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BLUEPRINT

SOVEREIGN DEBT AND FINANCIAL CRISIS

AN OPPORTUNITY FOR POOR COUNTRIES?

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Sovereign debt restructuring procedures enforced by the International Monetary Fund (IMF) used to be good enough « *for the undeserving poor* », for the underdeveloped countries, for the corruption-ridden regimes of the Third World, in short, for "THE OTHERS". This time, it was of relevance "at home", first as a threat or eventually as the solution "*of last resort*" and it was brandished against the likes of Iceland, Ireland, Italy, Spain, Portugal, Greece - fringe or full-fledged members of this proud European Union which had once run the world.
What was it that had brought the threat of the Barbarians – meant to remain beyond the *limes*, from Scotland in the North to the South of Tunisia - so close to the heart of the Empire, so close to home ?
Was it a case of irrational **lenders** ? Were the bankers and financial operators at large to blame for having taken risks without adequate reserves – in which case they would have jumped out of the windows of their cozy offices and borne the consequences of their "*culture of entitlement*" ? Or was it a case of an inconsiderate **spending** spree (Governments eager to be popular, especially in the 'Club Med' geographical area – forget Iceland and Ireland - having authorized, directly or indirectly, a level of consumption or a rise in real estate prices which exceeded the effective production of goods and services – and they were to blame, like the Argentinian Peronists of old).
These two questions had been asked on the occasion of most previous financial crisis experienced by third world countries: indeed, each crisis had followed and put an abrupt end to, a period of "euphoria" during which bold financial operators –typically from the wealthy "North" or "West" - had ripped off the golden foam of "economic take-offs". The subsequent catastrophic turn of events had generally been attributed to the misbehavior of "local" Governments duly criticized for not having been wise enough, to build reserves from the initial profits of said "take-off" - assuming they would had been in a position to prevent the repatriation of profits to the Northern or Western world from which the "generous" and "bold" capital flows had originated.
So, what was "new" in the crisis of 2007-2008 ?
Quite early on, it was recognized as a **bank crisis** first, and a **sovereign debt crisis** next, when the European Governments – and their EU "college" – were blackmailed into funding with Government debt, the *de facto* bankruptcy of "too-big-to-fail" (TBTF) financial conglomerates whose activities had been authorized to extend from the cozy oligopoly of payments and savings systems, to the manipulation of so-called "market" references (interbank lending rates or LIBOR) and the broad distribution, either directly or through "shadowy" structures dubbed "alternative" investment schemes, of **instruments of speculation** which were "financial securities" in name only – when the name was not conveniently avoided at the behest of astute legal advisors.

The major difference of the recent "crisis" is :

(i) one of perception – this crisis is not caused by OTHERS, and OTHERS cannot be blamed for it – the "evil" is INSIDE the fruit, and
(ii) the admission that the banks (as "lenders" or seducers) and the sovereign Governments (as "borrowers" or seduced) were BOTH on the same side of the economy of the crisis: both enjoyed the profit while it lasted, and both had to carry the cost of the bursting of the bubble.

Emerging countries have eventually been also affected by the crisis, but this is a collateral damage that cannot be described in terms of "imperialist exploitation", as it may have been tempting to do for previous typical "third world" financial crisis.
Another difference with previous "third world-type" crisis, is that it seems impossible to "assign" the formal obligations that have arisen from the inflation of "paper-money", because the exuberance corresponding to the "hole" in the banks' accounts can hardly be identified with profit margins accumulated by some "wealthy" Western multinational companies. The "hole" in the finances of the financial sector-turned-casino, and subsequently transferred to the public budgets of the USA and of most European countries, seems to correspond to resources which have been either "appropriated" by a few privileged operators who are unlikely to accept any "clawback" on their abusive remuneration, or accumulated in the form of global balance of payment surpluses that are attributed to the "sound" economies of the dominant sovereign states (Germany and, to an extent, the USA…. together with their "clientele").
The only practical way to "mop up" the "bouncing" financial obligations which have inundated the economic system without any corresponding real assets, seems to be, to impose a selective reduction of economic activity – austerity measures generally aimed at all forms of "transfer" or "collective" payments, while keeping the consumer society working as well as it can.
The political backlash against these 'typical' IMF measures based on the good old "third world punishing" model has already resulted in an observable disaffection for the "open" or "global" economic ideology which had successfully reduced all political "barriers" over the past 45 years. The problem is that the risk of a return to protectionism would most probably affect the level of economic development in the countries or areas which would attempt to protect themselves.

THE CHRISTIAN CALL: FEAR NOT !

Yet, we should have no fear: indeed, we are currently at a junction; before a new wave of euphoria carries us away again, and before the pain of unemployment and needs of all sorts pushes angry voters towards reactionary options, the Christian tradition has something relevant to tell: this crisis has made us aware that we can suffer in the same way, and maybe soon as much, as those "others" whom we had managed to keep at bay. Awareness is an essential first step:

> 1 ***Judge not, that ye be not judged.***
> 2 ***For with what judgment ye judge, ye shall be judged: and with what measure ye mete, it shall be measured to you again.***
> 3 ***And why beholdest thou the mote that is in thy brother's eye, but considerest not the beam that is in thine own eye?***
> 4 ***Or how wilt thou say to thy brother, Let me pull out the mote out of thine eye; and, behold, a beam is in thine own eye?***
> 5 ***Thou hypocrite, first cast out the beam out of thine own eye; and then shalt thou see clearly to cast out the mote out of thy brother's eye.***
> Matthew VII, 1-5

The second element of awareness, or consciousness, which has emerged for us from the recent crisis, is the fact that in spite of the magnitude of the figures that are mentioned by experts whom we had been told to respect because of the reliable character of their scientific knowledge, we cannot believe anymore that the amounts of money that are quoted, be it debt or losses, correspond to a measurable reality: the head of the largest US bank is unable to say whether his London desk has incurred a loss of USD 5 or 9 billion…. And those are round numbers !
At that stage, it becomes obvious for a Christian that the "financial" assessment of wealth – or ruin – must be misleading.

15 ***And he said vnto them, Take heed and beware of couetousnes: for a mans life consisteth not in the abundance of the things which he possesseth.***
16 ***And he spake a parable vnto them, saying, The ground of a certaine rich man brought foorth plentifully.***
17 ***And he thought within himselfe, saying, What shall I doe, because I haue no roome where to bestow my fruits?***
18 ***And he said, This will I doe, I will pull downe my barnes, and build greater, and there will I bestow all my fruits, and my goods.***
19 ***And I will say to my soule, Soule, thou hast much goods layd vp for many yeeres, take thine ease, eate, drinke, and be merry.***
20 ***But God said vnto him, Thou foole, this night thy soule shal be required of thee: then whose shal those things be which thou hast prouided?***
21 ***So is he that laieth vp treasure for himselfe, and is not rich towards God.***
22 ***And he said vnto his disciples, Therefore I say vnto you, Take no thought for your life what yee shall eate, neither for the body what yee shall put on.***
23 ***The life is more then meate, and the body is more then raiment.***
Luke XII, 15-23

The evil we believed we could relegate, has come home, like the plague on the ship of Nosferatu, the casualties we believed we could abandon on some deserted island "overseas", are our very kin; the numbers in which we had placed our faith through generalized quantifying exercises, are imprecise…by the billion dollars !

THE TRUTH IN DEBT

While there is cause for alarm in the developments of this crisis, we can also take the view that we are eventually reaching a stage where we must cease to delude ourselves, so that this crisis has its own "grace", the grace of "truth".
We should find it interesting that in the Arabic language, a Semitic language like Hebrew, the word "faith" ("d-ï-n") has the same root as the word "debt"("da-ï-n"); the day of Apocalypse, the day of the last judgment, is the day of the faith, the day when the debt must be repaid. Our religious traditions establish a strong link between

- Giving/receiving
- Entrusting with the accompanying Risk of Loss or non-performance
- A time-span or time limit ("deadline")

The gospel in general, and the better part of Luke in particular, is filled with comparisons with money transactions of all sorts. Yet, the Christian tradition seems to have preferred to go for "spiritual" interpretations of these comparisons and parables and to stay away from money matters, except for a tolerance vs the *necessary evil of (preferably) Jewish bankers, and a recommendation for prudence.*

May be this is the time to remind ourselves that **prudence** is not the last word of the Christian Revelation: **risk** is, because every human occupation is called to be re-built on the model of the risen Christ – and this for us on earth, can only be implemented through faith and hope, and faith, like hope, means taking a risk, i.e. acting without full knowledge, acting by putting ourselves at the mercy of somebody else. Judas is less of a "traitor" than someone who "delivers" his master to the messianic rating agencies of the time, because he is not prepared anymore to take upon himself the risk of the faith. The great priests will know. Selling an option on the faith in the Savior, made Judas Iscariot the patron saint of all 'hedge' funds and derivative traders.

We are unlikely to overcome the effects of the recent crisis if we do not recognize that it is due to **our lack of faith**, and if we do not endeavor to restore our ability to develop economic relationships – i.e. sharing among ourselves the resources which are entrusted to our management – on the basis of faith, mutual faith and for those of us who are conversant with a religious tradition, faith in a revelation which gives the mutual faith among human beings its complete meaning and dimension.

The question "What has **faith** to do with banking and indebtedness?" should be reworded: "What has **risk** to do with banking and indebtedness?" – the question, then, contains its answer.

TWO WAYS TO ADDRESS THE ISSUE OF RISK

A lot has been said, lately, about two different functions of the large banking conglomerates which public money has been called to save from bankruptcy: some people have gone as far as advocating that these conglomerates be split according to two their two main **functions**. Each function, has developed a philosophy, or a culture of the financial risk by reference to its purpose.

The first function is that of collecting the savings (for which banks in most modern societies have a de facto monopoly, or oligopoly) and performing payment and transfer services. The institutions dedicated to this function, because they dispose of the savings of the general public, should only use these resources within the limited realm of short term treasury advances to private individuals or commercial or industrial companies, as a sort of natural extension of their payment services. This would reflect one of the origins of banking activities, (among which the Italian banks, notable the early Medici bank holding), which did concentrate on financial advances meant to facilitate commercial transactions throughout Europe.

Depositors would be assured that (i) their money is used by those who need it for their business or their private expenses, but (ii) in such a way, and under such a surveillance system, that they rest assured, to be able to withdraw it "at sight" – it would be up to the bank, on the basis of statistical calculations, to put together the required reserves to be able to respond to withdrawal requests from their Depositors/customers, or to establish a relationship with other banks or with a Central Bank who would step in to assist in a temporary "credibility" crisis.

It would not be correct to state that such a structure would ensure that 'ordinary' deposits – which are mandatory because no citizen can effectively make use of his money without having it in a bank account (where his salary is paid, and wherefrom any significant payment must be registered – are **"risk free"**: the bank may still go bankrupt as a consequence of bad management, but bank **licenses** granted by the Sovereign/Government would be associated to the observance of strict regulation (regarding the liquidity reserves and the disciplines of lending in general). Conversely, Central banks, with the support of the Government, would undertake to come to the rescue of any particular bank who would unduly be the victim of 'panic withdrawals'. The risk on deposits (for the Depositors) would still exist, but in this structure (or "culture"), it can also be said that the political community – be it at regional or "national" level or at a larger level, either European, or, why not, "world" level, would undertake to guarantee that money deposited can be withdrawn "at sight". The risk on Deposits would be "collectivized" – as

counterparty to the privilege granted to banks, to collect the savings and effectively dispose of any unspent money owned by ordinary people.
The management culture of a banking structure built around this "function" would clearly be "risk averse", in order to limit, or even avoid, the recourse to public assistance (which, obviously, would come at a "cost" for the bank and its shareholders).
It is worth observing that this sort of "public service" banking is mentioned in the gospel, as an alternative to more risky endeavors: "you could at least have put my money in the bank, where it would have produced interest."

> ***« Wherefore then gavest not thou my money into the bank, that at my coming I might have required mine own with usury? »*** Luke XIX, 23

The parable contains no criticism against this form of "banking" – save for the fact that there is not much risk or "faith" involved !

MOVING INTO MORE RISK – OR TRANSFERRING THE RISK ?

Clearly the basic function described above may not be very "risky", but it is of limited use to the few beneficiaries of short term advances, and it may also be only moderately profitable for those who exercise this profession- unless they are "shylocks", of course !
Accordingly, it would be called to evolve – which it did in the past, except when it was regulated in such a way that it had to remain within the constraints that were set to the granting of a banking license.
One possible direction in the evolution of the "deposit-taking" banking model is to emphasize the public service perspective: if public authorities observe that private banks are too risk averse and do not offer credit facilities that are commensurate with what the Government believes would be required to ensure economic growth, public authorities may encourage the Central bank to accept/discount certain types of loans. The discounting procedure does not free the bank from its ultimate liability if the debtor does not repay his debt, but it "frees" fresh money that the bank may lend to another borrower (at a profit for the bank !). The management of the way the Central Bank would accept certain loans or not ("the discount window") has been a traditional way to "slice the dice" between the Central Bank and the private lending banks. On the other hand, the independence of Central Banks vis à vis their Governments has become a dogma which would have to be reviewed, for this avenue to become effective again.
An apparently small step could be taken – and it was historically taken – beyond discounting loans to the Central bank: the loans which are sitting on the balance sheet of the bank as "assets" can be – subject to legal authorization – "bundled" in such a way that they can be sold to third parties (other banks or any individual or institutional investor) as "securities". In this case, the bank who had originated the loan transfers all its rights to the purchaser of the new "security". The effect in the accounts of the bank is two-fold: in terms of liquidity, the sale of a securitized asset is identical to the discounting procedure described above, but in terms of balance sheet structure, the bank has "less" assets – or may purchase more assets with the proceeds of the loan which it has sold, while the sale of the securitized loan allows it to classify all commissions perceived in relation to the loan as "income without recourse"; the bank does not need to consider that these revenues – in whole or in part – should be set aside to build provisions or reserves against the occurrence of a default.
The major change is of a cultural nature: the loans which are granted with a view to subsequent selling cannot be associated to the same "risk" concerns as before. At least during the initial period of a "securitization" fad – as it happened historically, banks authorized to sell their assets through securitization vehicles, will most likely relax their prudential rules…. to the great pleasure

of the beneficiaries and even of the Governments who enjoy the get-well feeling of happy borrowers.
The problem is, what has happened to risk, and what has happened to trust ? Risk has not "disappeared", except for – and from - the balance sheets of the banks. The risk of default has been **transferred** – in most cases without the consent of the beneficiary. The "indebtedness" relationship has been deeply modified.
If the borrower is unable to comply with the terms of his borrowing/debt/loan, he is not facing (i) the loan officer of a bank who has decided to grant the loan and (ii) in a remote manner, the depositor of the bank who has "funded" the bank by leaving his deposit with the bank.
These two persons were able, at least in theory, to reconsider the terms of the loan, and for example, accept an extension of the term, or, as the case may be, a change in the rate of interest.
Once the loan has been "securitized", the beneficiary of the loan only faces an "investor" – often with other investors through one or several legal vehicles – whose sole relationship with the borrower is described in the document of the loan – the terms of the "security".
This "final" investor knows very little of the beneficiary of the loan; he may imagine that the loan has been granted without much care, but he has no recourse against the original lender. He may consider that he has paid a "fair price" for the security he has purchased – even though such a security is not actively traded in a "market" whose depth would secure a reliable valuation.
The case could be complemented by more structural "niceties", but it may be justified to mark a pause in the initially hypothetical description of what could be the evolution of a deposit-taking bank: authorizing deposit-taking banks to "securitize" their loans – even if such loans are sold to clients of other banks, transforms the risk assumed by the clients/depositors in a substantial way.
If the depositor is offered an investment fund containing securitized loans, he ceases to be a Depositor – his money will not appear on the balance sheet of the bank anymore – and he becomes an investor. This subtle change, however flattering it may look to some people, has often lacked an adequate description made to the person concerned.
Even if he remains a Depositor, his money is not used

- to fund loans over a period of time that can be estimated (by reference to the average life of the loan portfolio) and
- compared to the average amount of the sight deposits left on the balance sheet of the bank.

His money is used

- to fund on an intermediate basis
- the initial structuring of loans which are
- subsequently sold to other parties.

Depending on

- the amount of the inventory of "new originated" loans that are accumulated on the balance sheet of the bank, and on
- the absorption capacity of the "market" operators who are potential purchasers of these loans –at a profit vs the conditions at which the bank has initially concluded them, the potential illiquidity or loss-making position of the "loan-book" of the bank, can hardly be rationally compared with the average amount of the sight deposits left with the bank by the Depositors.

The current thinking about bank structures is to separate deposit-taking banks and other financial service companies which would not be authorized to accept deposits. Those companies would

deal with investments or arrange loans, without being able to fund their operations with bank deposits, in the sense of what has been described before.
The main reason for wanting to separate the two forms of business is their attitude to risk and more specifically, to restore the perception of risk which may exist in both, but had eventually been lost in both, as both forms of banking had been merged under the same roof of the "too-big-to-fail" conglomerates.

RISK EVALUATION

A deposit-taking bank may think it has eliminated a risk once it has sold part of all of its securitized portfolio; an investment bank would immediately acknowledge that the risk has been transferred.
Accordingly, the investment bank would consider that it must

(i) set a price at which an investor will accept to run the risk attached to the investment vehicle;
(ii) evaluate the cost of funding the position as long as there is no purchaser for the investment;
(iii) identify the asset whose price behavior is sufficiently close to that of the investment, to 'hedge' the bank against market price variations while the position has to be "carried";
(iv) borrow the 'hedging' asset in order to be able to create a forward-sale position meant to 'hedge' the carried investment and last (but not least)
(v) evaluate the cost of funding both the "carried" investment and the "hedging" investment.

A true investment bank would never go into the 5 phases of the management process described above, if there is no real active "market" at every level of the process, which would legitimate balancing and hedging calculations.
The problem is, that by mixing the deposit-taking bank culture and the investment bank culture, market-related calculations and estimates have been performed by actors who operated under the umbrella of deposit-taking banks, where a considerable number of "market" transactions were internalized, i.e. seller and buyer were either notional, or often within the same institution. Historically, all market operators who, before the "Big Bang" in the 1970's, had been independent entities, were either purchased or integrated in banking conglomerates. Within the "investment banking" departments of the universal banks, it has progressively become usual to replace the demanding (and costly) solicitation of true market transactions data, by computer models and algorithms where one or two elements are deemed sufficient to "derive" all other data, by adding or subtracting a "margin" considered to be statistically relevant – but which may be as misleading as the historical loan default statistics collated over a period when the loans had to remain on the books of the banks which had granted them, without any possibility of escaping from any event of default by selling the "securitized asset".

SECURITIZATION AS A LATIN AMERICAN 'DÉJÀ VU'

This summary overview of the background of finance in 2014, is necessary to understand where we stand vis a vis the actual situation of sovereign indebtedness in general and the indebtedness of LAC's ("Less advanced countries" or "Pays Moins Avancés") in particular, and how the crisis may open new ways to address these issues.
The description of the securitization process – treated as a hypothetical evolution of the deposit-taking model, and alluded to as an effective cause of the financial crisis of 2008 – is very relevant for the consideration of the indebtedness of emerging countries because a similar evolution took place towards the end of the XXth century as a consequence of the Latin American "quagmire".

By this time, it was still admitted that lesser quality credits **could not** access the "real" financial markets – where bearer securities with intermediate maturities represented "benchmarks" for other bonds or any other form of future financings. These benchmarks were characterized in terms of remuneration conditions, range of maturities and potential amounts to be raised.
Before borrowers were deemed reliable enough to "float" paper in their name – which was treated by investors as quasi money – they had to negotiate **loans** with banks which were usually gathered in ad hoc "syndicates". The banks would not only (i) draft a loan documentation with provisions significantly more inquisitive than the documentation of a straight bond, but they would (ii) monitor the respect of any covenants and (iii) stand by in case the borrower's condition or intentions would change over time. This regime of surveillance or conditional freedom, reflected the flexibility which might have been needed to accommodate the evolution of a relatively "young" or "recent", in anyway "fragile" borrower.
When the Latin American states debt crisis erupted during the 1980's, all the banks involved in the various banking syndicates which had been put in place, did "even out" their positions in order to build blocks important enough to get represented to a negotiating table – most of which ended in the hands of the large US money center banks. This "super-syndicate" was able to negotiate with the various Latin American Governments from a position of strength. One of the notable results of this negotiation round was the creation in the late 1980's of the **Brady Bonds**, named after the US Treasury Secretary of the time Nicholas Brady, and through which **the bank debt was effectively re-scheduled and "securitized"**, exactly 20 years before the Greek sovereign debt had to be restructured under the benevolent guidance of Richard Dallara, who had learned his trade as a junior assistant of Nicholas Brady, and had subsequently become a Managing Director of JP Morgan. Now formally empowered as Managing Director of the Institute of International Finance, Mr. Dallara successfully claimed to **represent** most of the institutional investors holding bonds issued by Greece. In this capacity, he was able to negotiate the "haircuts" which were accepted by the various parties involved.
The major difference introduced by the use of Bonds (instead of bank loans) was that in theory, each bondholder is authorized to defend his rights on the basis of the terms of the bonds he is holding, and **collective action** by an assembly of bondholders where a majority might impose their views on minority holders – and reach a compromise solution – is rarely provided for.

WHAT'S IN A BOND ?

Bonds – in the sense of **publicly offered**, **broadly distributed** and **actively traded** debt instruments - have traditionally been considered as safe investments issued by recurring borrowers eager to secure

- a cost of money to themselves, and
- a fixed income revenue for their investors,
- with a view to regular roll-overs of the maturing instruments, such that this debt is not meant to be ever repaid.

According to this definition, the paradox of a traditional bond is that it contains a promise to pay back which is expected to never come into effect !
Understanding this paradox requires to focus on the core concept of public debt, (i) as it had traditionally been developed and established, (ii) as it has been damaged by business practices which have led to the crisis of 2008, and (iii) as it will have to be restored if a new modus operandi is to be found.
The backbone of a bond is initially an act of trust: it consists in the exchange of money against a piece of paper IOU("I ow you") outlining the obligations of the borrower to pay interest and repay the principal at certain dates) associated to a relatively concise set of prudential measures (the bond conditions or Trust Indenture). From the date of its issue to the date of its maturity

(when it ceases to exist) the validity of the terms of a bond is subjected to daily, sometimes hourly confirmation by a multitude of operators who express the continuing value of the trust inherent in the bond, through effective, multiple and sizeable transactions. This is why the "maturity date" is not so relevant as far as the perception of the credit quality is concerned, because a "true" bond investor expects the bond to be "rolled over", i.e. replaced by a new bond issued by the borrower, in order to secure the stream of income in which he is interested. A bond is therefore an act of (mutual) faith. Per se, it is not a "safe" instrument. On the contrary, it is a very risky form of investment, since it is "only" worth the trust the sequence of successive purchasers/investors have in the issuer and that sequence is submitted to a constant confirmation – which also explains why an organized market must be "stabilized", a process of intervention which is completely different from "manipulation" because it intends to neutralize random events that might affect the continuation of the "trust" effect.

Beyond the legal form of the instrument, the economic rationale for a bond – be it issued by a Sovereign Government or a corporate entity – is based on the assumption that the issuer will be able to generate **more profit** from the investments he will make with the proceeds of the bond over the period during which the money will not be claimed back from him, **than the cost** of borrowing resulting from the coupons of interest which he has undertaken to pay.

Should the issuer not be able to generate a profit in excess of, or equal to, the interest payments, the bondholders, often through an external party designated to protect the economy of the process (Trust) are authorized to access the assets of the issuer, or to interfere with its management in order to defend the interests of the bondholders and ensure that they receive what they had been promised, thereby bringing a de facto correction to the error of economic judgment made by the issuer of the bond.

The implication of this rationale for a bond issued by a sovereign entity is that in case the indebted Government is unable to extract from its public accounts the amounts which are due under the bond, an external body (say the IMF) may be called to replace the local authorities and "manage" the resources of the country, in such a (better) way, that the national "product" can generate the resources necessary to pay the sums due to the lenders.

BOND 'PERVS'

Bond finance is a process which involves an issuer and a universe of investors, and calls for judgment on the part of each party. It therefore entails **judgmental risk**. Reaching a sound judgment requires a full understanding of the **identity** of the (moral) person who seeks to obtain finance, because trust is vested in a clearly identified person. Moreover, although trust cannot be quantified, the modalities of the support which is provided to the trusted person, are calibrated by reference to an order or a **hierarchy** which takes the form of a "**risk premium**", i.e. the cost which will be considered rational for the borrower to pay (in association with the amounts which can be granted, and the duration over which the loan will be consented). And since the chain of "mutual faith" is collective in its essence, the "zero" degree of the "risk premium" corresponds to the cost of borrowing of the Government who issues the currency in which the bond is denominated.

The financial crisis of 2008 has unveiled that these two prerequisites (**identity** of the issuer and rational **risk premium**) had been progressively perverted by the operators of the financial markets – and this had coincided with the invasion of financial markets by the large banking conglomerates.

With respect to the identity of the issuer, the generalization of **interest rate swap agreements**, or **currency and interest rate swap agreements**, arranged privately in conjunction with public bond offerings, had made it difficult and sometimes impossible to relate the trust of the bondholders, with an economic rationale which would be relevant for the issuer. For instance, the French utility Gaz de France did issue Yen denominated Bonds although it had no revenues denominated in Yen, without incurring an irrational currency risk, because it had "swapped" all of its Yen payment obligations with an issuer of another bond issue denominated in EUR or DEM. Gaz de France had taken advantage of an effect of "scarcity" of French utility names among holders of Yen Bonds desirous to diversify their credit risks, and was therefore able to borrow in Yen at (more) favorable financial conditions. Such conditions, in whole or more likely in part, were "passed" to another borrower – a Japanese entity - who enjoyed a corresponding "scarcity" effect in the EUR bond market. This form of "arbitrage" is achieved to a **"substitution" of borrowers:** Gaz de France will only be able to make the Yen payments under the Yen-denominated bond, if another borrower makes these payments to Gaz de France as per the swap agreement. The fact that Gaz de France' ability to perform under its Yen bond is conditional upon the ability of another borrower to perform under another debt instrument, is absent from the evaluation process of the investor and distorts the integrity of his perception of the identity of the issuer. Gaz de France bond holders may suspect that Gaz de France is not the only party involved in the transaction, but they have no way to find it out.

Progressively over time, most of the bond issues have been associated with "private" swap agreements which, for reasons of mutual convenience, were not concluded directly with other corporate or Sovereign bond issuers, but with the same large banking conglomerates who had arranged the initial bond issue and the swap agreement.

With respect to the "risk premium", a similar arbitraging process has progressively eroded the rational elements which were taken into consideration to determine the "risk premiun" associated with different categories of borrowers, according to their specific credit risk. Largely as a result of the confusion created by the substitution of borrowers achieved by the generalization of swap agreements – sometimes even a chain of successive substitutions - , the risk premium has tended to decline in absolute terms, and the "risk-free" reference has progressively become the level of inter-bank medium to long-term swap commitments. As it turned out during the crisis of 2008, this apparently technical development did not result from an objective improvement of the "real" credit quality of the banking conglomerates, but from the "judgment" (perverted by "moral hazard" considerations) according to which said conglomerates were "**too big to fail**" and enjoyed a de facto Government guarantee. Subsequent analysis performed by international bodies (IMF, OECD, etc…) have quantified the amount of the "**implicit subsidy**" by Western Governments, which large banking conglomerates enjoyed: the latest evaluation, expressed in terms of lending margins, is in the order of 1.15% p.a.

This means that the bank basis of "straight" financial bond markets has become too cheap by 1.15%.

Interestingly, this yield spread used to be associated to the difference between "top quality" ("AAA") credits and issuers who did not deserve the rating "investment grade" ("BBB").

PRICE AND VOLUME

The apparent "cheapness" of finance that resulted from this perversion of the financial markets by large banking conglomerates did not result in an easier access to bond finance for entities or countries which would have previously been considered as lower credit quality issuers obliged to pay a higher risk premium.

The determination of the appropriate risk premium requires a lot of attention, and entails judgmental risks. The large financial operators, once they had "killed the hen with the golden eggs" by reducing the yield spread of the traditional "risk premium", did not re-orient the investment appetite of investors frustrated by low returns towards lower credit borrowers, because this would have required greater efforts and would have exposed them to judgmental risks. Instead, they continued to work on the confusion of the identity of the bond issuers by **getting altogether rid of the issuer as a (moral) person**. They convinced the rating agencies, that the safest possible issuer was not a corporation or a Government, but a heap of financial assets, once bundled and often "leveraged". Instead of having to evaluate the capacity of a corporation or a Government, to generate revenues or resources sufficient to make future payments, the rating agencies – and the bondholders – had to be satisfied with loan loss default statistics relating to historical periods when such loans were kept on the balance sheet of, and monitored by, the banking institutions which had granted them. The fact that these statistics were not relevant for loans originated by banks which were just happy to originate and sell them, was simply ignored.

The lesson taught by true financial markets had been lost: apparently "cheap" finance does not mean that it is "accessible" finance, because it also means that nobody is prepared to extend finance at such a "cheap" level, until – which is exactly what happened and led to the financial crisis of 2008, the "assets" offered at such "cheap level" are recognized as having no "verified" value. Hence a collapse of the system, as trust evaporates.

THE IDOL OF RISK CONTROL

In parallel with the erosion of the risk premium and the confusion about the identity of borrowers the financial environment created by the large banking conglomerates imposed on the financial markets operators and theoreticians (the academic world at large) a fake culture of **risk control** that, surprisingly, had its roots in the universe of deposit-taking banks where all commitments must be balanced or 'hedged' by symmetrical commitments. However, what is conceivable is the relatively simple world of "commercial banking", was utopic and/or heretic to the financial operators who had experience in the complexity and unpredictability of the real financial markets.

Once large banking conglomerates had taken over the appropriate networks of traders and investors, they promoted a full-fledged culture of "**risk control**" which was effectively meant to extricate the banks from all uncertainties linked to financing operations. All risks had to be packaged and "sold" to other parties, either

- in the form of "**guarantees**" obtained from large insurance companies ("*monolines*") or
- in the form of **speculative products** embedded in "bonds" or "loans" alike and distributed to the erstwhile customers/depositors turned "investors" or "speculators".

Pricing the various elements or "components" of risk (which were purposely segmented), was performed by computer models, in the absence of effective transactions, without any consideration to the volume that such transactions might have generated. The overriding argument was that large banks could make savings by executing transactions within their own clientele. The consequences of "internalizing" market transactions were ignored.

In spite of the self-proclaimed "**disintermediation**" whereby bank lending would have been replaced by "direct" financial market transactions, the "freeze" of **the interbank market** which occurred in 2008 proved that the flow of exchanges and transactions had been deeply perverted by the intervention of large banking conglomerates who had lost every sense of servicing clients, be they borrowers or investors, but who were pursuing their own interests, sometimes acting as borrowers in their own right, sometimes acting as investors thanks to their monopoly of the collection of savings, and their ability to transform their customers/Depositors into investors to whom they could "sell" their assets and the risks attached thereto, not to speak of their involvement in trading, distributing and "managing" portfolios of financial securities.

CAUSES AND OBSTACLES

Banking conglomerates would not have flourished if they had not been authorized and even specifically "licensed" to. It is therefore not entirely surprising that Governments, who also had a vested interest in the manipulation of debt markets which they hoped to take advantage of, are reluctant to acknowledge their share of responsibility, and have not, so far, taken any of the radical measures which would be necessary to restore the order that has been "perverted".

Two major obstacles stand in the way of any serious restoration of the financial markets as an efficient mechanism to allocate resources to the "real" economy. One belongs to politics and economics: "exfiltrating" the banking conglomerates from the financial markets cannot be achieved without lowering the profitability of what has become a large sector of the economy, and a major employer. As a result of this mitigated aspect of the "Too big to fail" blackmail, banking 'lobbies', paradoxically, get the largest possible support extending from (i) shareholders and representatives of private interest groups of all sorts to (ii) trade unions scared by the perspective of thousands of lay-offs (unless a re-conversion of useless salespeople into effective bank officers is undertaken, at no minor cost for the employers!). The second obstacle is of a cultural nature: it has to be recognized by all parties involved, including academics in high places – those very places in universities and business schools which have been heavily subsidized by the banking conglomerates – that finance is about trust alright, but trust also means risk, and risk cannot be 'hedged' - at least while also making a profit !

The consequences of the deterioration of the debt market for those who belong to the "weaker credit quality" borrowers, may not be entirely negative, but they call for a comprehensive reassessment of their objectives, and of the resources they are prepared to dedicate to an effort to correct the present situation.

The quest for the disappearance (through arbitrages of all kinds) of the "risk premium" must be replaced by admitting the validity of a level of **risk premium** which is acceptable and economically "tolerable". This may not necessarily mean that financing will be more expensive, because the artificially low level of the "risk premium" meant that financing was just not available. It may be preferable to secure effective financing at a higher cost, than to be prevented from access to finance at all. The relationship between "price" and "volume" can be best illustrated by the example of the strategy of the French Treasury during the crisis of confidence that followed the election of François Mitterand – and the formation of a Government with Communist ministers. The cost of money registered in the Swiss bond market by French Government-guaranteed bonds increased to a level close to, if not identical to, the cost of money for bonds issued by Mexico – which was then rated as an emerging countriy. Yet, the French Treasury made the conscious decision, to keep borrowing in Switzerland, on the understanding that it was more important to maintain the commitment of Swiss institutional investors, to the French economy via a continuation of subscription to French bonds (which in the eyes of the French, were horribly expensive), rather than lose touch with the Swiss investors' **recurrent** source of money. In due time, the strategy proved to be the right one, as the "yield premium" on French bonds progressively came back to the level of "top rated" entities.

Working on the quality of the **identity** of sovereign borrowers, is also a direction in which investments (of time and communication) should be made, if these borrowers are to take advantage of the current window of "**awareness**" among institutional investors. Accepting any subterfuge proposed by the banking conglomerates to bridge a temporary gap, may provide temporarily "cheap" sources of funding, but it would eventually backfire.

Getting back to the authentic logic of the risk inherent to bond financing, it would also be worth to explore a formulation of bond terms which reflects the economic condition of the borrowers: in spite of the attractiveness of bonds issued in local currencies, this is a case where the prudence of issuers is the speculation of investors. Bonds ambitioning to become "benchmarks" must be denominated in either of the major world currencies (USD or EU. For those countries where this creates a currency risk, it should not be impossible to point to the resources (from exports) which are denominated in the currency of the bond, and make it therefore "rational" to borrow in this currency.

The uncertainty which surrounds the evolution of currencies word-wide, and the recent attempt to familiarize investors with commodities, may also make it rational, to include indexation clauses

in the remuneration of bonds issued by certain exporting countries, whenever the commodities referenced in the index are effectively exported by the issuing country.
Brady Bonds had gone as far as combining the credit of countries too "weak" to borrow on their own name, with the credit of the USA, by building a "reserve" of US Treasuries as a back-up in case of default. This avenue may be worth exploring in the new context of a deteriorated bond market, provided some or all European countries accept to involve themselves in a form of "underwriting" of countries with which they have retained significant economic links.
The realization that real investors (as opposed to banking institutions) do not intend to avoid risk (at all cost), but are quite willing to accept a reasonable level of risk in exchange for an acceptable level of remuneration, is key to an improvement of the indebtedness situation of many countries.
The crisis of 2008 has unveiled considerable deficiencies in the financial system as it works today; it has also indicated how Governments can work together to restore a global function for finance which is recognized as useful and even indispensable. The difficulty is, to accept that if Sovereign borrowers are to recover the status and the access to the trust of investors which they deserve, they cannot rely on most of the companies operating in a financial sector which is unlikely to amend itself before long.
The doctrine of the Church on **fructification…**

> "***And he called his ten servants, and delivered them ten pounds, and said unto them, Occupy till I come.*** »
> Luke, XIX, 13 – *in latin « Negotiamini ! » which could be crudely translated by « Trade ! »*

…contains a clear incentive to extend the attitude of **faith**, to the economy in general and finance in particular. The true financial risk is the field "par excellence" where faith and reason must work together, while recognizing that the last wor**d** will be given to "*grace*" and to the cancellation of all indebtedness for the sake of charity, on the day of the last judgment, which in the Arabic language, is called the day of the religion and the day of the debt ("al yaoum al-dîn")

> « ***Blotting out the handwriting of ordinances that was against us, which was contrary to us, and took it out of the way, nailing it to his cross"***
> Col II, 14

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delens, quod adversum nos erat, chirographum decretis, quod erat contrarium nobis, et ipsum tulit de medio affigens illud cruci »
Col, II, 14