

Fall of the Titans

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GHALIB CHAUDHURI

TODAY saw the demise of investment banks on Wall Street. The last of the two large independent investment banks -- Morgan Stanley and Goldman Sachs -- have asked to be supervised by the Federal Reserve Bank (Fed) of the US, like all other commercial banks.

The two banks had applied to the Fed to be banking institutions that would give them the liquidity through the Fed funding window, and offered to be regulated by the Fed.

Investment banks from Wall Street once ruled the world of finance, till hubris and greed drove them to believe they were invincible.

making business. They match buyers and sellers of stocks and bonds, by acting as brokers and also as bankers; they raise finance for companies from third party investors, and help buy and sell companies through mergers and acquisition.

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By then, with most of them listed and with access to more capital, they had essentially turned gamblers by betting on markets with their own money through leveraging their balance sheets.

Transitioning from a safe

model, where it matched buyers and sellers with little capital at risk, to taking long and short positions on its own balance sheet meant gearing up on its capital. And this is what caused the downfall of the industry, manifested in the demise of Bear Stearns (that was bought over by JP Morgan), Lehman Brothers filing for chapter eleven, and Merrill Lynch being gobbled up by Bank of America.

And the final nail in the coffin came today with the remaining two largest independent investment banks left -- Goldman Sachs and Morgan Stanley -- folding as investment banks and re-emerging as commercial banking institutions with the blessing of the Federal Reserve Bank of the US.

Some of the cleverest people

from B school join investment banks, partly drawn by the challenge of the cut and thrust of markets and the opportunity to deal with high finance and partly by the massive potential upside in compensation.

Many would say it is the chance to be quick millionaires that drives people into this industry, and this may not be far from the truth.

Fundamentally, there is nothing wrong with that -- after all monetary incentive is often a key criterion for choice. But when financial compensation leads to greed and to moral hazard then society will have a problem with the breed of investment bankers.

According to Wikipedia, "Moral hazard is the prospect that a party insulated from risk may behave differently from the way it would behave if it were fully exposed to the risk."

Moral hazard arises because an institution does not bear the full consequences of its actions, and, therefore, has a tendency to act less carefully than it otherwise would, leaving another party to bear some

responsibility for the consequences of those actions." This is precisely what happened in the industry.

The investment banks were responsible for creating the Credit Default Obligations (CDO's) in the market. These were mortgage loans securitised as CDO's or collateralised bonds with a pile of mortgages inside them and because they were sufficiently over collateralised, meaning that the mortgages were worth more than the value of the bonds being issued, the rating agencies gave the bonds triple A or double A credit ratings which made it easy for them to sell.

So here is how the moral hazard happened. Investment banks told the mortgage lenders to create as many new mortgages as they could. The mortgage lenders did precisely that, without much caring about the ability of the borrowers to repay the loans.

The loans were then repackaged by investment banks as CDO's and sold to investors, leaving very little of the assets on the books of the mortgage lenders or the invest-

ment banks, but both parties did handsomely on fee compensation in the whole process, paying out large bonuses to the bankers.

The investment banks or the mortgage lenders had no concern with the quality of the mortgages, as default on the mortgages would only affect the investors holding the CDO's and not them.

Or so they thought. Creating CDO's involved putting complicated tranche structures in the collateralisation process, and the rating agencies rate each tranche separately. Some of the tranches get the highest rating of triple A, which investment banks like to hold themselves because of their rating and more than commensurate return.

They, indeed, looked fairly safe in the beginning as it would need a whole lot of default on the mortgages inside the CDO's before the triple A tranches got effected. The mistake was that no one anticipated the torrent of default that followed with the weakening of the US economy and, lo and behold, the triple A tranches also turned



The bigger they are, the harder they fall.

into junk and ate into the capital of the investment banks, resulting in the demise of an industry.

Could all this be avoided? Yes, of course. The clever investment bankers should have known that economies don't always grow. Business cycle is part and parcel of growth and a little sensitivity analysis of a downturn would have shown

the weakness of the CDO structure.

It's now all water under the bridge, but let us hope that we have learnt our lessons and will not allow this monumental financial disaster to occur again and shake the very foundation of capitalism.

Ghalib Chaudhuri is a freelance contributor to The Daily Star.

An eminent scientist and visionary

Anwar's varied career, beginning with lectureship at Dhaka University and a short stint with the Army Education Corp, ultimately landed him in the area to which he belonged, viz nuclear energy and research, with which he remained attached till his retirement. His contributions and achievements at the atomic energy establishments at Karachi, Rawalpindi, and particularly at the Dhaka centre, are too well known to need any repetition.

MOHAMMAD DELWAR HOSSAIN

ANWAR Hossain was one of 12 brothers and sisters. He was the most talented one, enjoying a brilliant academic career all through, and securing first class first position in M.Sc in Physics from Dhaka University in the year 1951. Three years later, at the young age of 25, he obtained Ph.D in Physics from Bristol University, UK, working under the guidance of the famous nuclear scientist, Professor Rutherford.

Here, I may also add that although he was a student of science, he secured the highest marks in Bengali in the Matriculation Examination of

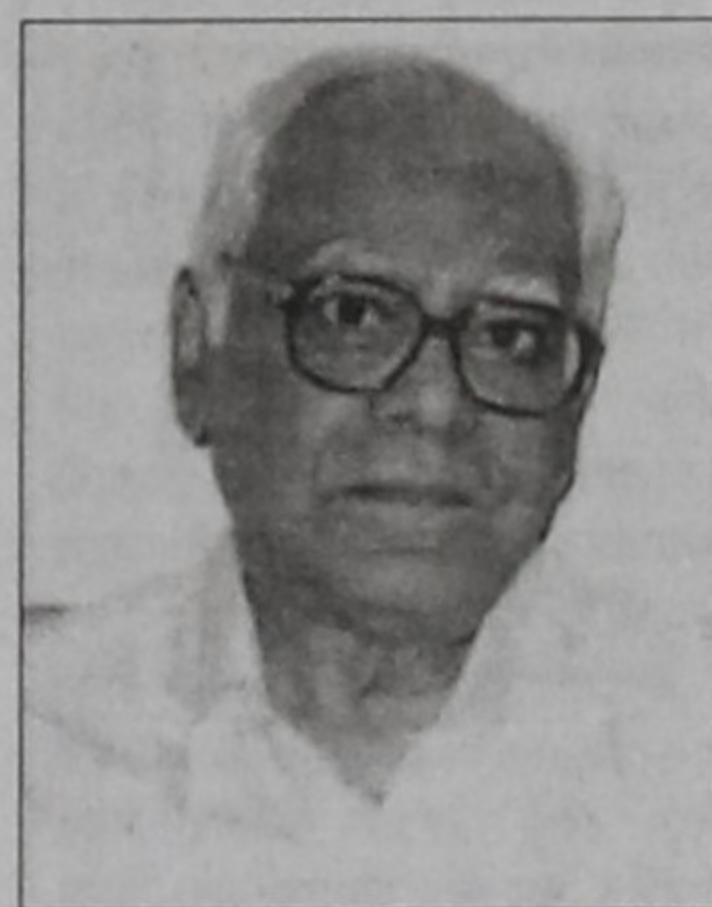
the Calcutta University in 1945.

His many qualities included his lucid power of expression, both in writing as well as in his speeches, making difficult scientific issues clear for the audience to understand, his ability to organise international seminars, workshops etc (here mention must be made of the seminar on "Albert Einstein and SN Bose," he organised in Dhaka in 2005 which, together with the book he edited containing the papers presented at the seminar, drew high accolade, both inside and outside the country), leading many delegations with complete mastery of the subject.

Apart from his reputation as a brilliant scientist, he was also

very highly regarded at the IAEA, Vienna, and in many other centres of atomic energy research in the UK, France, USA, India, Yugoslavia, Russia and Japan, and most of the heads of institutions there were his close personal friends.

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Dr. Anwar Hossain

tre, are too well known to need any repetition.

His researches in non-conventional sectors like wind, water, solar etc., as well as on the rare and precious minerals at Cox's Bazar sea beach and elsewhere, are also well known.

This remarkable scientist had realised decades earlier that the ultimate solution of the energy shortage in our country lay in the generation of atomic power. As a practical visionary, he was able to complete, in the early sixties, all the ground-work of his life-long dream of

setting-up a nuclear power plant at Roopur.

This included taking over possession of the land required and building the major portion of the residential accommodation needed, and training a body of scientists and engineers. Unfortunately, the plant has not been set-up as yet. He narrated the story of missed opportunities in an article which was published in The Guardian, London, in October 2003.

The fortnightly magazine Energy and Power later reproduced this here in October, 2007.

Just before his untimely death, Anwar was deeply involved in the formulation of the energy policy of the country by the present government, which was convinced about the need of atomic energy as a long-term solution of the serious crisis in the sector. As the acknowledged expert in this field, he was regularly consulted for achieving a sustainable solution. He was on the point of being appointed as the

senior consultant, and his sudden departure certainly put a brake on the progress being made.

We are sure that the dream, which Anwar had for a nuclear power plant in the country, will come through, and I fervently hope that it will be named after him, in grateful memory of all he had done to achieve the goal.

He was very proud of the culture and heritage of his country, and like many other eminent scientists both at home and abroad, he was very fond of music, both vocal and instrumental. Apart from being a connoisseur of good food, he was also a very good bridge player. I also fondly remember the many hours in recent years, of watching together battles royal in cricket, tennis and football on TV. I shall never have the good fortune of sharing such rare moments together.

Mohammad Delwar Hossain is a former Chairman of Bangladesh Sugar and Food Industries Corporation and founder president of a village based high school, and the elder brother of the deceased.

Back to the end of history

In 1992, Francis Fukuyama, a second-generation Japanese-American historian and philosopher, published the precocious, controversial treatise *The End of History*, which held that the age-old struggle over political ideologies had ended and that liberal democracy was the victor. But the past 16 years -- the rise of Russian authoritarianism, China's huge economic growth and the failure of neo-conservative ideals in Iraq, where Fukuyama argued early to dislodge Saddam Hussein -- have cast doubt on his premise. He spoke with Newsweek's Matthew Philips.

Philips: Does the thesis behind *The End of History* still hold up?

Fukuyama: The basic premise still holds true. The problem with the popular understanding of the thesis was that history was just meant as things happening, when in fact the hypothesis dealt more with the evolution of human societies, the direction they were moving in, and the likely final destination in terms of forms of government.

So, in spite of authoritarian revivals in Russia and China, liberal democracy is still the only legitimate form of government broadly accepted. Of course, several groups have opted out, like the Islamic fundamentalists, but in the long run I am still fairly confident that democratic systems are the only viable ones.

Doesn't it counter your thesis that America may be on the wane and liberal democracy was dealt a blow in Iraq?

It was never specifically connected to American hegemony. The European Union represents

those ideals better, actually. American power relative to the world is declining because of the growth of other centers of power, which was certainly foreseen.

But the one thing that has changed is that the very idea that democracy is a good thing -- that we should care that countries are democratic -- has been tainted by the way the Bush administration used it to justify this War on Terror. Now people around the world associate the very idea of democracy with the Bush administration, and Vladimir Putin can say: "We're not interested in democracy."

In 1992, you were upbeat about Russia. Do you still feel that way? What's happening in Russia is more of a generational thing. Younger Russians who came of age in the 1990s have a negative association with the period that followed the collapse of the Soviet Union.

They like the growth of consumerism. They see the 1990s as a time of national humiliation, of weakness, chaos and retreat

abroad. They have nostalgia for the strength of the Soviet Union. They didn't directly experience it, which is why they feel that way. This is the basis of Putin's support. The real question is: does that generation want to give up the possibility of traveling to Europe for the sake of dominating Ukraine and Georgia?

Should those two be admitted into Nato?

Yes, and I believe they deserve the guarantee that we'll send forces to defend Nato members. But it's unrealistic to think the US is going to do that in either of those two cases.

We have our hands full protecting Poland and the Baltic states, and now, with an aggressive Russia, people feel that Nato is this magic talisman that conveys protection without having to back it up.

Under the current circumstances, it's not realistic that we push the boundaries there with Russia pushing back so hard. We have to realise we should not make promises for military commitments we're

not going to be able to fulfill.

You're a long way from your early neo-conservative leanings.

I disavowed those years ago. I've always had a Marxist understanding of history: democracy is a result of a broad modernisation process that happens in every country. Neo-cons think the use of political power can force the pace of change, but ultimately it depends on societies doing it themselves.

Is that the way you felt in 1992?

The process is harder and longer than I felt back then. I appreciate to a greater degree that democracy is built around institutions that are quite difficult to put into place, especially the rule of law. The other big thing I did not imagine back in 1992 was that the U.S. could become so controversial and damaging to the prospects of democracy.

How long does it take to fix that?

Probably a decade of rebuilding work. But it's something that can be revived because the underlying thesis -- that democratic societies are necessary -- remains strong.

Should the United States refocus on domestic issues?

I would not dial back foreign involvement. There are lots of problems out there, and we've made lots of commitments and we need to keep them. Most of them are better kept with non-military power, so I think there needs to be a re-emphasis on the use of American soft power.

Book advertisement for 'THE END OF HISTORY AND THE LAST MAN' by Francis Fukuyama. It includes text like 'WINNER OF THE LOS ANGELES TIMES BOOK PRIZE', 'THE NEW YORK TIMES BESTSELLER', and 'AWESOME... A LANDMARK WORK... PROFOUNDLY REALISTIC AND IMPORTANT... SUPREMELY TIMELY AND COHERENT... THE BEST BOOK TO FULLY FATHOM THE DEPTH AND RANGE OF THE CHANGES NOW SWEEPING THROUGH THE WORLD.' It also features a quote from George Clider in the Washington Post Book World.

What now?

You've said China poses a bigger challenge than Russia.

There are two choices. You can either construct a containment barrier against China, which is something my neo-con friends have suggested, or you can try to suck the Chinese into as many

global institutions as possible, like the WTO. I think the more preferable scenario is the latter, particularly as you imagine a world in 20 years where China is the same size as the US.

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