Notes

1 The Mismanagement of Credit Risk

1. *The Economist*, 23 February 2008.
2. ECB, *Financial Stability Review*, December 2007.
3. *Financial Times*, 4 February 2008.
4. *The Economist*, 16 February 2008.
5. In the US, the economy became a casualty with the Greenspan years because of his policy of attacking one problem at a time, while leaning towards the markets. In contrast, the European Epilog Central Bank has a balanced approach towards economic stability, avoidance of inflation, and economic growth.
6. D.N. Chorafas, *Rocket Scientists in Banking*. Lafferty Publications. London and Dublin, 1995.
7. Borrowed from swaps deals, the notional principal amount is specified by the contractual obligations, and is used as the reference on which profits and losses will be calculated.
8. Over-the-counter transactions are bank-to-bank (more precisely trader-to-trader) commitments, which do not transit through an established exchange. Therefore, they are very difficult to control and mark-to-market; most often the OTC instrument has no market.
9. *The Economist*, 19 April 2008. The same article also stated that at end 2007 CDSs exposure (section 5 of this chapter) stood at $62 trillion.
10. Bernard M. Baruch, *Baruch: My Own Story*. Henry Holt, New York, 1957.
11. Warren Buffett, "Avoiding a Megacatastrophe," *Fortune*, 12 March 2003.
12. Originally invented by Thales, one of the sages of antiquity, an option is an agreement between a buyer and a seller that, when exercised, gives the former the right but not the obligation to require the option writer to perform certain specific financial duties. Futures are current commitments that can be exercised, as th*eir* name implies, in the future. They are traded in exchanges. Forwards are like futures but they are not traded in exchanges. They are essentially customized bilateral agreements that have no active market. A standard swap involves period receipt of a predetermined fixed amount, and corresponding period payment of the spot value of a unit of the reference asset. Swaps usually involve two parties that enter into an agreement that, for a certain period, they will exchange regular payments; for instance, swapping floating-rate interest for fixed-rate interest.
13. D.N. Chorafas, *An Introduction to Derivative Financial Instruments*. McGraw-Hill, New York, 2008.
14. A CDO is a structured financial instrument which, with issuance of rated debt securities (tranches) based on a pool of loans or other debt, funds the purchase of an asset. It is the most complex and opaque instrument to have become mainstream.

15. *The Economist*, 9 August 2008.
16. On 27 February 2008, a Reuters report indicated that Norway's StatoilHydro (the national oil firm) posted a loss of Kr800 million, after tax in derivatives transactions, for 2007.
17. Statistics from *The Economist*, 1 September 2007.
18. D.N. Chorafas, *Alternative Investments and the Mismanagement of Risk*. Palgrave Macmillan, London, 2003.
19. Deutsche Bank insists that all the risks were spelt out in its marketing materials. It is wise to wait for the judge's decision.
20. Exposure to CDSs stood at $50 trillion, according to a late February 2008 report by New York money managers. But on 19 April 2008, *The Economist* estimated it at $62 trillion as of end 2007.
21. Basel Committee, *Liquidity Risk: Management and Supervisory Challenges*. BIS, Basel, February 2008.
22. *Executive Information Report* (*EIR*), 25 January 2008.
23. Notice that CDS losses come over and above the subprimes losses, which on 9 April 2008 the chief economist of the IMF estimated at $1 trillion – or, about four times the losses incurred up to that date by the banking industry.
24. Responsible for the stock market bubble in 2000, and hefty buildup of the subprimes bubble.
25. A writedown and a credit loss are not the same. Investment banks and other financial organizations mark-to-market th*eir* assets, whether these are loans, securities, CDOs or something else. They write them down when values decline. Credit losses are charge-offs for loans.
26. *Financial Times*, 8 February 2008.
27. In mid April 2008 the Bank of England also made available to the banking industry £50 billion against which they could deposit worthless mortgages and mortgage bonds taking instead valuable British government bonds.
28. *Wall Street Journal*, 1 February 2008.
29. The other side of the coin is that, since the 1990s, complex structured finance deals have been made possible because insurers, who act as third parties, have shouldered some part of the credit risk that others could or would not take.
30. With the help of Citigroup and Dresdner Bank.
31. The bank or other institution that gave a loan, and buys an insurance of sorts that it will get back its money if the borrower defaults, is the protection buyer.
32. A payment which will come into definite exercise only on occurrence of some event, such as bankruptcy, credit downgrading, or other well-established reason, is known as a contingent payment.
33. A bank, insurance company, hedge fund, or other entity providing against a fee a guarantee that the protection buyer will be reimbursed in case of its borrower's default or other specific credit event, is the protection seller.
34. The amount loaned to a borrower is always subject to credit risk (and, depending on the contract also to market risk): credits may be secured (by collateral) or unsecured; the borrower may default; be downgraded; or be subject to a leveraged buyout; or its collateral may turn to ashes (as with subprimes). All these are examples of credit events.

35. Whether we talk of loans, trading, or other financial operations, a counterparty is the other party (usually a client) with which the bank engages into a legally binding transaction.
36. The International Swaps and Derivatives Association (ISDA) has produced standardized documentation for these transactions under the ISDA Master Agreement.
37. A binary payoff is all or nothing.
38. D.N. Chorafas, *Economic Capital Allocation with Basle II: Cost and Benefit Analysis*. Butterworth-Heinemann, London and Boston, 2004.

2 The Fed Has Got It Wrong

1. The fourth function of a central bank, to act as the government's commercial bank, is not part of this discussion.
2. In the 1920s, Carlo Ponzi, an Italian-American operating in Boston, was rewarding old depositors with a hefty interest taken out of the money of new depositors till that money, and his luck, ran out.
3. The measures proposed on 31 March 2008 by Treasury Secretary Hank Paulson for supervisory restructuring in the US are way short of what is necessary (see Chapter 10).
4. Above the Western countries' average.
5. *Financial Times*, 24 January 2008.
6. *Business Week*, 11 February 2008.
7. Merrill Lynch, *Investment Strategy Update*, 22 January 2008.
8. D.N. Chorafas, *Economic Capital Allocation with Basle II: Cost and Benefit Analysis*. Butterworth-Heinemann. London and Boston, 2004.
9. European Central Bank, *Financial Stability Review*, December 2007.
10. A similar list exists for British, American and Japanese LCBDs.
11. The Securities and Exchange Commission is conducting more than twenty investigations, including one into the arrangements banks entered into with hedge funds that may have been designed to delay or actually hide losses from marking-to-market th*eir* positions.
12. *The Economist*, 22 December 2007.
13. *The Economist*, 2 August 2008.
14. *Executive Information Report* (*EIR*), 11 January 2008.
15. Critics have said that the very special care the US government and Federal Reserve have shown for self-wounded big banks but not other companies "too big to fail" has been a bias toward certain firms and markets.
16. *The Economist*, 23 February 2008.
17. *Financial Times*, 17/18 May 2008.
18. *The Economist*, 14 June 2008.

3 The Globalization of Credit Risk

1. *Financial Times*, 6 February 2008.
2. *The Economist*, 3 May 2003.
3. They may also be preferred stocks and student loans.
4. The 7, 14, 28, and 35 days are the intervals more frequently used.
5. But by 2008 it fell to $200 billion.

6. *The Economist*, 9 August 2008.
7. *Bloomberg News*, 11 August 2008.
8. *Financial Times*, 27 February 2007.
9. Merrill Lynch, *Investors' Strategic Update*, 19 February 2008.
10. European Central Bank, *Monthly Bulletin*, January 2008. China is in 5th position after the US, South Korea, Japan, and Germany. India, by contrast, is in 24th position behind Mexico, Argentina, and Turkey

4 Earthquake in the Subprime Mortgage Market

1. D.N. Chorafas, *Reliable Financial Reporting and Internal Control: A Global Implementation Guide*. Wiley, New York, 2000; D.N. Chorafas, Implementing and Auditing the Internal Control System. Macmillan, London, 2001.
2. In lending jargon, a prime borrower is one of high creditworthiness justifying a reasonably low interest rate. Practice has seen to it that this term has been extended to cover nearly all qualifying borrowers. Subprime refers to borrowers who do not qualify under proper credit terms.
3. *Executive Information Report* (*EIR*), 9 November 2007.
4. *Executive Information Report* (*EIR*), 23 November 2007.
5. On 1 March 2008, Goldman Sachs said banks may face an additional $60 billion in writedowns.
6. People, and most particularly bureaucrats, never learn. In 1994, Orange County had lost a *fortune* with "inverse floaters" – another derivative instrument whose risks were unknown territory to its treasurer. In the aftermath, the county had no money to pay its teachers and other civil servants.
7. A borrower's credit rating is an assessment of his ability to pay his obligations.
8. Alt-As stands for "alternative As," meaning A credit rating. The term is a cheat because contrary to a correct credit analysis, the "Alt-A" is based only on usually fake borrowers' declarations about th*eir* income.
9. *Financial Times*, 17 October 2007.
10. *Financial Times*, 21 March 2007.
11. *Financial Times*, 17 October 2007.
12. The large Dutch banking and insurance conglomerate.
13. An unsecured loan made to a customer with no job.
14. D.N. Chorafas, *The Management of Bond Investments and Trading of Debt*. Butterworth-Heinemann, London, 2005.
15. William D. Cohan, *The Last Tycoons*. Doubleday, New York, 2007.
16. *Bloomberg News*, 2 April 2007.
17. *The Economist*, 24 March 2007.
18. *Bloomberg News*, 2 April 2007.
19. Bad car loans in the US increased 30 percent in 2007. An article in the French Le Figaro (31 January 2008) suggested the average debt of American car owners is $4,221 above the value of th*eir* cars

5 The Industrialization of Credit Risk

1. D.N. Chorafas, *Stress Testing for Risk Control Under Basel II*. Elsevier, Oxford and Boston, 2007.

2. *Executive Information Report* (*EIR*), 14 September 2007.
3. Quotation from a personal interview.
4. Sterling Seagrave, *The Soong Dynasty*. Corgi, London, 1996.
5. In fact there is a structured instrument named "airbag" by its designers and vendors; D.N. Chorafas, *Wealth Management: Private Banking, Investment Decisions and Structured Financial Products*. Butterworth-Heinemann, London and Boston, 2005.
6. William D. Cohan, *The Last Tycoons*. Doubleday, New York, 2007.
7. D.N. Chorafas, *After Basel II: Assuring Compliance and Smoothing the Rough Edges*. Lafferty/VRL Publishing, London, 2005.
8. *The Economist*, 30 June 2007.
9. A variable-interest entity (VIE) is a term used by the US Financial Accounting Standards Board in FIN 46 to refer to an entity (the investee) in which the investor holds a controlling interest but is not based on majority of voting rights. This is closely related to the more popular concept of special purpose vehicle (SPV), discussed in section 5 of this chapter, the one practically being a different term for the other.
10. According to bond research firm CreditSights.
11. From here on will be used the more commonly employed SPV rather than VIE.
12. *The Economist*, 18 August 2007.
13. Merrill-Lynch, *Economic Commentary*, 19 November 2007.
14. According to some experts, the danger associated with adjustable rate subprimes and Alt-As will continue till late 2010.
15. *The Economist*, 1 December 2007.
16. European Central Bank, *Monthly Bulletin*, June 2008.
17. *Executive Information Report* (*EIR*), 25 January 2008.
18. *Financial Times*, 6 February 2008.
19. In December 2007 the US trade deficit hit $64 billion, the highest in 14 months and 5 percent over forecast. This cancels the argument that the reason for keeping the dollar at an all-time low is to cut the current account gap.

6 Leveraged Instruments, Their Credit Ratings and Other Unorthodox Practices

1. *The Economist*, 2 August 2008.
2. *Financial Times*, 3 July 2007.
3. *Financial Times*, 19/20 May 2007.
4. D.N. Chorafas, *An Introduction to Derivative Financial Instruments*. McGraw-Hill, New York, 2008.
5. Merrill Lynch, *Global Research Highlights*, 29 June 2007.
6. Ryan cited the fact that hedge funds account for 30 to 60 percent of all trading activity, depending on asset class and instrument. He also pointed out that the surge in liquidity has brought down lending standards, which is a generally held opinion.
7. Merrill Lynch, *European Equity Strategy*, 14 August 2007.
8. Reference made in a personal interview.

9. *Financial Times*, 1 April 2008.
10. In Greek slang, "para" means money. This fits well with the allegory of parachutes, because what the failed CEOs and th*eir* underlings are really doing is self-gratification with big money.
11. D.N. Chorafas, *Management Risk: The Bottleneck is at the Top of the Bottle*. Palgrave Macmillan, London, 2004.

7 Northern Rock: a Case Study

1. *The Economist*, 1 December 2007.
2. Which sold 5 percent of its equity to Sovereign Wealth Funds to get cash (this volume, Chapter 4).
3. Advertising the chairman's vacancy in *The Economist*, 19 January 2008, page 19.
4. *The Economist*, 8 December 2008.
5. Deutsche Bundesbank, *Monthly Report*, September 2000.
6. Statistics as of 13 September 2007 by Collins Stuart.
7. The British public will doubtless want to know why the authorities took th*eir* eye off the ball.
8. *The Economist*, 20 October 2007.
9. *Executive Information Report* (*EIR*), 20 December 2002.
10. Merrill Lynch, *Interest Rate Committee Forecast*, 19 November 2007.
11. *The Economist*, 1 December 2007.

8 Responsibilities of Financial Regulation

1. Merrill Lynch, *Bear Stearns*, January 2008.
2. This happens because banks manipulate the correlation coefficients relating to th*eir* exposure. Correlation coefficients used in Basel II are unstable, uncontrollable, and unreliable.
3. In early 2008, Bloomberg television said that using VAR Merrill Lynch calculated its maximum exposure equal to $65 million. Instead, it was $8 billion.
4. The theme of liquidity, its importance and impact on individual banks and the banking industry as a whole, is treated in Chapter 10 – in conjunction with solvency, assets-backed commercial paper (ABCP), and the carry trade. This section addresses itself to liquidity assurance in the banking industry as a new regulatory function.
5. Professor of economics at the University of Leuven; *Financial Times*, 2 November 2007.
6. D.N. Chorafas *Reliable Financial Reporting and Internal Control: A Global Implementation Guide*. Wiley, New York, 2000.
7. The original twelve plus Slovenia, Cyprus, and Malta.
8. Merrill Lynch, *Investment Strategy Update*, 22 January 2008.
9. *Private Banker International*, June 1995.
10. George Soros, *Soros on Soros: Staying Ahead of the Curve*. Wiley, New York, 1995.
11. *Financial Times*, 1 August 1994.
12. Bernard M. Baruch, *Baruch: My Own Story*. Holt, New York, 1957.
13. Merrill Lynch, *European Banks*, 29 October 2007.

14. *Financial Times*, 6 February 2008.
15. *The Economist*, 21 July 2007.
16. http://www.manager-magazin.de/unternehmen/artikel/0,2828,druck 532124,00.html

9 Solvency, Liquidity, Asset-Backed Paper, and the Carry Trade

1. The result of international cooperation among Group of ten banking regulators.
2. *The Economist*, 20 May 2006.
3. American regulators imposed strict capital requirements for all banks in 1984, after Continental Illinois, the country's seventh-biggest bank, lost half its funds overnight. Until then, US big banks had not been subject to minimum capital requirements, in the belief that they could be trusted to manage th*eir* own balance sheets.
4. A monetary policy is "accomodative" when the central bank keeps its rate low, either because of government pressure in order to reduce unemployment and increase consumption or else to give a hand to the banking industry and capital markets, as was done by the Fed in 2007 and 2008.
5. European Central Bank, *Monthly Bulletin*, February 2008.
6. As of mid 2007 there has been a C$115 billion ($110 billion) ABCP market in Canada.
7. Credit Suisse, *Economics/Research Monthly*, 24 April 2007.
8. *Executive Information Report* (*EIR*), 2 March 2007.

10 Is There a Remedy for the Problems of Bank Supervision?

1. For instance, relating to controlled leasing entities where the bank itself is the lessee.
2. The exact figure the IMF has projected is $945 billion, and even this is a guestimate.
3. Merrill Lynch, *Investment Strategy*, 17 March 2008.
4. Strauss-Kahn did not forget to add flavor to the banking crisis, declaring himself in favor of bailouts. Issued 8 and 9 April 2008, the IMF's Global Financial Stability Report and its World Economic Outlook support the lie that the global financial crisis was caused by a combination of a US housing crisis and "profound errors in risk management among its leading financial institutions." Of "errors" there was a horde, but they were made willingly – not accidentally. Dominique Strauss-Kahn also suggested that France bails out its banks along the model of the 1990s bailout of Crédit Lyonnais, which is preposterous because as a nationalized bank Crédit Lyonnais was abused by all sorts of politicians during the Mitterand years and finally the French taxpayer paid the bill.
5. *International Herald Tribune*, 14 April 2008.
6. *Executive Information Report* (*EIR*), 28 March 2008.
7. *New York Times*, 16 April 2008.
8. *Executive Information Report* (*EIR*), 7 March 2008.

9. *Bloomberg News*, 6 May 2008.
10. Another of the crazy suggestions is that the housing deflation should be counted to counterbalance inflation in energy and commodity prices. But if house prices rise, then this should not be counted as inflation.
11. *The Economist*, 5 April 2008.
12. *Financial Times*, 1 April 2008.
13. *Executive Information Report* (*EIR*), 11 April 2008.
14. http:www.bloomberg.com/apps/news 08/04/2008
15. In 1998 when I made a study in which OTS participated there were 1100 thrifts. Their number has shrunk significantly in 10 years.
16. And the loans will be for 28 days instead of just overnight.

Epilog

1. Which means a 9 percent cost of insuring the bank's debt against default.
2. The announced price was 21 cents to the dollar, but Lone Star asked and obtained from Merrill a loan for 75 percent of the amount due, which practically replaced one credit risk with another.
3. Which are certainly not "free," since governments are hand-feeding them with lavish amounts of money and take positions in big banks, effectively nationalizing them.
4. Whose 8-year watch over the *fortune*s of America Maureen Dowd, of the *New York Times*, has named "The Reign of Error."

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