Making a killing

Kyle Bass, manager of the Hayman Capital hedge fund in Dallas. Picture: Getty Images *Source:* Getty Images

WHILE I was at work on a book about the 2008 financial disaster I became interested in a tiny handful of investors who had made their fortunes from the collapse of the sub-prime mortgage market.

A lot of people had thought that the debt-fuelled US housing boom was unsustainable - but only 15 or so had gone all in and placed enormous bets that vast tracts of American finance would go up in flames. Most of these people ran hedge funds in London or New York. Most, usually, avoided journalists. But on this topic, at that moment, they were surprisingly open. All had experienced the strange and isolating sensation of being the sane man in an insane world.

Among them was Kyle Bass, the manager of a hedge fund called Hayman Capital in Dallas. He was a Texan in his late 30s who had spent the first years of his career selling bonds for Wall Street firms. In late 2006 he'd taken half of the $10 million he had saved on Wall Street, raised a further $500 million, created his hedge fund and made a massive wager against the sub-prime mortgage bond market. By the time I went to see him, the sub-prime mortgage bond market had collapsed. He was now rich and, in investment circles, a little famous. But his mind had moved on - having taken his profits, he had a new all-consuming interest: governments. In his opinion, the financial crisis wasn't over. It was simply being smothered by the faith and credit of Western governments, which had taken on to their own books the risks associated with dodgy securities worth trillions.

Bass and his colleagues were no longer talking about the collapse of a few bonds but about the collapse of entire countries. They had a shiny new investment thesis. From 2002 there had been something like a false boom in much of the rich, developed world. What appeared to be economic growth was activity fuelled by people borrowing money they probably couldn't afford to repay. At a rough count, worldwide debts, public and private, had more than doubled since 2002, from $84 trillion to $195 trillion. "We've never had this kind of accumulation of debt in world history," Bass said.

Critically, the big banks that had extended much of this credit were no longer treated as private enterprises but as extensions of their governments, sure to be bailed out in a crisis. So the public debt of rich countries, already at dangerously high levels and growing rapidly, now included not just the official public debt but also the debts inside each country's banking system.

"The first thing we tried to figure out," Bass said, "was how big these banking systems were, especially in relation to government revenues. We took about four months to gather the data. No one had it."

The numbers added up to astonishing totals: Ireland had debts of more than 25 times its annual tax revenues, Spain and France of more than 10 times their annual revenues. Historically, such levels of government indebtedness had led to government default.

The only way things could work out for these countries, Bass said, was if they started running real budget surpluses. "Yeah, and that will happen right after monkeys fly out of your ass."

Still, he wondered if he was missing something. "I went looking for someone, anyone, who knew something about the history of sovereign defaults." He found the leading expert on the subject, a professor at Harvard named Kenneth Rogoff.

"We walked Rogoff through the numbers," Bass said, "and he just looked at them, then sat back and said, 'I can hardly believe it is this bad.' I said, 'Wait a minute. You're the world's foremost expert on sovereign balance sheets. You are the go-to guy for sovereign trouble. You taught at Princeton with Ben Bernanke [chairman of the Federal Reserve]. You introduced Larry Summers [former US Treasury secretary] to his second wife. If you don't know this, who does?' I thought, 'Holy shit, who is paying attention?'?"

He started to believe the sub-prime mortgage crisis was more symptom than cause. The deeper social and economic problems that gave rise to it remained. There was another, bigger financial crisis waiting to happen.

When we met in late 2008, Bass had just bought his first credit default swaps on the countries he and his team of analysts viewed as the most likely to be unable to pay off their debts: Greece, Ireland, Italy, Switzerland, Portugal and Spain. A credit default swap enables investors to bet against the price of a bond - to "short" it. It is an insurance policy with a twist: the buyer doesn't need to own the insured asset. No insurance company can legally sell you fire protection on another person's house, but the financial markets can sell you default insurance on another person's investments.

The prices Bass paid for default insurance now look absurdly cheap. Greek government default insurance cost him 11 basis points, for instance. That is, to insure $1m of Greek government bonds against default, Hayman Capital paid a premium of $1100 a year. He guessed that when Greece defaulted, as it inevitably would, it would be forced to pay down its debt by roughly 70 per cent - which is to say that every $1100 bet would return $700,000.

He couldn't see how any sane person could do anything but prepare for another, bigger financial catastrophe. "It may not be the end of the world," he said. "But a lot of people are going to lose a lot of money. Our goal is not to be one of them."

He was totally persuasive. He was also totally incredible. A guy sitting in an office in Dallas, Texas, making sweeping claims about the future of countries he'd hardly set foot in: how on Earth could he know how a bunch of people he'd never met might behave?

As he laid out his ideas, I had an experience I've often had while listening to people who seem perfectly certain about uncertain events. One part of me was swept away by his argument and began to worry the world was

about to collapse; the other part suspected he might be nuts. "That's great," I said, already thinking about the flight I had to catch. "But even if you're right, what can any normal person do about it?"

He stared at me as if he'd just seen an interesting sight: the world's stupidest man. I asked him: "What do you tell your mother when she asks you where to put her money?"

"Guns and gold," he said simply. So he was nuts. "But not gold futures," he added. "You need physical gold." He explained that when the next crisis struck, the gold futures market was likely to seize up, as there were more outstanding futures contracts than available gold. People who thought they owned gold would find they owned pieces of paper instead. He opened his desk drawer, hauled out a giant gold brick and dropped it on the desk. "We've bought a lot of this stuff."

At this point I made my excuses and took my leave of Dallas, and more or less dismissed him. When I wrote the book, I left him on the cutting-room floor.

Then the financial world began to change again -and very much as Bass had imagined it might. Entire countries started to go bust. I began to travel to these places, just to see what was up.

The tsunami of cheap credit that rolled across the planet between 2002 and 2007 wasn't just money; it was temptation. It offered entire societies the chance to reveal aspects of their characters they could not normally afford to indulge. Entire countries were told: "The lights are out, you can do whatever you want to do and no one will ever know." What they wanted to do with money in the dark varied. Americans wanted to own homes far larger than they could afford. Icelanders wanted to stop fishing and become investment bankers. The Germans wanted to be even more German; the Irish wanted to stop being Irish. No response was as peculiar as the Greeks', however.

For most of the 1980s and 1990s, Greek interest rates ran 10 per cent higher than Germany's, as Greeks were regarded as far less likely to repay a loan. There was no consumer credit in Greece: Greeks didn't have credit cards. They didn't usually have mortgages, either.

Of course, they wanted to be treated by the financial markets like a properly functioning northern European country. In the late 1990s they saw their chance: get rid of their currency and adopt the euro. To do that, they needed to prove they were capable of good European citizenship - that they would not, in the end, run up debts that other countries in the euro area would be forced to repay. In particular they needed to show budget deficits under 3 per cent of their gross domestic product (GDP) and inflation running at roughly German levels. To hit the targets, the government moved all sorts of expenses (pensions, defence) off the books, froze prices for electricity, water and other state utilities and cut excise taxes on petrol, alcohol and tobacco.

In 2001, Greece entered the European Monetary Union, swapped the drachma for the euro and acquired for its debt an implicit European (read: German) guarantee. Greeks could now borrow funds long-term at roughly the same rate as Germans. To remain in the eurozone, they were meant, in theory, to maintain budget deficits below 3 per cent of GDP; in practice, all they had to do was cook the books.

Here entered Goldman Sachs, which engaged in a series of apparently legal but nonetheless repellent deals designed to hide the Greek government's true level of indebtedness. For these trades Goldman Sachs - which, in effect, handed Greece a $1 billion loan - carved out a reported $300 million in fees.

The machine that enabled Greece to borrow and spend at will was analogous to the machine created to launder the credit of the American sub-prime borrower - and the role of US investment bankers in the machine was the same. The investment bankers also taught Greek officials how to securitise future receipts from the national lottery, highway tolls, airport landing fees and even funds from the EU. Any future stream of income that could be identified was sold for cash and spent.

As anyone with a brain must have known, the Greeks would be able to disguise their true financial state for only as long as (a) lenders assumed that a loan to Greece was as good as guaranteed by the EU (read: Germany) and (b) no one outside Greece paid much attention. Inside Greece there was no whistleblowing, as basically everyone was in on the racket.

As it turned out, what the Greeks wanted to do, once the lights went out and they were alone in the dark with a pile of borrowed money, was turn their government into a piñata stuffed with fantastic sums and give as many citizens as possible a whack at it.

In the past 12 years the Greek public sector wage bill has doubled in real terms - and that doesn't take into account the bribes collected by public officials. The average government job pays almost three times the average private-sector job. The national railway has annual revenues of $137 million but an annual wage bill of $550 million and $400 million in other costs.

On October 4, 2009, the Greek government fell. The new government found so much less money in the coffers than it had expected that it decided there was no choice but to come clean. The new prime minister, George Papandreou, announced that Greece's budget deficits had been badly understated - and that it was going to take some time to nail down the numbers.

Pension funds and global bond funds and other sorts who buy Greek bonds, having seen several big American and British banks go belly-up, and knowing the fragile state of a lot of European banks, panicked. In came the International Monetary Fund to examine the Greek books more closely; out went whatever tiny shred of credibility the Greeks had left. "How in hell is it possible for a member of the euro area to say the deficit was 3 per cent of GDP when it was really 15 per cent?" a senior IMF official asks.

That's more or less what I asked when I went to see the new Greek minister of finance, George Papaconstantinou, whose job it was to sort out this fantastic mess. Papaconstantinou attended New York University and the London School of Economics in the 1980s and then spent 10 years working in Paris for the OECD. Like many people at the top of the new Greek government, he came across less as Greek than as Anglo - indeed, almost American.

"The second day on the job I had to call a meeting to look at the budget," he said. "I gathered everyone from the general accounting office, and we started, like, this discovery process." Each day they discovered some incredible omission. A pension debt of a billion dollars every year somehow remained off the government's books. Everyone pretended it did not exist, even though the government paid it. The hole in the pension plan for the self-employed was not the $400 million they had assumed but $1.5 billion; and so on.

"At the end of each day I would say, 'OK, guys, is this all?' And they would say, 'Yeah.' The next morning there would be this little hand rising in the back of the room: 'Actually, minister, there's this other 100 million to 200 million euro [$137m-$274m] gap.'"

By the final day of discovery, after the last little hand had gone up, a previously projected deficit of roughly $9.6 billion was actually more than $40 billion. The IMF's question - how is this possible? - is easily answered: until then, no one had bothered to add it all up. As he finished his story, he stressed that this wasn't a simple matter of the government lying. "This wasn't all due to misreporting. In 2009, tax collection disintegrated, because it was an election year."

"What?"

He smiled. "The first thing a government does in an election year is pull the tax collectors off the streets."

"You're kidding."

Now he was laughing at me. I'm clearly naive.

The evening after I met the minister of finance, I went for coffee with a tax collector. He took it for granted I knew that the only Greeks who paid their taxes were those who could not avoid doing so: salaried employees of corporations, who had their taxes withheld from their pay. The vast army of self-employed workers - the biggest in Europe, from doctors to the guys who ran the newspaper kiosks - cheated. "It's become a cultural trait," he said. "The Greek people never learnt to pay their taxes. And they never did because no one is punished."

Greece's tax-collecting system, it turned out, mimicked that of an advanced economy - and employed a huge number of tax collectors - but it was rigged to enable an entire society to cheat on its taxes. The Greek state was not just corrupt but also corrupting. Once you saw how it worked you could understand a phenomenon that otherwise made no sense at all: the difficulty Greek people have in saying a kind word about one another. Everyone is pretty sure everyone is cheating on his taxes, or bribing politicians, or taking bribes, or lying about the value of his property to avoid taxes. And this total absence of faith in one another is self-reinforcing. The epidemic of lying and cheating and stealing makes civic life impossible; and the collapse of civic life only encourages more lying, cheating and stealing.

The structure of the Greek economy is collectivist, but the country, in spirit, is the opposite of a collective. Its real structure is: every man for himself. Into this system investors poured hundreds of billions of dollars. And the credit boom pushed the country over the edge into total moral collapse.

Just now the global financial system is consumed by the question of whether the Greeks will default on their debts. At times it seems as if it is the only question that matters, for if Greece walks away from $400 billion in debt, then the European banks that lent the money will go down, and other countries flirting with bankruptcy might easily follow.

But there's a second, more interesting, question: even if it is technically possible for these people to repay their debts, live within their means and return to good standing inside the EU, do they have the inner resource to do it? Or have they so lost their ability to feel connected to anything outside their small worlds that they would rather just shed the obligations?

On the face of it, defaulting on their debts and walking away would seem a mad act: all Greek banks would instantly go bankrupt, the country would be unable to pay for the many necessities it imports (oil, for instance) and the government would be punished for many years with much higher interest rates, if and when it was allowed to borrow again.

But, as I said, the place does not behave as a collective; it behaves as a collection of isolated particles, each of which has grown accustomed to pursuing its own interest at the expense of the common good. There's no question that the government is resolved at least to try to recreate Greek civic life. The only question is: can such a thing, once lost, ever be recreated?

This northern summer, when I returned to Dallas to see Kyle Bass, Greek credit default swaps were up from the 11 basis points he had paid to 2300. Ireland and Portugal had required massive bailouts; and Spain and Italy had gone from being viewed as essentially riskless to nations on the brink of financial collapse. On top of it all, the Japanese ministry of finance was about to send a delegation to America to seek someone, anyone, willing to buy half a trillion dollars' worth of 10-year Japanese government bonds.

"This is a scenario in which no one alive has ever invested before," Bass said. "Our biggest positions now are Japan and France. If and when the dominoes fall, the worst, by far, is France. I just hope the US doesn't collapse

first. All my money is bet that it won't. That's my biggest fear - that I'm wrong about the chronology of events. But I'm convinced what the ultimate outcome is."

His stacks of gold and platinum bars had roughly doubled in value, but he remained on the lookout for hard stores of wealth. Nickels, for instance, the American five-cent coins.

"The metal in a nickel is worth 6.8 cents," he said. "Did you know that?" I didn't.

"I just bought one million dollars' worth of them," he said, and then, perhaps sensing I couldn't do the maths: "Twenty million nickels."

"You bought 20 million nickels?"

"Uh-huh."

"How do you buy 20 million nickels?"

"Actually, it's very difficult." He had to talk his bank into ordering them. The bank had finally done it, but the Federal Reserve had its own questions. "The Fed apparently called my guy at the bank. They asked him, 'Why do you want all these nickels?' So he called me and asked, 'Why do you want all these nickels?' And I said, 'I just like nickels.'" Bass pulled out a photograph of his nickels: there they were, piled up on giant wooden pallets in a vault in downtown Dallas.

The past two and a half years had seen the confirmation of Bass's dark view of the global financial system, and the people who run it. But it didn't get him down. It thrilled him to have got his mind around seemingly incomprehensible events. "I'm not someone who is hellbent on being negative his whole life," he said. "I think this is something we need to go through. It's atonement. It's atonement for the sins of the past."

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