2016-10-10 From the preparatory notes for Class 24 of the introductory course on political economy: 'The evolution of property and how it rules the world'.

Last time we looked at the flow of surplus in monetary form into the financial part of the economy. We now need to look a little more deeply into the nature of abstract entitlements and what goes with them — into assets and liabilities, legal rights and legal obligations. Transactions in the financial sector are really only a more sophisticated and complex development of what goes on in everyday life in a market economy — i.e., an economy characterised by production for exchange. To find our way through the intricate entanglements of high finance, we need to start by understanding a few basic legal concepts that have evolved over the centuries and apply generally in economic life.

Let's begin with the fundamental distinction in law between 'real rights' and 'personal rights'.

Suppose you sell me your book for R200. You own the book. In law, your ownership is a **real right**, valid against the whole world. But you and I have now entered into a contract of sale regarding the book. I now have a **personal right** against you for delivery of the book (more precisely for the transfer of ownership to me) and you have the corresponding **personal obligation** towards me. Conversely, you have a personal right against me for payment of the R200 purchase price and I have the corresponding **personal obligation** to pay.

Note that **ownership** of the book doesn't pass from you to me until the book is **delivered** to me with the intention that ownership be transferred. Once ownership has passed to me, the law will in principle protect my ownership of the book not only against you personally but against the whole world.

In a cash sale, the intention would be that ownership passes together with payment. But there is no reason why you could not agree to give me credit, so I pay only later — i.e. after delivery of the book transferring ownership to me. So then I would have become the owner of the book (have a real right in the book, and bear the risk of loss which goes with that) while you would still have a personal right against me for payment and I would have a personal obligation to make payment when it falls due.

The personal right on each side is an **asset** and the personal obligation on each side is a **liability**. In principle, in a voluntary exchange, the assets and liabilities on each side match, so that when both obligations are discharged both rights are extinguished. In the aggregate of personal rights and obligations, there is nothing net.

But **ownership of the book** — a **real right** valid against the world with no corresponding obligation — is a pure **net asset**.

In *Applied Economics in Banking and Finance*,[1] the Oxford Polytechnic lecturer Ian Partington concisely explained the broader relevance of this difference. (He was writing in 1989 — there is no later edition of his work.)

> The 'output' of the financial system may be thought of as consisting of two kinds. On the one hand the various firms operating within the financial system provide their customers with a variety of services which use their specialist knowledge and skills; the modern operation of the banks is an

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[1] Oxford University Press, 4th edition, 1989.

obvious example of such a provision .... On the other hand the financial firms and institutions within the system are involved in the production of a slightly less obvious form of output, and that is the production of *financial assets* or *claims*. As a result of such direct and indirect financial activity within the financial system, the total of financial claims in existence is very substantial. For example, the market value of UK company securities in 1987 amounted to £ 1,285 billion; company security value was almost four times as great as national income. However, this is only a small fraction of the total financial claims which exist, since it does not include many other forms of financial asset, such as government securities, bank deposits, assets of pension funds, and so on.

2.2 Forms of wealth

Financial assets represent part of the wealth of individuals and institutions which hold such assets. Such wealth is, however, only one constituent of the total wealth of individuals and institutions since wealth can take a real (i.e. physical) form, for example property, stocks of goods, raw materials, land and machines.[2] Therefore if one is asked to add up the value of one's own wealth such things as a house and a motor car would be included as well as the amount of money one has in a bank and also the shares one might own. Thus, for the individual,

wealth = real assets + financial assets

But an individual is also likely to have liabilities (debts) such as a mortgage or a bank loan, and in assessing the individual's *net worth* these liabilities need to be taken into account:

net worth (individual) = real assets + financial assets - liabilities

If one wishes to extend this approach to the whole community the result is quite interesting. It is important to realize that although *financial* assets have a corresponding liability, real assets do not. For example, an individual's mortgage with a bank or building society is that person's financial liability, but for the bank or building society it is represented as an asset in its balance sheet — an asset which is *equal* to the liability of the individual. So for all individuals, groups, and institutions, that is the community,

net worth (community) = real assets + financial assets - financial liabilities

But since, every financial asset is someone else's liability, for the community as a whole, net worth will equal real assets only since financial assets and liabilities cancel each other out. Thus

net worth (community) = real assets

The position is somewhat curious. Financial assets held by the individual will be rightly regarded as part of his wealth (and if financial assets exceed financial liabilities then part of his net worth), but for the community as a whole the financial assets 'wash out' when assets and liabilities are aggregated. This phenomenon has given rise to controversy amongst economists, because although it would appear that financial claims are not part of net worth it would be hard to argue that they do not have any economic significance.

[2] [Our footnote:] By 'physical' wealth Partington means *material wealth* as we have explained it. This includes not only physical objects but intangible real objects such as designs, poems, musical productions etc.

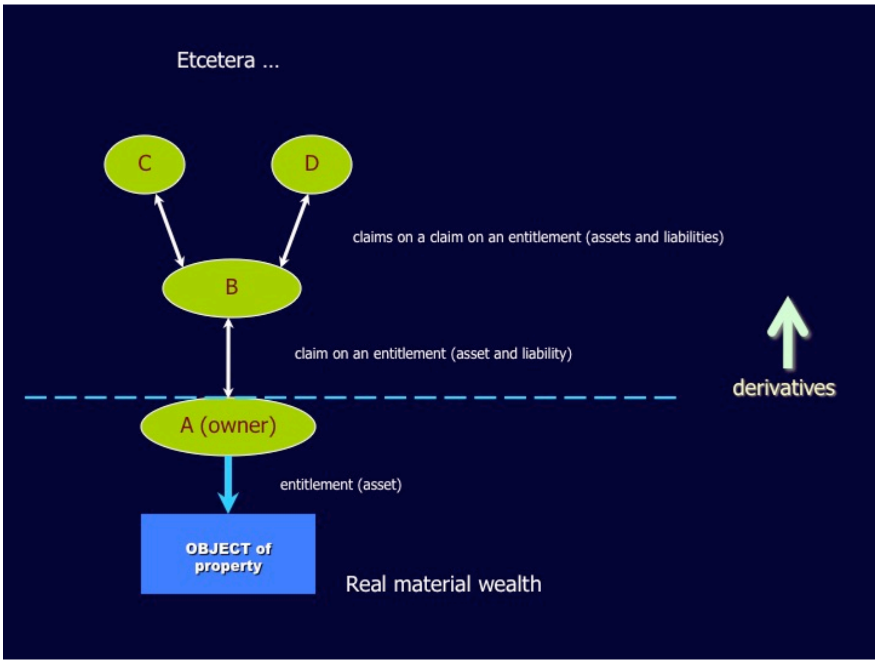
Real and 'derivative' entitlements

We have seen that ownership is a **real right** — a *real* entitlement — and that its object (a book, in our example) is a pure net asset. The general law may impose certain duties on owners, but in principle a real right is not accompanied by a matching liability. The fact that you and I enter into a contract of sale in regard to the book means that we create **personal rights** against each other, and matching **personal obligations** towards each other, in respect of the book. Since transferring ownership of the book is the ultimate object of the contract, these personal rights (with their matching obligations) are in a sense dependent on or derived from the underlying real right of ownership in the book. A personal right whose object is the transfer of a real right is in that sense a 'derivative' entitlement.

But transactions can and do take place in which the object is the transfer, not of a real right, but of **another personal right**. Such transactions are legion in the financial sector. For example, the purchase and sale of a share in a company involves the purchase and sale, and ultimately the transfer, not of any real assets of the company, but of a bundle of personal rights in respect of the company (bound together with certain obligations to the company and its members which need not concern us here). The personal rights and matching obligations created by the purchase-and-sale transaction are thus built on, or derived from, an existing bundle of personal rights (the share) which itself is ultimately a derivative form of entitlement.

Complex constructions of derivative entitlements dependent on other derivative entitlements are constantly being engineered in the financial sector — each of them matched at the outset by a corresponding liability, and none of them therefore adding anything to the underlying **real net assets** of society as a whole. They are, however, quite capable of altering the distribution of society's real assets among individuals, and this of giving rise to systemic effects.

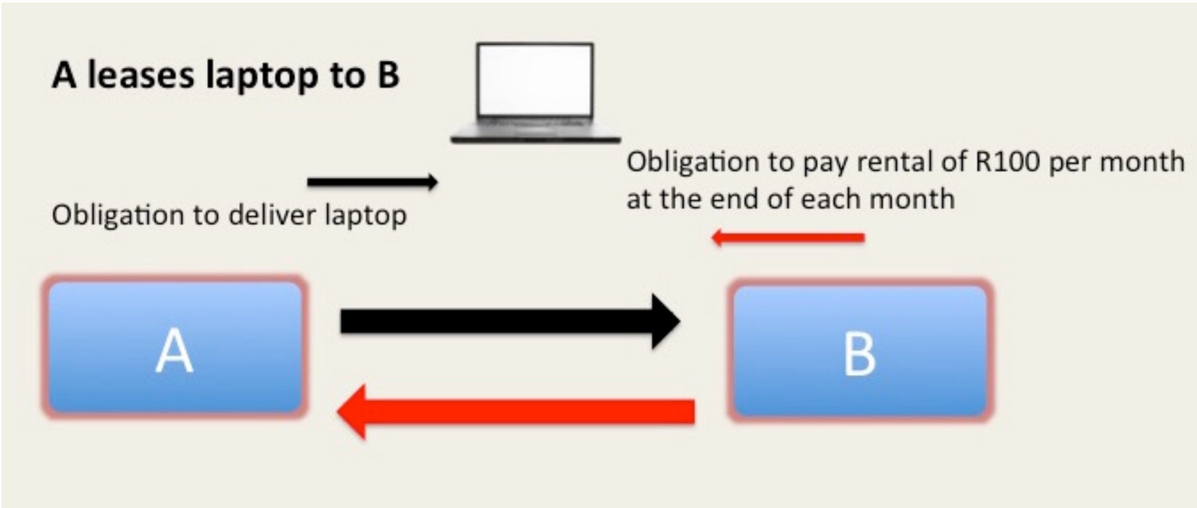
What are technically referred to as 'derivatives' in the financial sector are in fact entitlements (with matching obligations) derived from other derivatives in the true sense. This slide (the last in a sequence of 6 slides) may help explain it:



Cession and transfer of personal rights

Let's now consider what is involved in transactions in which the object is the transfer from one person to another of an existing personal right. Such a transaction is referred to in our law as 'cession' (in English and US law as 'assignment'). We'll take as a hypothetical example the cession of the right to the rental stream in regard to a leased laptop.

Suppose that A has leased his/her laptop to B for a month, for a rental of R100 payable at the end of the period. A now has a personal right or claim against B for payment of the R100 when it falls due, but has the correlative obligation to furnish B with the laptop for the month agreed. Conversely, B has the right to be furnished with the laptop, and the correlative obligation to pay the R100 to A. Each is a creditor in respect of his/her right (or claim) and a debtor in respect of his/her obligation.

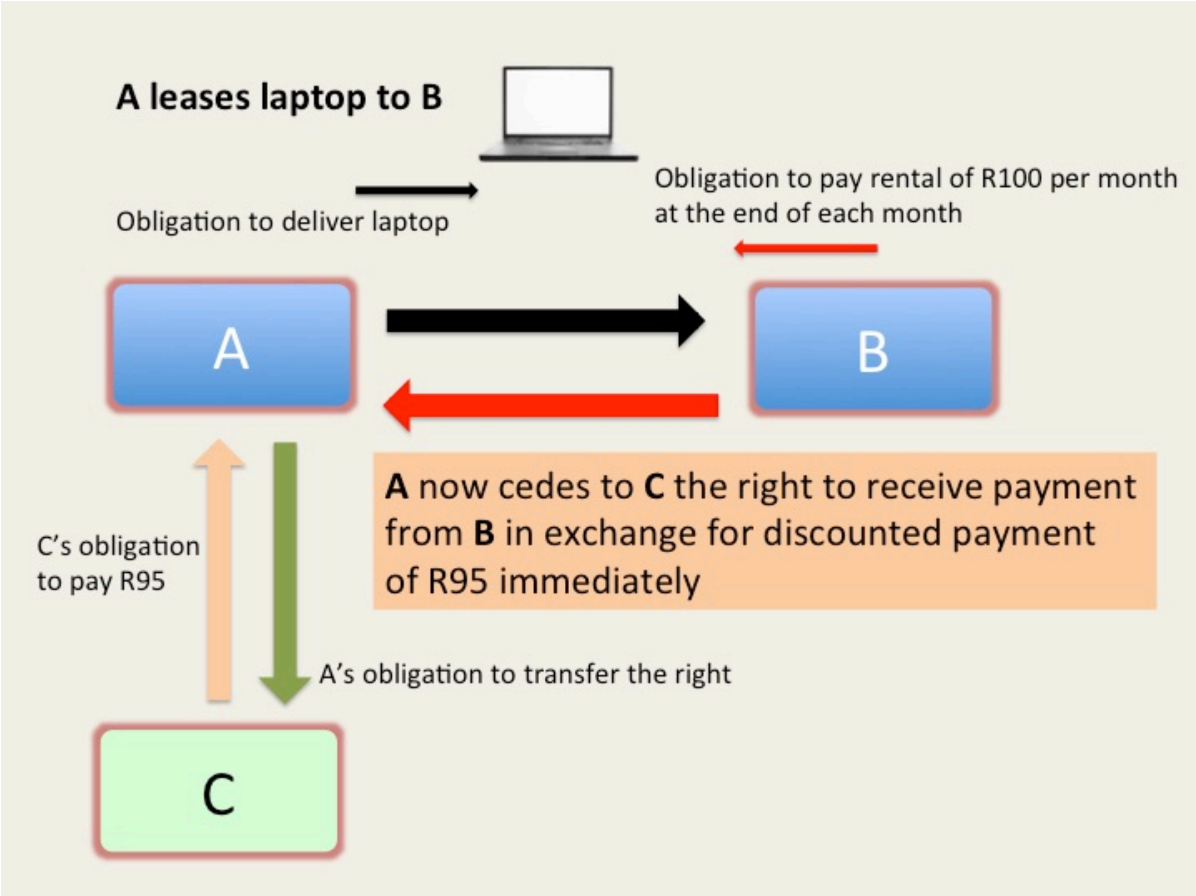


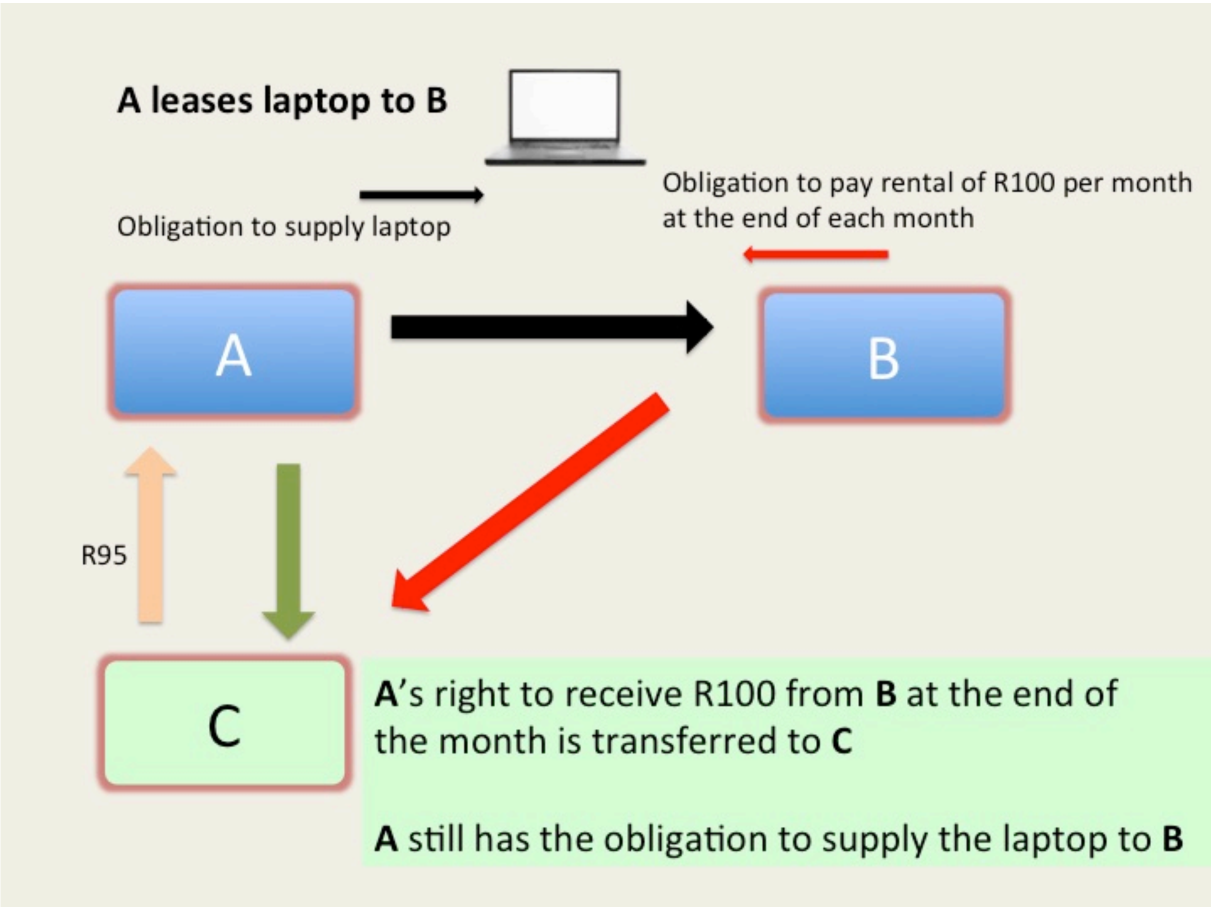
Generally speaking, the law holds that a debtor may not transfer his/her obligation to another person without the creditor's consent, but that a creditor may freely transfer his/her right to another person without the debtor's consent. There are sound practical and policy reasons for this differentiation.

Suppose now that C enters the picture and makes some sort of discounting agreement with A in terms whereof C takes over A's right to claim the R100 rental from B when it falls due, and in exchange agrees to pay A now the sum of R95.

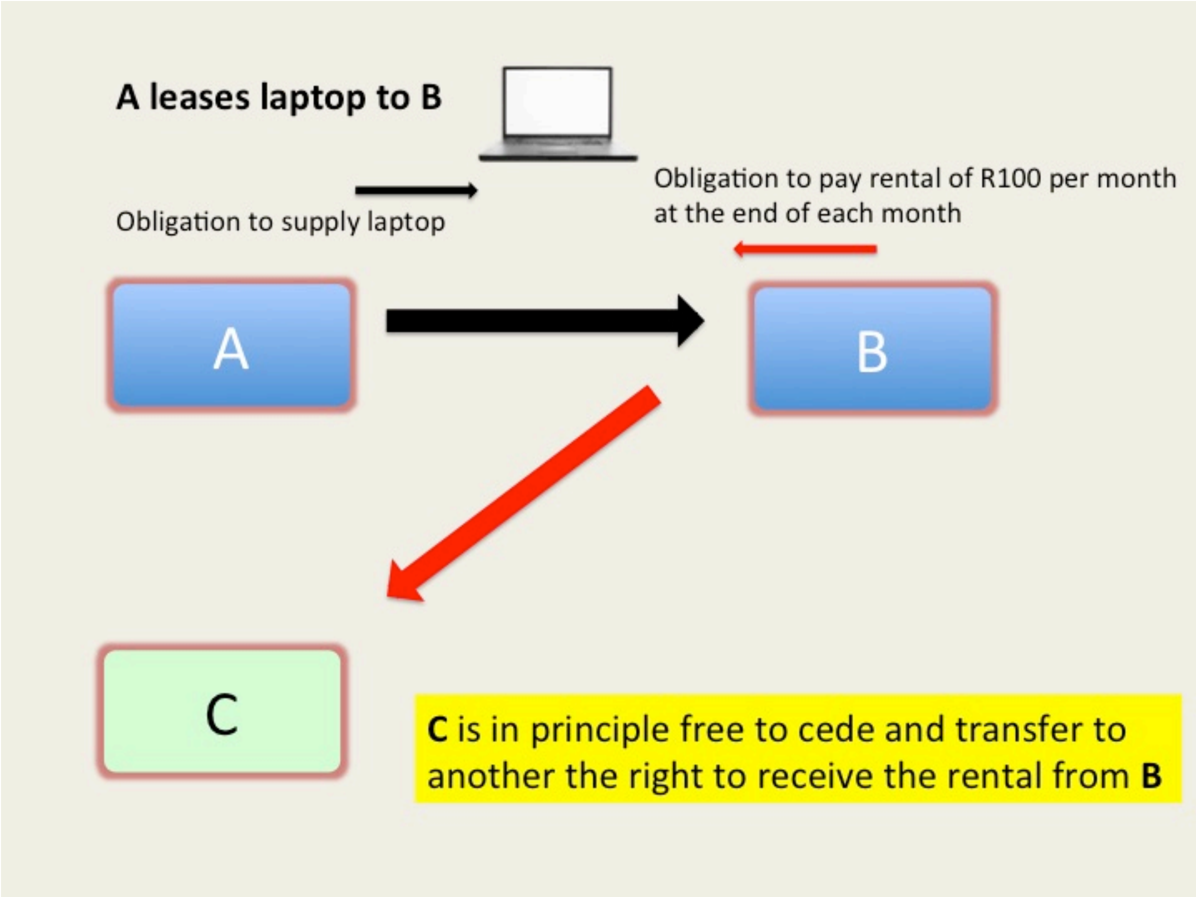
Once notified of the change, B must pay the R100 to C (in whom the right is now vested) when it falls due, but B must continue to look to A to fulfil the obligation of furnishing the laptop.

This is depicted on the next page.


A leases laptop to B
Obligation to deliver laptop
Obligation to pay rental of R100 per month at the end of each month
A
B
A now cedes to C the right to receive payment from B in exchange for discounted payment of R95 immediately
C's obligation to pay R95
A's obligation to transfer the right
C


A leases laptop to B
Obligation to supply laptop
Obligation to pay rental of R100 per month at the end of each month
A
B
R95
C
A's right to receive R100 from B at the end of the month is transferred to C
A still has the obligation to supply the laptop to B

The right transferred from A to C need not end its journey in C's hands. C may cede and transfer it to D, and D to E, and so on.



The right to claim payment has begun to travel in apparent independence from the correlative obligation to furnish the laptop. But that independence, though actual in some respects, is illusory in other respects. The right can never truly part company with its correlative obligation. Except by swindling, the asset cannot escape its correlative liability — and generalised swindling cannot long sustain a system of free exchange. B may (and obviously will) withhold payment of the rental if the laptop is not furnished.

C thus remains dependant on A for the fulfilment of A's obligation to B.

Financial 'paper'

We turn next to consider financial 'paper' — using this in a broad sense to refer to any formal acknowledgement of debt (in other words an 'IOU') coupled with a promise to repay at a particular time and on particular terms as to interest or otherwise, and which may change hands in the market.

For explanatory purposes we use the example of a 'coupon' bond, and a crude illustration showing the interest 'coupons' attached to the declaration of the capital sum owed. The 'coupons' may theoretically be 'cut off' and traded as separate debt instruments or zero-coupon 'bonds' in their own right. This provides an illustration of cession at work in the financial economy.

10-year bond certificate recording

R1,000 capital sum

borrowed on 01 Jan 2017 repayable after ten years on 31 December 2026

with interest payable as per coupons

Coupon	Amount
31 December 2017	**R100**
31 December 2018	**R100**
31 December 2019	**R100**
31 December 2020	**R100**
31 December 2021	**R100**
31 December 2022	**R100**
31 December 2023	**R100**
31 December 2024	**R100**
31 December 2025	**R100**
31 December 2026	**R100**

Explain the difference between such 'bonds' and a mortgage bond — a form of **real security**, whereby the house (for instance) serves as security to the lender for repayment of a home loan, so that upon the debtor's default the house may be sold and its proceeds taken by the lender to the extent needed to satisfy the debt, in preference to the claims of other creditors.

Various forms of 'security' for the repayment of debts are possible, including 'suretyship', whereby one person guarantees repayment of the debt owed by another in the event of default, and the handing over of other entitlements such as share certificates as pledges for due performance. In the United States the term 'collateral' is used to refer generally to security for the repayment of debt.

Security for the repayment of debt is **entirely different from what is called 'securitisation'**. The latter term refers to the packaging of so-called 'securities' — a term we encountered when we were dealing with companies and shareholding. 'Securities' basically mean shares and debt instruments (IOUs). 'Securitisation' involves packaging or bundling securities together and then subdividing entitlements *to the bundle itself* into smaller units which are then separately sold off. This can be illustrated in class by putting bits of paper of different kinds and colours, representing financial paper, into a brown paper bag. You, as an investor, may not be able easily to verify the true worth of the contents of the bag when you buy units of entitlement to it. We can illustrate this by adding sheets of toilet paper to the package. Securitisation is itself a legitimate and necessary part of the financial system, but is so open to abuse that it needs stringent regulation.

'Junk' bonds and 'subprime' mortgages

This brings us to the subject of 'junk' bonds and 'subprime' mortgages.

A 'junk' bond is one which is rated as riskier than so-called 'investment grade' bonds — i.e. there is a higher risk that the debtor may default, and the rate of interest is therefore usually higher. The 'junk' bond is not necessarily a bad thing if you know it is high-risk when you buy it. It can be a way of channelling funds to high-risk projects which can be very beneficial where they succeed. The problem is that junk bonds are hyped as other than what they are, or are concealed in packages with other securities so you don't know what you are buying.

'Subprime' mortgages, on the other hand, almost inevitably entail deception and fraud. The impoverished borrowers, desperate for a home, are persuaded to take out home-loans that they have little or no prospect of repaying — putting the house itself up as security. The initiators of these loans quickly securitise the mortgages in packages and sell them off to investors while house prices are still rising because of increased demand and the security looks good. They can thus recover their own initial outlays and escape with their winnings before the crash comes.

The 2008 financial sector crisis was triggered by the collapse of the subprime mortgage lending market in the USA. This precipitated a global financial crisis of huge proportions.

The US regulatory body, the Securities and Exchange Commission (SEC), has a very poor record of investigating financial institutions in order to *prevent* fraud on the public. Once frauds have occurred, they move into the spotlight. The allegation of the SEC against the investment bankers Goldman Sachs was that they deliberately constructed a dodgy package of mortgage-backed securities so they could bet against it. This would be like nobbling your own horse so you can go and make a big bet that it will lose the race. On 11 April 2016, the US Department of Justice and other state agencies reached a settlement with Goldman Sachs which required the firm to pay $5.06 billion [R70 billion] in penalties and damages.

Michael Lewis's 2011 book *The Big Short* provides a brilliant picture of the financial manipulations which go on. The movie of the same name is well worth watching.

In *The Big Short*, the heroes are some highly intelligent individuals, inclined to go against the stream, who figured out early on that the subprime mortgage boom was a system-wide, unsustainable Ponzi scheme. They had the courage to defy the trend that kept inflating it along with house prices; and they succeeded in raising the money necessary to bet, and bet big, on the inevitable crash. They were out to enrich themselves rather than rescue others from the coming disaster.

Their betting operation involved buying **credit default swaps** — financial instruments issued in exchange for premiums, supposedly in order to hedge or 'insure' funders against default by homeowners on the subprime mortgages which they had been persuaded to take out at deceptively low initial interest rates and which they could never afford to maintain.

The initial lenders' claims on these unsustainable mortgages were bundled together in opaque parcels (**collateralised debt obligations**, or bonds, issued by financial institutions) and sold to investors — including pension funds and the like — who were deluded into thinking that the contents were sound.

The well-known rating agencies were central in enabling the systematic fraud. Credit default swaps were then issued, albeit in much smaller quantities, to 'insure' against default on the bonds. True insurance, which is regulated, requires the policy-holder to have an insurable interest (a real stake) in the asset insured, in order to distinguish it from mere gambling. Thus one cannot ordinarily take out insurance, for example, on the life or the house of a complete stranger — the general incentive that would otherwise spread to have strangers killed or their houses burned down in order to claim on insurance, is social and legal taboo. Not so in the financial sector, however.

Credit default swaps are pure gambling contracts, at that time fundamentally unregulated, and issued at the stroke of a pen. Many were underwritten by the mega-insurer, AIG, which the taxpayer ultimately had to bail out. By the end of 2007, the total outstanding CDS amounted to $62.2 trillion.[3]

Lewis's heroes in *The Big Short*, in order to win big in their bets against the so-called insurers, had first to persuade the latter to issue this so-called insurance to them in large quantities (although they themselves did not hold and were not at risk on the collateralised debt). Because of the widespread under-estimation of the risk, they were able to obtain these credit default swaps at very low premiums, which they then had to finance during the nerve-wracking period of uncertain length when rising house prices were still defying gravity.

They badly needed the system to crash in order to claim on the insurance. To ensure a payout soon enough after they had built their stake in credit default swaps, they had to go out and reveal in brutal detail, and indeed trumpet as loudly as they could in the marketplace, the unwelcome fact that the subprime mortgages, and the bonds built on them, were bound to fail and fail soon. It seems they had little success in this regard, such was the euphoria of money-making in the financial sector at the time — but the defaults began anyway, and with them came the crash. Although insurers themselves went under, rendering

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[3] https://en.wikipedia.org/wiki/Credit_default_swap

many credit default swaps worthless, the gambling heroes of *The Big Short* were astute enough to emerge very wealthy from the catastrophe.

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This completes the 1st part of the course, on the historical evolution of the property relation.

Where are we going from here? A brief outline is given of the remaining classes.