In the first of a two-part series on how the markets facilitated their own downfall, **David Young** explains why there was still much money to be made in the midst of the disaster

Stock market trader Alessio Rastani's received much attention for his comments on how the recession provided great money-making opportunities for his profession; background, protestors outside the Central Bank in Dublin. Picture: Sasko Lazarov/Photocall Ireland

When the lunatics got rich running the asylum

AWAKING nightmare for most, but for others, the global financial meltdown has become an opportunity. Cue Alessio Rastani, a London trader who's found notoriety with his recent interviews on BBC and ITV, by claiming he goes to bed at night dreaming of recessions. It's no new thing to know how to make a buck, regardless of the flow of the world's fortunes. But are his profiteering ilk to blame for getting the rest of us into this financial mess?

"If you take a bunch of bankers, put them in a room, and say: 'Make money as fast as you can lads, and we won't regulate ye too badly', you shouldn't be surprised if something goes wrong," says Dr Sheila Killian, department head in the Kemmy Business School, University of Limerick.

"Of course, it doesn't seem very likely that the people at the very top couldn't have seen the crash coming," she adds, "But the structuring of remuneration schemes fostered this short-termism. Think about it — if you've been paid a massive bonus on this year's results, then there's a moral hazard there ... that you'll focus on now, and say to hell with next year and the year after."

"And if you're working at a junior level in Goldman Sachs, you're probably a bit institutionalised. You probably don't think long term because you're encouraged towards snappy decisions," says Killian.

It's a view shared by Dr Ray Donnelly, lecturer in accounting and finance at University College Cork. "People have limited memories. Call it disaster myopia. They thought 1929 would never happen again. But it has," says Donnelly.

And so the collapse of Wall Street in 2008 was both inevitable, and of its own making: ironically, its financial institutions were the creators of the financial instruments that would bring about their very own demise. Yet, there remains an odd confusion as to the mechanics of it all.

The experts tell us it happened due to over exposure: too many bundles of failed sub-prime loans coupled with the payouts on the credit default swaps issued to cover them. And this scenario spiralled out of all control knocking banks in the US and Europe, and leaving global stock values and pension funds in a heap. But what does any of that really mean?

MAKING MONEY WHEN THE MARKET HITS A DOWNTURN

When markets take a bearish turn, short selling comes out in force. The basic idea is to borrow stock, and immediately sell it. Thus capturing a certain price. The seller then hopes (and prays) that the value will drop so they can buy, at the reduced price. And when it does, the stock — on loan — is returned, leaving a profit in its wake.

Now, imagine doing the same with bank shares you thought were overvalued, at say, €2 a pop. You enter into a 'short selling' agreement to take a thousand of them — a cool two grand's worth. The value drops as you anticipated, to €1.50. You now buy a thousand outright, costing yourself €1,500. And so make good on the initial agreement by returning what you borrowed.

You've just made a profit of €500, minus the brokerage fees, and interest of course. Thus, it is possible to accumulate profit, even when the values of stocks and commodities are dipping. The only catch is guessing the movement of the market. The practice of 'shorting' allows traders to sell what they don't even own, and thus make tidy profits — essentially, based on savvy forecasting of price drops.

"There's nothing unethical in the financial instrument per se," cautions Donnelly, "It's the way it's used. For example, this trading becomes somewhat precarious when the 'short' seller undertakes to sell what he hasn't even borrowed. This is the 'naked' version of the practice. And one that is deemed detrimental to markets. The fundamental problem is the potential failure to deliver."

Now, consider the scenario: more and more people are holding 'short' positions in the market. As this becomes obvious, the likelihood is that share prices start to further decrease in value. And a momentum is gained, magnifying the downturn. "There's usually a ban on shorting when there's a freefall in stock values," Donnelly says.

Hence, the 'uptick rule' — it's a protocol that was instituted for this very reason by the US Securities and Exchange Committee back in 1938. But they decided to abandon it in 2007 because it was deemed a constraint on market liquidity. Ironically, 'shorting' is one sure way to create volatility in the markets, thereby creating uncertainty in a system that is essentially illiquid.

THE BIG SHORT — THE WALL STREET DELUSION

As Wall Street shifted the focus of its billion dollar business from stocks to bonds, a certain cohort of traders scrutinised the move. And noting the colossal investment banks' hubris, and their wizardry and predilection for creating new products, coupled with their institutional ignorance of the warnings of an imminent demise in the property market, they schemed how to 'short' these bands. The top financial thinkers had manufactured mortgage-backed securities that essentially saw them transform pools of debt into saleable bonds — subprime derivatives. By combining home loans with other debts, they created billion dollar instruments and presented them as having verifiable values. The resulting 'collateralised debt obligations', sanctioned by the ratings agencies, were duly sliced and diced up into so-called tranches and sold off.

What was the immediate result? "Wall Street ... getting rich shuffling bits of paper around to no obvious social purpose," writes Michael Lewis, author of the Big Short, who also argues that the rating agencies were integral to the whole process. Donnelly also fingers the invigilators: "They made a mess of it. And these same agencies are now rating countries."

Donnelly asserts: "There was a disconnection between loan makers and the lenders. Where banks had operated under the guiding principle of due diligence — concerned about mortgages being paid back — they no longer thought the same. In essence, they were selling money and passing on the risk. To become someone else's problem."

Voilà, the mortgage bonanza. Regardless of income, and career prospects, finance houses entertained customers — for the sake of punting a product. And the credit ratings agencies blessed it all. Cajoled by banks' top brass, they collected large fees for very little probing. In truth, their feeble efforts stoked the engine rooms further. By assembling various types of contractual debt (residential, commercial mortgages, and the likes of car loans and credit card receivables) and consolidating them as bonds, banks essentially repackaged and made palatable to investors what they otherwise wouldn't have touched.

"The thing about risk, it just doesn't go away," says Donnelly. "You can't change that fact. And the so-called 'securitisation' only served to mask that the true face of the financial arrangements. According to Wall Street hedge fund guru Steve Eisman, the bond market "had extended into an unprecedented place: the debts of ordinary Americans". He deduced that the investment banks, "who didn't give a damn", had found fuel in the insolvency of the general public.

With a flaw now embedded deep in the system, it would only be a matter of time before the entire structure sundered. A few, like Michael Burry, an obscure home-based stock market investor, spotted it. Lewis tells how Burry approached seven of the top banks to broach taking out a new type of derivative — a credit default swap on a subprime mortgage bond, only to find they had no idea what he was talking about.

Inside three years though, Burry's enquiry had became a trillion-dollar market. He said it was only a matter of time before the adjustable rates in subprime mortgages adjusted upwards.

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JARGON BUSTING — WHAT THE HELL ARE THESE DERIVATIVES?

"Derivatives are financial instruments," explains Sheila Killian. "Complicated you could say by the fact that they derive their value from something else. And they're being invented all the time. For example, weather derivatives only appeared in the last 10 years. Say, you're investing in commodities such as coffee. A weather derivative could be a form of insurance to help you cover your risks.

"Similarly, credit default swaps are a form of insurance. If I lend you money but I'm worried about your ability to repay, I'll buy a swap, and pay 'x' every year to cover any potential loss," she says. "There's nothing morally right or wrong about them. They're only market instruments. It just depends on how they're employed.

"Normally, you can only insure things in which you have an interest; for example, your own house against fire. You can't insure anybody else's house against fire. There are very good reasons for that. It would be a little like taking out policies on other people's homes while carrying a can of petrol and a box of matches."

Yet, this is effectively what the credit default swap on the home-mortgage bond became: a policy that someone could hold — as a bet — on the ability of the lender to repay. Without holding any real interest in a property, the owner of the swap could wager that a mortgage holder, or entire securities composed of the same quality loans, would lapse.

"If there's a real economic value in all this, then I need some more education," says Professor Michael Greenberger, University of Maryland. "It's essentially preying on other people's misfortune."

But that's just what a select group of marketeers did. Detaching themselves from the financial industry's groupthink of never-ending property appreciation, they forged a path in the opposite direction to the Wall Street mainstream, and trumped the glorified Ponzi/pyramid scheme that was the property market.

Ever so smartly, the credit default swap on the subprime mortgage bond circumnavigated the legality of taking out an insurance policy on a neighbour's house; thereby facilitating investors who wished to bet on mortgage holders being unable to prevent themselves from winding up in a world of financial woe.

Dr Ray Donnelly: "They thought 1929 would never happen again. But it has."

MAKING MONEY ON YOUR MISERY — AIG BLOWS

"And AIG, the world's largest insurance company, got into the business of insuring these financial instruments," explains Greenberger. "Insuring the value of payments being made and their returns. Betting, essentially, on the whether or not people could pay off their loans." Risky propositions, especially when they weren't sure what was in the derivative lucky bags.

"They had more than 20 divisions. And all but one was inside the regulatory net — their London office," Greenberger continues. "There, they never put capital aside for the eventuality of the triggering of these policies. And when it happened, they had more than $400 billion issued in insurance premiums. All on the shaky premise the trigger would never be pulled. But it was."

Inevitably, AIG began to implode, putting trillion dollar holes in the global economy, only to be saved by government intervention; just like Goldman Sachs and others were cushioned by the nationalisation of so-called investor debt. In Greenberger's opinion, the surreality of it all is the impossibility of determining how much of the money handed over props up the interests of the banks, their clients, and other corporate entities.

"We're paying off the losses incurred on unregulated instruments that look like insurance policies," says Greenberger. "We've stepped into the casino and picked up the tab for the wealthy institutions and wealthy people who bet big."

And the crisis is far from over. "We're only moving into the second act," says Michael Lewis. "From here on, the fiction can take any number of paths. The betting has moved on from shorting investment banks to shorting sovereign debt, and placing money on countries like Greece defaulting."

Will the Greeks make good on their national debt? "Not a chance," offers Donnelly, without hesitating, "and by the way, it won't be called a default. It'll be given another name." As for the fate of the euro, Killian envisages: "It's entirely possible that it breaks up. Currencies change, and the world goes on."

As for Alessio Rastani — no need to vent your spleen at him — he's but a clown in the world's financial circus. Consider instead, the negligent regulators who allowed the safety net to be removed during the high wire act, while citizen Joe was being ushered to the trapeze.

TOMORROW: PART 2

We take a look at the politics dogging the euro; how brinkmanship and indecision could destroy not only the common currency, but the European project too.