The Great Escape

To understand this, one has to see the great changes that have taken place in the world's financial institutions. I call this the "Great Escape." Central banks have diligently tried to supervise and monitor commercial banks to insure that the depositors' money was safeguarded. This effort has apparently been successful, with few bank failures, and most central banks were able to respond correctly and promptly to commercial banks' problems.

But groups and families with deep financial pockets were looking for better returns and other ways to earn safely, without the risks of the share markets or the low returns from bank deposits. They needed to escape from the regulatory regimes. Funds were accumulating in insurance companies, pension funds, and private fortunes that sought investment opportunities. There began the proliferation of financial instruments that sought to refinance commercial banks and corporations by lending money through special type of instruments.

The most interesting of these was the bundling together of a lot of debt from car loans, credit cards, and house loans. By finding ways to group these together and sell the loans the commercial banks are refinanced and can lend more.

These are called collateralised debt obligations (CDOs). CDOs are put together in complex patterns so investors can choose the mix of risk and return that they want. If the mortgages are all "prime" then Fannie Mae or Freddie Mae may buy them. They did so in large amounts.

As the value of these CDOs declined with rising defaults by home owners the two financial institutions saw their assets fall, eroding their capital and forcing them to seek more. But their share values declined, and replenishing capital became too difficult. Heading towards insolvency and the collapse of the world financial system they were taken over by the US government.

In Bangladesh, a commercial bank has for its liabilities deposits, borrowing from other banks (which of course cancel out in the aggregate), and borrowing from the central bank. The banks have only begun to securitise their loans -- bundling them together -- and lending them to, say, a provident fund. But in the western world this became the central idea of financial institutions. These types of instruments will have higher interest rates than deposits, and so attract funds that are tired of the low return on bank deposits or government securities.

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Once this idea is loose in the financial world it can keep on expanding. Any financial institution can take its assets, bundle them together and sell that to some other financial institution. One builds a higher and higher tree of assets and instruments. Somewhere at the bottom of this tree are the actual loans connected with the real economy -- the house loan, the car loan, the equipment lease, the credit card facility. But on top of this are endless financial instruments built on whatever assets one has.

The difficulty is obvious -- it is hard to assess the risk of these CDOs. Particularly for CDOs linked to the sub-prime market, but not restricted to those assets, there grew credit default swaps (CDS). Company A wants to buy a CDO from Company B; but Company A wants insurance against default. Company C offers this insurance in return for a fee. If there is a default then Company C pays Company A. Company A also demands collateral from Company C to insure the obligation is meant.

The CDS market is a vast, complex network of these insurance-like agreements. Estimates of its size range from $5 trillion to $40 trillion! Unlike insurance there is no fund set aside, often only some of the company assets. For example, the large insurance company AIG had about $50 billion of these CDS agreements; it received payment of the fees for these and the assets of the company (largely shares of its subsidiaries) were collateral. The CDO and CDS markets expanded rapidly. Actually, no one really knows the extent of all of this.

Now consider what happens when the loans at the bottom of the tree begin to go bad. Everything else begins to go bad with them. But no one knows how much. If I default on a house mortgage it reduces the value of the bundle of house mortgages that my particular loan is bundled into. If the institution that got that bundle has bundled it with other things and sold that off my little house loan has now reduced the value of still another financial instrument. But no one knows which one or how much.

Suddenly, financial institutions do not know how to value their liabilities and assets. Such institutions then become very conservative. They do two things: First, they