

Nesvetailova, A. & Palan, R. (2013). Sabotage in the financial system: Lessons from Veblen. *Business Horizons*, 56(6), pp. 723-732. doi: 10.1016/j.bushor.2013.07.009



**CITY UNIVERSITY  
LONDON**

[City Research Online](#)

**Original citation:** Nesvetailova, A. & Palan, R. (2013). Sabotage in the financial system: Lessons from Veblen. *Business Horizons*, 56(6), pp. 723-732. doi: 10.1016/j.bushor.2013.07.009

**Permanent City Research Online URL:** <http://openaccess.city.ac.uk/14109/>

### **Copyright & reuse**

City University London has developed City Research Online so that its users may access the research outputs of City University London's staff. Copyright © and Moral Rights for this paper are retained by the individual author(s) and/ or other copyright holders. All material in City Research Online is checked for eligibility for copyright before being made available in the live archive. URLs from City Research Online may be freely distributed and linked to from other web pages.

### **Versions of research**

The version in City Research Online may differ from the final published version. Users are advised to check the Permanent City Research Online URL above for the status of the paper.

### **Enquiries**

If you have any enquiries about any aspect of City Research Online, or if you wish to make contact with the author(s) of this paper, please email the team at [publications@city.ac.uk](mailto:publications@city.ac.uk).

# **Sabotage in the Financial System: Lessons from Veblen**

**Anastasia Nesvetailova and Ronen Palan**

In the wide-ranging discussion of the causes of the global financial crisis, and the role of banking in today's economy, questions of business tactics or financiers' motives are rarely addressed. Indeed, while 'incentives', 'vested interests,' power and increasingly, social utility, are often factored in into analyses of financial regulation, the motives and tactics of financial institutions are rarely discussed in a systemic way in academic and policy debate. And yet we believe that these two elements are key to understanding the financial system not as a mere sector of the wider economy, but as a business enterprise, driven by its own logic and shaped by a variety of business tactics of its key agents. In our vision of finance as business, we draw on the concept of industrial sabotage as a business tactic, originally developed by Thorsten Veblen, to inquire into the roots of the contemporary architecture of the financial sector. Our key premise is that the key motive driving the process that has been described as 'financialization' or financial innovation is the sabotage instinct of finance operating as businesses. Whereas Veblen originally understood sabotage as 'conscientious withdrawal of efficiency', today, we argue, the workings of the banking and financial sector augment the very notion of efficiency by relying on concepts, techniques and institutions of financial innovation, crucially, shrouded in complexity. In this paper we explore conceptual and institutional dimensions of this phenomenon.

## **Introduction**

"Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief"- so confessed Alan Greenspan, the Chairman of the Board of Governors of the Federal Reserve System, at the House Committee on Oversight and Government Reform hearings on the financial crisis in 2008 (Greenspan 2008, 2). His testimony was greeted with a collective shudder that for a time, altogether too brief a time, placed the entire edifice of economic thought into question. Greenspan acknowledged that one of the key tenets of standard economics, the idea that 'markets' are best placed to judge what is good for them, might be wrong. Financial institutions and their managers proved either unable or unwilling to differentiate between AAA financial securities and worthless, and even toxic, assets. It turned out that many CEOs of large banking houses did not understand the nature of many of the products their institutions were selling. Senior executives could hardly fathom why they were making such lucrative profits, but felt, nonetheless, that the gigantic bonuses they merrily swallowed were entirely justified. Inquiries like the one conducted by the Congressional committee in 2008 showed that senior management of many leading banking groups often had vague ideas what kind of entities their organizations maintained. Like the proverbial ex P.F.C Wintergreen in

Catch-22, the only people who seemed to know or understand what these financial innovations were, were to be found among the most junior and least experienced staff of the banks. Sharp and skilled, they were traders of fixed income securities working for commissions, or financial engineers devising complex mathematical schemes of value. Few, if any of them, had any overview of the systemic impact of their activities and products. More often than not, they simply were not interested in such questions. Beneath the layer of precision and sophistication, there was chaos in the financial system.

In the years that followed, academics and policymakers have been trying to make sense of this chaos. Many of them draw their inspiration from the work of Hyman Minsky, largely forgotten before 2007, but resuscitated by the 2007-09 crisis. Working in isolation during his career, Minsky was influenced by two traditions of thought that were skeptical of the paradigm of self-regulation and efficient finance. One familiar tradition leads back to Keynes and his focus on speculation in the financial system. The other current is less well-known, although it goes back even farther in the history of economic thought, to a group of economists led by Thorstein Veblen, John R. Commons and Joseph Schumpeter who are known today as scholars of Old Institutional Economics (OIE). Minsky – although he never truly acknowledged it in his own writing -- was highly influenced by the OIE tradition. In fact, he started his doctoral studies at Harvard under the supervision of Joseph Schumpeter.

We turn to Veblen, Commons, Schumpeter, Berle and other OIE scholars, in large part because these scholars were writing at the time of the most dramatic economic crisis and reorganization of the 20th century capitalism. Interestingly, the Great Depression brought students of Veblen to the very core of policy-making: Adolf A. Berle, Rexford G. Tugwell and others were members of the first Roosevelt's administration's 'brain trust' (Tilman 1996). The crisis of 2007-09 has also brought a new wave of scholars to the fore, who like OIE, demonstrate strong preference for inductive, as opposed to the traditional deductive methodologies of economics. Andy Haldane at the Bank of England, Adair Turner at the FSA, Zoltan Poszar at U.S. Treasury, Claudio Borio and William White at the BIS, Manmohan Singh at the IMF, acknowledge, in one way or another, their intellectual debt to the OIE group and to Hyman Minsky.<sup>1</sup>

---

<sup>1</sup> Incidentally, back in 1957 Minsky himself consulted the first Commission on Money and Credit set up to investigate the adequacy of monetary and financial regulation in the USA.

These echoes, we believe, warrant further inquiry into the fundamental ideas of OIE scholars and their descendants today. In what follows, we focus on one key element in Veblen's thought that can serve, we argue, as the basis for an alternative 'macro theory' of finance but which had been ignored thus far. Largely, we reckon, because it is rather simple and obvious. It is his notion that modern economy, that is, the economy that he witnessed taking shape in the late 19<sup>th</sup> century U.S., and which has been internationalized since, was dominated by the personality of the businessman, the principal 'habit of thought' of whom in terms of their outlook on profit making enterprise was what Veblen described as the technique of sabotage.

Veblen analyzed primarily industrial enterprises and his concept of sabotage was centered on the activities of the manufacturing sector (known as industrial sabotage). We believe though, that the idea has traction also in the sphere of finance. Our key premise is that the motive driving the process of financialization and more specifically, financial innovation, is the sabotage by the financial industry of its role of a provider of public good.

### **Veblen's Theory of Business and Sabotage**

In contrast to deductive approach and abstraction principles of orthodox economics, Veblen's approach to economics was observational and empirical. His primary data series were congressional committee reports of late 19<sup>th</sup> and early 20<sup>th</sup> century, centering on the predatory practices of American businesses. Veblen concluded that the central figure in modern capitalism was neither the rational consumer, nor the 'capitalist' but rather, the figure of the businessman. Businessmen were people, he argued, with no specialized expertise in production, manufacturing, services or management, but were experts in 'the art of buying and selling'. Veblen's theory amounted in essence, to a series of generalizations of the likely behavioral patterns of the businessman, as purveyors and traders in property rights, under diverse environmental conditions. In our analysis of finance we propose, following on Veblen, to start from a simple and straightforward premise: Banks, as well as the various departments and desks that they are made of, tend to think and behave like businesses, and they see their interest and function exclusively in money terms.

What does it mean that banks are businesses? Far from embracing competitive markets, Veblen believed that businesses were concerned by the state of equilibrium

conditions described in standard economics, since open and ‘fair’ competition inevitably would end up in wafer-thin profits, if at all. Businessmen complained about ‘ruinous competition,’ and devised an impressive array of techniques, documented by various congressional reports, that were intended to ensure that the free market of standard economics does not apply to their businesses. Best known of these devices were monopolies and cartels, but according to Veblen, these were only the tip of a very large iceberg.

Veblen used a generic term to describe the businessman’s techniques for profit generation as ‘*sabotage*’. Sabotage was, in his words, ‘the deliberate, although entirely legal, practice of peaceful restriction, delay, withdrawal, or obstruction used to secure some special advantage or preference’ (Veblen, 2001 [1921], 4). At the time of his writing, the term sabotage was associated with the fledgling trade unions as they sought to increase their power within the production process. Veblen appropriated the concept, and used it as a generic term to describe the behavior of the ‘captains of industry’ as they manipulated the rules and norms of property to ensure what he saw as ‘withdrawal’ from market, or the right to ensure that supply of goods and services is restricted in order to raise prices. These sorts of restrictions and withdrawal became key tools in the armory of, for instance, the railway companies, who would deliberately limit the number of journeys and available space on their lines to ensure higher prices. Some companies even employed private armies to destroy the lines placed by their competitors, resorting literally to physical sabotage. John R. Commons would later generalize upon the practice showing that subtle changes that were introduced by the Courts in the U.S. property laws in late 19<sup>th</sup> century allowed an interpretation of property rights from a right to hold, to a new and powerful right: the right to withhold. These sorts of rights, known in legal parlance as intangible property, were rights to withdraw or withhold, for instance, certain knowledge or patent and use it for private, profit making purposes.

Sabotage was even more deeply rooted in the world of business. Businessmen, Veblen argued, would deliberately seek to disorient their competitors by restructuring and reorganizing the world around them in ways that would sabotage their clients, competitors and governments. Sabotage, he argued, ‘commonly works within the law, although it may often be within the letter rather than the spirit of the law. It is used to secure some special advantage or preference, usually of a businesslike sort. It commonly has to do with something in the nature of a vested right, which one or another of the parties in the case aims to secure or defend, or to defeat or diminish’ (Veblen 2001 [1921], 6).

Sabotage did not necessarily produce deleterious impact on society. On the contrary, Veblen believed that innovation of new products, re-organizations and efficiencies in production, manufacturing and delivery, or managerial innovations, were driven primarily by the sabotaging instinct. Businessmen were not interested in producing better products per se; they adopted innovation in products and logistics as way of sabotaging their competitors. Alas, such positive outcome of the sabotaging instincts of business was not inherent to the economic system, nor were they proportionally as important as mainstream economists believed.

Neither Veblen nor John Commons appear to have made a distinction between industrial or commercial businesses, and financial entities. They considered J.P. Morgan or the Rockefellers ‘captains of industry’ as much as Jay Gould, ‘commodore’ Vanderbilt or Andrew Carnegie. We would interpret this to mean that the concept of sabotage, or the deliberate action that is aimed at weakening and disorienting another entity for own gain, be they the consumer, the competitor or the government, through subversion, obstruction, disruption or destruction, is also applicable in the financial sphere. Taking advantage of others – be they states, governments, shareholders, competitors or your own clients - has become essence of financial innovation and an ethos of many financial institutions today. As a sociologist of finance observed recently, “financial innovation is, at heart, the subversion of existing routines, rules, and boundaries...Profit-making need not be its only goal; it includes non-pecuniary motivations and objectives (Polillo 2011, 364). Only that Veblen would argue that such practices were very well established already a century ago.

### **The Concept of Financial Sabotage**

We identify three key dimensions of the sabotaging instincts of financial businesses. First, with regards to their clients, second, the government, and third, sabotaging each other. Gary Dymksi writes: ‘ownership rights in productive assets are embodied in long-lived, alienable nominal contracts or claims. So any individual’s wealth is more properly measured by the market value of her net assets than by the value of the “real assets” to which those paper assets correspond’ (Dymski 1991, 2). This is an important distinction. Economists fully understand that economic actors are interested in the ‘bottom line’ – this is the theory of profit maximization. There is, however, a debate between standard economics and OIE as to

which bottom line is of interest to businesses, and equally important, how businesses go about achieving their goals.

Veblenian approach would suggest that financial businesses understand that their clients are interested primarily in the transitory market value of assets (in that sense, they are concerned with short-term calculations). As a result, they are likely to respond to their client's 'demand' in a variety of ways, not least by inflating transitory asset values, worrying less about the long-term impact of such transitory techniques. As a result, competition in the financial markets does not necessarily produce long-term efficiencies in the provision of services. Rather, competition typically concentrates minds on various bench-marking comparative statistics. Financial businesses aim to demonstrate, in any way they can, including fraudulent and manipulative use of statistics, accounts and numbers, that they are able to produce above-average appreciation of market value assets compared with their competitors.

### **Sabotaging the clients**

How then, do financial businesses go about establishing their above average rate of asset value growth? There are mind-boggling numbers of techniques devised throughout the ages. The standard assumption is that whatever techniques are used, bench-markings pick up those financial actors that are successful because they are really good at what they do. Those who understand better the market, those who are better informed, are more clever and more efficient, or possess the best software, staff and intricate knowledge of the financial system, are those that are likely to be successful and 'beat the average' rate of return on financial assets. Being the best (and often the first) to recognize and establish a trend, is what distinguishes a dynamic institution like Goldman Sachs from, a more conservative and less dynamic entity like, say, Standard and Chartered. Or so has been the general belief before 2007.

Yet there are other techniques for inflating value, and they are legal, even if not, as Veblen notes, in spirit of the law. One simple but widespread technique is to use what economists call 'asymmetric information' – that is, the fact that clients are likely to be less knowledgeable than their banks -- and leverage. Both work best by playing with other people's money (OPM) – which is the expertise of the financial actors. The idea is very simple: slight growth in financial assets could be magnified many times over depending on the leverage that one can obtain. Most individual consumers' 'habit of thought' is stuck at a

1:1 leverage ratio, i.e., their salary or personal profit is gauged in a 1:1 ratio. The consumers of financial services are therefore habituated to think in terms of 1:1 of investment ratio.

Some consumers had learned that in good times they seem to be making good money in the real estate sector for a number of related reasons, but which essentially have to do with leverage. If a person takes a 75% mortgage (ideally, to be paid back interest only) then they achieve 1:4 leverage. In other words, on every dollar they put in, they achieve 4 dollars of appreciation (if there is one). For a while, appreciation is assured for no other reasons than as more people learn about the 'profits' made in real-estate, they 'invest' more and more in the market. Some wanted to be 'on the ladder', and many began to speculate on real estate. The effect was akin to what Jan Toporowski (Toporowski 1999) calls capital market inflation, or net inflow of capital chasing limited opportunities. The result of individual consumers factoring in their calculations of rising value was a self-fulfilling mechanism, as property rises appeared to be heading in one direction.

In their roles as Veblenian businessmen, financiers realized there were enormous short-term profits to be made by feeding the habits of their consumers. But feeding the habit proved risky on two counts. First, when real estate markets are rising in value, a declining portion of clients are able to put down the customary 25% down payment. The theory is that this would slow down demand for housing would lead then to the wonderful forces of equilibrium in action. The preferred solution to market signals was not to follow the market return to equilibrium, but instead to reduce the percentage of necessary down payment from 25% to 10%, then to 5% and eventually to 0% and even less, on the grounds that as property prices rise, the percentage of real 'down payment' would rise with it. Clients were now able to increase their leverage from 1:4 to 1:10 or even more, and made as a result, what appeared to be fabulous profits.

Second, financial businesses understood that their own resources were too limited to feed the frenzy. Regulated banks were constrained in their activities by the requirements of banking regulation such as Basle 2. Under the rules, if they wanted to engage in new activities such as the subprime mortgage market and thus take on more risk, they needed more regulatory capital to account for these risks. The Holy Grail of financial innovation came in 1994-95, when a technique that would later become known as collateralized debt obligation (CDO) was invented. The instrument allowed banks (JP Morgan initially) to insure and move off the books (sell to a third party, AIG in this case), the risk of default of a



corporate clients. Soon enough the technique started to be applied to the mortgage products and specifically, to subprime mortgages and eventually other types of unsecured. The practice, now centered on several types of risk trade, reliance on wholesale market funding (or shadow banks) for loans, allowed more risk-prone financial institutions to sabotage their more conservative competitors. On the surface, the practice appeared as the perfect example of innovation in the financial market producing efficiencies in intermediation between savers and borrowers. The reality was different: the expanding bubble economy and the shadow banking system were bound to implode at some point.

Was it an act of financial sabotage? Was it a deliberate action aimed at profit making through subversion, obstruction, disruption or destruction? It is possible to argue, as many economists do, that the concept of mortgage-backed security (MBS) or asset-backed security (ABS) is a good one, as it ensures continuing liquidity in the housing market. A CDO is a brilliant invention as it allows banks to free up capital to employ it more productively. But at the same time, a good rational actor of standard financial economics should have been very careful in dabbling in securitization and re-securitization during ‘good times’. The key function of banking institutions, after all, is to ensure the smooth and efficient intermediation between savers and borrowers. They were playing with other people’s money and should have been prudent in doing so. But these types of rational actors, were swamped by the bullish ones, and subsequently suffered losses.

We believe, therefore, that the behavior that is commonly associated with human failure in finance (greed, exuberance, fraud), became widespread practice and can be best described as sabotage in Veblenian terms. It amounted to technique of sabotaging clients, although, as Veblen acknowledged, it is not easy to prove the case in court of law. During the Savings-and-Loan crisis of the 1980s, a thousand prosecutions were launched against financial companies and hundreds of financial executives were convicted of crimes. In the wake of the dot-com collapse, more than a thousand were. During the latest crisis, the US authorities have largely been unable to convince juries that the desperate efforts of executives to persuade investors that things were under control in the depths of the crisis amounted to wrongdoing (Zaring 2013).

Shifting the products of securitization and re-securitization was clearly the Achilles heel in this process. Financial institutions had to sabotage, therefore, not only their clients, but also their competitors and other financial institutions so they will purchase these very

doubtful products. A former executive of Goldman Sachs has summarized three quick ways to become a leader in the firm:

a) Execute on the firm's "axes," which is Goldman-speak for persuading your clients to invest in the stocks or other products that we are trying to get rid of because they are not seen as having a lot of potential profit.

b) "Hunt Elephants." In plain English: get your clients — some of whom are sophisticated, and some of who aren't — to trade whatever will bring the biggest profit to Goldman.

c) Find yourself sitting in a seat where your job is to trade any illiquid, opaque product with a three-letter acronym (Smith 2012).

Such behavior is seen nowadays as some form of distortion and perversion of what finance should be about. The behavior is often described as 'rogue' or exceptional behavior within these institutions, blinded by a poorly-designed bonus culture, whereas the highly remunerated senior partners in such institutions, many of whom dabble in politics as well, profess to have known nothing, indeed, are personally indignant and upset, as they learn about these practices. The Veblenian theory of sabotage suggests that far from being evidence of some rogue behavior, these practices are exactly how business are likely to behave unless they are placed under close scrutiny.

Financial innovation plays an important role here, in two respects. First, the technique of sabotage works best undetected. Innovation, both structural and product innovation, has generated opacity, ostensibly warranted by the complexity of risk management tasks and money values involved. As Biais et al (2009) note, "hedge funds shroud themselves in mystery as to strategies, holdings, turnover, costs, and leverage. It is hard to monitor the diligence and competence of their managers in the absence of information on the sources of performance. The growth of structured finance and CDS's has meant greater reliance on over-the-counter trades that circumvent the discipline of open markets and regulation." Kurt Kew (2007) has observed that in cases where 'propensity to innovate' is a stable characteristic of institutional culture rather than a random result occurring within many equally creative institutions, "opacity might become a critical property of innovative financial institutions" (Kew 2007, 6).

Opacity and complexity can be interpreted from a Veblenian perspective as sabotage that was aimed to ensure that clients, the regulators, and even the management of the firm itself, had difficulties grasping what was really traded or created. Other papers in this Issue discuss the unique asymmetric information advantages of banks, so we take this advantage as a given and argue here that it is used in sabotage. At the aggregate level, the complexity that is inherent in the financial system that thrives on financial innovation is also a powerful agent by itself. Citing the French philosopher Pierre Bourdieu in her own account of the 2007-09 financial crisis, Gillian Tett notes that in a range of tools employed by elites to exercise control over society, the so-called areas of social silence are no less important than say, ownership of the means of production or financial resources. Power in a given socio-political context in other words, is not defined simply by the control over financial, intellectual or physical capital of a society, but also by the way a society talks about itself and understands its behavior. As Tett argues, ‘what matters is not merely what is publicly discussed, but also what is not mentioned in public’ (2009: xiii, italics in the original). Tett continues her own story about a credit derivative – which many believe, is the actual instrument that brought down the world financial system in 2007-09 – explaining that an important area of social silence, both inside and outside the banking world, developed about credit derivatives during the boom years of 2000-07. Such silence was partly a reflection of the opacity necessarily built into the process and products of financial innovation, but such silence was also accepted, publicly and politically, because of the presence of so-called silos – ‘self-contained realms of activity and knowledge that only the experts in that silo can truly understand’ (Tett 2009: xiv).

Second, financial innovation has been tightly intertwined with legal mechanisms. The principles of ownership, analyzed by Veblen and Commons a century ago, have become absolutely central in era of ‘originate and distribute’ model of banking. Only this time around, it is the principle of non-ownership that finance seems to thrive on. Financial businesses have tended to set up entities called Special Purpose Vehicle (SPV). These vehicles were supposed to be separate and independent of the issuing entity for bankruptcy purposes. Clients would therefore be less concerned with the doubtful situation of the selling entity (a bank originating the mortgages), and focus only on the products (bonds issued by the legally orphaned SPV) – which the rating agencies believed were safe. Post-crisis reality proved somewhat different as courts were not prepared to accept the fiction of separation for bankruptcy purposes. The validity of the claims for separation by SPVs was not challenged

in court of law before the crisis. Was it known that SPVs are dangerous, possibly toxic? Yet it was. Experts knew and wrote about it – but somehow the message did not get through. We argue here it was due to effective sabotage.

### **Sabotaging Governments**

Another important sabotaging technique goes under the title, ‘structured finance’. Nigel Lawson, former UK Chancellor of the exchequer under Thatcher and member of the House of Lords selected to sit on a parliamentary investigation into the Libor-rigging scandal said on the leading BBC program, *Newsnight*, in 30/01/13 that ‘structured financial vehicles in a euphemism for tax avoidance’. Lawson has a point. A good number of SPEs were registered offshore, presumably to obtain what a BIS study described as ‘tax neutrality’ – or tax avoidance in layman’s terms (BIS 2009). Everyone loves the idea: those who gain from the facility of tax neutrality (i.e. avoidance, or sabotaging your own government) clearly did. Those who bought the products assumed they were getting cheaper deals as the sellers were not burdened by taxation. Those who provided the facility happily charged for the service.

Let us consider the nature of a not atypical Cayman registered set of SPEs that were run by Bear Stearns. SPEs are highly obscure financial entities, and not much is known about them. The reason we know so much about these SPEs is due to the bankruptcy proceeding that Bear Stearns entered into. Bear Stearns maintained two High-Grade open ended investment companies that invested in *asset-backed securities* (“ABSs”), mortgage-backed securities, derivatives, options, swaps, futures, equities, and currencies. Funds that were registered as Cayman Islands exempted limited liability companies. The funds were administered by PFPC Inc., a Massachusetts corporation, which administered the funds and performed all back office functions, including accounting and clerical operations. The books and records of these funds were maintained and stored in Delaware, a state known as internal tax havens in the U.S. (Sharman 2011). Deloitte & Touche, Cayman Islands, performed the most recent audit of these funds. The investment manager of this fund was Bear Stearns Asset Management Inc., a New York corporation (“BSAM”). The investor registers were held in Dublin, Ireland (another well-known tax haven) by an affiliate of PFPC Inc... Two of the three investors in one of the Funds were registered in the Cayman Islands as well, but they were both Bear Stearns entities, which appear to have the same minimal Cayman Islands profile as did the two Funds. Accounts receivable were located across Europe and the U.S.;

counterparties to master repurchase and swap agreements were based both inside and outside the U.S., but none were in the Cayman Islands.

The courts concluded that the link between Cayman Islands that two SPVs was tenuous. The funds were registered in the Caymans, and had two ('dummy') directors that were residents of Cayman – but that was about it. Bearn Stearns went into the trouble of setting up very complex structures, spanning many jurisdictions, paying hefty fees for lawyers, accountant, clerks, all sort of license fees and the Cayman Islands dummy directors whose job was to do absolutely nothing. What exactly was the purpose of such complex structures like the one maintained by Bearn Stearns in the Caymans? The concept of 'dummy director' is very popular (McCabe 2012). McCabe's analysis of 3,232 companies with address at the Irish Financial Services Sector (IFSC) named individuals, each sitting on the boards of hundreds of companies, a lucrative business for these individuals. The Irish stockbroker firm A&L Goodbody, is company secretary for 1,088 companies! Including aircraft leasing, banks, investment funds, asset management, real estate and energy, where Matsack Trust limited is a company secretary for 1,295 companies, and so on. Clearly Goodbody and Matsack cannot possibly execute their task as company secretary in any meaningful way for any of those companies. Similar finding for large scale brass plate companies are found in the Netherlands and in Cayman.

Why then, to set up these complex and expensive structures that do not appear on the surface to be the most efficient way of allocating scarce resources? There were a number of reasons for doing so. First and foremost, offshore SPEs facilitate tax neutrality, or tax optimization. In Veblenian language, that amounts to sabotaging your government. The idea of tax minimization is so widespread and built in into our psyche that it is not seen as problem. The problem arises, however, when the financial system implodes, as it did in 2008, requiring the state to bail it out. But it is the same financial system that already weakened the state to the point that bailing out the financial system has led to very large sovereign debt crisis which ultimately damages the ability of the state to sustain the economy which finance feeds upon.

Our own research into the uses of offshore SPVs revealed other sabotaging purpose. Another now widely known bankruptcy case, the one of the British bank, Northern Rock, a Jersey-based SPV called Granite was used by the bank to affect a sham process called 'true sale.' True sale means somewhat different things in different jurisdictions, but essentially it

refers to exchange between two entities that do not share common ownership. The idea is that when two separate entities trade assets they will do so for good economic reasons, hence, the trade may be considered as 'true sale' as opposed to the very common intra-company trade that take place world-wide. Rating agencies were prepared to rate only the products that were sold in the markets under 'true sale' arrangements. The beauty of offshore SPEs was that that no one was able to know for sure who were the ultimate owners and beneficiaries of assets or the SPE, as was the case of Northern Rock (and we have learned subsequently, many other banks). Hence, financial houses could 'sell' a product effectively to themselves or to the entities they controlled offshore at any price they wish to cite, and the apparent 'true sale' would serve as pointer for other trades that would then follow the original true sale. Was it an act of rogue behavior of some marginal financial actors, or was it a typical act of Veblenian sabotage? Complexity was introduced, as in many other instances in finance, in order to fool gullible investors. Yes, but incredibly, as Veblen notes, not illegal, if not in the spirit of the law.

Too big to jail, but too good not to sabotage.

Andy Haldane of the Bank of England calculates that the 'natural' size of large bank, that is the natural size of the efficient standard economics banking entity, is about \$US 100 billion of assets (Haldane 2012). Yet, many banks evolved somehow into much larger entities, some of them had over US\$ 1 trillion of assets. Why is that? Veblenians point out that size had become a prime technique of sabotaging both the state as well as the competitors. In the leverage game, banks learned that size does matter. For three related reasons. First, the market factored in their 'too big to fail', which meant, they could now garner lower rates of interest in the 'open markets' because the markets factored in sovereign support to them. Haldane calculates that the combine advantage of being too big to fail gave these institutions discounted interests rates that would account collectively to about \$US 70 billion annually before the crisis. That is, their large size gave them an advantage compared to lower size banking institutions (Brewer III and Jagtiani 2007; Hughes and Mester 1993).

Second, and more directly, size combined with leverage has increased their economic leverage and apparent profit (Mester 2005; Mishkin 2006). The profits were sustainable however, only for as long as the boom continued. When the music stopped playing, the complex interconnections and the size of leverage created during the boom years, have pulled

down large banking houses and the banking system as a whole. The link between apparent performance during good times and impact of potential losses during a crisis is the third opportune technique of sabotaging by size.

Third, size, or systemic significance widely understood, appears to give immunity to financial institutions. Our banks have become not only too big to fail, but also too big to jail (Alessandri and Haldane 2009; Mishkin 2006; Pennacchi 2000). Eric H. Holder, Jr., US attorney general, has noted the failure to persecute multinational banks for various transgressions during the recent boom: “I am concerned that the size of some of these institutions becomes so large that it does become difficult for us to prosecute them when we are hit with indications that if we do prosecute – if we do bring a criminal charge – it will have a negative impact on the national economy, perhaps even the world economy” (Henning 2013).

Analyzing the possible lessons of such a crisis, Veblen warned that: “the abruptness of the recapitalization and of the redistribution of ownership involved in a period of liquidation may be greatly mitigated, and the incidence of the shrinkage of values may be more equally distributed, by a judicious leniency on the part of the creditors or by a well-advised and discreetly weighted extension of credit by the movement to certain sections of the business community” [Veblen 1904, 205]. It appears that the age of the financial innovation has stretched the Veblenian notion of such mitigation to extreme. Table 1 below presents an analysis of the so-called ‘Heads I Win, Rails Your Lose’ bank bonus culture and specifies in detail the size of bonus packages paid out by the banks who were the recipients of TARP scheme in 2008. The summary of the investigation contused by New York State Attorney at the time is simple enough: “When banks did well, their employees were paid well. When banks did poorly, their employees were paid well. And when banks did very poorly, they were bailed out by taxpayers and their employees were still paid well. Bonuses and overall compensation did not vary significantly as profits diminished” (Cuomo 2009: 1).

Insert table 1 about here.

## **Conclusion**

It is generally accepted that simple, parsimonious theories are more preferable to complex paradigms because they offer a better handle for analysis and regulation. In finance, the

simplicity is offered by the efficient market theory; an elegant vision that combines actors, incentives, and dynamics of inter-relationships among them. We argue in this paper that Thorstein Veblen offers an alternative simple, parsimonious theory that provides an equally good analytical tool to cut through the maze of complexity and apparent randomness in the financial system driven by financial innovation, namely, though his conceptualization of sabotage as business tactics.

Veblen suggests that instead of using the standard economics production function and apply it nilly-willy to finance, it is better to think of financial houses as businesses, and as businesses that operates primarily by sabotaging their customers, their government and their competitors. Theories of financial regulation, in turn, would work the ideas as a central premise as well, seeking to regulate and anticipate the behavior of sabotaging entities in a complex system of finance.

Table 1.

**TARP recipients 2008 Bonus chart**

Legend: each bank's earnings/loses; bonus pool, number of employees, earning per employee, bonus per employee, amount of TARP funds received and the amount of bonus payments in excess of \$3 million,. \$2 million, and \$1 million

Source: Guomo, A. 2009.

	Earnings/ (Losses)	Bonus Pool	#of emplo yees	Earnin gs/ emplo yees	Bonus/emp loyees	TA RP	>- \$3 M	>\$2 M	>\$1 M
Bank of Americ a	\$4,000,000, 000	\$3,300,00 0,000	243,00 0	\$16,46 1	\$13,580	\$45 bn	28	65	172
Bank of New York Mellon	\$1,400,000, 000	\$945,000, 000	42,900	\$32,63 4	\$22,028	\$3b n	12	22	74
Citigro up, Inc.	(\$27,700,00 0,000)	\$5,330,00 0,000	322,80 0	(\$85,8 12)	\$16,512	\$45 bn	12 4	176	738
Goldm an Sachs Group	\$2,322,000, 000	\$4,823,35 8,763	30,067	\$77,22 8	\$160,420	\$10 bn	21 2	391	953
J.P.Mo	\$5,600,000,	\$8,693,00	224,96	\$24,89	\$38,642	\$25	>2		1,6



rgan Chase & Co.	000	0,000	1	3		bn	00		26
Merrill Lynch	(\$27,600,000,000)	\$3,600,000,000	59,000	(\$467,797)	\$61,017	\$10bn	149		696
Morgan Stanley	\$1,707,000,000	\$4,475,000,000	46,964	\$36,347	\$95,286	\$10bn	101	189	428
State Street Corp.	\$1,811,000,000	\$469,970,000	28,475	\$63,600	\$16,505	\$2bn	3	8	44
Wells Fargo & Co.	(\$42,933,000,000)	\$977,500,000	281,000	(\$152,788)	\$3,479	\$25bn	7	22	62

### References

Alessandri, P., and A. G. Haldane. *Banking on the State*. Bank of England working paper, London: Bank of England, 2009.

Biais, B., Jean-Charles Rochet, and P. Woolley. *Rents, learning and risk in the financial sector and other innovative industries*. FMG Discussion Paper, London: The Paul Woolley Centre, 2009.

BIS. *Report on Special Purpose Entities*. Joint Report, Basle: Bank of International Settlement, 2009.

Brewer III, E., and J. Jagtiani. *How Much Would Banks Be Willing to Pay to Become "Too-Big-to-Fail" and to Capture Other Benefits?* RWP 07-05, Kansas: Federal Reserve Bank of Kansas City, 2007.

Commons, John. *Institutional Economics*. Madison: University of Wisconsin Press., 1961.

Commons, John R. *The Legal Foundations of Capitalism*. Madison: The University of Wisconsin Press., 1959 [1924].

Cuomo, A. *No Rhyme or Reason. The 'Heads I Win, Tails you Lose' Bonus Cultiore*. Social Reptsort , State of New York. : Attorney General, 2009.

Dew, K. *Why are Profits from Financial Innovation So Difficult to Identify? Innovation Clusters and Productive Opacity*. NFI Working Paper No. 2006-WP-13, NFI , 2006.

- Dymski, Gary. "From Schumpeterian Credit Flows to Minskyian Fragility: The Transformation of the US Banking System, 1927-1990." *unpublished*. 1991.
- Greenspan, Alan. "Testimony of Dr. Alan Greenspan." *Committee of Government Oversight and Reform*. 23 October 2008.  
<http://democrats.oversight.house.gov/images/stories/documents/20081023100438.pdf>.
- Haldane, Andrew G. *On Being the Right Size*. Speech, London: Bank of England, 2012.
- Henning, P. "After Financial Crisis, Prosecutors Navigate Tricky Waters." *New York Times dealbook*, 13 March 2012.
- Hughes, J., and L. Mester. "A Quality and Risk-Adjusted Cost Function for Banks: Evidence on the 'Too-Big-To-Fail' Doctrine." *Journal of Productivity Analysis*, 4 (September), pp. 293-315., 1993: 293-315.
- J., Sharman. "Testing the Global Financial Transparency Regime." *International Studies Quarterly* 55, no. 4 (2011): 981-1001.
- McCabe, Conor. "Snapshots of the Modus Operandi of the Irish Financial Services Sector." *IRL*. 14 August 2012.  
<file:///D:/Users/Ronen/Documents/OFF/AUTHORS/Irish%20Left%20Review%20%20%20SNAPSHOTS%20OF%20THE%20MODUS%20OPERANDI%20OF%20THE%20IRISH%20FINANCIAL%20SERVICES%20SECTOR%20.htm> (accessed march 01, 2013).
- Mester, Loretta J. *Optimal Industrial Structure in Banking*. Working Paper No. 08-2., Philadelphia: FRB of Philadelphia , 2005.
- Mishkin, F. "How Big a Problem is Too Big to Fail? A Review of Gary Stern and Ron Feldman's Too Big to Fail: The Hazards of Bank Bailouts." *Journal of Economic Literature* 44, no. 4 (2006): 988-1004.
- Pennacchi, G. "Comment on Incentives for Banking Megamergers: What Motives Might Regulators Infer from Event-Study Evidence?" *Journal of Money, Credit and Banking* 32, no. 3 (2000): 702-5.
- Polillo, S. "Wildcats in banking fields: the politics of financial inclusion." *Theory and Society* 40, no. 4 (2011): 374-83.
- Smith, G. "Why I Am Leaving Goldman Sachs." *New York Times* , 14 March 2012.
- Tett, G. *Fool's Gold* . New York: Free Press, 2009.

Tilman, Rick. *The intellectual legacy of Thorstein Veblen: unresolved issues*. Westport, Conn.: Greenwood Press, 1996.

Toporowski, Jan. "Monetary Policy in an Era of Capital Market Inflation." *Ninth Annual Hyman P. Minsky Conference on Financial Structure*. The Jerome Levy Economics Institute of Bard College, 1999.

Veblen, Thorstein. *Absentee Ownership and Business Enterprise In Recent Times. The Case of America*. Boston: Beacon Press, 1923.

—. *The Engineer and the Price System*. Kitchener, Ontario: Batouche Publishing, 2001 [1921].

—. *The Theory of Business Enterprise*. Clifton, New Jersey : Augustus M. Kelley , 1904.

Zaring, D. "The Financial Crisis in the Courts." *New York Times dealbook*, 7 January 2013.