TILBURG LAW REVIEW
Journal of International and European Law

Reinout Wibier, 'Expulsions: The Destructive Power of Finance' (2019) 24(3) *Tilburg Law Review* pp. 15–18.
DOI: https://doi.org/10.5334/tilr.174

COMMENTARIES

Expulsions: The Destructive Power of Finance

Reinout Wibier*

Keywords: Montesquieu Lecture; Expulsions; Financial Crisis; Destructive Power of Finance

1 Introduction

I would like to focus on one important aspect of Saskia Sassen's fascinating Montesquieu lecture: the destructive power of finance. It is a central part of Sassen's thesis that there are a number of negative aspects to the extractive logic that can be seen in many places in current society.[1] These include negative social outcomes resulting from finance transactions such as the loss of property and housing due to foreclosure, and the use of housing as speculative property instead of simply providing shelter.

Finance's destructive power has been effectively demonstrated by the 2008/2009 financial crisis. What basically began as a slowdown in the American housing market almost resulted in the complete breakdown of the entire financial system, which, incidentally, would have been nothing short of disastrous. This is by no means an exaggeration. In the Netherlands alone, two major banks, ABN AMRO and SNS, a banking and insurance group, were nationalized to prevent them from bankruptcy. A third financial giant, ING Group, was saved from insolvency by a state guarantee exceeding 10 billion euros. Only Rabobank, another major Dutch bank,[2] survived the crisis without state aid. Rabobank, however, surely would have gone bankrupt had ING or ABN AMRO been allowed to fail. Though, the 10-billion-euro guarantee provided to ING Group probably prevented an all-out bank run (where depositors would have scrambled to get their money back within a very short period of time). It is doubtful whether the Dutch state could have rescued ING Group in such a scenario, especially since it was already overburdened by its nationalization of ABN AMRO.

An ING Group insolvency would probably have resulted in a bank run becoming a systemic financial crisis. The government would be hard pressed to prevent panic in the streets and restore trust in financial institutions. In fact, the banks that continue to operate would have a hard time functioning without the ability to engage in 'maturity conversion'. As a consequence of this system and of the resulting inability of banks to fulfil the sudden demands from depositors withdrawing their funds, the banks would go insolvent. They would also no longer be able to handle the electronic payment system on which so much economic activity depends. Moreover, ATMs would be left empty within hours. Economic activity would be reduced to bartering, where possible, and chaos would most likely be the result. Hundreds of thousands would have lost their jobs and a period of economic chaos would ensue.

This total meltdown was (just) prevented, but the economic consequences of the financial crisis were dear indeed and can still be felt at the time of this writing. The unsustainably large bank debts were absorbed by government debt, bringing countries like Greece, Portugal, Spain and Italy to the brink of financial ruin. In many of these Southern European countries, the financial crisis created a 'lost generation' of young people who could not find work and may be shackled to a life of relative poverty as a result. Politically, the rise of populist movements across Europe and the United States may have been inevitable, but if there is one clear cause, it would be the financial crisis.

This begs the question: how could a decrease in the value of American real estate have such a devastating effect on the world's financial system? This is where the destructive power of finance (and in its slipstream: the law enabling the relevant transactions) comes in.

* Professor of Private Law at Tilburg Law School. R.M.Wibier@tilburguniversity.edu.

[1] For a more detailed overview of Sassen's ideas I refer to her excellent book: Saskia Sassen, *Expulsions – Brutality and Complexity in the Global Economy* (The Belknap Press of Harvard University Press Cambridge/London 2014).

[2] The other two are ING and ABN AMRO.

2 Securitization

The original intention of a financial innovation is often good. Securitization was designed to find an additional source of funding for mortgages, which could also benefit potential homeowners by potentially lowering their borrowing costs. A securitization enables investors in the capital markets to invest in relatively safe assets: the monthly payment homeowners make on the loan they used to finance their home. By pooling these securities, or claims, against homeowners and subsequently issuing a security that gives the claimholder the right to receive those payments, an attractive, almost risk-free security has been created and a new source of finance for mortgage lenders has been created in the process. For banks and homeowners a whole new market is opened up, making them less dependent on deposits for the funding of mortgage loans.

Financial innovation did not stop there, however. In their thirst for generating fees, investment bankers invented new financial products; for instance, by pooling the securities that were mentioned in the previous paragraph into a nice basket and subsequently slicing those baskets up into specific risk categories. Each category would correspond to a specific security which could then be sold to investors looking for exactly that risk profile. This was enacted through a distribution waterfall for the mortgage payments from homeowners with the AAA rated bonds[3] being the first to be paid in full and only making payments to lower rated slices if and when there were sufficient funds available to do so. In theory almost any risk-return profile can be created in this way; this would also lead to optimal risk pricing by market mechanisms.

Furthermore, it became possible to include less robust mortgage-backed loans in securitization transactions—mortgage-backed securities (MBSs). As long as there were enough of these subprime loans in a basket and as long as the AAA rated securities had enough priority compared to the lower rated securities, it became possible to issue those AAA rated securities on the basis of a pool of loans that generally consisted mostly of subprime loans. Many pension funds are only allowed to invest in 'super safe' assets to protect the interests of their clients. Investors with more appetite for risk could then purchase other tranches of the relevant security which offered a higher risk profile and consequently, a lower rating.

In theory, this and similar financial engineering, would lead to an optimal distribution of risk throughout the economy through a risk-pricing system. In practice, however, one of the most destructive results was that mortgages (and houses) could now be sold to people who would not normally qualify for a mortgage. Since so many investors were looking to invest in MBSs, the standards for qualifying for a mortgage became lower and lower. As investment banks kept looking for loans to put into their transaction structures the practice ultimately lead to things like NINJA loans, where the acronym stands for: no income, no job, (no) assets. *Ninja* loans indeed.

Of course, reality caught up with these practices. Once borrowers under subprime loans started to default on their monthly payments, this spreading of risk had almost the opposite effect of exposing many financial institutions to this financial risk nearly bringing down the entire financial system.

The reasons for subprime phenomenon are multiple but can be summarized as a lack of transparency. Because various banks had invested in MBSs or were otherwise exposed to subprime mortgages (e.g. through credit default swaps, which were effectively insurance policies against defaulting creditors) and because it was unclear who had invested in what, once MBSs started to take losses, it was also unclear who would ultimately bear the relevant losses. Moreover, it also became unclear to what extent the AAA ratings that were issued by the rating agencies were accurate. This led to a lack of confidence among banks in each other's balance sheets and the breakdown of inter-bank lending and borrowing, resulting in immediate liquidity problems for a number of banks. Due to various cross-exposures between banks, this had a huge knock-on effect within the entire banking system. Basically, one could no longer be sure of the another's financial health. Risk had not been spread in an optimal way. MBSs and related financial innovations had turned the entire system into a house of cards.

3 The Law: Enabling or Regulating?

An interesting question that Sassen's lecture and research touches upon but does not quite tackle is that of the role of the law and lawyers in the resulting financial fiasco. Here it is important to distinguish between two quite distinct functions of the law.

First, there is the law as an enabling factor—with this I mean that the law has provided the legal means to structure the transactions that almost caused the financial meltdown. Securitization transactions require

[3] Bonds were rated by rating agencies, including Moody's, Standard & Poor and Fitch. A rating indicates the chances of the relevant debt obligation being repaid in full on time. A AAA rating corresponds to the best, least risky debt obligation; a AA rating is a bit riskier; a BBB rating is riskier still, and a C rating corresponds to an extremely risky asset.

substantial legal documentation, including the incorporation of special purpose vehicles (SPVs) to issue the relevant securities, transfer documentation for the claims from the bank to the SPV, ISDA Master Agreements for the relevant swap transactions, contracts dealing with the issuance of the bonds and legal opinions as to the validity of the various transactions and contracts. These last documents are especially interesting because they function analogous to a legal check on the whole transaction. Legal opinions are letters signed by the relevant lawyers, stating that the transactions entered into by all parties involved were valid and constitute the legal and binding obligations of these parties. Without these legal opinions, the relevant parties would not have been able to enter into the transactions necessary for the issuance of MBSs. Financial regulators and rating agencies often require issuing legal opinions.

The second function of the law is to regulate certain transactions. The financial sector is regulated in many ways. A good example is the prohibition in the EU from running an insurance undertaking or a bank without the requisite permits. The process of obtaining the right permits is lengthy. Once a corporation has the right to run a bank or insurance undertaking, regulators have wide powers to check whether the relevant financial institution operates its business in accordance with the thousands of rules that apply and, if necessary, enforce them. Lack of compliance may lead to the loss of the relevant permit. Rules vary from the way in which a financial institution should behave (transparency, minimum capital requirements, risk-management requirements, etc.) to the qualifications of its directors and other employees should have. Moreover, all kinds of transactions are specifically regulated. This includes securitization transactions with the law detailing when such a transaction is allowed, what it should look like and what the effects on the bank's capital requirements are.

It is interesting to note that these types of regulations tend to be seen as checklists. As long as a transaction falls within the scope of the regulatory framework, legal advice will generally follow that there are no legal rules that would prohibit the relevant transaction. In this way, the regulatory framework sets the boundaries of what is allowed. Though, parties in the financial markets often find ways around these regulations. Sassen mentions credit default swaps in this regard, which can indeed be seen as (credit) insurances without a need to adhere to the rules applicable to insurance undertakings.

This raises the interesting question of the role of legal advisors that are typically involved in these types of transactions discussed here. Legal advisors have to deal with both the enabling and regulatory aspects of the law. Often, there is huge pressure on the legal advisors from the commercial side to 'just get the deal done'. If a legal advisor would come to the conclusion that they feel that, although there is no direct regulatory rule prohibiting the transactions there is some sort of overarching principle that may apply and that may lead them to conclude the transaction should not be entered into, this legal advisor would be in deep trouble since the parties involved tend to make a hefty profit upon completion. Only if the legal advisor can point to a direct rule that prohibits the transaction are they on sufficiently solid ground to advise that the transaction cannot be executed as planned. And, more often than not, even then the problem is directly passed back to said legal advisor: 'you are the lawyer; you find a way around it'. As a result, legal advisors sometimes find themselves in the awkward position where they are defending the regulatory framework to their own client, as if they were the government issuing the relevant regulations.

This is even more pressing for the enabling function of the law. Clients will generally not be amused when their lawyer tells them that the contract they drafted is invalid. Again, the immediate response will often be: 'I could easily find 100 lawyers who can tell me that this cannot be done. I hired you to tell me how it can be done'.

Finally, it is often the case that lawyers will only be paid in full if the transaction is actually completed. This of course contributes to lawyers trying to come up with solutions for legal obstacles rather than advising that the proposed transaction cannot be done. Even if this is not the case, a lawyer who was perceived as being unnecessarily 'difficult' in a previous transaction will most likely not be hired again by the same client.

As a result, it should not be surprising that lawyers have generally not formed a buffer against excessive deal making. Lawyers and their legal structuring of transactions are often seen as a necessary evil by their clients and there are few lawyers who want to be known as an obstacle to doing business. This problem is similar to that of the rating agencies. Knowing that the feasibility of the deal significantly depended on the rating given, their function as a safeguard and neutral arbiter came under pressure. A pressure that few rating agencies could resist.

4 Is There Something We Can Do About It?

Of course there is. It would be a huge improvement if transactions would require an independent legal check from truly independent lawyers who would not depend on commission from the transactions. These lawyers could still be paid by the parties involved but should be hired by regulators or some other government agency and only report to them. This would add some additional transaction costs, but the cost may be worth the more robust legal checks from an external audit. These independent legal advisors could report both on the enabling side of the law and on the regulatory aspects of a transaction and should not be hindered by the fact that their review may lead to cancellation of the proposed transaction. It is only a matter of political will whether such a requirement could be introduced.

Others may feel more drastic measures are required. The view that housing is a public good rather than a speculative asset does seem to be gaining ground. There is a lot to be said for this view, which ties in with the more general concern that wealth is only accumulating with the one percent. Addressing this question is well outside the scope of this article, however.

5 Conclusion

Expulsion is a real problem in the world of finance. Requiring independent legal advice on proposed transactions would be a somewhat costly-but-beneficial safeguard against the worst excesses.

Competing Interests

The author has no competing interests to declare.

How to cite this article: Reinout Wibier, 'Expulsions: The Destructive Power of Finance' (2019) 24(3) *Tilburg Law Review* pp. 15–18. DOI: https://doi.org/10.5334/tilr.174

Published: 29 November 2019