years. Particularly when conducted on a large scale, short selling contributes to the rapid devaluation of assets, as markets become flooded with supply and even those who don’t hold short positions seek to sell, pushing prices down even further (as in the example of ‘black Wednesday’).

Case study:

Long-Term Capital Management

Hedge fund Long-Term Capital Management (LTCM) collapsed spectacularly in the 1990s following its rapid expansion through speculative derivatives trading. The fund's investment strategy involved gambling on incremental changes in price and so its huge profits arose from the sheer volume of trades undertaken. Prior to its collapse, LTCM held an estimated \$1 trillion worth of derivatives on its books, most of which was acquired with leveraged funds; it predicted that US Treasury bonds were mis-priced, and so looked to exploit the movement in price once their value was 'corrected', purchasing the bonds in large quantities. However, when Russia defaulted on some foreign loan repayments in 1998 and the rouble lost value, investors were spooked and bought US Treasury bonds in large numbers. This shattered LTCM's strategy: it became unable to re-coup its trades and pay back its creditors. In just one month the fund lost 44 per cent in net asset value.¹ Because LTCM had borrowed huge sums from other banks and investors to amplify its bets and exploit differences in price to maximum effect, when LTCM began to sink the rest of the financial market began to panic too. It was feared that the collapse of LTCM would trigger a global financial crisis: "The knock-on effect of a collapsing pyramid of deals considerably reduced the share prices of banks and industrial companies and damaged their credit ratings."² The Federal Reserve organised a bail-out for LTCM worth \$3.6bn, even though it had not operated within the 'mainstream' financial system, but had traded with derivatives beyond the reach of state regulation. This sent a clear message to hedge funds to proceed with their risky business models, because the state, as 'lender of last resort' would be there to pick them up when they fail.



1. Peter Stalker, *The No-Nonsense Guide to Global Finance*, New Internationalist Press, 2009, p.99
2. Donald MacKenzie, *An Address in Mayfair*, LRB. <http://www.lrb.co.uk/v30/n23/donald-mackenzie/an-address-in-mayfair>

1. Richard Minns & Sarah Sexton, The Corner House, *Too Many Grannies? Private Pensions, Corporate Welfare & Growing Insecurity*, May 2006. <http://www.thecornerhouse.org.uk/resource/too-many-grannies#fn017ref>
2. *Ibid.*

÷ Case Study: George Soros and 'Black Wednesday'

Quantum Fund, the hedge fund owned by mega-investor George Soros, led the charge of speculators who made billions betting on the Pound's devaluation on 'Black Wednesday' in September 1992. The Pound's crash prompted the British government to withdraw from the Exchange Rate Mechanism – a system devised by the then European Community (now European Union) which set an upper and lower limit (called a 'band') for European currency exchange rates within which they could go up and down. The government spent £3.2bn on fruitless measures such as buying pounds in high quantities to calm the markets, trying to keep the currency within its band, before finally giving up and pulling out of the scheme.¹

Quantum Fund operated by betting on large-scale economic shifts, such as dramatic changes in currency values. In the run up to Black Wednesday, it bet that the pound would fall in value. Soros placed \$10 billion worth of short-sales against the pound. Such large quantities of trades, which flooded the market with sterling, and panicked others into selling too, drove the value of the pound down further. This earned Soros the infamous title 'the man who broke the Bank of England' and made him a tidy \$1billion profit.² Quantum Fund and Black Wednesday exemplify the fact that hedge funds do not merely exploit external circumstances to make profits, but that their speculation actively shapes events, often with disastrous consequences for ordinary people and their decidedly undemocratic economies.

Private Equity

Private equity means investment in companies that are not listed on public stock exchanges. It is a specific type of equity investment which goes much further than buying and selling shares. Private equity involves high risk and high profits and involves a number of different investment strategies.

'Venture capital' and 'angel investors' put money into small, start-up companies in need of capital, aggressively bargaining for ownership stakes which are then cashed out when the business goes 'public' (floating its shares on the stock exchange).

The Most notorious branch of private equity is known as 'corporate raiders' or 'vulture funds'. These firms aggressively buy up shares in companies with the aim of taking majority ownership and then extracting as much value as possible from them in the short-term. Once they take control of the companies they buy, private equity firm fund managers join company boards and preside over serious 'restructuring'. To extract maximum profits from the companies they control, such restructuring invariably involves job cuts, closing plants, and asset stripping (selling off property, equipment and other assets). This is all done behind closed doors, with companies being de-listed from the stock exchange and their 'private limited' status removing them from public scrutiny and regulatory demands. Private equity firms are notorious tax dodgers, registered in tax havens and sheltered by their 'private' status.

Private equity firms often fund their buyouts by taking on huge amounts of short-term debt. Bought-out companies are used as the collateral against which the private equity companies borrow the large sums needed acquire them. This is called a 'leveraged buyout', or 'LBO'. The debt is placed onto the acquired company's books, allowing the private equity company to avoid holding the debt itself. It is then repaid from the bought-out company's profits and assets, again shielding the private equity company from the burden. Typical private equity leveraged buyouts would comprise 80 per cent debt and 20 per cent equity provided by external investors (such as pension funds and hedge funds) in the private equity fund. Low interest rates and correspondingly cheap credit in the 'boom' period prior to the financial crisis allowed private equity companies to borrow large sums with ease: between 2004 and 2007 loans totalling \$450bn were used in leveraged buyouts. Investment banks also gained from this exchange, generating \$12.8bn in fees from private equity firms in 2006 alone. Leveraged buyouts are, however, a gamble that the interest paid out on the debt will be lower than the returns made on the investment. This increases the pressure to both asset-strip and sell companies on as fast as possible once the *appearance* of enhanced profitability has been achieved.

Private equity firms are ruthless; the collapse of Southern Cross after its takeover by corporate raiders Blackstone meant 30,000 elderly residents faced eviction from their care homes¹, whilst the purchase of Gate Gourmet by Texas Pacific saw 670 workers at Heathrow lose their jobs in 2005. Firms such as Blackstone, Carlyle Group and Kohlberg Kravis Roberts & Co (KKR) are part of an expanding private equity business that is taking advantage of the government's private sector outsourcing and PFI deals, with education and healthcare already subject to private equity involvement.

“Were they to be assessed in terms of annual revenues, several private equity firms would rank among the world's top 25 corporations. The biggest five private equity deals have involved more money than the annual public budgets of Russia and India.”²

Despite landing bought-out companies into massive debt, from which many do not recover, and forcing large numbers of workers into unemployment, private equity companies nonetheless make themselves spectacularly wealthy. The co-founders of the private equity firm Kohlberg Kravis Roberts & Co (KKR), Henry Kravis and George Roberts, each hold personal wealth of \$3.9bn, receiving 'carried interest' (a performance fee typically based on 20 per cent of profits generated) of \$19.5m for 2010 alone.³

1. *The vultures circle: Private equity and the NHS*, Corporate Watch, May 10, 2011, <http://www.corporatewatch.org/?lid=3969>
2. Kavaljit Singh, *Taking it Private: the Global Consequences of Private Equity*, The Corner House, September 2008, PP. 1-2
3. www.efinancialnews.com/story/2011-03-11/forbes-billionaires-2011-finance

iii) Institutional Investors

Pension Funds

It is a largely unknown fact that some of the most important players in the financial sector – particularly the stock markets – are the funds that manage ordinary people’s pensions. These funds, whose task is to safeguard the retirement savings of the working population, control more than two-thirds of all listed shares in the UK¹ and own more than £13 trillion of assets worldwide (about 10 times the UK’s GDP). This makes them the largest single class of investors, far outstripping hedge funds and private equity². Pension funds come in two varieties: public and private, which are usually subject to different legal regulations.

By and large, pension funds focus their investments on long-term, low risk assets rather than short-term, speculative trades. In the 1940’s and 50’s almost all pensions were invested in government bonds – primarily for their security and stability. However, in the face of rising prices in the 70’s, such bonds offered insufficient protection against the devaluation of savings (as prices increase, the real value – or purchasing power – of money decreases). Thus fund managers, striving to ‘beat’ inflation, transferred their investments to price-linked assets such as shares and property.³ In more recent years it has become commonplace for pension funds to invest – usually indirectly – in financial derivatives; although, in line with their mandate, opting for the supposedly ‘safe’, low-yield varieties.

Pension funds are overseen by trustees but investment strategies are designed and controlled by appointed fund managers, who earn a performance-based fee for their work. Such managers are often in fact divisions of huge financial corporations such as Citigroup or Merrill Lynch, and as such seek to promote the interests not only of the fund but also of their parent company. The exorbitant fees charged by private fund

managers can almost halve the growth of a personal pension over a 40-year period.⁴ Furthermore, so long as managers ‘perform’, that is, bring in an acceptable profit on investments, they retain almost complete autonomy in their actions. As Robin Blackburn has emphasized, “However sophisticated fund management becomes, it remains the case that the nominal owners or beneficiaries of the assets in a pension fund [i.e. the pension holders themselves] have no say in how their savings are managed”, whilst the trustees with overall authority “often do not

understand complex credit derivatives and the risks they pose”⁵. This demonstrates the highly limited sense in which the actions of fund managers can be said to represent the interests of the mass of pension-holding individuals.

“Whereas just two decades ago, welfare policies for the unemployed, sick, disabled and elderly were

perceived as a counter to, or insurance against, “the market” and its failings, many governments now use such policies to support or bolster “the market” itself. Pensions are a prime example.”⁶



1. Peter Stalker, *The No-Nonsense Guide to Global Finance*, New Internationalist Publications Ltd, 2009, p67
2. *Asset-backed insecurity*, The Economist, Jan 17th 2008. http://www.economist.com/node/10533428?story_id=10533428
3. Robin Blackburn, *Finance and the Fourth Dimension*, New Left Review 39, May-June 2006.

4. *Ibid.*
5. *Ibid.*
6. *Ibid.*

Pension fund investment is premised on the idea that social provision can fit harmoniously into a positive model of capitalist growth, increasingly as a constituent aspect of this growth rather than a form of welfare to complement it. Private pension funds cement the idea that only the private sector and the financial markets can fulfil our social need for security in old age. Accordingly, the pension system and the financial system “emerge as two sides of the same coin.”⁷ This has produced increasingly contradictory effects for the majority of the working or retired population, who now see their own financial security inextricably bound up with global processes of exploitation and environmental destruction. For example, since the 80’s pension funds have contributed to a growing shareholder pressure to place share prices at the forefront of corporations’ concerns, a shift which has stimulated huge waves of corporate mergers and acquisitions, downsizing and outsourcing (i.e. job losses), union-busting, tax evasion and waste-dumping. In effect, “the stewards of labour’s capital used pension funds in speculative investment activity, which closed plants and strangled communities” and more fundamentally, “the labour movement, in developing its pension strategies, has embraced two economic concepts – market rates of return and property rights – that work against its interest”⁸.

And all this is assuming that the stock market remains ‘healthy’. Through our pensions we are tied to the notorious and inevitable volatility of the markets. The stock market crash of August 2011 wiped £250bn from the value of ordinary peoples’ pensions⁹, whilst the Financial Times calculated that on average savers had lost one fifth of their pensions.¹⁰ Advice from The Guardian Money is “More of the same: save more, work longer, retire later.”¹¹ Adrian Boulding, Pension Strategy Director at Legal and General, commented that: “Markets go in cycles and we will ride through several more drops before arriving at our retirement...Pensions are a long-term investment. People put their money in and accept volatility as they go along.”¹² It is questionable, however, just how people are able to accept or reject this volatility considering the lack of personal control over where pension funds are invested, or even knowledge that their pension funds are so dependent on financial markets in

7. Richard Minns and Sarah Sexton, The Corner House, *Too Many Grannies? Private Pensions, Corporate Welfare and Growing Insecurity*, May 2006. <http://www.thecornerhouse.org.uk/resource/too-many-grannies#fn017ref>
8. Teresa Ghilarducci, *Labors Capital*, MIT Press, 1992, p. 130
9. <http://citywire.co.uk/new-model-adviser/market-turbulence-wipes-250bn-from-pension-funds/a517906>
10. <http://www.ft.com/cms/s/2/de19040e-c297-11e0-9ede-00144feabdc0.html#ixzz1Vy8qlFJa> “One month ago, a pension fund worth £100,000 could have bought a 65-year-old man a guaranteed income for life of £6,440 a year. Since then, if the fund tracked the FTSE 100 index, its value has fallen to £83,000 and the annuity rate has slipped from 6.44 per cent to 6.3 per cent, giving an annual income of £5,230.”
11. <http://www.guardian.co.uk/money/2011/aug/05/stock-market-crash-how-it-affects-you>
12. http://www.mirror.co.uk/advice/money/personal_finance/2011/08/17/stock-market-volatility-wipes-120billion-off-value-of-pension-funds-115875-23349845/

the first place. The growing pension crisis has put lie to the myth that relying on private financial institutions and the stock market to generate a secure pension for each individual is viable; it is clear that the supposed symbiosis of personal and corporate interests is deeply troubled.

Pension funds are some of the largest investors in corporations which fuel a devastating form of ‘growth’ inflicting ecological destruction and human rights abuses: fossil fuels, mining, mega-dams, arms, bio-tech, and so on. The UK stock market in particular has very high involvement from the fossil fuel industry, meaning UK pension funds are particularly heavily invested in oil.¹³ However, such a scenario also provides interesting avenues for resistance – the successful campaign against mining company Vedanta Resources has seen disinvestment by the Norwegian Government Pension Fund, Martin Currie Investments, the Church of England, the Joseph Rowntree Charitable Trust, and the Dutch Pension Fund PGGM.¹⁴

13. <http://oilprice.com/Finance/the-markets/UK-Pension-Funds-Unhealthy-Overweighting-of-Fossil-Fuel-Stocks.html>
14. http://www.banktrack.org/show/companyprofiles/vedanta_resources



iv) Credit Rating Agencies

Credit rating agencies are private companies that assess organisations, companies, institutions, financial products and national economies for their credit-worthiness. A credit rating is essentially an assessment of the ability to meet financial commitments – particularly to re-pay debt. It is an evaluation, for investors, of how risky a company, product or government is. Credit ratings are graded alphabetically, normally from 'AAA' (the highest, safest grade normally reserved for wealthy and stable nation states) to 'C' (risky or 'junk'), with slight variations in grading systems between different agencies and for long or short term loans.

There are three major credit rating agencies in the world: **Standard & Poors**, **Moodys**, and **Fitch**. They are all private companies in competition with each other for the handsome fees paid by those seeking a rating. Banks and other financial companies employ credit rating agencies to provide a rating for them and their products. One implication of this system is that banks can choose to offer business to the agencies most willing to provide good ratings for their financial products. This poses obvious problems, shown by the fact that all three credit rating agencies granted 'A' ratings to both Lehman Brothers and AIG right up to their collapse.

The revolving doors between credit rating agencies and investment banks spin fast; rating experts are highly sought after within banks where insider knowledge, experience and industry connections are all valuable assets for those looking to put together highly rated financial products. The aim of such recruitment strategies is to increase profits through 'ratings arbitrage', whereby investment banks actively attempt to create packages of securities that are awarded ratings above their real value, thus generating huge profit margins. This is made possible largely through the expertise of ratings agents, who advise banks on how to structure products so as to give the appearance of holding more value than the underlying assets actually do. The ubiquity of such techniques was an important cause of the current financial crisis as few investors were aware just how overvalued their assets were.

Ratings agencies thus wield incredible power and influence within the markets and, by extension, in politics - a fact rendered increasingly tangible by the developing sovereign debt crisis. Most nation states depend on the bond markets to finance their spending budgets, issuing regular bonds to repay old debts and take on new ones. Scepticism about state finances in the context of a prolonged global recession has led many countries to have their credit rating downgraded by the main agencies. This inevitably results in lower investor confidence and higher borrowing costs for the nations in question.

Greece, Portugal, Ireland and Spain have all suffered from rating downgrades which have forced them to unroll huge spending cuts and austerity measures in attempts to placate the markets. Even the United States has been subjected to a downgrade by Standard & Poors because of perceived 'structural problems with the US public finances'¹. Meanwhile, many other countries including Britain have implemented similar measures, including pay-cuts, pension reductions, increases in retirement age and mass downsizing and privatisation of public services, all to pre-emptively avoid similar downgrades and increased borrowing costs.

1. <http://www.firstpost.com/world/sp-moody-fitch-the-politics-of-rating-agencies-57990.html>

Case study:

Shin Yukawa & Abacus

In one notorious example, Shin Yukawa, formerly of rating's agency Fitch was snapped up by Goldman Sachs to work on the creation of the 'Abacus' Collateralised Debt Obligation (CDO) packages. CDOs are financial products made from the combination of multiple securitised mortgage contracts, notable for their ability to counter-balance – or at least mask – risk; such products played a pivotal role in triggering the 2008 financial crisis. With Yukawa's technical expertise the Abacus CDO package was granted a AAA rating – the highest possible, bringing Goldman Sachs a healthy profit at auction. However, the Abacus package was also created with the assistance of hedge fund manager John Paulson, who had a hand in selecting the mortgage contracts on which the bonds were based. Paulson, predicting the immanent collapse of the housing market, selected weak looking mortgages. The Paulson & Co hedge fund bet against the Abacus package and made a cool billion when 84 per cent of the underlying bonds were downgraded - all within six months of their issuance.¹

For deceiving investors over the Abacus package, Goldman Sachs received a \$500 million fine from the US Securities and Exchange Commission (SEC), the largest ever meted out by the SEC. However, the rating agencies who played a pivotal role in the deal walked away unscathed, remaining as influential and credible as ever.

1. <http://dealbook.nytimes.com/2010/04/24/rating-agency-data-aided-wall-street-in-deals/>

v) Products

Real Assets

In financial jargon any amount or part of actually existing, material things in the world is referred to as a 'real asset', which can be bought and sold in the financial markets. This can include parts of companies, food, energy and raw materials, different currencies or interest-bearing loans. Roughly, this category can be divided into four types of asset: **credit**; **equity** (shares); **currencies** and **commodities**.

Credit

Credit refers to the borrowing and lending of money. Every time money is loaned out or saved it is actually being sold as credit. The 'price' of credit is set as an 'interest rate', which is the fee the borrower pays to the lender. This rate varies according to a number of factors – length and size of the loan, perceived ability of the borrower to repay, availability of credit in general (known as 'liquidity'), and so on. A savings account at a high street bank, for example, involves the customer 'selling' credit to a bank, just as a mortgage involves the bank 'selling' credit to a household. Large banks are perceived to be stable and reliable borrowers so the interest they pay on saving is relatively low, households however are seen as less 'secure' so the interest rate on a mortgage is higher. Interest, then, can be thought of as the price of credit over a certain time period.

High street banks operate by buying credit from customers at a lower interest rate and then lending it out at a higher one. The difference is the bank's profit. What we experience as debt, the bank views as an asset, generating interest payments and its profit. Prior to the financial crisis, it was relatively cheap for people to borrow from high street banks, who levelled relatively low interest rates. This, alongside increased dependence upon credit as a result of declining social welfare and stagnant wages, helps to explain the fact that the UK has highest levels of personal debt in the world: in September 2011 the UK public owed £1,451bn in personal debt, paying £174 million a day in interest alone.¹ PriceWaterhouseCoopers estimates that the average household spends 15% of net income just to service the interest payments arising from debt.

1. <http://www.creditaction.org.uk/helpful-resources/debt-statistics.html>

Bonds

The so-called 'credit market' works in a similar way, but buys and sells very large loans in the form of bonds. Bonds are a way for investors to sell credit to governments (in the form of 'sovereign' bonds) and companies (in the form of corporate bonds). Like many other kinds of credit, a bond consists of a contract which guarantees the 'holder' (owner of the bond) repayment of the original sum after a set date (known as the 'maturity') plus a 'coupon' (the extra interest on top of the original loan).

Alternatively, some bonds are paid off in installments (known as 'amortizing' bonds) rather than in a lump sum at the end of the maturity period. A bond represents an asset, which can be borrowed against and used to leverage further capital. The idea is that companies and governments use the money invested in them via bonds to undertake some activity which makes back the bond money, enough to pay bond investors a rate of interest, and profit for the company (or extra tax revenue for a government). Government bonds are usually viewed as the most stable form of investment, because a government has access to tax income as a means to guarantee repayment.

Bonds can be traded in the bond market, though unlike shares, this does not usually happen in exchanges but rather via brokers who match buyers and sellers in 'over-the-counter' trades. This means they are much less transparent, and much harder to track than shares. Recent years have seen corporations relying increasingly on bond financing over direct bank loans. When bonds are publicly issued by a company, a 'prospectus' is issued detailing what the investment capital raised will be used for. This is a good place to look when researching the financing of corporate projects.



Government Bonds

Like companies, the state needs to pay for its projects, be it hospitals, roads or warheads. The shortfall between expenditure and tax income is met by borrowing from the credit markets. The state raises finances by selling 'sovereign bonds' to investors in the city; these generally have specific names depending on which government issues them, UK government bonds are known as 'Gilt', whilst those issued in the US are called 'treasuries'. In developing countries with supposedly unstable economies, governments are forced to issue bonds denominated in dollars or some other major world currency, this reassures investors that the government won't simply start printing extra money to pay off its debts.

The rate that governments have to pay to borrow from the bond markets depends on their perceived financial stability, often as assessed by the credit rating agencies. It is quite normal for most governments to hold large amounts of debt and is not necessarily seen as a sign of bad finances. The US, for example, has the highest level of public (government) debt in world and also one of the strongest economies. Therefore debt is not strictly a problem for governments. Instead, the problem is when the cost of borrowing for states increases because their economic outlook shifts. If a country gets downgraded it not only becomes more difficult to buy more debt, but it suddenly becomes much more expensive for the nation to 'refinance' (essentially to renew) its current debts and can lead to serious financial problems.

Sovereign bonds are issued with different 'maturity' periods, varying from a few months to several decades and are traded between investors on the secondary capital markets throughout their entire lifespan. The price paid for bonds on the markets varies according to factors such as supply and demand, as well as perceptions of the country's economic outlook. In particular if a government starts to look like it might not be able to meet its bond repayments, sellers will be willing to accept much less than the original value of the bond, even though the interest rate is fixed to this original sum of money, as it has become a much more risky investment. This affects the 'yield' that a bond pays (the interest it pays out compared to what it was actually bought for). When the price of a bond on the market falls to lower than its face value, then its 'yield' goes up, as it pays the same amount of interest in return for a smaller investment. Conversely, if it sells for more than its original price then the yield has fallen, as investors get less interest for their money.

Equity (Shares)

A share is essentially ownership of a piece of a company. Such ownership is generically termed 'equity, as each share of the company is of equal worth. In return for purchasing an ownership stake, and thus investing in the company, shareholders are entitled to a regular payment, called a 'dividend', of a percentage of the company's profits.

Ownership, in the form of shares, is bought and sold in stock markets. A corporation gains investment the first time shares are issued, during the Initial Public Offering (IPO). After that shares are traded amongst investors, but this does not directly bring any new capital to the corporation. Given that equity amounts to partial ownership of a company, as shares change hands so does the decision-making power which determines how the business will be run. It is this fact which makes corporations liable to 'hostile takeovers', where outside investors buy up majority stake ownership in order to strip down a company and sell it on for a profit. (see 'Private Equity')

Equity value reflects expectations of a company's future capacity to create profit, as well as possible mergers and external market and industry trends that might push up or depress company value. Predictions are often influenced by scares, rumours and assessments of investor confidence, which is not only difficult to quantify but also notoriously easily spooked. This produces

many opportunities for speculative trading within stock markets - essentially gambling to make a profit from changes in share prices. This is a primary way that hedge funds and other parts of the shadow banking system make their money.

One of the most controversial methods of share trading seen in recent times is 'short-selling'. This occurs when a share price is expected to fall. A trader borrows, for a fee, shares owned by someone else (often pension funds and other institutional investors) and sells them on the stock market. They then buy them back once the share price has fallen and returns them to their owner, pocketing the difference in price. Short selling contributes to the driving down of share prices and was a contributing factor in the collapse of Northern Rock in 2007, during which it was estimated that half of the 420 million Northern Rock shares in the market were on loan to short-sellers.¹ Lansdowne hedge fund alone made \$200m from short-selling Northern Rock shares.²

1. <http://www.guardian.co.uk/business/2007/sep/22/ukeconomy.economics>
2. <http://www.ft.com/cms/s/0/0d5e9ae8-73a6-11dc-abf0-0000779fd2ac.html#axzz1Vxu1QYQr>

Commodities

Commodities are goods produced for consumption which are traded on markets. They include foodstuffs such as coffee and grain, and raw materials such as oil, metal and minerals. Trade takes place on markets called commodity exchanges. For example, the London Metal Exchange, based in Leadenhall Street in the City of London, is the global centre of metals trading (no surprise when you consider that the majority of the world's biggest mining companies are listed on the London Stock Exchange¹). The exchange trades \$7.41 trillion each year, with 95 per cent of its business based abroad.²

Commodities are bought and sold by the companies that produce, export/import, distribute and process them. Huge commercial trading houses such as Cargill (which deals in agricultural and industrial products and services) and Glencore, Vitol and Trafigura (the world's three largest natural resource traders), hold massive monopolies within which producers, particularly

those in the global south and operating on a smaller scale, hold very little power. These commercial trading houses are almost all privately listed and highly secretive companies. Cargill is the largest privately owned company in the world and owns a "global infrastructure with feed mills, port and storage facilities in 59 countries and operations in 130 others. In most of the sectors in which it operates Cargill controls at least 25% of the market and is either the largest or second largest player".³

But in the commodity exchanges of London, alongside the representatives of these companies, you will also find financial institutions speculating on changes in commodity prices. They buy and sell the commodities with no intention of ever using or even seeing them, directly contributing to price volatility, derivative contracts such as 'futures' are key to this (see the next section for more). The UN Commission on Trade and Development commented that: "a major new element in commodity trading over the past few years is the greater presence on commodity futures exchanges of financial investors that treat commodities as an asset class. The fact that these

1. <http://londonminingnetwork.org/mining-and-london/>
2. <http://www.telegraph.co.uk/finance/newsbysector/industry/mining/8179224/London-Metal-Exchange-a-history.html>

3. Corporate Watch, *A Rough Guide to the UK Farming Crisis*, 2004. <http://corporatewatch.org/?lid=3811>

market participants do not trade on the basis of fundamental supply and demand relationships, and that they hold, on average, very large positions in commodity markets, implies that they can exert considerable influence on commodity price developments.”⁴

Constant growth is the driving force of capitalist social production. This leads to more and more useful things being transformed into tradeable commodities, around which new markets and new financial infrastructure can arise. One of the major recent steps in commodification has been carbon trading. The world’s largest carbon market, the European Union’s Emissions Trading Scheme was already worth \$63 billion in

4. World Development Movement, *The Great Hunger Lottery: How Banking Speculation Causes Food Crisis*, July 2010.

2008, and continues to grow.⁵ The current global recession attests to a generalised slowdown of growth - we are experiencing a ‘crisis of capital accumulation’. Alongside this we are facing a crisis of natural resource depletion and an urgent need to limit our fossil fuel usage. Carbon trading is an attempt to marketise both of these problems – granting access to scarce resources and the ‘right’ to pollute only to those who can pay, whilst at the same time providing a means for corporations to access new sources of profit.



5. Tamra Gilbertson and Oscar Reyes, *Carbon Trading: How it Works and Why it Fails*, Dag Hammarskjöld Foundation, Critical Currents no.7, November 2009.

The 2008 Food Crisis

The food price crisis of 2008 was directly caused by speculation with derivatives on the commodity markets, for example through index funds established by investment banks such as Goldman Sachs. Commodity index funds are an investment portfolio which includes derivatives on many different types of commodities, including food products, generally marketed to large investors such as pension funds, and created by Goldman Sachs (who made \$5 billion from commodities trading in 2009 alone). Index funds “allow institutional investors to ‘invest’ in the price of food, as if it were an asset like shares”, and do not distinguish between essential products like food and non-essential commodities such as gold. Investing in these index funds allowed investors to place bets on the future price of food without ever intending to buy or use the food itself. Food commodity derivatives were included in the index funds partly because commodity derivatives are seen as a ‘hedge’ against other types of risk, such as inflation risk.

The price of food was directly affected by the large quantities of these derivatives. Food prices increased in line with the increased purchase of commodity derivatives by index funds, with the number of commodity derivatives rising by over 500 per cent between 2002 and mid-2008. This large-scale purchase of food commodity derivatives was unrelated to the actual supply and demand factors of food itself, meaning prices were affected by financial speculation rather than how much food there was and how many people wanted to buy it. From the beginning of 2007

to mid-2008, the price of wheat increased by over 80 per cent, whilst maize rose by almost 90 per cent, precipitating riots and social unrest across the developing world. Prices then fell astonishing quickly, over the space of a few weeks in the second half of 2008. According to the World Development Movement’s calculations, this food price spike increased the number of ‘chronically malnourished people’ by 75 million in 2007 and another 40 million in 2008.⁶

In addition to the quantity of derivatives, the second factor affecting food prices was that speculators were taking up ‘long positions’ in food commodities. This is where a trader buys a financial product to profit from its price increasing in the future. The index funds took up long positions with the derivative contracts included in them – massively increasing the number of people and financial products betting on the price of food rising.⁷ These derivatives bet that the future price would be higher than the present price, indicating to commodity sellers that demand would pay more – thus distorting the market and pushing prices up. They were essentially betting on, helping to create, and profiting from, a dramatic price increase, using derivative contracts as “the virtual equivalent of hoarding in a warehouse.”⁸

6. World Development Movement, *The Great Hunger Lottery: How Banking Speculation Causes Food Crisis*, July 2010.
7. All from: World Development Movement, *The Great Hunger Lottery: How Banking Speculation Causes Food Crisis*, July 2010.
8. Nick Hildyard, *A (Crumbling) Wall of Money: Financial Bricolage, Derivatives and Power*, p.42

Currencies

A currency is the type of money a country uses. In theory its value is determined by the strength of a country’s economy. However, when traded on the financial markets, currencies are treated like shares, commodities and other financial products and so rise and fall according to supply and demand. If a lot of people want a currency, the price goes up; if a lot of people sell their holding in a currency, the price goes down. The value of a currency is measured relative to other currencies – e.g. how many dollars or euros you can exchange a pound for. If the value of the currency is lower, it means national exports become relatively cheaper to buy for foreign countries and thus more ‘competitive’, whilst imports become more expensive (as they are set in the price of foreign, and stronger, currencies). The converse is true if a currency becomes higher in value, as is the case in developed countries where cheap goods are generally shipped in from abroad.

Like commodities, currencies are bought and sold by two groups: the companies and countries who use them, and the speculators who gamble with them. Any company involved in international trade has to change currency to operate in different countries. Forex, the foreign exchange market, is the largest market in the world. On average, \$4 trillion changed hands every day in the global foreign exchange market in

2010, up from \$3.3 trillion in 2007.¹ The Bank of International Settlements explains that: “Electronic trading has been instrumental to this increase, particularly algorithmic trading” which is a key tool in the speculators tool box.²

Under the post-war Bretton Woods agreement, global currencies were pegged to the US dollar, which was pegged to the price of gold (\$35 per ounce). This meant exchange rates between different currencies were much more fixed than they are today, making currency prices more stable. However, following the inflationary effects of the US debt-financing of the Vietnam war, this became unsustainable. In 1971 Nixon removed the dollar’s convertibility into gold and in 1973 removed its convertibility into foreign currencies. A floating exchange rate system was adopted in which currencies no longer had fixed exchange rates but their value in relation to other currencies became determined solely by the markets. This opened the door to massive volatility and speculation in currency values. For example, in the United States, the volume of Forex trading leaped from \$110.8 billion in 1970 (10.7% of US GDP) to \$5.449 trillion in 1980 (195.3% of US GDP). This also made currency derivatives an important means of fixing prices and avoiding risk (for more on this see derivatives over).

1. Bank for International Settlements, *Triennial Central Bank Survey: Report on global foreign exchange market activity in 2010*. <http://www.bis.org/publ/rpfx10t.pdf>
2. Michael R King and Dagfinn Rime, *The \$4 trillion question: what explains FX growth since the 2007 survey?*, 13th December 2010. http://www.bis.org/publ/qtrpdf/r_qt1012e.htm

The East Asian crisis in 1997

The early 1990s saw battles over opening up Asian economies to free markets and globalisation. The compromise reached was that Asian governments would retain laws preventing foreign ownership of national firms and restricting privatisation but that they would remove barriers to their countries’ financial sectors. This triggered a surge in currency trading and brought a “flood of hot money” invested into Asian financial systems.¹ In 1997, the surge of speculative, short-term investment in Asian currencies suddenly withdrew, prompting “a stampede by the electronic herd”;² after rumours that the Thai baht was not properly backed by dollars. Events moved quickly, with attacks on Asian currencies turning a rumour into reality and causing extreme devaluation: people were no longer able to buy the things they needed with their wages. South Korea, which received \$100 billion in investment in 1996, suffered negative investment of \$20 billion in 1997. In 1998, South Koreans experi-

enced a 50 per cent increase in the suicide rate.³ As Naomi Klein has analysed, this was a prime moment for the doctors of ‘disaster capitalism’ to administer their ‘shock doctrine’ medicine: “Top investment analysts instantly recognised the crisis as the chance to level the remaining barriers protecting Asia’s markets once and for all.” For example, Jay Pelosky, Morgan Stanley’s ‘emerging market strategist’, stated at the time: “...we need more bad news to continue to put the pressure on these corporates to sell their companies”.⁴ IMF bailout loans came with heavy conditions: radically reduced government spending, privatisation, targets for increased job cuts, and total free trade. Currency speculation had been successfully utilised to create the right political and economic conditions in which the ‘Asian Tigers’ could be slain, dissected and re-constructed in the neo-liberal mode.

1. Naomi Klein, *The Shock Doctrine: The Rise of Disaster Capitalism*, Penguin, 2007, p.267
2. *Ibid*, p.264

3. *Ibid*, p.264-5
4. *Ibid*, p.267

Derivatives

Derivatives are a special kind of financial product or ‘instrument’, which, unlike the ‘real’ assets outlined above, do not give the holder ownership of any actual ‘thing’ like money, gold, land or sugar. However, what makes them valuable (or worthless!) is directly related to what happens in the world of ‘real’ assets. They are financial products which bet on the *future* performance of an ‘underlying’ asset or commodity. Trading with derivatives can therefore be likened to betting on a horse during a race: you do not own the horse directly, but place a



financial stake on its activity. If certain conditions relating to this external, physical ‘asset’ are met – in this case which position the horse comes in the race – then the owner of the derivative is entitled to a pre-agreed payout. The derivative itself is much like a betting slip or lottery ticket – if the ticket contains the winning horse or numbers it will be highly valuable, if not, it will be a worthless scrap of paper.

Derivatives then, In more technical terms, are agreements between two parties which oblige the ‘issuer’ to pay a fee or to purchase, return or swap an asset, at an agreed point in the future – either a specified date, or when some other threshold (normally price) is reached. There are three main types of derivative contracts: **futures**, **options**, and **swaps** (see breakout box). A vast array of more complex versions of these three types also now exist (referred to in the industry as ‘exotic’, as opposed to ‘plain vanilla’ derivatives). Derivatives have emerged on an increasing range of commodities, assets, and even events – for example the Chicago Mercantile Exchange has issued weather futures where investors can bet on changes in the weather.

The size of the global derivatives markets, particularly over-the-counter trades, exploded between the late 1990s and the 2008

financial crash. In 2007, the total value of the global derivatives market reached \$596 trillion. Global GDP in 2007 was c.\$65trn, making the derivatives market roughly nine times the size of the world’s ‘real’ economy. In terms of turnover, derivatives constitute the largest economic activity in the world, with global foreign exchange markets making a staggering \$1.9 trillion each day in April 2004.¹ The largest growth was in the Collateralised Debt Obligations (CDOs) and the Credit Default Swaps (CDSs), now notorious as the financial instruments at the heart of the financial crisis.²

Derivatives are used by investors to ‘hedge’ against risk, protecting their investments from suddenly falling in value. They could be compared to a mobile phone contract – the buyer pays a fixed sum in return for the right to make a fixed amount of phone calls across a period of time, instead of paying for each call individually and potentially spending more overall on their phone bill. This technique is in fact hundreds of years old; the original derivative was the futures contract, which arose within agricultural markets as a means of insurance against volatile prices and varying harvests. They enabled buyers and sellers to agree on a certain price for a crop long before the harvest, giving them security against short supplies or a flooded market. Derivatives are still used as a method of risk management, particularly to safeguard investments that are highly dependent on volatile underlying variables such as interest rates, currency exchange or the price of oil and gas.

Derivatives do not operate like a traditional insurance scheme, where premium payments enter into a pool that is then used to pay out claims. Rather they are a method for exchanging risks between individuals: “there is no pool, just a set of contracts where someone else, with a different perspective on risk, is prepared to buy your risk.”³ For example, one investor might fear the dollar rising, whilst another may stand to lose if the dollar falls. They can choose to create a derivatives contract which fixes a mutually beneficial dollar price, then if the value of the dollar falls above or below this price, whichever side bet against this happening makes up the difference for the other, thus ‘normalizing’ the value of the dollar to the pre-agreed level. The Economist therefore explains that: “Derivatives can [...] help firms to manage their risks. For example, a risk-averse firm might use derivatives to hedge against a possible rise in interest rates by shifting the risk to an investor more willing to take it.”⁴ Derivative contracts can be sold and traded like any other financial product; they do not necessarily apply only to the original two agents involved in their creation. Derivatives are traded

1. Dick Bryan and Michael Rafferty, *Capitalism with Derivatives: A Political Economy of Financial Derivatives, Capital and Class*. p.6
2. Adrian Buckley, Financial Crisis: Causes, Context and Consequences, Pearson, 2011, p.60
3. Dick Bryan and Michael Rafferty, *Capitalism with Derivatives*, p.2
4. The Economist’s Guide to Economics

Main Types of Derivatives

- ♦ **Futures** contracts are essentially price agreements for the future – making an agreement to buy or sell a specific asset or commodity for a set price in the future.
- ♦ **Options** contracts provide agents with the right, though not the obligation, to buy or sell the underlying asset at a certain price in the future.
- ♦ **Swaps** are an agreement to exchange assets or commodities in the future – and are designed to eliminate future uncertainties.

see: Nick Hildyard, A (*Crumbling*) Wall of Money: Financial Bricolage, Derivatives and Power, p.4

in two ways: on exchanges and over-the-counter; the latter is less transparent than the former and largely unregulated. Bespoke derivatives are also created by banks to capture untapped markets, or for investors with specific needs; this is an extension of over-the-counter trading. Barclay’s Capital, for example, offers a range of so-called ‘structured products’ which are “derivatives products, packaged in such a way that they don’t look like derivatives products”⁵. This allows them to expand their customer base to include low-risk investors such as pension funds and local governments who are wary of possible losses and bound by strict mandates and regulation.

5. Brett Scott, Barclays PLC & agricultural commodity derivatives, March 2011, p.5

Credit Default Swaps (CDS)

Credit default swaps are notorious derivative contracts which allow investors to ‘insure’ securities against default. Much like a traditional insurance policy that you might take out on a house or car, a CDS contract entitles its owner to compensation if their loans default; in exchange for this protection they pay a fee. However, CDS’ differ from traditional insurance in that any one can sell a CDS, and offer ‘insurance-type’ protection, whilst equally anyone can buy CDS protection, regardless of whether they own the actual security being insured or not. The largely unregulated market in CDS’ has led to a practice known as ‘naked CDS’ trading, where investors take out insurance on securities which they don’t actually own, betting that they will default and thus pocketing a profit without ever touching the bad assets. This means that when one security defaults, multiple insurance claims can be made on it - and when a whole industry

As well as hedging against risk, or more normally in addition to it, derivatives are used by traders to profit from short-term price changes, often without owning the ‘real’ asset on which the derivative is based (see box ‘Credit default swaps’). The large volume of these short-term trades can contribute massively to volatility in the financial markets and puts many traders in a position where there stand to profit directly from a fall in the value of an asset. This exposes one of the central contradictions of financial trading activity – that by utilising derivatives and trading techniques such as short selling, short-term investors can benefit from the devaluation or failure of underlying long-term assets such as companies, infrastructure projects and even government debts. In this way, financial capital attacks its own basis in the ongoing processes of accumulation taking place in the ‘real’ economy.

Derivatives have generally promoted the idea that it is possible to account for and counterbalance risk; that it can be worthwhile to take on great uncertainty if it can easily be offset with a derivative contract. However, as the current economic crisis demonstrates, rather than diminishing overall risk, this perception has ultimately propagated an increase and generalisation of risk taking. The Derivatives explosion in the 2000’s capitalised on a wider economic boom that was largely fuelled by cheap credit and a housing bubble. But a market saturated with derivative contracts can only hedge against risk if overall levels of profitability remain high and there is plenty of cash in circulation. As the boom came to an end and debt defaults became widespread, it was impossible to protect everyone from the worsening ‘credit crunch’.

like the housing market goes belly up, it triggers economic meltdown! During the 2008 financial crisis, CDS contracts were instrumental in spreading the contagion of defaulting sub-prime mortgage debt to many more investors, financial institutions and major insurance companies, ultimately leading to the collapse and \$85 billion bail-out of AIG, the largest insurance group in the US. Credit default swaps demonstrate how derivatives can both increase and spread risk, and are an example of the type of derivative contract Bryan and Rafferty referred to when predicting in 2006 that derivatives “have made it likely that any financial crisis will have a more pervasive and speedy impact than was previously the case”.⁶

6. Dick Bryan and Michael Rafferty, *Capitalism with Derivatives: A Political Economy of Financial Derivatives, Capital and Class*. p.5

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