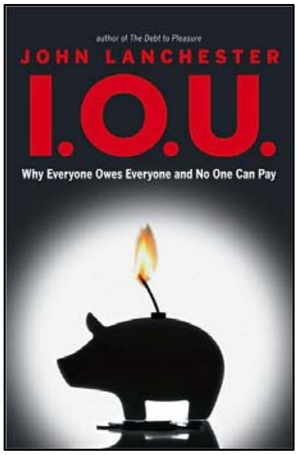
CapitolReader
POLITICAL BOOK SUMMARIES™



I.O.U.:

Why Everyone Owes Everyone and No One Can Pay

Author: John Lanchester
Publisher: Simon & Schuster
Date of Publication: January 2010
ISBN: 9781439169841
No. of Pages: 272

Buy This Book

[Summary published by CapitolReader.com on April 22, 2010]

Click here for more political and current events books from *Simon & Schuster*.

About The Author:
John Lanchester is a novelist and a contributing editor at the *London Review of Books*. His work has appeared in *The New Yorker, The New York Times, Granta, Esquire, The Observer,* and *the Daily Telegraph.* In 2008, Lanchester received the E.M. Forster Award from the American Academy of Arts and Letters. He lives in London.

General Overview:
In *I.O.U.: Why Everyone Owes Everyone and No One Can Pay*, John Lanchester takes an in-depth look at the causes of the current financial crisis and explains how the booming global economy collapsed seemingly overnight. He also points out the most important lessons we can learn from this crisis and offers solutions on how to avoid another such catastrophe in the future.

Please Note: This CapitolReader.com summary does ***not*** offer judgment or opinion on the book's content. The ideas, viewpoints and arguments are presented just as the book's ***author*** has intended.

Introduction

In 2008, the global economic system came to a screeching halt. Major financial firms failed, credit dried up, unemployment and foreclosures soared, and the financial system as we know it teetered on the brink of complete collapse.

Capitalism is supposed to be self-correcting, so how exactly did we end up in this mess?

The origins of the current crisis can be traced back to the fall of the Berlin Wall. Throughout the Cold War, capitalistic societies recognized they were in a public relations struggle with their socialistic counterparts. As a result, capitalistic societies maintained robust social safety nets to protect their citizens from the inevitable upheavals and dislocations that free markets produce. Once Communism failed, however, capitalistic systems saw no further need to offer the kinds of social safeguards that were intended to win hearts and minds. After all, with socialism vanquished, there was no viable alternative to capitalism.

Ronald Reagan and Margret Thatcher instituted a wave of deregulation and laissez faire policies. For instance, banks were unshackled from Depression-era laws that were intended to make sure they remained financially sound. Of special note, in 1999, Congress repealed the Glass-Steagall Act, which had constructed a wall between retail banking and investment banking. Put simply, the Act was intended to keep mom-and-pop (retail) banking separate from casino (investment) banking in order to ensure that Main Street deposits were not jeopardized by Wall Street's risky wheeling and dealing.

Ultimately, the world's largest and most powerful financial institutions managed to extricate themselves from any meaningful accountability or oversight. These financial firms convinced themselves, government officials, and regulators that they had discovered foolproof ways of managing risk. In particular, complex mathematical formulas for dividing risk supposedly immunized banks and other financial institutions against financial disaster. Further, banks and financial institutions engaged in complex hedging strategies that included repackaging and securitizing debt, as well as the buying and selling of financial insurance designed to mitigate all risk.

In short, the masters of the financial universe believed they had discovered a foolproof way of making record profits without taking on risk. Needless to say, this led them to believe they deserved stratospheric compensation.

In fact, the financial edifice constructed by our financial elites rested on the flimsy foundation of sub-prime borrowers. Collateralized Debt Obligations (CDO) packaged out of sub-prime debt were given AAA ratings, but all too often these borrowers had no income, no job, and no assets. Fancy formulas and complex instruments had convinced the financial wizards that risk had been abolished and therefore, they could even profit by lending money to insolvent deadbeats. Their house of cards rested on this shaky premise.

When their financial architecture collapsed, the collateral damage was so great that these firms threatened to bring down the entire financial system with them. As a result, taxpayers the world over have had to bail out financial firms that created the economic crisis in the first place. This is socialism for the rich, pure and simple.

The bill for dealing with the financial meltdown will be onerous indeed. In the United States alone, the costs of bailing out failed financial firms will reach $7.76 trillion, according to an estimate by Bloomberg. And that's just the beginning.

Government debt is compounded by personal indebtedness. This means that an increasing share of personal income and government income will go to paying off interest owed, which will mean less money to invest in vital national needs such as education, infrastructure, and healthcare.

Governments are understandably taking a Keynesian approach to the crisis; i.e., deficit spending to maintain liquidity. But at some point, higher debt will entail higher taxes, reduced services, or both. In all likelihood, we are at the cusp of an era of inflationary pressures, higher interest rates, underemployment, and big reductions in public services.

The current crisis is analogous to a patient who had a massive heart attack from living an unhealthy and unsustainable lifestyle. The financial system can't go back to the way it was anymore than a cardiac patient can go back to smoking, drinking, and overeating. The financial system must be scaled back and reigned in so that it serves society rather than feeds off it.

The ATM Moment

In October 2008, thousands of Icelandic residents discovered they were unable to withdraw funds from their ATM accounts. This was not due to a lack of funds within the individual accounts, but rather because the Bank of Iceland was broke. In fact, the entire country of Iceland was virtually bankrupt.

Iceland's problems, as it turns out, were just the tip of a global economic iceberg.

What happened? To begin with, Iceland privatized and deregulated its state-owned banking industry in 2001, which led to an explosion in fake growth. "A wave of cheap credit lifted Iceland into a kind of economic fantasyland."

The market meltdown of 2008 is inextricably tied to the fall of the Berlin Wall and the fall of Communism. Throughout the Cold War, capitalism and communism acted like contestants in a beauty contest trying to woo a global citizenry. The West's liberal democracies were morally superior to their communist counterparts, but the sharp edges of capitalism were tempered in order to make the system seem even more palatable. With the demise of the Soviet Union, there were fewer pressures within capitalistic systems to reign in capitalism's harsher features. As a result, capitalism became a winner-take-all arena where income disparity soared.

The financial sector was unfettered, which fueled a vast increase in wealth among the financial elites, which of course bolstered their political clout. As a result, the financial industry came to dominate the United States, Great Britain, and many other countries. In fact, at the height of this trend, the U.K.'s biggest bank, the Royal Bank of Scotland, had assets that were larger than the GDP of the U.K itself! Of course, RBS's immense wealth turned out to be a mirage.

Banks like the RBS were highly leveraged, frequently employing leverage rates of 30-to-1 and higher. That meant banks were borrowing $30 dollars for every $1 they had in the vault. With some banks, this rate was more than 60-to-1. However, when the real estate bubble burst, it decimated the market for collateralized debt obligations (CDOs).

CDOs became known as "toxic assets." In fact, what was "toxic" about them was the prices investors were willing to pay for them once the housing crisis hit.

Put simply, investors were typically only willing to pay just twenty-five cents on the dollar for CDOs, which meant the market for these complex instruments (which few people understood) dried up. As a result, many banks found that they no longer met minimum capital requirements. In other words, many banks and financial institutions were insolvent.

If a homeowner has negative equity, then he or she may be able to weather the storm and perhaps sell their home once the real estate market recovers. However, when banks are faced with negative equity, their natural response is to clean up the balance sheets by cutting back loans and hoarding cash.

This is exactly what many banks did. Unfortunately, credit is the lifeblood of the economy and when credit stops flowing, so does economic activity.

Rocket Science

Warren Buffett once referred to derivatives as "financial weapons of mass destruction." The billionaire investor, who shunned complex financial instruments, was prescient about the dangers of derivatives.

In essence, a derivative is a financial contact that derives its value from an underlying product. Basically, derivatives involve the option (or obligation) to buy a specific product (a commodity or shares in a company) at a set price sometime in the future.

Derivatives have always been tricky instruments to price. But in 1973, mathematicians Fisher Black and Myron Scholes devised a formula that calculated the value of derivatives, essentially weighing complex factors such as the underlying asset prices, time, interest rates, price volatility, and risk. With the advent of the Black-Scholes equation, the market for derivatives took off.

With derivatives, finance and banking came to be dominated by mathematics. Investors sought to place bets on both sides of trades and exploit small differences in prices to make what they thought were risk free wagers that led to surefire profits. Of course, to turn small price differentials into large profits, one needs to employ tremendous leverage. High levels of leverage can lead to outsized returns, but high leverage can also leave investors dangerously exposed if the unexpected occurs.

Mathematical formulas can help calculate probabilities, but they do not help manage uncertainty.

The distinction between probability and uncertainty is one of the key points the economist John Maynard Keynes insisted upon. Simply put, calculating probabilities works when there is a wealth of pertinent data from a sample size to make predictions. For instance, actuarial data can help insurance companies accurately predict the likelihood of a typical 50-year-old male dying from a heart attack within the next year. However, there is no amount of historical data that can help one determine if a given company will be in business one year from now.

"Confuse probabilities with uncertainty, and you have dug a tank trap for yourself." But the architects of multiple financial crises committed just this very bad mistake.

The notion that uncertainty could be managed and risk eliminated was the Holy Grail that led to the creation of ever more complex financial instruments. The credit default swap is one such instrument. Basically, a credit default swap is a form of insurance a lender takes out against the possibility that a borrower won't be able to pay back a debt.

Credit default swaps were a windfall for banks. For instance, banks garnered fees for making loans, and then still more fees for selling securities based on these loans. Best of all, this practice took loans off their books. And at the same time, they didn't have to worry borrowers defaulting on their loans.

Needless to say, banks had a clear incentive to make to make as many loans as possible.

Conversely, because banks were passing off these loans to third parties – and because the financial formulas and fancy financial instruments supposedly abolished risk – lenders had little incentive to scrutinize their borrowers.

Instruments designed to mitigate risk actually ended up exacerbating risk. This was because everyone felt certain they could reap fantastic profits without any downside whatsoever. The cardinal rule that higher rewards inevitably entail greater risks was ignored.

"These new financial instruments were very, very clever, but they had an unfortunate side effect: they broke banking."

Banking is – and should be – a simple business. Traditionally, banks borrow money at a low interest rate (say 3%) and lend money at a slightly higher rate (say 6%). Their profit consists of the spread. The fancy financial instruments severed the most important relationship banks can have, the relationship with their customers. Making quality loans leads to modest, but sustainable profits. Banks eschewed this time-tested model for a form of finance that one would expect to find in a casino.

The value of the fancy financial instruments was always elusive and dubious. Ultimately, AIG, the biggest underwriter of debt insurance, was done in because it failed to appraise the risk it was assuming. AIG, of course, was too big and too interconnected to be allowed to completely fail. If AIG had been allowed to go under, then its counterparties (Goldman Sachs, Deutsche Bank, and Barclays) would have been ruined. Thus, the U.S. government bailout of AIG essentially entailed a U.S. taxpayer bailout of both American and foreign banks.

The total cost to the American taxpayer so far: $173,000,000,000.

Boom and Bust

The United States and the U.K. are cultures that encourage home ownership. In the United States, Republican and Democratic administrations have sponsored legislation pushing financial institutions to extend mortgages to low-income borrowers. As a result, under the administration of George W. Bush, home ownership reached an all-time high of nearly 69%.

Homeownership may have many merits. However, Americans have long entertained illusions about real estate. For instance, real estate is not "the best investment most of us will ever make." In fact, from a historical perspective, stocks offer a significantly higher rate of return. Concomitantly, for reasons that should be obvious, housing prices cannot grow faster than income growth over the long term.

In the decade leading up to the real estate bubble, home prices rose nearly 69% in the United States. The rise in home prices in Europe was even more astounding; in Britain prices went up by 135%, in Ireland by 242%, and in Spain by 114%.

The Fed's decision to slash interest rates and keep them low following the bursting of the tech bubble was undoubtedly a major factor that fueled runaway home prices. But an even bigger factor was China, which, as a matter of economic policy, invested its trade surpluses in U.S. Treasuries. Essentially, the Chinese lent us their savings so Americans could afford to buy Chinese products. Cheap credit pushed home prices into the stratosphere.

Wall Street's wizards then sought new and creative ways to profit from the real estate boom.

Enter the Geniuses

In the United States, the government had been aggressively pushing lenders to offer mortgages to "underserved communities." This meant low-income borrowers with little or no credit. The financial industry saw an opportunity. After all, riskier lending entailed higher fees and higher interest rates. It wasn't long before the financial wizards devised a "CDO based on these sexy subprime mortgages."

Getting credit agencies to assign AAA ratings to instruments bundled out of sub-prime mortgages would pose a challenge. Risk assessment is based on mathematical modeling and the science of probabilities. So, Wall Street devised new statistical techniques to supposedly correlate seemingly unrelated factors. For instance, if the likelihood of mortgage default could be correlated with other market indicators, then the problem of rating sub-prime instruments would be solved. The new financial formula was, in effect, like a magic wand; it transformed subprime lead into financial gold.

Armed with this new tool, the market for sub-prime CDOs took off.

Securitizing sub-prime debt was a windfall for banks. They collected lucrative fees from borrowers and sold off pools of risky assets to third parties. This freed up their balance sheets, preserving their capital so it could be lent out again. In fact, banks had no incentive to worry about whether the loans they made would ever be repaid.

There is a tremendous irony in the fact that sub-prime lending pools garnered AAA ratings. After all, it assumes that the sub-prime instruments were as safe as safe U.S. Treasury bonds. But the industry was determined to stretch the rules in every way it could. This included the invention of special purpose vehicles (off-shore subsidiaries and the like) to shelter profits. But, it also included blatantly deceptive salesmanship and predatory lending practices.

The Mistake

The world's financial system could have weathered abusive and fraudulent lending practices. But the one mistake the system could not survive – indeed, the one mistake that is most responsible for bringing down the financial system – involved a flawed way of looking at risk. That is, the conflation of risk with uncertainty.

The economist John Maynard Keynes made a persuasive case that the profession of economics was misguided when it assumed that human beings acted as rational economic agents. Cognitive research proves that human beings utilize heuristics – mental shortcuts – that dispose us to cognitive illusions and errors. The mathematical models economists have developed describe an idealized world, but human behavior never conforms to these models.

Most of the serious cognitive illusions we harbor involve risk assessment. However, the financial industry was determined to find way ways to manage risk. “How does the industry seek to master the risk? Through mathematics.” As a result, mathematics became central to modern banking.

Value at risk (VAR) was one of the most important statistical tools developed to manage risk. In simple terms, VAR is a probabilistic assessment of a worst-case scenario – i.e., there’s a 5% chance you’ll lose your entire investment portfolio within the next year.

VAR appeared to provide the certainty that money managers and financial players wanted. However, VAR models have two fundamental problems:

1) *A VAR system is only as good as its data.* VAR models were based on data that was often thinner than people realized.
2) *VAR models were based on the Bell Curve.* It is a questionable assumption that events in the financial market conform to the normative distribution of the Bell Curve.

The mathematician Nassim Taleb insists that VAR models attempt to do the impossible – namely, estimate the risk of rare events. In Taleb’s view, VAR models offer a false sense of security. He writes: “You are worse off relying on misleading information than on not having any information at all. If you give a pilot an altimeter that is sometimes defective he will crash the plane. Give him nothing and he will look out the window. Technology is only safe if it is flawless.”

The correlation data that VARs relied on to assess the risk of sub-prime CDOs was garbage. “Subprime mortgages were new and had never been through a severe period of market difficulty.” In other words, there was no real historical data which could be used to calculate probabilities for these CDOs.

No wonder, then, then that the VAR models got it so wrong. In fact, the VAR models estimated that the odds of a 20% decline in U.S. housing prices were several trillion to one.

Once again, relying on VAR was like relying on a faulty altimeter. The statistical and mathematical models used to gauge risk were worse than useless.

Funny Smells

It was the job of the Federal Reserve, especially Fed Chairman Alan Greenspan, to sniff out financial trouble. However, the Fed utterly failed to recognize clear warning signs of the crisis. Greenspan’s ideological blinders prevented him from questioning the free market tenet that markets are inherently self-regulating and self-correcting.

Lack of oversight and government regulation of the financial industry was a prime cause of the financial crisis. "The financial industry caused the crisis, but it could not have happened without the help of governments, which spent decades committed to the idea of pure laissez faire capitalism."

Prior to the crisis, the financial industry was a culture suffused with arrogance, misaligned incentives, and erroneous attitudes towards risk. For three decades, there was an ever widening gap between the public good and the interests of the financial industry.

Canada is one of the few countries that didn't need to bail out its banking system. The reason: Canada was serious about regulating its banks as it refused to join the laissez-faire bandwagon. As a result, the average income of Canadians has been growing at a rate double that of Americans. This proves that "a country doesn't have to have a frenetically overactive financial sector in order to have a thriving economy."

Conclusion: The Bill

Western democracies are not perfect, but they have produced the best societies that have ever existed. Often, we take our prosperity for granted and don't realize how fortunate we are. The credit bubble and ensuing financial calamity was partly a product of the fact that most people were caught up in the euphoria of financial good times. As a result, many of us borrowed and spent more than was prudent. Now, the bill has come due.

Ronald Reagan and Margaret Thatcher implemented changes that made the U.S. and the U.K. more reliant on financial services. Economic values came to dominate all aspects of culture. We seemed to know the price of everything, but the value of nothing.

Today, the hangover from the financial binge is causing us to reassess the wisdom of traveling on the "hedonic/consumerist treadmill." As painful as things have been, the bill for our collective excesses has yet to be delivered. Government balance sheets are in dismal shape. Soon, they will need to be repaired. Once the economy is on the road to recovery, governments will have to contemplate raising taxes and freezing spending. Otherwise, we will drown in red ink.

"The huge bailouts of major financial institutions mean that the Anglo-Saxon model of capitalism has failed." In essence, the obscene banking bonuses paid out to the executives in charge of failed financial firms amounts to socialism for the rich. This should outrage both the Left and the Right. This financial crisis was a wakeup call. The world faces serious environmental, social, and economic challenges. We need a financial system that serves society, not one that preys on it. We have to respond to this challenge – collectively and individually – by not allowing the economic dimension of life to crowd out all other values.