From US Sub Prime to London Prime: Shadow Bankers in London

By Nicholas Hildyard

Introduction to a Hedge Fund Tour of Mayfair organised
by London Mining Network and The Corner House

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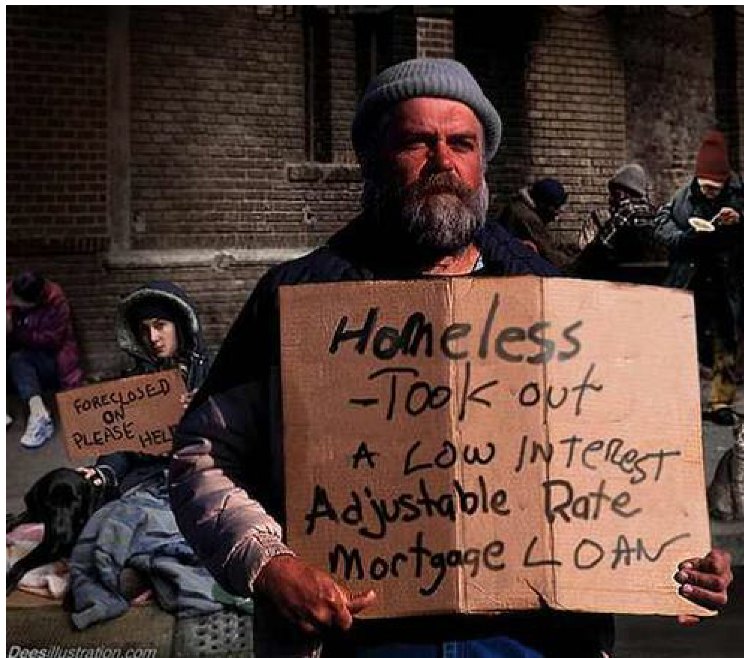
Videos of Tour available at: http://londonminingnetwork.org/banking-tour/



Man who lost his home to sub-prime crisis, USA
Photo: Dees*illustration*.com

Earlier this year, I was in Washington DC to attend a conference on community banking. Returning to where I was staying one evening, I was confronted with a shocking sight: an entire family, its possessions piled up on the pavement, the children sitting on their packed suitcases, who had just been thrown out of their apartment for non payment of their mortgage.

The family on the sidewalk was among the many millions of losers from the so-called sub-prime crisis in the US.

The proximate origins of the crisis are well known. In the wake of the dot.com boom, the US sought to reflate the economy not through public sector spending but through consumer spending fuelled by cheap credit.

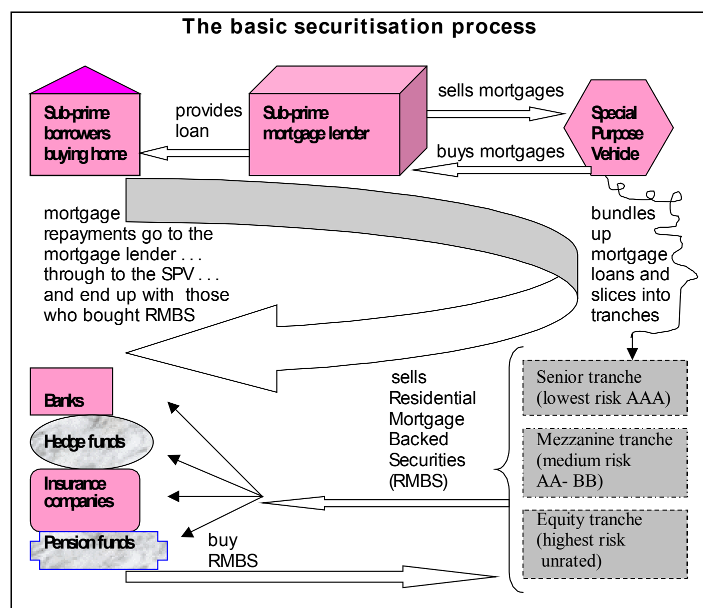
With interest rates low, mortgage companies pushed loans on borrowers who would never previously have even been considered as potential clients – so called NINJAs: No Income, No Job or Assets. As house prices rose, people were encouraged to borrow still further against the gains they had theoretically made.

Then interest rates went up. And the whole house of cards began to fall apart. The NINJAS and other "sub-prime" borrowers began to default.

From "Securitisation" . . .

In previous eras, the bursting of the US housing bubble could have been contained within the US. But the problem rapidly spread to other countries and beyond mortgage lenders, due to the use of new financial instruments – notably securitisation.[1]

No one knew where the loans had ended up. The banks panicked and refused to lend. Many banks went under – or were saved only through massive injections of public money. And the economy in the US and Europe went into recession.



. . . to Dispossession

Millions of people have been affected.

In the United States, 1.2 million homes have already been repossessed. And the evictions continue.

Some 6.2 million people in all are expected to end up losing their homes.

To put that into perspective, that is equivalent to everyone in Birmingham *and* Manchester *and* Leeds *and* Glasgow *and* Edinburgh *and* Cardiff *and* Liverpool *and* Belfast *and* Bristol losing their homes.[2]

And even then you would not be finished. You would still have 1,648,000 homes to repossess.

Adding in half of all the homes in central London would just about do it.[3]

Poor black and Latino families were the first and worst affected by the sub-prime crisis in the USA, which caused what has been described as "the largest loss of African-American wealth in American history."[4]

With recession has come unemployment, triggering a perfect storm of hardship.

Many have been reduced to living in slum conditions.

Roman Trujillo shaves

Photo: Matt Black
http://www.poyi.org/67/10/third_01.php

In this award-winning picture (above) by Matt Black, Roman Trujillo is captured shaving in front of his home in "Taco Flat", a shantytown in downtown Fresno, California.

The caption states:

> "After he lost his construction job, Trujillo built this house out of scrap lumber and tattered blankets, joining over a thousand other unemployed residents in this makeshift community just blocks from City Hall. He shaves with a shard of mirror he found in the trash while hunting for cans to recycle, his only source of income."[5]

Where am I supposed to live?

The question posed on the T-short of one dispossessed man (*see below*) speaks volumes: "Where am I supposed to live?"

Homeless man, California
Photo:
http://www.onepennysheet.com./2009/11/un-investigator-accuses-us-of-shameful-neglect-of-homeless/

One person who doesn't need to ask that question is John Paulson, probably the world's most successful hedge fund manager, seen below (on the right) with Alan Greenspan, former Chair of the US Federal Reserve and once High Priest of banking deregulation, who has now admitted that the sub-prime crisis has shaken his assumptions about the claimed efficiency of free markets.

Allan Greenspan (left) and John Paulson (right)
Photo:
http://seeker401.files.wordpress.com/2009/11/15_greenspan_lgl.jpg

Greenspan, in one of those now familiar moves that regulators seem to make between the public and the private sector, went on to work for Paulson . . . .[6]

In 2008, Paulson was the world's top earning hedge fund manager (*see* Table below).

His company – Paulson and Co – earned $15 billion that year, and Paulson himself walked away with $3.7 billion, or roughly $10 million a day, or approximately $1 million a hour.

BEST-PAID HEDGE FUND MANAGERS GLOBALLY			
1	John Paulson (above)	Paulson & Co	$3.7bn
2	George Soros	Soros Fund Management	$2.9bn
3	James Simons	Renaissance Technologies	$2.8bn
4	Philip Falcone	Harbinger Capital	$1.7bn
5	Kenneth Griffin	Citadel Investment	$1.5bn
6	Steve Cohen	SAC Capital	$900m
7	Timothy Barakett	Atticus Capital	$750m
8	Stephen Mandel Jr	Lone Pine Capital	$710m
9	John Griffin	Blue Ridge Capital	$625m
10	O Andreas Halvorsen	Viking Global Investors	$520m
BEST-PAID UK HEDGE FUND MANAGERS			
13	David Slager	Atticus Capital	$450m
27	Noam Gottesman	GLG Partners	$350m
27	Pierre Lagrange	GLG Partners	$350m
31	Greg Coffey	GLG Partners	$300m
41	Alan Howard	Brevan Howard	$245m
47	Michael Platt	Bluecrest Capital	$220m
47	George Robinson	Sloane Robinson	$220m
47	Hugh Sloane	Sloane Robinson	$220m

Source: http://i.telegraph.co.uk/telegraph/multimedia/archive/00869/money-graphics-2008_869201a.gif

Incidentally, Paulson no longer occupies the No 1 slot for earnings.

That was taken in 2009 by David Tepper of Appaloosa, another hedge fund, which earned $7 billion gambling on bank debt in the wake of the collapse of the banks. Tepper himself earned $4 billion as a result. He is reported to keep a pair of brass testicles in a "prominent" spot on his desk, which he rubs "throughout the day for luck, and a laugh."[7]

David Tepper
Photos:
http://static5.businessinsider.com/~~/f?id=4abd0c97b9d6b36e438691d1
http://leverageacademy.com/blog/wp-content/uploads/2010/12/david-tepper1.jpg

But back to Paulson.

His massive earnings in 2007 derived from "shorting" the housing market – betting that the value of the securitised mortgages would go down, not up.

In the wake of the credit crisis, he was hailed as a prescient genius – and investors fell over themselves to place money with him. His fund swelled from $12 billion to $35 billion.

It now emerges that he was involved in helping investment banking firm Goldman Sachs put together one of the very securitised mortgage packages that he was betting against. Goldman Sachs reportedly sold the package to investors without telling them about Paulson's involvement in choosing the mortgages that made up the package – some of them extremely toxic.

Paulson used a day or so's worth of his profits to buy a new house (purchase price $43 million).[8]

Paulson/s new house
Photo:
http://dallasdirt.dmagazine.com/wp-content/uploads/2010/04/Paulson-home.jpg

He also gave $15 million to the Center for Responsible Lending to fund legal aid for those facing foreclosure.

Moving into Gold

And what is Paulson up to now?

Having made several more billions shorting bank stock, Paulson launched a hedge fund dedicated exclusively to gold bullion related investments, including mining shares.

Paulson is personally investing between $200 and 250 million of his own wealth into the fund.

He now controls more gold than Australia.[9]

The latest filings show that he is heavily invested in:

- Anglogold Ashanti $1,660 million – whose activities in Ghana have resulted in the pollution of poor communities with arsenic, iron, manganese and heavy metals.[10]
- Kinross Gold Corp (KGC.N) $ 567 million.[11] Kinross has been at the centre of mining controversies in Congo (DRC) and is proposing to strip mine the Espolon Valley in Chile.[12]

Paulson has also made a recent private placement for $100 million in NovaGold, active in Alaska and British Columbia.[13] It primarily explores for gold, silver, copper, zinc and lead ores. Last year, it paid a $900,000 fine for pollution violations in Alaska.[14]

Others follow . . .

Other funds pouring into gold, convinced like Paulson that the sovereign debt crisis will result in hyperinflation as countries print money to erode their debts, include:

- David Einhorn's **Greenlight Capital**;
- Kyle Bass's **Hayman Advisors**, another high earning hedge fund – it held more than 15% of its portfolio in gold and other precious metals earlier this year;[15]
- **Eton Park Capital**, headed by former Goldman Sachs trader Eric Mindich. Eton Park is invested in AngloGold Ashanti, Gold Fields and Harmony Gold;[16] and
- Paul Tudor Jones, chairman of giant hedge-fund **Tudor Investment Corp**. Gold now forms the most heavily held commodity in his fund.[17]

John Paulson's London office is just 100 yards away from where we are now in Piccadilly – not that you would know it from just passing by . . . nor from looking at its website, which permits entry only to registered investors. (Eton Park doesn't even have a website, even for investors.) [18]

Nor will you find them listed on any of the sites dedicated to the businesses of Mayfair, which are hardly shy about extolling the area's wealth and exclusivity.

Which is odd, given that 80 per cent of Europe's hedge funds and private equity funds are based in London . . . and the majority are in Mayfair and the West End.

In fact, the only asset management firm listed on the various Mayfair websites is . . . a pawnbroker, albeit a rather exclusive one. It specializes in "high end loans against fine jewellery, fine Swiss made watches, art, antiques, luxury cars and rare items."

No, the only sign that Paulson Europe works out of 70 Jermyn Street is its doorbell. And the only way you will find the address is by combing through the entries on Companies House[19] for the company's annual return[20] or by walking the streets.

One reason for this lack of visbility is that hedge funds and private equity are not allowed to advertise, but another is . . . . . . they like their privacy.

As recently observed, "private" in private equity is often interpreted by private equity managers to mean "secretive".

They like to operate in secret.

Hedge funds

Photo:
http://4.bp.blogspot.com/_hV7j3UOwmSc/TSi1nuNfgBI/AAAAAAAABf4/f1Iuc01htm8/s1600/who%2Bare%2Bthose%2Bguys-MovieMinutes-ButchCassidySundanceKid-A.jpg

In the 1969 classic movie *Butch Cassidy and the Sundance Kid*, when the posse is in relentless pursuit of the two bank robbers, Butch Cassidy (Paul Newman) turns to the Kid (Robert Redford) and says: "I couldn't do that. Could you do that? Why can they do it? Who *are* those guys?"

Good question.

Most obviously, they are hedge funds.

There are an estimated 8,000 hedge funds in existence, down from 10,000 a couple of years ago.[21]

The latest figures from *Hedge Fund Manager's Week* put the amount of assets under management by hedge funds at more than $2,700 billion – 200 times what they controlled in 1997.

Hedge funds date back to the 1940s when US investor Alfred Jones, an alumnus of the Marxist Workers School in Berlin, set up a fund to combine long and short positions – that is, betting on whether the price will go up ("going long") or go down ("going short") – in order to reduce losses. Short selling characterises many – though not all – hedge funds. According to Data Explorers, asset owners earn more than £15 billion a year from lending securities, mainly to hedge funds, for shorting.

Just to be clear. These bets are effectively bets on companies failing, or at least doing worse than they have been doing. If enough people "short" a company, they can force it out of business.

After the crash

Many hedge funds went under in the financial crisis.

But the industry is now bouncing back.

RAB Capital, for instance, was one of the biggest and best-known hedge funds. In 2007, it had $7 billion worth of assets under management. But it collapsed, not least because it bet on the recovery of Northern Rock (which didn't happen; the bank was bailed out by the British government) and saw its assets tumble away to $1.25 billion.

But it's now making a come back. This year, 2010, RAB Energy and RAB Global Mining were first and third respectively in the Eurohedge 2009 league table.

It is now investing in African Minerals,[22] which has significant iron ore and base metal interests in Sierra Leone, West Africa.

New areas of investment

RAB was already an investor in mining – most infamously in Phulbari, the proposed open pit coal mine in northwest Bangladesh that would displace thousands of people and degrade land, forests and water.

But other hedge funds are moving out of areas in which they had previously invested and into new sectors.

As Crispin Odey of Mayfair based Odey Asset Management told the *Financial Times* recently: "Sell banks, buy cheese."

Investments in food, land and commodities are increasingly a feature of hedge fund portfolios. Agricultural assets under management rose from $104 million in 2003 to $835 million in 2009.

Private equity

Other funds include private equity funds.

These are essentially funds that buy up companies, delist them if they are publicly traded – that is, take them off stock exchanges – strip their assets and then sell them on at a higher price.

The reason for delisting is that companies whose shares are not publicly traded are not legally bound to disclose information about their operations or those of the companies in which they invest or buy.

So, once they have control of the company, the private equity funds can get on with restructuring it behind closed doors.

The five largest private equity firms are: the Blackstone Group; the Carlyle Group, Bain Capital, TPG Capital (formerly Texas Pacific Group) and Kohlberg Kravis Roberts & Co. (KKR).

Together, they manage assets worth hundreds of billions of dollars.[23]

Once private equity firms buy out companies, they invariably downsize the workforce, slash workers' benefits and abrogate collective agreements between workers and management.

Private equity firms make extensive use of "leveraged" or borrowed finance to buy out companies – they borrow money to acquire a company's shares in the hope that the interest they will pay on the resulting debt will be lower than the returns they will make from their investment.

In the wake of the credit crunch, many thought that private equity would simply wither away, as it would be unable to get cheap finance from the banks with which to leverage.

But private equity has proved to be very adept.

Many banks have been left with loans to private equity that are worthless. And guess who wants to buy those debts – at a vastly discounted price, of course? Private equity firms. One blogger comments:

> "The best metaphor I can think of is this: You pay your friend a few dollars so that you can host a small party while she's out of town. You leave the pool filled with garbage, beer cans, and human waste. The next day you show up dressed as a pool cleaner and charge your friend a few bucks to mop up the mess you made."[24]

And like hedge funds, private equity funds are now bouncing back.

Blackstone is now reported to be bidding for 300 branches of the Royal Bank of Scotland.[25]

Many are moving into education and health care – in the expectation, perhaps, of taking advantage of substantial cuts in funding for these public services to address the UK's substantial debt, incurred in part in bailing out the banks.

One-fifth of recent deals worth more than $100 million have been in the healthcare sector.

Exchange Traded Funds

And then there are the new kids on the investor block – new at least to most investors: Exchange Traded Funds or ETFs.

In essence, these are funds that comprise a pool of securities representing a specific industry sector, or a specific index such as the Dow Jones Industrial Average or the S&P 500. ETFs are put together much like mutual funds but they trade like stocks. They are priced continually and can be bought or sold throughout the trading day.

The fund provider constructs some of the indexes. Investment banker Goldman Sachs was one of the first to put an ETF together – a commodity index based on a basket of 18 commodities

Other providers include Ishare (owned until recently by Barclays) and Powershares (owned by Deutsche Bank).

ETF growth

According to Barclays Stockbrokers, the number of investors piling into ETFs has almost doubled since September 2008.

ETF trades accounted for some 30 per cent of trading on the New York Stock Exchange in 2009.

Collectively, ETFs are now worth more than $1 trillion.

ETFs for gold have managed to amass some 1,850 tonnes of the metal – which means they are now the sixth-largest holders of gold, behind the central banks of the United States, France and Germany but ahead of China, Japan and the UK.[26] They are banking on the central banks needing to buy gold in the near future.

Some ETFs own the actual physical commodity. But many, in Europe in particular, do not, instead using ETFs as a “wrapper” for what are essentially swap-based derivative trades.

ETFs and hunger

The surge of new money pouring into ETFs, and commodities more generally, from speculative investors has been fingered as a key factor in driving up the price of food in 2005-2008, causing an estimated 250 million people worldwide to join the ranks of the hungry.

The spike in oil prices has also been attributed in part to ETF investors.

The reasons are complicated. But in essence, many ETFs buy only long, rolling over their contracts when they come due. It is this "virtual" demand that has created the upward price movement, not actual physical demand.

Shadow banking

Collectively, hedge funds and private equity have been referred to as constituting a shadow banking system.

This shadow system has not come about by design. Rather it is the outcome of the opportunistic use of the space created in the wake of the deregulation of the financial markets in the 1980s and 1990s, in particular the repeal of legislation that banned or constrained the use of derivatives.[27]

Hedge funds and private equity have exploited the non-regulated space that followed – and the discrepancies between regulatory requirements in the US, the UK and Continental Europe.

In that sense they have created a parallel financial system – in the shadows of the formal banking system.

And they have come to play an increasingly important part in financing everyday commercial activities.

Three years ago, for example, securitisation was providing more than half of all credit creation in the US economy.

Hedge funds have also been lending money directly to firms. In particular, they are increasingly the first port of call for distressed companies seeking to restructure themselves.

And the financial instruments they use have become increasingly important to how companies themselves raise money. Some 80 per cent of the income of energy giant GE recently came from derivatives trading.

ETFs and other oil speculators have also been acting as quasi bankers. Recently the oil market has been in what is known as "contango". That is, future contracts are

selling at a premium over and above the price obtained by selling oil direct into the market. So it makes sense, if you are an oil producer, to hold off selling and wait for the price to rise. But this can be done only if cheap storage – oil tankers – of the oil is available so that you can delay selling.

The emergence of the contango has provided oil companies with a way of surfing the credit crisis. As traditional financing from banks has seized up, oil companies have been storing oil in tankers and indeed any other containers they can find, and then loaned it to ETFs and other speculators who need to roll over their futures contracts.

In effect, speculators have directly supported the industry's exploration and production activities during the credit crunch.

Beyond regulation

And the problem is not just lack of regulation. Indeed, many derivatives are specifically designed to get around regulation

"I wish we were regulated", one trader recently lamented. "Why?" he was asked. "So I could bend the rules".[28]

The problem lies in how the shadow banking sector is organised – socially and institutionally. It is not structured so as to engender solidarity with poorer people, prudence and public service but so as to serve self interest, risk-taking and private profit.

Changing that culture will require more than new regulations.

Real change requires rooting finance in different social institutions and relationships – institutions where greed, avoidance of socially-agreed rules and accumulation at other people's expense are frowned upon, not encouraged.

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1 *See* "The Sub-Prime Mortgage Crisis" *in* Kavaljit Singh, *Taking It Private: The Global Consequences of Private Equity*, Corner House Briefing 37, October 2008, pp.14-15. http://www.thecornerhouse.org.uk/resource/taking-it-private

2 http://www.citypopulation.de/UK-Cities.html.
Birmingham (1,010,400); Manchester (465,900); Glasgow (637,000); Edinburgh (452,200); Cardiff (310,800); Leeds (477,600); Liverpool (464,200); Belfast (268,400); Bristol (465,500).

3 http://www.london.gov.uk/shaping-london/london-plan/facts/.
The population of central London is 3 million.

4 Martin Eakes, CEO of the Center for Responsible Lending, testifying to the USSenate banking committee, cited *in* Rothchild, M, "Comment: Mortgage Vultures", The Progressive, May 2007, http://www.progressive.org/mag_comment05072

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http://www.goldcoinsgain.com/blog/tag/john-paulson/

18 http://wiki.answers.com/Q/What_is_the_website_for_eton_park_capital_management

19 The official UK government register of UK companies. http://www.companieshouse.gov.uk

20 An annual return is a snapshot of general information about a company's directors, registered office address, shareholders and share capital.

21 http://richard-wilson.blogspot.com/2007/11/hedge-fund-industry-basics.html

22 Phil Davis, "Fallen Star RAB picks itself up with a reformed structure", *Financial Times*, 23 May 2010.

23 For more information, *see* Kavaljit Singh, *Taking It Private: The Global Consequences of Private Equity*, Corner House Briefing 37, October 2008, pp.14-15. http://www.thecornerhouse.org.uk/resource/taking-it-private

24 Gotham City Insider, http://www.gothamcityinsider.com/2007_08_17_archive.html

25 James Moore, "Wellcome joins with Blacktone RBS bid", *The Independent*, 10 April 2010.

26 Jonathan Spall, "Gold remains the shining star in turbulent economic times", *Financial Times*, 3 June 2010.

27 A derivative is an asset whose value depends on – or is 'derived from' – the future price of another underlying asset. There are three basic types of derivative: future, option and swap. They are the financial instruments at the heart of the current financial crisis. For more information, *see* Nicholas Hildyard, *A Crumbling Wall of Money: Financial Bricolage, Derivatives and Power,* Corner House Briefing 39, October 2008, http://www.thecornerhouse.org.uk/resource/crumbling-wall-money

28 Quoted in Bower, T, " The Squeeze: Oil, Money and Greed in the 21st Century, HarperPress, 2010, p. 38.