

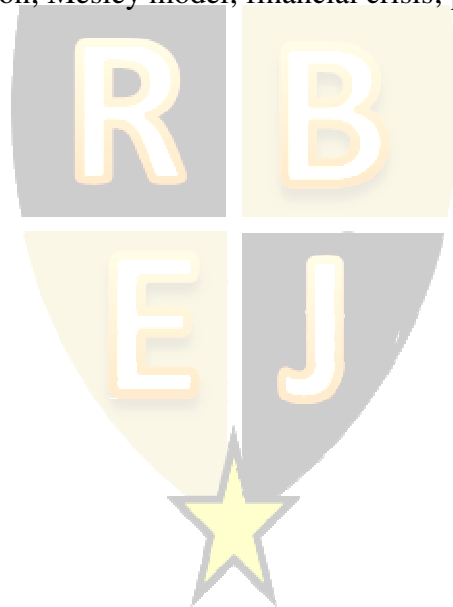
A view at the economic impact of financial predation

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ABSTRACT

Following an original take on various events that have disfigured the financial market of the US and the world, this paper arrives at the conclusion that there exists a predatory financial ecosystem much like in nature there is an ecosystem involving predators and preys. This ecosystem accomplishes the function of cleaning the market place of the weaker elements, such as small investors who blind fully trust their financial advisors) while inevitably creating financial crises and generating systemic risks in the marketplace.

Keywords perceived predation; Mesley model; financial crisis; perceived risk, systemic risk.



INTRODUCTION

A look taken at the American government over the last decades promptly leads the observer to notice that many key positions are held by member of an elite clique, most notably by former Goldman Sachs' executives. The same is true for some the organizations that benefited from the Paulson plan (himself a former president and director of Goldman Sachs Bank) such as Merrill Lynch, Wachovia) and many others.

Furthermore, a glance at past financial crises points to the role networks of key influential individuals have had on both sides of the financial equation: financiers and regulators. See Table 1 in the Appendix

Hellwig (2009, p. 186) posits that a large part of the 2008 subprime crisis has to do with a severe lack of risk assessment, citing among other examples the fact that quantitative risk models had inherent flaws which participated in creating a domino effect. This may be true for some companies but not necessarily for all. It may well be that some companies which understood the benefits of technology, such as Goldman Sachs, were in fact well aware of the blowing bubble and its approaching point of explosion. Whether with respect to risk modelling or fair value accounting procedures, the massive failures point to the presence of untracked systemic risk, which is troublesome given that the financial experts at the helm of organizations that should best control risks seem to fail in that respect.

As Rajan explains (2010, p. 8) "We have long understood that it is not income that matters but consumption"; thus, it may be that some financial predators use their networking influence to attract preys that are motivated by investors with short-vision and information deficits.

The theoretical paper is organised as follows. First, a presentation is made on the theory of financial predation as put forth by the various works of ----- (2009, 2010, 2011 and 2012). Second, a description is given of the so-called financial web. Third, this paper proposes ways used by financial experts to build webs that will eventually have the potential to become predatory webs. The 2008 subprime crises in then given as an example. A discussion is held on the consequences if financial predation prior to concluding.

THE THEORY OF FINANCIAL PREDATION

The theory of perceived predation rests on perception, that of a potential investor developing towards a financial expert, not knowing that the latter wants to take advantage of him to serve his own benefit, causing him a financial loss, by surprise. The surprise element imposed onto the investor turned into prey is a critical element of the theory of financial predation, just like in nature all predators aim to surprise their targeted preys so as to maximize their chance of capture and to impose maximum damage (e.g. death) onto them.

A financial expert must necessarily act by surprise because in the realm of business relationships, a negative association leads to increased perceived risk (Bergeron and Laroche, 2009). This perceived risk may paralyze the potential investor who would otherwise open his wallet as wide as possible, in the hope of earning substantial profits as fast as possible. Perceived predation must be differentiated from the concept of opportunism presented by 2009 "Nobel" price of economy winner Oliver Williamson

(1975, 1981 and 1985): it necessarily involves a predatory strategy (e.g. predatory mortgages) and relies on mutual trust rather than on formal contracts.

One key element of this strategy is the desire to occupy the leading position of the financial system. Why? Because just like in military action, occupying the highest point gives a definite advantage to the predator. This highest point operates, from a financial perspective, on two fronts: the investor side and the regulator side. Bernard Madoff is an exemplary case: he is sitting on a number of committees: the National Association of Securities Dealers (NASD), a self-regulated group under the supervision of the SEC (Securities and Exchange Act); NASDAQ, of which he was non-executive president in; president of the Securities Industry Association. His niece Shana (1967) is married to a former key player of the SEC organization.

The other key element of the predatory strategy is the building of a financial web. The following section delves into details as to functioning of such a web.

THE FINANCIAL PREDATION WEB

In nature, predators build a net around themselves and around their preys. Felines will mark their territories with their urine; spider will deploy quasi-invisible webs some of which can extend several meters long.

Predation is best described by the predatory web as indicated in Figure 1 (Appendix).

Predatory mortgages are one example of a financial act of predation. Typically, predators want to maximize the damage on their preys by aiming for the three components that form their identity: their assets, their activity and their mobility. Financial predators, however, have a unique feature: they are only interested in their prey's assets. By opposition, a judge would go after a criminal's mobility by jailing him.

Financial predation occurs when all of the structural (on the left side of the web) and at least three functional variables (on the right side) of the predatory web are proven to be present and active with a focus on the prey's assets, but not necessarily on its activities or mobility.

HOW TO BUILD A FINANCIAL PREDATORY WEB?

The exact mechanism of perceived predation is as indicated in Figure 2 (Appendix). This model called the Mesley model (operation predator-prey) reads as follows: the financial predator does all he can to reduce the negative perception the targeted prey may have of him. He associates himself with a large financial firm, dresses properly, drives a nice car, participates in social functions and so forth. This lowers the defence mechanisms of the prey, which starts believing that the agent is trustworthy. The financial expert appears to be common interests with the prey, is benevolent, seems very capable and appears honest. Trust immediately leads to some cooperative efforts, which immediately help raising the level of trust (from suspicion towards blind trust). The predator cooperates with the prey: he adapts to the prey's needs, shares some information, helps the prey solve problems and demonstrate a high consumer-orientation. Add to this a sense of win-win and a perfect working atmosphere is created, which in turn helps annihilate any apprehensions the prey may have had initially.

To achieve this feat, the financial predator cannot act alone; unlike other types of human predators, the financial predator is always part of an ecosystem into which he is constantly trying to rise to the highest position.

Financial predation involves in particular the use of trust, whereby trust is composed of four key components, none of which can be taken out without jeopardizing the image of the financial expert as a trustworthy person as indicated in Figure 2.

In addition, the financial predator wishes to ensure that he displays cooperative efforts with his clients, because these lead to building a sense of trust as indicated in the Appendix.

From a financial point of view, all of the above elements of trust and cooperation (Fig. 2 and Fig. 3) can only take place in the context of a social network, which is called the financial predatory web.

The case of Bernard Madoff is exemplary: he did not register with the SEC until 2006, he accumulated potential and real victims in all walks of life (including his friend of 25 years, Mr. Shapiro); he built up a Ponzi-scheme that was not overly complicated (it had been discovered by Mr. Markopoulos seven years earlier), and he was making unexpected gains, both in terms of value and consistency (Gregoriou and Lhabitant, 2009). Furthermore, a high dose of secrecy surrounded his business.

THE 2008 CRISIS

In the case of the 2008 predatory mortgage crisis, a strategy had been put in place to target eager home buyers who normally would not have had the capacity to pay off their mortgage debts to buy, and to keep buying more and more. Such strategy cannot have been implemented without some pre-testing and some computer simulation. Lending billions of dollars would have necessarily demanded from the banks that they devise a way to recover their loans should the debtors prove unable to reimburse their mounting debts.

There seems to have been a strategy put in place long before the final dramatic events occurred. Computer simulation is something known in the financial sector and companies like Goldman Sachs have proven the importance of data manipulation. The firm went at considerable length to sue their employee Aleynikov who in 2009 had allegedly stolen 32 MG of a computer program aimed at speeding financial transactions. These 32 MG were in fact obsolete and useless by themselves; clearly, computer technology is the key in today's financial markets.

The functional variables of predation are to the number of five. The first one is the identification of strengths and weaknesses of the target prey. By 2008, the weaknesses of house buyers had been identified – their eagerness to make money quick and easy in the real estate sector. The weakness of such companies as AIG who had taken up the risk associated with these mortgages was also known to such firms as, for example, Goldman Sachs, which challenged AIG to pay huge sums of money in a very short period of time prior to the downfall of 2008.

As of 2008, obvious weaknesses plagued the financial system: lack of proper regulations that could have protected the avid and naïve buyer (a mechanism shortfall dating back to the Reagan administration in 1986).

The second functional variable of predation is what is called disposition, that is, the ability of the predator to put the prey in some form of trance, or else of blind trust, in an

attempt to lure the victim. With respect to the predatory mortgage crisis, this was achieved by passing on the risk, a process called securitization. This allowed to putting all market agents in an artificial sentiment of comfort, which turned out to be a disaster as they chose to ignore the real risk of defaulting on payments, including the “unsuspecting buyer” (Corneil and McNamada, 2010).

The third functional variable is decision: predators force a quick and uniformed decision upon their preys so as to confuse them. Prior to and up to 2008, such pressure was achieved by enticing potential home buyers to buy before the escalating prices of houses became out of reach. The mere complexity of transactions, the displacement of the risk factor by taking liabilities out of the balance sheets, the exemption of the special purpose entities (SPE) from the Investment Companies Act and the opacity of the securitization all participated in hiding the up-coming fiasco (Corneil and McNamara, 2010) and in preventing the curious home buyer to attempt to know more.

The fourth functional variable is action, that is, the predator makes his move onto the prey and the prey decides on a defensive move of its own (counter-attack, submission, escape, ignoring). The prey is or feels trapped in one way or the other. In the predatory mortgage case, the buyers and loan companies were obliged by contract to respect their obligations; however, common business sense would have commanded that the number of risky buyers be minimized.

Finally, the last of the functional variable of predation is what is called the conclusion. In a sale, the conclusion occurs when the buyer takes possession of the title of the goods. In the 2008 financial predatory scheme, the conclusion was the awkward gains made from it: for example, Goldman Sachs received billions of dollars from the average American taxpayer through the Paulson plan while firms the likes of Lehman Brothers were forced into bankruptcy.

THE CONSEQUENCES OF FINANCIAL PREDATION

Financial predation does not lead to important if not severe consequences onto the economy and world wide markets. A brief look at past trends points towards the damages that the economy (so, essentially, the average tax payer) has suffered as a result of some of the financial predatory behaviors that have taken place in the past. Figure 4 (Appendix) traces the history of financial events that have affected the US economy, including the 1929 great depression and the 2008 subprime crisis.

Figure 4 implies the lack of proper regulation, poor risk management (e.g. Madoff’s accounting firm was a poorly known firm), the presence of luring mechanisms, the building up of the financial schemes, systemic failures and unexpected gains are some of the elements that seem to be present in some of the major financial crises that have hit the market place in the last hundred years.

The theory of perceived predation states that preys monitor potential predators in fear of being abuse, by surprise. However, when risk is systemic, it no longer seems threatening; rather, it seems part of the picture. The result is financial blindness whereby preys ignore warning signs, avoid catastrophic scenarios and assume things will keep going fine.

The next financial crisis may actually be country-based. It would not be the first time in history that a country ends up in financial trouble (e.g. England, 1866; Mexico, 1994). If

the next crisis is articulated around countries, then what country is best positioned to gain out of such crisis? That country, as a good predator, would have to have enough financial resources and manpower to take full advantage of the situation. Given that financial markets are a web of closely knit international ties between governments and large firms, the emerging predator may have multiple heads.

CONCLUSION

In this paper, we have presented the theory of financial predation. If indeed there is such a phenomenon as financial predatory ecosystems, one of the consequences of this theoretical finding is that financial bandits must not be punished in isolation. Rather, all the human elements that participated in building the web should have to pay for the harm they cause on their preys. For example, it is extremely hard to believe Bernard Madoff acted alone from a purely logistic point of view: he would not had had time to send the monthly reports to his clients (still prepared using an older system of financial cards) while taking care of his business and living the high profile life (he was a member of the two most prestigious US golf clubs).

The influence of financial markets over the financing of the global economy has risen from a mere 2.2% to a staggering 108% in 2000 (Juvin, 2004). Hence, addressing financial predation is not merely discussing isolated behaviors; it is looking at the global economy. The Greek problem may actually be due to exquisite yet deceptive accounting operated when Greece entered the Euro zone. The world market now knows what consequences this has had and will likely continue to have on the entire system.

We believe that the theory of financial predation deserves to be further developed as it is in its infancy. Practical applications would include the marketing of financial services and improvements on current regulations aimed at stabilizing the markets and protecting investors large and small as well as consumers in general. It is only through better management of risk and predatory behaviors that the financial sector will benefit from a stronger social image.

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APPENDIX

Table 1 – A brief overview of past financial crises

Crisis	Element				
	Poor regulation	Poor risk management	Financial schemes	Unexpected gains	Intimate Financial Network
Nowadays	Basel Accord II implementation challenges	Foreign debt in Europe	“Predatory accounting”: Greek’s financial reports provided by Goldman Sachs in order to enter into the EEC	Compensation structure for traders biased towards issuer	20 firms account for approx. 80% of financial sector assets in the US
2008	Lack of control by the SEC	-Securitization Unjustified AAA ratings -Decoupling of rewards versus long-term sustainability	Predatory mortgages	Some companies receive billions of dollars paid by the tax payers; others are left to go bankrupt	Goldman Sachs intricate links with government regulators
Great Depression	Deregulation	Excessive rural (farmer) credit in particular by the Federal Housing Administration (FHA) bearing the risks of mortgage defaulting	Predatory lending	Predatory lending creating substantial income inequalities	Powerful expansion of banks (Federal Reserve not starting to operate until 1913)

Source: see in particular: Rajan, 2010.

Figure 1 – The predatory web

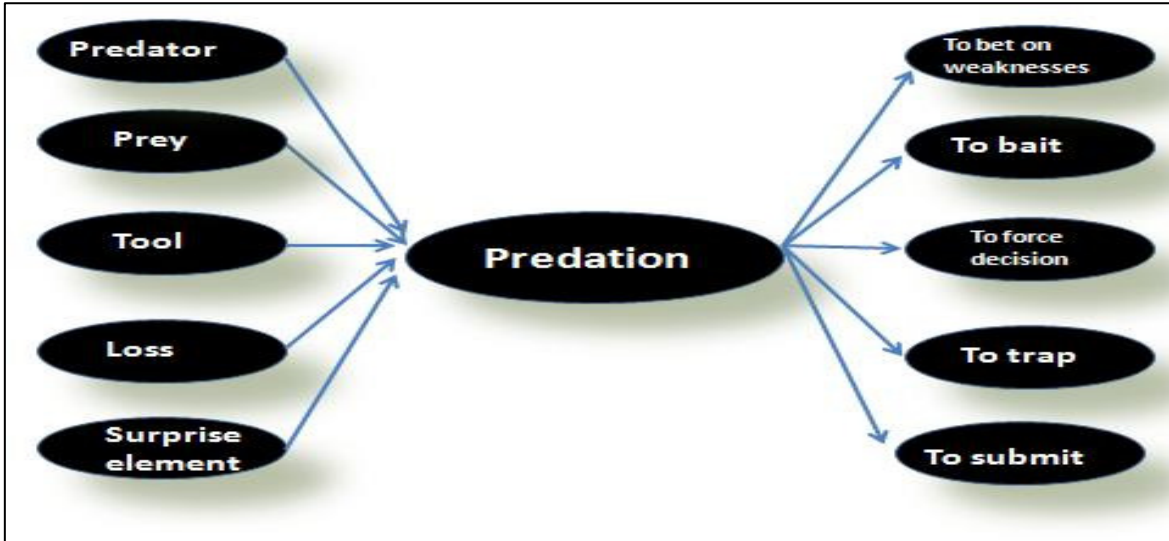


Figure 2 – Perceived predation (The ----- model)

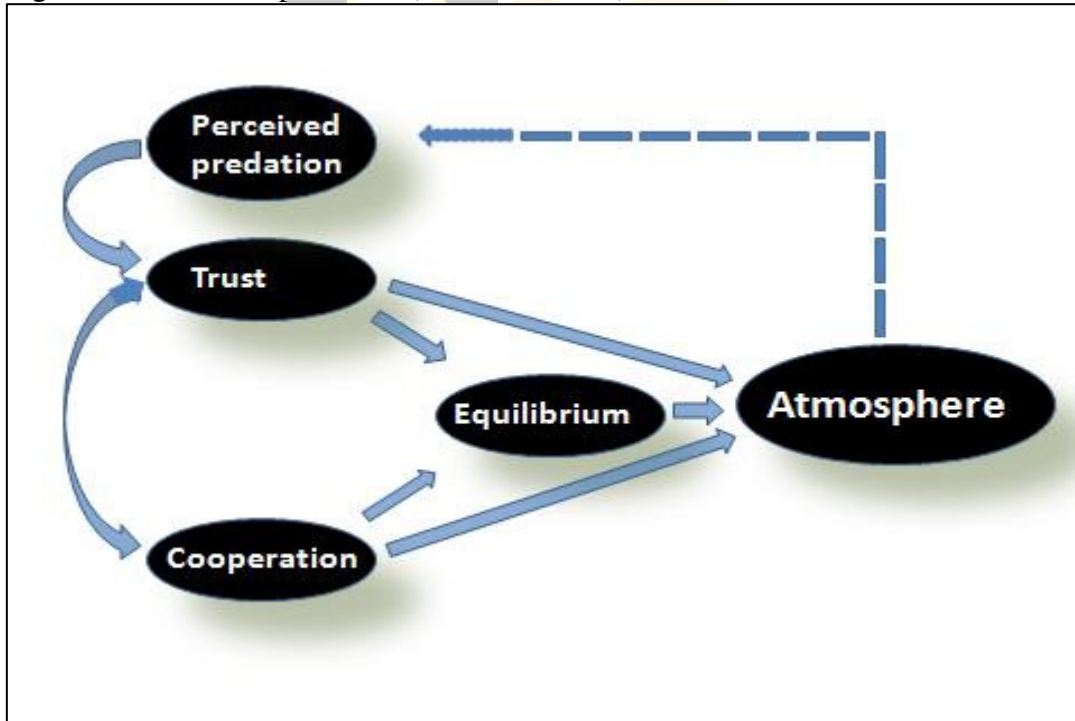


Figure 2 – The building of trust within the predatory web

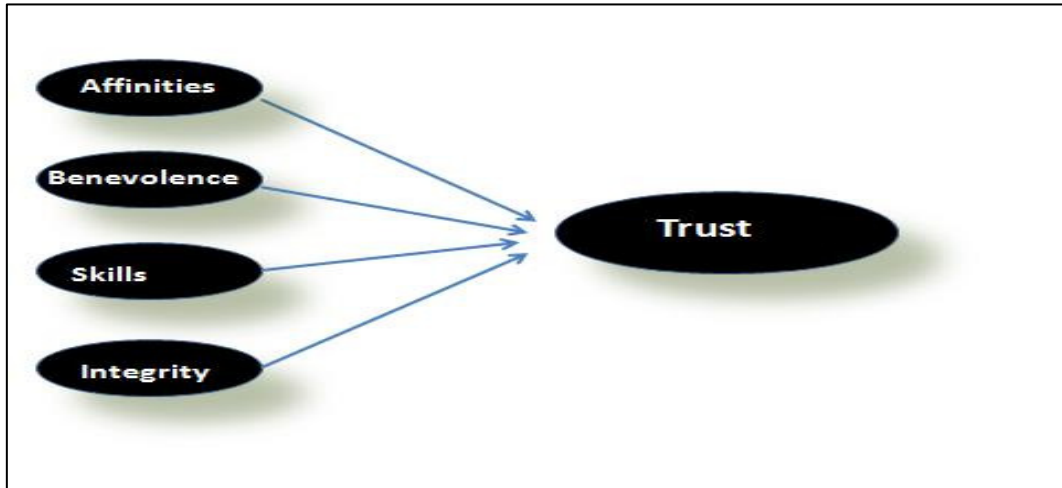


Figure 3 – Doing what’s necessary to instil trust: cooperative efforts

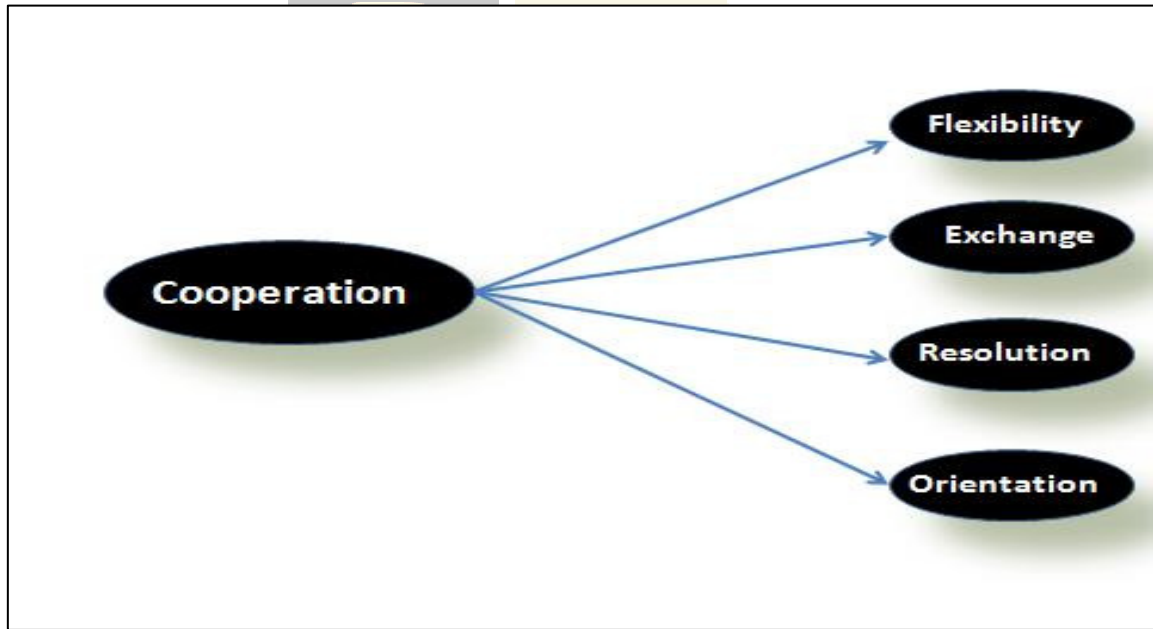
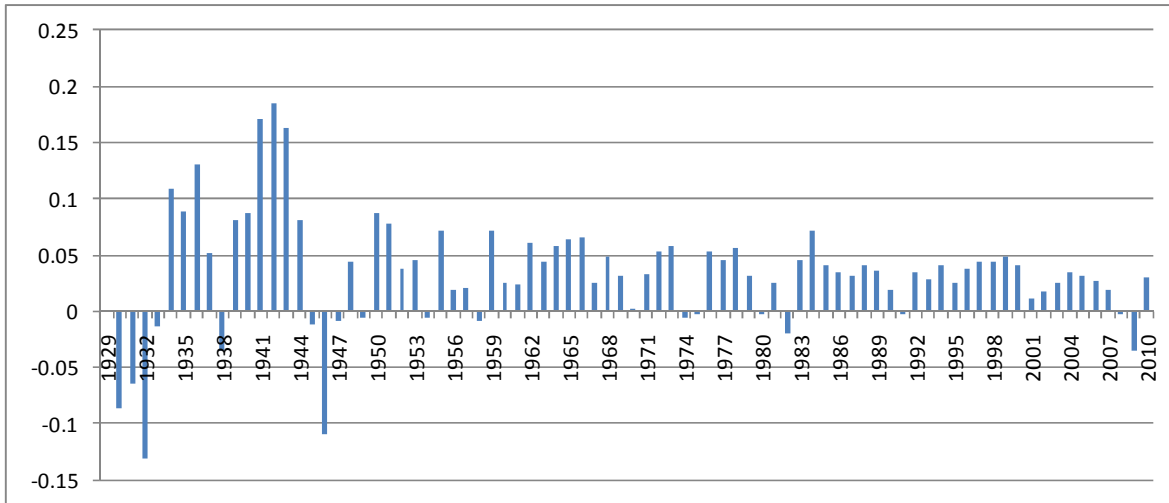


Figure 4 – Annual United States GDP growth from 1930 to 2010



Source: U.S. Department of Commerce: Bureau of economic analysis.

Author Biography

Olivier Mesly is professor of marketing at the University of Quebec in Outaouais (Canada). He holds a post-doctorate degree from HEC Montreal, a doctorate degree in marketing from the University of Sherbrooke (completed in a record time of two and a half years with high honours), as well as an MBA and a Bachelor in East Asian studies from McGill University (with Distinction). He teaches in French, English and Spanish in various countries around the world. His main research theme is that of predation, particularly financial and marketing predation.

