Financial bubble - who will say that the emperor is naked?

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This post is not directly about energy, but it is about one of the other big imbalances of our times - the giant financial bubble that has been inflating for the past few years, on the heels of the prevous bubble, the now-infamous dotcom bubble. It is about how society can be blind to trends that are obvious to many - including amongst those that are in a position to act and should know better than to do nothing.

I'm on record saying (repeatedly) that we have a huge, unsustainable asset price bubble, and that banks are doing insane things right now. And those of you that have read me previously may remember my quip that a good banker is not one who is right, it is one who is wrong at the same time as the other bankers (and thus bankers right now have no incentive not to participate to the increasingly aggressive deals one can see around).

The scariest thing is that a large number of senior bankers are aware of what I'm saying, are on the same line - and are doing nothing about it.

> A headache awaits when the credit party fizzles out
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> A few days ago in London, a senior banker made a striking admission to me: in his long career, he had almost never seen such bubble-like conditions in the credit markets as exist now. “Perhaps back in the 1980s – just before the collapse,” he muttered, with a despairing chuckle, over an elegant (and expensive) lunch.

> That is alarming stuff. But worse is to follow: this very same banker makes a living by arranging loans and bonds to risky companies – and he freely admits there is little chance that his institution is about to switch off this financial tap.

> Other senior financiers are privately echoing these concerns, sometimes even more forcefully. But right now, nobody appears ready to take away the punchbowl from the credit party. On the contrary, as Mr Bolton noted, the standards used to lend money to the private equity world are becoming weaker by the day, as new innovations keep appearing such as “cov-lite” loans (instruments on which the normal covenants protecting investors have been stripped away).
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> Why? One factor is what the Bank of England coyly calls “strong incentives [at banks] to match performance by competitors” – perhaps better described as “the banking rat race”. When times are good, bankers make large bonuses by arranging deals. But they

> rarely get paid for pulling them. While some financiers and investors have tried to argue that credit conditions looked over-exuberant in recent years, the credit cycle has stubbornly refused to turn. As a result, most bankers are now terrified of refusing deals, particularly at a time when the European economy is picking up. *No one gets rewarded for taking the risk of crying wolf – yet again*.

As one of those that have been crying wolf - repeatedly over the past 2 years and more - and getting mocked for it, and at the same time being a participant (1, 2) in the "rat race" (or arms race, really), let me give a few thoughts on this.

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The hard truth is that banks need to earn money, and thus they do the deals that are in line with then current market practices, however unpalatable these might be. And the rationale is thus that 'others are doing it, so we have to (and it's okay, then)'. And bankers will of course push for deals as their personal income is directly linked to doing deals.

And thus the only way this ends is when some deals actually hit the rocks and bring about some real pain for the financial markets - at which point, those bankers aware of the context will finally have an excuse to pull out, thus triggering a stampede out, and generating more 'credit events' as more companies suddenly become unable to refinance.

Because the dirty secret of today's financial world is that it is, just like a poor household trying to buy an overpriced home on an interest-only, resettable ARM loan, hoping that prices will keep on rising to make the transaction affordable. Loans in a number of markets today are made on the basis of no principal repayment, and available cash used to pay interest only; investors are allowed to take money out upfront and will have very little incentive to stay in the project if it turns bad (leaving the lenders holding the bag); and full payment of the loans in the absence of a refinancing would require quite heroic operational performance, and benign market conditions, for a number of years. 'Foreclosures' (defaults) will happen, and they will have the same effect as in the housing market: generate more need for lender support precisely at the time when lenders will decide thay can no longer afford to.

And the big characteristic of today's bubble, i.e. that risk is spread around, will come back to bite those that took advantage of it: bank loans are not always the most attractive products, in terms of pricing, but they have one great quality in hard times: there is only one person to talk to (the banker), and in most circumstances, banks are able - and have an interest - to take a longer view and organise a resturcturing. If the underlying business is not losing money, a bank will often find it more reasonable to help it survive than to pull the plug. Financial investors, especially multiple and diverse ones, will not behave like this - they will simply sell their 'paper' to those, like vulture funds, that thrive on squeezing just a bit of money from any business (just as long as it's more than what they paid for the paper). They will not care about survival of businesses and full repayment, just about extracting *enough* cash.

Thus banks that have taken extravagant risks and passed them on to investors will find themselves in the worst of worlds - they will still be nominally responsible for the loans going bad, but will have no power to solve them as they have passed on the relevant rights to outsiders (who will likely sue them while looking for any short term out).

Of course, today's investment bankers, having cashed in their big bonuses, will either be simply fired (but keep their money) or get more money to try to untangle the messes they created in the first place.

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It's a bit hard to write very specifically about my role in all this and not betray any secrets, but let's say that, while we see the very same pressures for aggressive deals, I am not yet too worried about the transactions I've worked on for a number of reasons set below. Remember that I work in project finance, which is seen as a relatively stodgy bit of investment banking - it's hard to make a quick buck with deals that take from 6 months to several years, the resulting asset is usually not tradeable on a market and thus not very 'sexy', and you actually need to delve deep in commercial and financial legal documents, and generally spend a lot of time in (yuck) due diligence processes to fulfill the standard requirements of the banks. Even our little corner of the banking world has been submerged by the maelstrom of liquidity unleashed since 2001 by the main central banks; financing terms have become increasingly aggressive, bank protections, and their remuneration, have gone steadily worse; underlying commercial hypotheses have become more and more optimistic. That means, for instance, longer loans, more price risk (for instance, instead of having a long term contract with a fixed price, your project sells on the market, with increasingly optimistic price assumptions) and less headroom should anything go wrong. Now, that said, here's what I see on my side of that business (energy):

- I'm working mostly in renewable energy. As these are investment-heavy projects, once they are built, they generate money whatever else happens - so there will be a financial incentive (in addition ot the obvious ones linked to global warming and energy independence) to keep them operating, and they will still generate funds which can be used to pay debt (their main cost to bear, as there is no fuel cost, and only a little maintenance), however slowly;

- being a market leader, we've chosen to take new technical risks (like offshore wind or solar projects) rather than fight it out with latecoming banks and investors in sectors that are becoming well-trodden (i.e. ferociously competitive on the lending side), like onshore wind;

- in addition, the likelihood of energy prices going down, even in the case of a pretty strong recession, is pretty weak. Electricity will still be needed, and its price will remain set by "low cost" producers like nuclear and carbon, the same as today; with wind power fully competitive with these when taking into account support mechanisms (and sometimes even without them) and before any carbon pricing is included, prices are likely to provide for sufficient income to repay debt within reasonablt time periods even in the worst scenarios;

- project finance is also a sector where there hasn't been a lot of repackaging of debt into fancy financial instruments. So if anything goes wrong, I'll be the one in charge of dealing with the outcome - together wil a small number or similarly-minded and experienced bankers. I already did that in 1998 with the Russian financial crisis (and nursed my deals then to full repayment) and expect that it could be done here again, with sound fundamentals underpinning (I'll tell you what 'sound fundamentals' I saw in Russia in 1998 on another occasion...). It is actually one of the strengths of the financial techniques we use that the projects are precisely more resilient in times of crises - it's their main selling point, and it is what makes us a kind of backwater in highrolling times (because it's an expensive strength), but some clients still value that - or simply don't have the choice. As in offshore wind finance, out thoroughness allows us to be the first to finance new classes of (industrial) assets.

But pain in other sectors will make the banks shy and will have indirect repercussions everywhere anyway.

This may sound a bit self-serving, but I can tell you that it is an appreciable luxury to have a job in finance that does not require for consumers to increase their spending (and their driving) by 2% per year for the next 15-30 years to still exist in a few years' time, and it is even better to be able to have a job whose purpose and actual results are not in direct contradiction with the lessons read here on a daily basis. But being deep in the banking world, it means that I also see what's happening there, and identify all the hidden assumptions (the biggerst being permanent growth) that underpin so much of our world today, driven by high finance, and do little else but watch in

morbid fascination, and warn those that will listen, as the crash approaches

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