Financialization now runs the gamut from corporate strategy to personal finance. It permeates everyday life, with more products that arise from the increasing commodification of the life course, such as student debt or personal pensions, as well as with the marketing of credit cards or the arrangement of mortgages. The individual is encouraged to think of himself or herself as a two-legged cost and profit centre, with financial concerns anxious to help them manage their income and outgoings, their debts and credit, by supplying their services and selling them their products. What is termed a financial product reflects not just what Slavoj Žižek, following Kojin Karatani, calls the ‘parallax view’, which considers demand as well as supply, the realization of surplus value as well as its extraction. Finance also necessarily considers the temporal dimension. The entrepreneur who commits capital to a project is looking for a return tomorrow, and the market will not know whether they have achieved alpha, that is outperformance, until all the returns have been counted up. Exploitation is longitudinal. It takes time.

Financialization can most simply be defined as the growing and systemic power of finance and financial engineering. As such it is not an entirely novel phenomenon. But no account of contemporary capitalist development can ignore the scale of the financial sector’s recent expansion. As a percentage of total US corporate profits, financial-sector profits rose from 14 per cent in 1981 to 39 per cent in 2001. As well as profits earned by banks, hedge funds, private equity concerns, fund managers and insurance houses, many large companies also organize finance divisions which make a large contribution to group profits. It is the growing
exposure of all institutions and arrangements to the opportunities of financialization, as well as to the more familiar pressures of globalization, which has made the distribution of power within corporations and financial networks so fluctuating and unpredictable in recent decades. As Gérard Duménil and Dominique Lévy have analysed in these pages, financialized techniques have lent themselves to an extraordinary enrichment of financial intermediaries and of the corporate elite. The granting of stock options to top executives gave them a direct incentive to use loans to ramp up share price, by taking out bank loans and then using most of the proceeds to buy back shares. Given their own remuneration levels, the finance houses were scarcely in a position to use their clout to rein in executive greed. The financial elite and the corporate elite need one another and financialized techniques have helped to cement the pact between them.

In an important exchange, Giovanni Arrighi and Robert Pollin agreed that the most fundamental question concerning financial expansion is ‘where do the profits come from if not from the production and exchange of commodities?’ The three possibilities they focused on were, firstly, where some capitalists were profiting at the expense of others; secondly, where capitalists as a whole are able to force a redistribution in their favour; and, thirdly, where transactions had allowed capitalists to shift their resources from less to more profitable fields. However, we should also take into account two dimensions internal to finance itself: firstly, the cost of generating finance functions and products; and secondly, efficiency gains in anticipating risk. The financial revolution of the last

---

3. Duménil and Lévy, ‘Neoliberal Income Trends’, *NLR* 30, Nov–Dec 2004. This and other aspects of financialization are more fully treated in my forthcoming book, *Age Shock and Grey Capital*, from which most of the examples that follow have been quarried.
two decades has registered large potential gains in dealing with risk; but most of this gain has been swallowed by the rising costs of financial intermediation, made possible by monopoly and asymmetric information resources, and generated by escalating marketing and trading expenditures as well as extravagant remuneration.

In what follows I will examine aspects of financialization at the level of the corporation, and explore some of the fourth-dimensional operations of hedge funds, private equity, investment banks and pension funds, as well as some of the shadier aspects of financial practice, citing examples of profits which answer to one or another of the sources of financial gain and loss mentioned above. In some respects, these practices extend the realm of what I have called ‘grey capitalism’, in which relations of ownership and responsibility become weakened or blurred. We will also see that financialization creates a swathe of new services and ‘products’ for both corporations and individuals, which are bought because they allow the purchaser to make a future gain, stemming from outperformance, wise custodianship or superior risk abatement. Temporality is once again central here. The characteristic instruments of financialization are derivatives which are bound to wax or wane in exact relationship to an underlying asset or liability, futures contracts, or options (rights to buy or sell at some future date at a specified price). From the individual’s point of view the financial product—an annuity, a pension, a mortgage or an insurance contract—also ties current contributions to future benefits.

The expanding sphere and powers of the multi-tentacled investment banks—‘mind-boggling’ in their implications, according to the Economist—are well illustrated in the case of Goldman Sachs. As a recent survey pointed out, Goldman or an associated concern is involved in one third of all trades made in US equities.\(^6\) The profits of investment banks arise not simply from their traditional underwriting and brokerage, from M&As (mergers and acquisitions) and IPOs (initial public offerings), but increasingly from proprietary trading and risk arbitrage; namely, from positioning themselves and their clients in relationship to the wider impact of a merger or some other major event. The investment banks have great skill, a strategic location in information networks and massive computing power. They can adopt positions that enable them to gain from changes in relative prices whether or not a deal goes ahead. Once they know the lie of the land, they can devise a hedge for their

---

\(^6\) ‘Goldman Sachs and the Culture of Risk’, Economist, 29 April 2006.
client and also commit their own resources. As the *Economist* report pointedly enquires:

Would General Motors be better off if Goldman had merely sought out a buyer for the property arm of its financing operation, instead of itself joining the buyout group, as it recently did? The bank cites numerous times when it advised on a deal and then provided a hedge of some sort that immunized the buyer from risk. Goldman’s profit from the hedge (which is often the most lucrative part of the deal) is irrelevant, except that it means that Goldman as an adviser was not looking out only for the client. Is this bad? It is a matter of judgement. In terms of its investment banking Goldman now finds itself on so many sides of a deal simultaneously that the mind boggles.

**The disposable corporation**

Finance has a double impact on corporations: on the one hand constraining their investment strategies, on the other helping them to find customers and realize profits. They are not quite the free agents sometimes portrayed by their critics. The latter often focus on the exorbitant powers of corporations in relation to communities, regulators, consumers and their own workforce. Naomi Klein’s *No Logo* furnished a vivid and compelling account of the corporate ‘brand bullies’, while Joel Bakan’s often trenchant book (and film) *The Corporation* stressed the legal privileges and immunities of public limited companies. It is not difficult to see how giant retail chains shape patterns of production and consumption or how famous brands insinuate themselves into the texture of everyday life. Yet even the most powerful corporations need the financial world to assess their own progress, to plan for the future and, often, to reach new customers. It is not household names like Nike or Coca-Cola that are the capstones of contemporary capitalism, but finance houses, hedge funds and private equity concerns, many of which are unknown to the general public. In the end even the largest and most famous of corporations have only a precarious and provisional autonomy within the new world of business—ultimately they are playthings of the capital markets.

Corporate credit-worthiness is determined by banks and ratings agencies. In its turn this establishes the cost of corporations’ capital. They may be able to finance all the investments they wish to undertake from their own resources, but this will not mean that they are free from the pressures of financialization. In drawing up their investment plans, they
will have to show that these will achieve the benchmark or ‘hurdle’ rates of return established by the financial sector.\(^7\) Even the largest corporations have to submit to the inspections and interrogations of the ratings agencies—Standard and Poor’s, Moody’s and Fitch Ratings—if they wish to reassure investors and ensure cheap access to capital. Making a good profit is no longer enough; a triple A rating is also needed.\(^8\) Theoretically, the value of a share has nothing to do with present or past profits, but exclusively relates to the prospects of future profit.

From the standpoint of the ‘pure’ investor, the corporation itself is an accidental bundle of liabilities and assets that is there to be rearranged to maximize shareholder value, which in turn reflects back the fickle enthusiasms of other investors. The corporation and its workforce are, in principle, disposable. The famous companies of the 1970s, let alone the 1950s, have, with a few exceptions, disappeared or become shadows of their former selves.\(^9\) In the 1980s hundreds of thousands, if not millions, of employees discovered their expendability; in the ‘downsizing’ of the early 1990s swathes of middle and upper management found that they, too, were surplus to requirements. In the years 2001–03 about three million jobs were lost in the United States. By the turn of the century Enron’s managers had become famous for a regime in which each employee knew that one tenth of the staff, those who failed to reach trading targets, would be sacked each year, no matter how good or bad the overall performance. Many of the most powerful corporations today do their best to avoid having a workforce; instead they out-source and sub-contract.

One of the impulses to financialization is that companies which have difficulty selling goods find that it can be easier if they offer finance too, from the humblest consumer credit network to complex deals where a company sells its product to a subsidiary, which then leases it to the customer. Not infrequently the transaction passes through a tax haven or involves the shedding of a tax obligation (e.g. because interest payments are free of tax). GE Capital has long helped the company’s customers to

\(^9\) Comparing the US or UK stock-exchange stars of former decades with those of 2005, the overlap is small. The oil companies, banks and GE still loom large in the NYSE but much else has changed. Microsoft, Wal-Mart, Intel, Google and eBay are quite new. IBM and Coca-Cola are still there but have shrunk in size. The UK FTSE 100 is likewise dominated by newcomers like Vodafone, while famous names like ICI, Marconi and Unilever are greatly reduced.
acquire its aero-engines and other machinery using tax-efficient leaseback arrangements. GE Capital soon diversified into consumer credit because of the attractive returns this generated. By 2003, 42 per cent of the group’s profits were generated by GE Capital. In the same year GM and Ford registered nearly all their profit from consumer leasing arrangements, with sales revenue barely breaking even. When these two auto giants encountered real difficulties in 2005–06, they came under pressure to sell their profitable leasing divisions as a way of raising badly needed resources. In 2004 the General Motors Acceptance Corporation (GMAC) division earned $2.9 billion, contributing about 80 per cent of GM total income. GM hoped that GMAC would be valued at $11 billion or more, and that it could retain a major holding even while selling a 51 per cent stake.10

During the same period, it was striking to see the eagerness with which gigantic financial concerns like Citigroup and HSBC sought to acquire consumer finance operations and even ‘sub-prime’ lenders (loan sharks), which they would previously have regarded with disdain. Citigroup acquired Associates First Capital, and HSBC bought Household Finance, blazing a trail others were to follow. Finance houses have teamed up with retailers to shower so-called gold and platinum cards on all and sundry with the hope of ratcheting up consumer debt—running at 110 per cent of personal annual disposable incomes in the US in 2002, rising to nearly 130 per cent by the end of 2005—and subsequently charging an annual 18 or 20 per cent on money for which the banks were paying 3 or 4 per cent. It is the hot rates of return that attract the banks to seamy lending. They believe that they can repackage the debts in ways that allow them to slough off the risk while retaining most of the high return that was supposedly the risk premium. The lessons learnt from the repackaging of corporate bonds as CDOs (collateralized debt obligations) are applied to personal debt.

With direct access to sub-prime mortgages, the banks and hedge funds could thus bundle together and divide up the debt into ten tranches, each of which represents a claim over the underlying securities but with the lowest tranche representing the first tenth to default, the next tranche the second poorest-paying, and so on up to the top tenth. Borrowers who can only negotiate a sub-prime mortgage have either poor collateral or poor income prospects, or both, and so are required to pay over the odds.

Of course the bottom tranche—designated the equity—has very weak prospects but can still be sold cheaply to someone as a bargain. The top tranches, and even many of the medium ones, will be far more secure yet will pay a good return. (Here, in contradistinction to Arrighi and Pollin’s categories, we have an instance of financial profits generated by a function internal to finance itself.) As the chief executive of a mortgage broker explains: ‘Sub-prime mortgages are the ideal sector for the investment banks, as their wider margins provide a strong protected cash-flow, and the risk history has been favourable. If the investment bank packages the securities bonds for sale, including the deeply subordinated risk tranches, it can, in effect, lock in a guaranteed return with little or no capital exposure.’ For such reasons Morgan Stanley purchased Advantage Home Loans, Merrill Lynch bought Mortgages plc and Lehman Brothers acquired Southern Pacific Mortgages and Preferred Mortgages. European banks’ like ABN–Amro have developed an interest in micro-credit in Africa, which links them to the world of sub-prime lenders: financial techniques allow them to reap exceptional rates of return from repackaging the debts of the very poor. While Western governments boast of forgiving African debt, Western banks get their hooks into loans to the poor.

Helped by the practices of financialization, the banks achieved remarkably good profits right through the post-bubble trough and well into the subsequent recovery. However, indebted consumers were not so good for non-financial corporations in the post-bubble era as demand was dampened. By 2003, 18 per cent of the disposable income of US consumers was required to service debt, and only a housing price boom and re-mortgaging maintained consumer purchasing power. (The US banks’ heavy stake in sub-prime lending, with its associated risks, was a material factor in delaying the Basle II international banking agreement on appropriate reserve levels.)

**Hedge fund boom**

The unbridled spirit of financialization is most famously embodied in the hedge funds, which are nimble enough to outwit the large institutional

---

investors. The last few years have witnessed a mushrooming of thousands of hedge funds—by mid 2006 the total was thought to be around 8,000, controlling nearly $1.5 trillion of assets (this compared with $7 trillion in US mutual funds of all types). The hedge funds started out as the preserve of the really wealthy investor, although eventually several pension funds gave them a small slither of their holdings. In the bear market of 2000–02 the hedge funds often made positive returns when most conventional funds, especially index funds, made heavy losses. The hedge funds practised ‘shorting’—borrowing a stock in the anticipation that its price would fall and then selling it. Institutional investors, who loaned stock that loomed large in their portfolios, were often on the wrong end of these trades. The conventional funds, whether actively managed or index-linked, were ‘long only’, which is to say that they bought and sold stocks but did not short them. The hedge funds also offer and employ ‘derivatives’, investment products like options that allow the purchaser to place a bet on the movement of sections of the market. Spotting price discrepancies, hedge funds made money by arbitrage, rapid trading and the use of credit derivatives, which would repackage corporate debt. Investment banks and the treasury departments of large corporations also engage in large-scale hedging of currency and interest rates, but hedge funds have the greatest latitude.¹³

Banks and mutual funds are lightly regulated, but the hedge funds do not have to reveal their holdings at all, and effectively escape all regulation.¹⁴ They charge fees that are often 2 per cent of the money invested plus 20 per cent of the annual rise in capital value. Their charging structure usually allows them to make a lot of money when they do well but not to forfeit these gains if the returns then collapse. The hedge funds do have higher costs than other fund managers because of heavy trading, but claim that this will enable them to outperform the market and to generate positive returns during a downturn. Many have performed very well for particular clients, encouraging pension-fund managers to take a lively interest in them—an interest generally encouraged by regulators and consultants on both sides of the Atlantic.

¹⁴ In 2005 the CBI, the main UK business federation, complained that hedge funds, exempt from the disclosure requirements of banks, were unscrupulous predators, stalking their prey in secret and striking without warning.
While hedge funds may deliver the consistent, double-digit returns that justify their fees for special clients, can they pull off the same trick for the entire class of pension funds, given that the latter constitute such a large component of the market? A shorting operation can deliver excellent results to its practitioner, but it does not directly benefit all investors, unlike a rising market. The pension funds that invest in hedge funds usually do so by purchasing a ‘fund of funds’ vehicle, yet in doing so lose the edge which the best hedge-fund managers will be able to offer. A diversified stake in the sector may offer a little more security but also lowers the return, since it will include poor performers and perhaps even those that go bust. Between 1998 and 2003, 1,800 hedge funds closed their doors—yet most statistics on the performance of the sector will display ‘survivor bias’, by failing to include their losses.

Because of their modus operandi the hedge funds were to have a starring role in the mutual funds scandals, some of which I describe below. During the 1990s, the large finance houses that sponsor mutual funds—Bank of America, Putnam, Morgan Stanley and others—discovered that they could earn extra fees from hyperactive traders, on top of the good fees they were already earning from the mass of their investors. They granted hedge funds privileges not extended to other investors, including providing credit to enable them to take advantage of their clients’ funds: this way the finance house can charge interest as well as earning a transaction fee. Furthermore, trades do not have to be in already existing shares. If new issues are imminent, then hedge funds and other punters can purchase call and put options on the not-yet-existing shares in what is termed, appropriately enough, the ‘grey market’. Shorting shares in the grey market can lead to extraordinary complications and the embarrassment of ‘naked shorts’, where the short-seller is discovered to have no stock, whether borrowed or not. Another problematic issue is where

15 Shorting is not all bad. It can boost liquidity, or help to uncover inflated assets (as did the Ursus Fund in the case of Enron), but better regulated and more modest hedge funds could do this—or other institutions could fulfil these functions.
16 John Bogle, *The Battle for the Soul of Capitalism*, New Haven, CT 2005, pp. 120–1. Bogle is the founder and former CEO of Vanguard, the third largest money manager in the United States.
17 In the UK short-selling of ‘grey market’ shares in Room Service in November 2003 led to a situation where there were more trades than shares to fulfil them. The short-sellers were exposed as ‘naked’ because a promised rights issue stalled. When the authorities suspended trading, and cancelled some prior trades, this damaged many who had unknowingly been involved in the shorting operation. Elizabeth Rigby, ‘Room for Change on Short-Selling’, *Financial Times*, 29 November 2003.
hedge funds use the voting power of borrowed stock to endorse takeover bids, especially where shareholders in the target stand to lose, but the hedge fund will gain because of other positions it has taken on the outcome of the bid.

**Arbitrage**

In the financialized world heart surgery is performed on capitalist property itself. A hedge fund that holds company stock in order to sell it short is looking to deflate shareholder value, not increase it. And a standard risk-arbitrage arrangement can be much more complicated than this. Daniel Buenza and David Stark write that:

Arbitrage hinges on the possibility of interpreting securities in multiple ways . . . In contrast to value investors who distil the bundled attributes of a company to a single number, arbitrageurs reject exposure to a whole company. But in contrast to corporate raiders, who buy companies for the purpose of breaking them up to sell as separate properties, the work of the arbitrage trader is yet more radically deconstructionist . . . For example they do not see Boeing Co. as a monolithic asset or property but as having several properties (traits, qualities) such as being a technology stock, a consumer-travel stock, an American stock, a stock that is included in a given index, and so on. Ever more abstractionist, they attempt to isolate such qualities as the volatility of a security, or its liquidity, its convertibility, its indexability and so on. Thus whereas corporate raiders break up parts of a company, modern arbitrageurs carve up abstract qualities of a security . . . Their strategy is to use the tools of financial engineering to shape a trade such that exposure is limited to those equivalency principles in which the trader has confidence. Derivatives, such as swaps, options and other financial instruments play an important role . . . Traders use them to slice and dice their exposure.18

It might be supposed that this virtual dissection of the corporation is a kinder and gentler process than that meted out by the corporate raiders of the 1980s, but this would be an error. In order to cash out their bets the arbitrageurs need ‘events’. A placid market with nothing happening and no volatility is bad for the hedge funds and for those on the ‘risk arb’ desks. But normally the traders need not worry since, as Hyman Minsky put it in a classic article, firstly ‘the internal workings

---

of a capitalist economy generate financial relations that are conducive to instability', and secondly, ‘the price and asset-value relations that will trigger a crisis in fragile financial structures are normally functioning events.’

One of the reasons for this is precisely that the prospects of a given stock cannot be distilled in a single figure since the balance sheet of an enterprise will always comprise a complex of receipts and liabilities in which the past, present and future uneasily coexist. These days a common ‘event’ for a large company will be the re-valuation of its pension fund liabilities, which in turn will reflect what is happening to the shares of other companies, new legislation or the introduction of a new accounting standard. The de-regulation of financial markets has also increased their proneness to ‘events’.

The techniques of the financial revolution—derivatives, swaps, hedging, spes, cdoś, etc—can be used simply to insure a corporation against hazard. But several of these devices lend themselves to manipulating a firm’s basic numbers. The cult of shareholder value and financial engineering could seem to conjure an immediate gain out of any merger or acquisition. Companies that perfected the art of growth by acquisition—GE, Vodafone, aol, WorldCom and so forth—became the darlings of Wall Street. Sometimes this corresponded to real growth and a more logical business. But it could also betoken ‘aggressive accounting’ and herald future share-price tumbles. The willingness of the old-fashioned type of investor to accept the consequences of ownership vanishes in the hedge-fund world. As a recent survey notes:

The hedge funds’ case has not been helped by behaviour such as that of Perry Capital, which in 2004 bought shares in Mylan Laboratories only in order to vote in favour of its acquisition of King Pharmaceuticals, in which Perry was a big shareholder. Perry hedged its exposure to movements in Mylan’s share price and was thus able to exercise its voting rights without having any apparent exposure to the consequences.

---


Hedge-fund managers use derivatives to unpack bundles of property rights or claims on flows of income, and to reassemble them in a supposedly more advantageous configuration. They may be guided by a hunch as to what will be the next big thing, but do not aim to take responsibility for running a business. On the face of it, ‘private equity’ concerns are quite different. They specialize in taking over under-capitalized and underperforming businesses, with the aim of reorganizing management and relaunching the business. This may take three or five years, during which distractions and loss-makers are spun off and the core business overhauled. Investors—including pension funds—are invited to back these operations. The private equity fund is really a sort of collective entrepreneur, and those with appropriate skills and judgement will deliver a good return to the patient and large-scale investor. Like hedge funds their charges are higher than those of ordinary fund managers, and normally comprise both a standard annual fee of 2 per cent of fund value together with a portion of the eventual pay-off, or ‘carried interest’, once the reorganization and refloat is complete. The investor thus contributes not to the private equity organization as such but to a specific fund that it will launch. It will raise a given sum—from as little as £10 million to several billions—which will be used to make acquisitions in a given sector. The private equity concern will have real costs, such as legal ‘due diligence’, insurance and staff; but as the size of funds grows the annual management fee will tend to become more interesting than the entrepreneurial profit, which itself will be spread over several years. Private equity ‘club deals’ enable different concerns to pool costs but increase their funds under management.

The combined effect of such trends is to bring private equity closer to a generalized fund management logic, where the real goal is to boost the size of the funds under management because this will boost the fees. In the process the spur to entrepreneurial gains will be blunted, and opportunities for speculation may be hard to resist. Those engaged in

23 When the Texas Pacific Group announced a $15 billion fund in April 2006 this was a record, but the scale of private equity had grown over the previous decade, albeit with a dip in 2001.
a range of take-over and buy-out possibilities will tend to have advance knowledge of market events, with those whose bid fails being most likely to talk, or seek compensation, by acting on the information in their possession. In March 2006 London’s Financial Services Authority published a study of the previous six years’ trading patterns on the FTSE 350 which found that ‘the level of insider trading is very high with over 30 per cent of significant announcements being preceded by informed price movements’.25

Pension funds

The immense sums raised by pension funds of all types have hugely increased the importance of institutional investment. In the 1940s and early 1950s nearly all pension money was invested in government bonds, on the grounds that their future value was guaranteed and that this was therefore the safe and prudent thing to do. But from the 1960s, pension-fund trustees were invited to consider adding private securities to the portfolio, and by the 1970s, the implications of a rising inflation rate were being factored into the argument: government bonds had proved to be a poor hedge against inflation; a fund with tangible assets, such as shares or property, would be able to keep abreast of rising prices. After about 1982, the cult of equity carried almost all before it, and even quite cautious fund managers would happily contemplate corporate securities comprising 80 per cent of fund assets. Finally, in the epoch of the new financialization, attention has focused not just on the right mix of assets but on financial products and treatments—swaptions and the like—which give one type of asset some of the characteristics of another. By the early 21st century, a fund manager or board of trustees worried about inflation or interest-rate risk can purchase a product that will hedge it. It has also become common for fund managers to earn a little more on their holdings by lending stock to hedge funds for short-selling operations, though the tiny sum made by repeated loans rarely amounts to as much as a return of one basis point (0.01 per cent) on the value of the stock.

It will readily be grasped that such procedures have the effect of complicating and weakening ownership rights. The trustees who permit

or encourage the use of financialized techniques are more concerned at saving the sponsor money than they are with fortifying the pension promise. And even if they give primacy to their fiduciary duty, they often do not properly understand complex credit derivatives and the risks they pose if there is a sharp change in the business climate.\textsuperscript{26}

However sophisticated fund management becomes, it remains the case that the nominal owners or beneficiaries of the assets in a pension fund have no say in how their savings are managed. There is thus a double accountability deficit, with fund managers not answerable to plan beneficiaries, and corporate management only sporadically answerable to shareholders. Indeed the now widely admitted crisis of corporate governance—several symptoms of which are to be considered below—has its roots in the failures of pension funds, and other institutional investors, properly to represent the interests and views of the ultimate owners, namely the plan participants. The evidence suggests that capitalism works better if its stewards are answerable to someone other than themselves.

From the 1980s, pension funds and other institutional money were made available to corporate raiders like James Goldsmith, and financial engineers like Michael Milken, who successfully sought to boost the importance of share value in corporate affairs. The financial professionals and takeover specialists organized a wave of mergers and acquisitions that boosted the share price of the target companies, but often brought little lasting benefit to the shareholders in the predator company. Looked at from the employee’s standpoint, the pain was felt by those who lost their jobs in the post-merger reorganization. Teresa Ghilarducci charged that pension funds aided and abetted the downsizing of the late eighties and early nineties: ‘the stewards of labour’s capital used pension funds in speculative investment activity, which closed plants and strangled communities’.\textsuperscript{27} Fund managers can gang up to remove CEOs who do not succeed in sustaining shareholder value. In the 1990s CEOs at a string of underperforming giants were removed thanks, in part, to shareholder pressure; amongst others, such exits were seen at GM, IBM, Westinghouse, American Express, Xerox and Coca-Cola.\textsuperscript{28} In other cases


\textsuperscript{27} Teresa Ghilarducci, \textit{Labor’s Capital}, Cambridge, MA 1992, p. 130.

institutional shareholders pressed for corporate reorganizations that broke up historic companies like AT&T and ITT. Concern for shareholder value was the driving force in these dramatic developments.\footnote{Michael Useem, *Investor Capitalism*, New York 1996, pp. 1–3, 108–9, 126–7. See also Bogle, *Battle for the Soul of Capitalism*, pp. 3–46.}

The fund managers are naturally attentive to the interests and viewpoint of the sponsoring board, which has nominated the trustees who will renew or drop their mandate to manage the fund. The fund managers are often themselves divisions of large financial concerns like Citigroup, State Street, Merrill Lynch and Morgan Stanley, which hope to make large fees from supplying other services to the corporations. This gives them a further reason to ingratiate themselves with the sponsoring CEOs and boards of directors. When the money managers come to vote the shares they hold in trust at AGMs they will usually defer to the board, often disregarding poor governance. Sometimes the trustees themselves will mandate such a policy. Simple shareholder passivity is usually enough to allow the board a free hand. Over the 1990s the investment banks, in their eagerness for extra business, became the handmaidens of executive aggrandizement. Business leaders, increasingly free from public regulation, found their most cherished schemes for expansion and enrichment cheered on by finance houses that made huge fees from mergers and acquisitions, IPOs and rights issues. This situation damaged the interests of policyholders and bred many of the business scandals and disasters of the last few years.\footnote{This is the conclusion of Abraham Gitlow, *Corruption in Corporate America: Who is Responsible? Who Will Protect the Public Interest?*, Lanham, MD 2005. The author is a former Dean of the Stern Business School at New York University.} While Wall Street allowed CEOs to garner exorbitant remuneration, they were also happy to escape responsibility themselves.

The services provided by the fund managers do not come cheap. Charges usually amount to at least 1.5 per cent of the fund each year, and if account is taken of hidden extras, such as soft dollars—business services furnished for free as a kickback by those who receive the trading business—the figure is often higher. Public-sector pension schemes often run on a fee as low as 0.3 per cent of the fund each year. The charges of the private fund managers often reduce the yield on a personal pension pot by as much as 40 per cent over a forty-year period. While profits are high, the other explanation for excessive charges is huge marketing costs. This
extravagance is rational because beneficiaries tend to stay with their first manager and will pay a large stream of contributions for decades.\textsuperscript{31}

**Bezzling**

It might be thought that during the share bubble, the fund managers would have seen the warning signals and tried to curb executive aggrandizement, or at least to dampen the speculative fever of the late 1990s. But they did not. They were playing with other people’s money and the incentives they were offered encouraged irresponsibility. Managers usually receive a bonus related to the performance of the funds they manage over the previous year. In a prescient 1993 article entitled ‘Churning Bubbles’, two financial economists, Franklin Allen and Gary Gorton, warned of the design flaw in fund-manager incentive schemes, encouraging them to join a speculative bandwagon even if they knew that it would eventually run into a ditch. As they explained:

> The call option form of portfolio managers’ compensation schemes [exposing them to upside gains but not downside losses] means they can be willing to purchase a stock if there is some prospect of a capital gain even though they know with certainty that its price will fall below its current level at some point in the future.\textsuperscript{32}

And beyond such calculations there was the fear of losing mandates, and even their jobs, if they carried out a rigorous assessment of company worth. In the late 1990s the analysts retained by the big banks joined the throng, with 97 per cent ‘buy’ or ‘hold’ recommendations on the stocks they tracked.

Another trial lying in store was that of dubious business practices that might help a company over a bad patch, but which could prove lethal if the bubble burst—as it inevitably would. J. K. Galbraith pointed out in *The Great Crash, 1929* that there is always a bit of ‘bezzle’ around even when things are going well.\textsuperscript{33} When the bad times arrive it can no longer be concealed, and the embezzlement is exposed to view. We were told that Enron and kindred organizations were companies of the future, with complex derivative products that could hedge everything from the price

\textsuperscript{31} I document high charges in *Age Shock and Grey Capital*, chapter 3.


of oil to next year’s weather. Yet scrutiny of the malpractices at Enron and other collapsing giants reveals that most of these deceptions were variations of ancient ruses, dressed in the language of up-to-the-minute financial engineering. The bankers and professional advisers should have been highly suspicious of revenue boosted by hollow swaps and sham transactions, of the booking of current costs as capital assets, or the hiding of liabilities in Special Purpose Entities (SPES). When Citibank and Morgan Stanley helped the energy company to devise SPES, they would have gained enough knowledge to smell a rat. Merrill Lynch, in a sham transaction designed to boost Enron’s profits, became the temporary owner of three energy barges off the coast of Nigeria. The bank had a commitment from Enron that it would buy back the barges as soon as the new reporting period had arrived. Citibank and Morgan Stanley lent large sums to Enron, but they then constructed ‘credit derivatives’, chopping up the loan into many pieces, with each carrying a different level of default risk. These were then sold, in a game of pass the parcel, to pension funds and other institutional investors. When Enron went bust many fund managers had to pick up the bill on behalf of their clients.

The banks subsequently agreed with the SEC and the attorney general of New York that they would pay $1.4 billion in fines and compensation, though insisting that they do not admit that they were in any way at fault. In several cases the banks, so far from being duped by their corporate customers, had themselves devised and sold obfuscatory or even fraudulent devices to the delinquents. Many fund managers fell over themselves to acquire what were touted as glamorous new financial products. Despite the ‘deal’ between regulators and banks, and the latter’s protestations of future good behaviour, the accountability and regulatory deficits that allowed the scams to happen have not been remedied.

The Sarbanes–Oxley Act (2002) focused on corporate governance, not the role of the banks. While leading executives at WorldCom, Enron and dozens of other failed corporations were prosecuted and sentenced to between eight and twenty years in jail, the banks’ role in helping to construct opaque or fraudulent financial instruments was deemed less culpable. Whilst banks never admitted any guilt, the fund managers, institutions and individuals who had lost tens of billions of dollars

---

pursued, and sometimes won, private suits alleging malpractice, neglect and absence of due diligence on the part of their financial advisers and brokers. Although the banks’ 2003 settlement with the regulators was just $1.4 billion, they paid out much larger sums in settlement of the private suits; by the end of 2005 they had paid $6.9 billion to settle Enron-related suits and $6 billion to settle WorldCom-related ones.

In each case the total losses stemming from the collapse were about ten times as great as the indemnity paid out. However inadequate, Wall Street seemed to accept that it owed some compensation. But their insurers discovered that even this expiation was not what it appeared. As a Wall Street Journal report explained:

The banks . . . are battling to recover a portion of the more than $13 billion they paid in fines for settlement and regulatory actions related to the frauds. They say insurance policies they bought during the 1990s should cover payments the banks made to settle class-action suits over their roles in advising Enron and WorldCom. The Swiss Reinsurance Co. and some other large insurance companies are balking.

One of the banks concerned, Bank of America, had taken out insurance to provide coverage up to $100 million for claims ‘arising out of any wrongful action committed by the insured’. Insurance of this sort exacerbates representational problems by insulating the agent from the most likely sanction for malpractice, a fine.

The business scandals were partly explained by pressure to produce results, at a time of underlying deterioration in the profitability in the provision of non-financial goods and services in the major Western economies. The wave of deregulation in the 1990s contributed further, with scandals proliferating in sectors where controls had been most thoroughly abandoned—finance, energy and communications. The Litigation Reform Act of 1995 shielded from legal challenge the claims and promises made by ceos and company promoters. Repeal of the Glass–Steagall Act in 1999 meant that investment banks were no longer constrained from going into the brokerage or retail business,

---

57 A point stressed in Nomi Prins, Other People’s Money, New York 2004.
even though this would mean that their brokers would be trading, and their analysts assessing, stock their bank had itself underwritten. But the scope and nature of the scandals also pointed to underlying ‘agency problems’, namely the betrayal of policyholders by their own representatives: the hallmark of what I have called ‘grey capitalism’. Financial concerns were helping CEOs out of a tight spot at the expense of millions of small savers. While the CEOs were anxious to conceal poor results the banks were expecting and demanding double-digit annual returns. The fund managers were flattered to have their business solicited by swanky ‘bulge bracket’ investment banks, even though they struggled to understand the nature of the credit derivatives and ‘collateralized debt obligations’ that they purchased. Agents who were not responsible to plan members and pension policyholders were handling much of the money lost by this kind of speculation.

Two US anthropologists, William O’Barr and John Conley, in a pioneering study, have evoked the typical outlook of a corporate executive looking after a pension fund. They report the following exchange:

_Do you have any contact with the beneficiaries of the fund? None whatsoever._

_It never happened? None whatsoever. What kind of reporting is done to the beneficiaries every year? The legal requirement under ERISA. What does it look like on paper? I’m trying to remember._

In contrast to this distant relationship, the pensions executive will be in close and daily contact with the Chief Financial Officer of the sponsoring company—indeed, in some cases, he will be the CFO.

_Vulture capitalists_

There is such latitude for make-believe in corporate pension funding that it is easy to come away with the idea that fund liabilities are infinitely fungible. But that is not the case. This is partly because employees do eventually retire and must be paid their pension. It is also because of the increasing nervousness of accountants, regulators and shareholders. Many older companies now have more retirees than they do current workers; if there is not enough in the fund then pensions become a

---

charge on cash flow.\textsuperscript{39} The conjuncture of 2001–03 echoed that of the early 1990s, when an orgy of downsizing—especially at defined-benefit sponsoring companies like the US steel corporations—put hundreds of thousands on the scrap heap with a reduced pension. Problems with defined-benefit pension commitments have been a significant factor in the debility of US and British manufacturing, since enterprises in this sector typically had mature DB schemes and often found themselves starved of funds just when investment should have been boosted. In late 2004 GM floated a bond specifically designed to help pay pensions—it has around a million pensioners. The damage to the overall creditworthiness of the auto giant led its bonds to be downgraded to junk status within months.

In 1974, the US Employee Retirement Income Security Act had established an insurance scheme, the Pension Benefit Guaranty Corporation, to which all corporations running DB schemes had to belong.\textsuperscript{40} American companies that enter Chapter 11 bankruptcy protection ask the court to pass over their pension liabilities to the PBGC, which becomes responsible for the future payment of benefits, albeit at a reduced rate—beneficiaries generally get about 75 per cent of their pension and none of their retiree healthcare benefit. The courts are likely to agree, if this is the only way to save the company as a going concern. Firms with large pension obligations have used the threat of receivership to obtain union agreement to benefit cuts, encouraging workers to agree to ‘give backs’ in order to save their jobs.

‘Pension-deficit disorder’ has produced a new breed of financier, the ‘vulture capitalist’, who specializes in extracting value from firms burdened by large pension and medical liabilities, largely by stripping employees of their entitlements. (In terms of Pollin and Arrighi’s classification, this would count as a clear case of forcing a redistribution in capital’s favour.) Filing for bankruptcy protection used to be a rigorous process, allowing the company an interval to get its affairs in order; it was meant to protect

\textsuperscript{39} At many leading companies, such as Boeing, Ford, General Motors or Colgate/Palmolive in the US—or BT, GKN or Unilever in the UK—the company pension fund has grown to be worth several times the equity valuation of the company itself. Financial analysts began to describe GM as a hedge fund on wheels, and United Airlines as a pension fund with wings (of lead, as it turned out).

\textsuperscript{40} In the UK a comparable scheme, the Pension Protection Fund, was established in 2004.
employees, among others, from a precipitate and perhaps unnecessary liquidation. But the specialists in ‘distressed assets’ use the pause for their own, very different, ends.

Robert ‘Steve’ Miller has appeared on the scene of a string of corporate wrecks. At Chrysler in the 1980s, Miller used threats from the company’s creditors and bankers to extract concessions from the unions and the PBGC. As CEO of Bethlehem Steel in 2001 he closed down the company’s pension plan, leaving $3.7 billion of unfunded liabilities to be inherited by the PBGC. Another financier, Wilbur Ross, stepped in to buy Bethlehem and four other dying steel companies, putting them into bankruptcy in order to wind up their pension plans, and then selling the newly viable concerns for a profit of $4.5 billion. The employees, by contrast, were left with shrunken benefits. Miller went on to become chief executive of Federal Mogul, a car-parts maker with factories in the UK as well as the US. In July 2004, the UK subsidiary of this company went into receivership and successfully shed pension obligations for over 20,000 employees, with losses for a further 20,000 in an associated company. The British government protested (and felt obliged to bring forward their own scheme for a Pension Protection Fund). However another ‘vulture’, Carl Icahn, bought up Federal Mogul paper at 20 cents on the dollar, in a bet that bankruptcy plus liability-shedding would succeed.

Stripping the barnacles

By the late summer of 2005 Steve Miller was CEO at Delphi, another company sinking under the weight of the pension and medical-insurance promises it had made to its employees. Delphi, previously a division of GM but spun off by it in 1999, was the world’s largest auto-part maker with 50,000 employees in the US and 180,000 worldwide. Miller’s sign-on fee was $3 million and an annual salary of $1 million (after an outcry he renounced the annual pay and kept the sign-on fee, but the value of any options package was not revealed). Miller also paid off twenty executives with comfortable retirement packages, while urging the great mass of employees to accept huge cuts—of 50 per cent or more—in their wages and healthcare and pension entitlements, saying that only this

---

would save their jobs and help Delphi to avoid bankruptcy. He spoke of workers earning $65 an hour, though average wages were in fact $27 an hour, and proposed that instead they should be around $10–12 an hour. On 8 October 2005, after Miller’s savage reductions were turned down by the UAW—as he must have known they would be—the company filed for bankruptcy protection under Chapter 11. Miller continued to urge huge cuts in benefits and the UAW continued to resist them.

Because Delphi had been spun off from GM, the auto-maker still had residual responsibility—estimated to be at least $4 billion, perhaps much more—to honour commitments to its former employees. This allowed Miller to seek credit from GM in order to keep Delphi afloat—and at least nominally be responsible for the pension and healthcare plans. Wilbur Ross once again expressed interest in the ‘distressed asset’, and was already positioning himself to acquire it by buying up other auto-parts companies. As Miller himself remarked: ‘Wilbur likes to invest in industries that are out of favour, and auto-parts are certainly in that category . . . But he wants assets that have gone through bankruptcy, had the barnacles stripped off and liabilities resolved.’ The barnacles, of course, represent past promises of a secure future for employees. Writing about parallel UK developments, Martin Wolf offers the following devastating verdict:

The implosion of private-sector defined-benefit pension schemes accelerates . . . Predictably, as the schemes disappear, the supply of self-serving, self-exculpation from managements and those who speak for them soars . . . What we are watching is the unwinding of what was—in effect, if not in intention—a confidence trick known as ‘bait and switch’: offering something attractive and then switch it for something else when the customer comes to collect. Pension provision provides attractive opportunities for such a game. The aim was to hold on to valuable staff, encourage them to acquire company-specific skills and pay them less than their market wage. A clever way to do this is to promise pay far in the future. That, after all, is all pensions are—deferred pay. Companies have played the bait and switch game: now comes the switch.

44 The hearing of the Delphi management’s case began on 9 May 2006 and should last about thirty days. During this period the union and management might reach a deal, but the UAW has requested authorization to call a strike. If there was a strike at Delphi it could easily spread to GM, since the latter’s fate is still intimately tied to its former parts division. See Barnard Simon, ‘Extent of Crisis Could Hinge on Court Decision’, Financial Times, 8 May 2006.
The manoeuvres at Delphi are part of the softening-up process for what will happen elsewhere, including the auto companies themselves, led by GM with its million-strong army of retirees. Ten days after Delphi went into Chapter 11, the UAW accepted cuts in health benefits at GM worth $15 billion.47

The owners of the large airline companies have also played the Chapter 11 card, notwithstanding the fact that they are rather implausible victims of globalization—they can buy fuel virtually tax-free and on their major routes they do not face competitors paying Third World wages. Auto will be next, with telecom companies not far behind. Financiers have not been the only ones to benefit, however. In October 2005 Northwest Airlines, having availed itself of bankruptcy protection and asked the court to allow it to repudiate its pension obligations, hired the services of eight law firms and two bankruptcy consultancies in order to outgun its employees. Delta took the same path, hiring seven law firms and four financial advisory firms. The Wall Street Journal commented:

Bankruptcy has long been lucrative for lawyers, but the airline industry is providing an unusual bonanza. This week’s fourth annual forum on airline re-structuring in New York, sponsored by the American Conference Institute think tank, serves as a summit about how lawyers can make money out of the turmoil—or, as they put it, ‘partnering with your clients to capitalize on opportunities in the distressed airline industry’.48

Stud farms and coronets

The specialists in distressed assets like to operate through closed, private-investment vehicles that do not have to obey the standards of

47 GM and Ford remain hugely important companies. Both have valuable plants, equipment, patents, research, brands and marketing networks. GM is heading for Chapter 11 for reasons that have everything to do with benefit shedding. It is worth underlining that the pension benefits that GM workers were due to receive, after at least thirty years of gruelling assembly-line work, averaged only $18,000 a year, or half of average earnings; if GM succeeds in offloading its obligation this would decline to about $13,000, and would be weakly, if at all, indexed. Analysts of quite different persuasions have agreed that the real problem at GM has been a board of directors that failed to invest in R&D, and bet the bank on unending demand for gas-guzzling suvs, while neglecting electric cars, hybrids and fuel economy. See, for example, Greg Easterbrook, ‘The GM Lesson’, New York Times, 12 June 2005 and John Schnapp, ‘GM Needs an Extreme Makeover’, Wall Street Journal, 24 October 2005.

disclosure and reporting of the normal public company. But the closed company can also be a source of vulnerability for its owner, exposing him or her to the liabilities of entities in which they have a controlling stake. In 1992, the financier Carl Icahn had a controlling stake in Trans World Airlines when it filed for bankruptcy protection. The PBGC, aware that it was about to be stuck with the airline’s pension obligations, took out a claim against Icahn’s assets, including his favourite racehorse and ocean-front residence. Icahn eventually agreed to pay $30 million a year for eight years to help cover TWA’s pension deficit.

This episode was recalled in February 2006, when the PBGC sought to attach the assets of another financier specializing in distressed assets. Ira Rennert’s holding company Renco is the owner of WCI Steel, which had issued bonds worth $300 million, redeemable in 2004. WCI’s 2,000 employees and retirees were alarmed to learn that the company was in bad shape and that, in case of bankruptcy, the pension fund would have a deficit of $189 million. The PBGC responded by taking a lien on Rennert’s other assets: in 1992, he had purchased AM General—the manufacturer of the Humvee and the Hummer—for $133 million, selling a 70 per cent stake for $930 million in 2004. With the fruits of such investments Rennert had built a palatial estate, ‘Fair Field’, situated in the Hamptons. This beachfront estate comprises five buildings, with 29 bedrooms and 39 bathrooms. According to a report: ‘its inlaid floors, its frescoes and other splendours have an asset value of $185 million, uncannily close to the $189 million shortfall that the WCI actuary found’. The PBGC claimed that Fair Field could be attached because Renco was its beneficial owner, owning over 80 per cent of Blue Turtles, the entity that directly owned the estate.49

In the past investors in distressed assets bought bonds, but there is now lively interest from hedge funds like Xerion, Appaloosa Management LP and Mellon HBV US in purchasing shares and helping to establish stockholder committees in such concerns as the Mirant Corporation, US Gypsum and Impath Inc. As the Wall Street Journal explains:

> there are likely to be plenty more companies slipping into bankruptcy proceedings where the new breed of distressed investor may want to target equity. These include large ‘old economy’ companies with large liabilities

---

such as underfunded pension plans or the costs of litigating environmental claims. Many of these companies will use bankruptcy proceedings to shed those liabilities.\textsuperscript{50}

Britain has acquired its own ‘vulture capitalists’. In March 2006 the \textit{Financial Times} carried the following report concerning a property group which had acquired a controlling stake in the Allders retail chain:

Minerva, which owned a 60 per cent stake in Allders when it went into administration in January last year, has always insisted the 3,500 pensioners in the group’s pension scheme were not its responsibility. But the circumstances surrounding the collapse of Allders, with a pension deficit of £68m, are still being examined by Kroll, the insolvency practitioners. Minerva paid £49m for Allders’ flagship Croydon store just months before the retailer’s collapse. It is expected that Allders will soon be put into liquidation, at which point the pension trustees can ask for help from the government’s Pension Protection Fund . . . Minerva has endured a turbulent 18 months, with . . . the Allders collapse and the replacement of chairman Sir David Garrard with Andrew Rosenfeld, former chief executive. It emerged last week that the two men had lent a total of £3.3m to the Labour Party. Mr Hasan [the chief executive] yesterday denied suggestions that Minerva may have won planning permission for its unbuilt Minerva Tower in the City as part of this loan.\textsuperscript{51}

In a peculiarly British twist to the vulture-capitalist scenario, Downing Street had also nominated Garrard for a peerage. While in the us the party donors get to influence legislation, in the uk they can actually become legislators as well—although in this case, untoward exposé of the secret loans in the March 2006 ‘cash for ermine’ debacle was to upset the calculation.

\textit{Scams and scandals}

Between 2001 and 2005, corporate scandals were eclipsed by the revelation that core financial institutions—the major investment banks, mutual funds and insurance houses—had colluded with corporate crime and were themselves awash with insider-dealing, kickbacks and techniques for skimming their own customers. The exposure of these


abuses, after the bursting of the share-price bubble, led to settlements in which the financial sector paid out billions of dollars in fines to regulators and reimbursed some clients. In 1921 the Martin Act, adopted after hundreds of thousands had lost their savings in Charles Ponzi’s famous pyramid scheme, gave the Attorney General of New York State the right not only to bring criminal prosecutions against suspect financial bodies but also to search their premises without warning and impound their documents.\textsuperscript{52} As we have seen, the 2002 Sarbanes–Oxley Act largely ignored the financial sector, but the current New York State attorney general, Eliot Spitzer, has put his powers to good use, seizing and publishing the internal records and emails of leading Wall Street concerns to reveal a string of abuses in the brokerage practices, investment advice and fund-management services offered to investors by the finance houses. Some of these abuses indicate Arrighi and Pollin’s first category of financial profits: groups of capitalists benefiting at the expense of other capitalists, in addition to the second category, where capitalists benefit as a whole.

The documents unearthed by Spitzer showed how analysts had boosted the shares of companies with which their bank did business. In a practice known as ‘spinning’, banks underwriting an IPO would allot a tranche at the offer price—usually set very low—to senior executives in companies whose business they wished to attract.\textsuperscript{53} The $7 trillion mutual-fund industry was similarly riddled with malpractice. Nominally owned by the investors, mutual funds are in reality controlled by the sponsoring financial corporation: the finance house sets up the fund and selects its directors. Many funds had allowed favoured clients the privilege of ‘late trading’ at the expense of ‘stale prices’, whereby these customers, mainly hedge funds, would be allowed to trade mutual funds after the market had closed, at the closing price, thus being able to take advantage of breaking news on other stock exchanges. Another widespread practice was for mutual funds to allow ‘market timers’ to buy just after the close, with the aim of selling the next day. Spitzer was assisted in his prosecutions by the work of academic researchers who had been puzzled by the extent of poor returns in the mutual-fund industry. Eric Zitzewitz

\textsuperscript{52} Charles Mills, Fraudulent Practices in Respect to Securities and Commodities, with special reference to the Martin Act, Albany, NY 1925.

\textsuperscript{53} During the bubble being allotted shares at the offer price was hugely lucrative: 309 IPOs generated $50bn in first-day trading profits. Joseph Stiglitz, The Roaring Nineties, New York 2003, p. 347, n. 9.
of Stanford subjected a huge mass of mutual-fund data to rigorous economic analysis, and concluded from the pattern of price movements and sales information that there had to be regular, large-scale trading taking place on the basis of ‘stale prices’.54

After investigating, the sec found that half of the 88 mutual-fund groups it had questioned—together responsible for 90 per cent of all mutual-fund business—allowed ‘market timing’, while one quarter of brokerage firms that sell mutual funds had allowed certain customers to make late trades. A Republican senator, Peter Fitzgerald of Illinois, described the industry as ‘the world’s largest skimming organization’. Spitzer’s conclusion, as explained to a congressional hearing, was that the root of the problem was the fake structure of the mutual funds, with their phoney boards of directors.55 However, Spitzer has little power to extract structural transformation.

The attorney general’s next target was ‘bid rigging’ in the insurance industry and, once again, he went for the really big fish, not the minnows. In October 2004 he charged that ‘on numerous occasions’ officers of Marsh and McLennan, the world’s largest insurance broker, had encouraged counterparts at American Insurance Group (AIG), the largest US commercial insurer, to submit a fake bid—pricing it so that it would appear that Marsh, in steering its clients towards a slightly cheaper bid, was vigorously forwarding their interests. It was, Spitzer argued, ‘a scheme to defraud’. His indictment focused on the pay-off Marsh and McLennan received from insurers who won their clients’ business: kickbacks paid by those who were allowed to win the fake bidding process. The enquiry also documented the practice of ‘finite insurance’, by which companies entered an agreement with an insurer to guarantee a top-up payment in case they proved unable to meet an earnings target. Not only would this make it hard for shareholders to assess company performance, it was also likely to be very expensive. Other insurance concerns under investigation included Ace and General Re, the insurance arm of

Warren Buffet’s Berkshire Hathaway.\textsuperscript{56} In 2004 the SEC indicted AIG for an ambitious campaign to market deceptive ‘loss mitigation’ products and off-balance-sheet ‘special purpose vehicles’, which could hide non-performing loans and other liabilities.\textsuperscript{57}

**A financialized future?**

Any account of the new world of finance runs the risk of neo-Luddism—of treating finance itself as necessarily a domain of delusion and chicanery. The financial techniques employed by hedge funds or the finance departments of large corporations are not all designed for some dubious purpose. The use of derivatives to hedge currency or interest rate swings usually aims simply to reduce uncertainty. It may make sense to offset other, similar, risks to achieve a balanced portfolio. But hedge funds, finance houses and accountants invariably go far beyond such tame procedures. They do not limit themselves to a plain ‘vanilla swap’—say, to replace fluctuating with fixed interest rates—but will sell clients a leaseback within a sale within a swap, in order to thoroughly befuddle regulators, tax authorities and shareholders. While financial engineering can bring great rewards to its practitioners, many of its most characteristic devices have nothing to do with improved performance, but are all about gaming the taxman or the shareholders. Likewise hedge funds often use leverage (borrowed money or assets) to increase their profits on a transaction, but in so doing also increase the exposure of their clients. Those who buy an asset stand to lose what they have paid. Those who buy a derivative can be exposed to unlimited loss. The barely contained collapse of Long Term Capital Management in 1998—patronized by central banks and staffed by brilliant minds—illustrated several of these dangers.\textsuperscript{58}


\textsuperscript{57} Michael Schroeder, ‘AIG May Pay Up to $90 million’, *Wall Street Journal*, 24 November 2004. The fine mentioned in this headline later appeared greatly to underestimate the damages for which the insurer was liable.

Financialization is defined by the use of sophisticated mathematical techniques to distribute and hedge risk, so it might be thought that these instruments are themselves a major part of the problem of ‘grey capitalism’. But this would be an error. The improvements in risk calculation are often genuine enough, but the problems arise from the ‘grey capitalist’ structure within which they are embedded. In today’s highly financialized world, a potentially systemic threat on the scale of LTCM could easily reappear, but it is more likely to be the result of poor institutional structures than of faulty calculations. After the collapse of Enron and WorldCom, the tangled mass of derivative contracts at stake unwound without much pain; the real disaster was for the pension funds and employees who had invested in the shares and financial instruments offered by these concerns. The fallout was similar after Refco, the largest US futures trader, was forced to declare bankruptcy in 2005 after revealing that an entity owned by one of its key executives had owed the company $300 million since 1998. The individual in question had, it is true, used a small hedge fund to help conceal this debt. But the financial manipulation he used was of breathtaking simplicity—the debt was simply rotated around three accounts with different reporting periods, one of the hoariest scams known to financial history. What allowed the fraud to succeed was the willingness of highly respected lawyers and accountants to prepare and endorse the rotating payments. The erring executive acquired his colleagues’ trust because of his access to funds held for an Austrian workers’ pension fund, BAWAG, which suffered a heavy loss. On the other hand, the counter-parties to Refco’s complex mass of derivative and futures contracts were able to settle them quite easily.

More generally, as Edward LiPuma and Benjamin Lee urge, the use of derivatives in contemporary financialization aims at short-term gains that short-circuit flows of production and trade, garnering an immediate profit at the expense of what might have been a long-term social surplus.\footnote{LiPuma and Lee, \textit{Financial Derivatives}, pp. 9–10, 125.} Hedging techniques permit advances in the efficiency of capital but the resulting gains are disproportionately reaped by financial intermediaries, especially those with access to huge computing power and privileged information networks. As we have seen, the financialized world has involved the dumping of pension promises and health entitlements, while the savings of many millions have been committed to credit derivatives or hedge funds which may deliver short-run returns but remain vulnerable to the business cycle in the longer term. In the
speculative process, large-scale finance has the edge over the small saver and the cash-strapped corporation. In the past the large banks were able to grow at the expense of the savings of the ‘little man’, because they had larger reserves and better information.60 Today the small savers’ holdings in pension, insurance and ‘mutual’ funds play the little man’s role. The mass of employees may own a significant slice of productive assets, but they do so in ways that render them vulnerable to hedge funds and other finance houses which are better informed and more nimble.

Because financialization is not embedded in a macro-policy or strategy it often plays a part in strangling growth. Booms lose their way if they are channelled into short-term speculation and arbitrage, rather than long-range investment. Sustained growth requires infrastructural and educational investments that may not pay off for decades. While arbitrage can help to spot and eliminate excess costs, if unregulated it will wipe out all long-range projects. Previous booms saw the construction of railroads or interstate highways, but the stock market thrills and spills of the 1980s and 1990s lacked the sort of commitment and foresight displayed by Henry Ford and other founders of industrialism, or John Maynard Keynes and other architects of the postwar boom. Indeed so feeble was the investment thrust of the 1990s boom that it did not even allow for completion of the broadband cable network. The managers of pension funds were part of the problem, since they wanted investments that yielded immediate returns and which could easily be turned into cash. This was, in part, the result of accounting methods which required that assets be ‘marked to market’ every year.

In the mid-1990s Giovanni Arrighi warned that financial expansion would have the further defect that—unlike advances in manufacturing, communications or trade—they tend to enrich only a small part of the population and do not create a broad basis for sustainable mass demand. Kevin Phillips confirmed that financialization fostered extreme inequalities, as gains were channelled to personal enrichment rather than productive investment.61 Inward foreign investment can cover the resulting imbalances and the expansion of personal debt can prevent domestic demand from faltering in the short term; in 2000–05 consumer confidence was

60 The ways in which big capital battens on small capital is a theme of Rudolf Hilferding’s classic study, Finance Capital: a Study of the Latest Phase of Capitalist Development [1910], London 1981.

shored up by a house-price boom and by the Bush tax-cuts. But balloon-
ing public and private debt, and a weak recovery, are storing up problems
for the future and have created a difficult climate for manufacturers.62

Here is Rudolf Hilferding exploring the birth of finance capital nearly
one hundred years ago:

The bank can use its great capital resources and its general overview of
the market to engage in speculation on its own account with comparative
safety. Its numerous connections extending over a wide range of futures
markets, and its knowledge of the market, give it the opportunity to engage
in safe arbitrage dealings, which bring considerable profits because of the
large scale upon which they are conducted.63

The futures to which he was referring related to the commodities mar-
kets in wheat, pork bellies, oil and metals, and some of the scope of
arbitrage was limited by the growth of cartels. The phenomena I have
been discussing relate to a post-‘monopoly capitalism’ world and a new
expression of the fundamental drives of capitalism—its ‘conatus’ as
Frédéric Lordon puts it—but in a dimension that now includes not simply
commodities but personal debt, mortgages of every type, currency
contracts, corporate securities and variance swaps.64

The foregoing sketch suggests that financial profits over the last dec-
ade have mainly taken the form of the cancellation of promises made to
employees—exploitation over time—the erosion of small capital hold-
ings by large and unscrupulous money managers and the swallowing
of shoals of tiny fish by a shark-like financial services industry. Few of
the gains from the reallocation of capital through superior risk assess-
ment have been channelled to production. Financial profits have instead
prompted a surge in upscale real-estate prices and the turnover of the

62 One of the few models we have of finance-led growth predicts uncertainty, even
though this initial exercise deliberately excluded any foreign trade or capital account
dimension. See Robert Boyer, ‘Is a finance-led growth regime a viable alternative
to Fordism?’, *Economy and Society*, vol. 29, no. 1, February 2000, pp. 111–45. The
intriguing diagram on p. 119 does not appear to accommodate the boom in capital-
ists’ consumption that is part of the financialized wealth effect: instead profits
unproblematically feed into share price and productive investment.
64 For the role of the latter in upsetting the UK securities market see Gillian Tett
May 2006.
luxury goods sector. The mass of employees and consumers have sunk deeper into debt. Yawning domestic inequalities have been compounded by escalating international imbalances, with an inflow of foreign capital covering a deficit on the US current account. With a sagging dollar, an oil price shock and rising interest rates, American households—the consumers of first and last resort—are likely to find the strain of carrying the world on their shoulders ever more difficult. Financialization promotes such a skewed distribution of income that it ends by undermining its own credit-driven momentum.