Understanding the jargon behind the banking crisis

What are they talking About?

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Financial ‘experts’ and economists seem to speak a different language to the rest of us. They rely on us not understanding what they’re on about. They know that if the gamble which constitutes the supposedly all-powerful ‘markets’ is revealed to us we will see just how crazy a system capitalism actually is.

But the truth is revolutionary and it is important that we look behind their jargon. Here we explain just a few of the most commonly heard terms.

CREDIT DEFAULT SWAP (CDS)

At its most basic a CDS is basically an insurance policy taken out against a loan default. For Example: Bank A is owed $100 million by Bank B at an interest rate of 5%, giving A an income of $5million per year from B. Bank A goes to Bank C and buys ‘protection’ against the possibility of Bank B defaulting on the loan, for $500,000 per year.This is a Credit Default Swap (CDS). Good business for all it seems – A retains $4.5 million per year of the interest and C has an income of $500,000 per annum for doing basically nothing. As long as B is able to repay the loan at the end of the 10-year term all are happy. But what happens if B defaults? Now Bank C owes the $100 million to A. But that’s the gamble it was willing to take. And more than likely C has ‘hedged its bets’ by selling on the risk to another ‘insurer’.

WHAT’S A ‘NAKED’ CREDIT DEFAULT SWAP?

This moves the CDS from ‘insurance’ to ‘gamble’. Take the example above and now enter Bank D. Even though it has had nothing to do with the initial transaction between A and B, Bank D can also buy a CDS on that transaction from B, a “Naked Credit Default Swap”. Again it seems like good business for Bank C – another $500,000 per year for doing nothing. Bank D is taking a punt on the hope of B defaulting.

CDSs are usually taken out for between 1 and 10 years, with the average being 5 years. In this example, D is taking the gamble of paying $500,000 per year for 5 years to C in the hope that B will default on his loan to A in which event C will owe the amount of B’s debt ($100million) to D .Now imagine the scenario whereby Bank C has sold 100 CDSs to different financial speculators on this transaction. As long as everything is going well and Bank B pays back the original loan to A as agreed, Bank C appears to have a booming business – an income of $50 million per year for doing little or nothing.But what happens if B defaults on the loan? Now C finds itself owing $100 million to A from the original CDS, and $100 million to each of the 100 holders of the ‘naked CDSs’ – a bill of a whopping $10,000 million. Suddenly the $50 million per annum income doesn’t seem quite so much.

CDSs have existed since the early 1990s but it was the passing of the Commodity Futures Modernisation Act (CFMA) by the Clinton government in 2000 that legalised the concept of being able to take out “insurance” on a transaction that you were not party to. By the end of 2007 there were $62.2 trillion worth of CDSs in the market, and well over half of these were pure speculation by ‘financiers’ who did not hold the original debt.This was casino capitalism at its most blatant. And it was totally unregulated.

COLLATERALISED DEBT OBLIGATION (CDO)

CDOs basically allow credit risk to be sold or passed on from one financial institution to another. The essential principle is that a package of asset-backed securities (e.g. home loans/mortgages, commercial real estate loans etc.) is bundled together and sold on in several tranches. The originator of the mortgages or loans is spreading their risk and the purchasers of the various tranches are making an investment in the expected return. In the middle is usually an investment bank which puts the package together, sells it on for a commission and earns a fee for 'managing' the 'investment'.

Of course the whole thing is predicated on the assets backing the loans holding their value and the mortagees or borrowers repaying the original loans. But — Take any one of the many sub-prime mortgage lenders which sprung up in the U.S. during the 1990s. Their basic modus operandi was to sell mortgages as fast as they could with little thought for whether the mortgagees were in a position to repay the loans. This was most often achieved through use of Adjustable Rate Mortgages (ARMs). In order to sign people up these ARMs were offered at an initial rate of just 1 or 2 %. But this rate would then be adjusted upwards within 1 to 3 years, jumping to as high as maybe 8 or 9%.

Because they were going to sell the debt on almost immediately, the mortgage company didn't care whether the loans were ever going to be paid back. As quick as they could sell them, they packaged together a bundle (say a thousand) of these mortgages and sold the bundle on to one of the bigger Wall Street banks. The bank would then bundle up the bundles, splice them up and sell them on as investments. But the banks, pension funds or hedge funds buying these investments were doing so on the basis that the original borrower was going to repay the loan plus interest thereby giving an 8 – 9% return. But when the property bubble burst and when holders of sub-prime mortgages began to default on their loans, a lot of holders of CDOs found their investments were actually worthless.

And when a mortgage went unpaid in California, it could be a hedge fund based in Hong Kong that held the worthless deeds to the property. CDOs were another invention of the 1990s regulation-free markets. The first one was issued in 1987. By the end of 2006 more than €2 trillion was tied up in CDOs.

COLLATERALISED LOAN OBLIGATION (CLO)

A CLO is a type of CDO. Instead of being mainly based on home loans, CLOs are mainly based on business loans – often loans associated with company takeovers or leveraged buyouts. Leveraged Buyout (LBO) companies – also known as private equity firms are one of the predators of the business world.The LBO company borrows a large sum of money (probably several billion dollars) from a Wall Street bank in order to buy out a business e.g. a retail chain or a hotel chain. The collateral offered is the business being bought. The plan is usually to 'rationalise' the business (which usually involves sacking loads of workers, cutting wages and working conditions etc.) and sell it on at a profit and thus repay the original loan.

Just as described above the Wall Street bank bundles up groups of such loans, splices them and sells them on as investments. It was a 'market' that exploded as the financial boom was about to go bust. In his book on the collapse of Lehman Brothers Bank "A Colossal Failure of

Common Sense", former Lehman vice president Larry McDonald recounts how *"In a land as innately avaricious as Wall Street, the kind of cold-blooded corporate raiding involved in LBOs is simply too big a temptation for the kind of grotesque personal greed that has slithered through Wall Street for more than a century … in summer 2005 … LBOs had exploded on a scale beyond anyone's imagination … Across the industry, stock sales and mergers and takeovers amounted to $117 billion … The value of take-overs over three months in mid-2005 was up 41 percent on the previous year. The leveraged-buyout specialists estimated $50 billion worth of takeovers in the same three months, with a year-end figure likely to be around $180 billion."* (p. 141)

But when the house of cards came tumbling down, it left devastation in its wake.

COMMERCIAL PAPER MARKET

Commercial Paper is a short-term loan (less than 9 months) used by banks and large corporations to meet their short-term debt obligations. It is a way in which large banks with 'blue chip' credit rating lend to each other. Because it is unregulated the Commercial Paper Market is the quickest and easiest way for them to raise fast loans.

Commercial Paper is essentially a promissory note, and as such has been around since the 19th Century. But in the 1990s and early years of the noughties Commercial Paper began to be used by the big banks as a means by which they would borrow short-term money and invest it in longer-term mortgage-backed securities which paid a higher yield. When it came to time to re-pay the short-term paper loan, they would simply take another one from a different bank and use this to keep the 'investment' going.

The amount of money outstanding in the U.S. Commercial Paper market mushroomed in the period 2001–2007 from $1.25 trillion to over $2.25 trillion. With much of this dependent on the U.S. housing market we all know now what was around the corner!

SHORT SELLING

Short Selling refers to the practice of selling assets (shares or bonds) that have been borrowed from a broker with the intention of buying back identical assets at a later date in order to pay them back to the broker. The seller is taking a gamble that the share price will fall so that he will make a profit on the transaction. The actual owner of the shares need not even be aware that her shares have been lent, sold and returned.

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