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Financial Predation: A Contemporary Problem

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Abstract

Based on the theory of financial predation, this short paper argues that certain financiers opt to become pure financial predators: their underlying financial motivation is to gain from others with the full knowledge that they are causing harm, such as a financial loss and psychological shock, to their victims, *by surprise*.

Keywords:

Predator, Prey, Harm, Financial loss, Psychological shock, Surprise.

JEL classification:

C51, D01, D03, G20, G21, G23, M14

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Depredación financiera: **Un problema contemporáneo**

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Resumen

Basado en la teoría de la depredación financiera, este breve artículo sostiene que ciertas personas o entidades optan por convertirse en puros depredadores financieros: la motivación financiera subyacente sería ganar a costa de otros con pleno conocimiento del año que pudieran causar a sus víctimas, como una pérdida financiera o un shock psicológico, todo ello como un depredador, *por sorpresa*.

Palabras clave:

Depredador, presa, perjuicio, pérdida financiera, shock psicológico, sorpresa.

1. The Theory of Financial Predation – A Definition

Perceived predation is the perception a market agent has that another agent wants to take advantage of him for his own benefit, causing him a loss, *by surprise* (Mesly, 2010). According to the theory of predation, the market is composed of four market agents, each capable of predatory acts: consumers (e.g. sabotage), producers (e.g. Madoff), regulators (e.g. corrupt governments) and outsiders (e.g. black markets). The importance is on *perception*: the reality is of minor relevance, rather it is how one thinks the other will act that matters. Perceived predation is to human interaction what perceived risk is to the perception a buyer has of a product that he thinks is likely to fail (e.g. a used car). Perceived predation is different from opportunism in the sense that it implies a predatory strategy (e.g. predatory mortgages) and is based on mutual trust rather than on contracts (Williamson, 1975, 1981, 1985).

The theory of predation as put forth by Mesly (2009, 2010 and 2011) stipulates that a predator (any one of the four market agents) is characterized by four key features: he is cold, calculative, self-centered and sneaky. He uses one or a series of subterfuges (e.g. complex financial mechanics) to confound his prey or else weaken it emotionally. He inevitably targets his prey's weaknesses (e.g. lack of knowledge of the financial market).

Five elements are required to conclude that there is predation from a structural point of view: a predator (e.g. a financier); a prey (e.g. a naïve multiple-home buyer); a tool (e.g. easy mortgage access); a loss (e.g. a house); and a surprise effect. It is not enough to have five static (yet defining) components of predation. These must be put in action. The theory of predation stipulates that a predator' strategy is divided into five steps. First, he identifies the victims' vulnerabilities. Second, he builds on the sentiment of trust, on cooperative efforts and a sense of win-win within the relationship with the prey. Third, the predator solicits a decision based on time pressure and information asymmetry. The hope is that the prey will reach a non-optimal decision that will allow the predator to gain a definite advantage. Fourth, the financial predator leads the prey into action (e.g. signature of a contract) so that it becomes locked in (e.g. assuming a mortgage too big to carry). Finally, the predator concludes the transaction which is materialized by a transfer of ownership or a movement of property titles. Figure 1 exemplifies what we call the predatory web:

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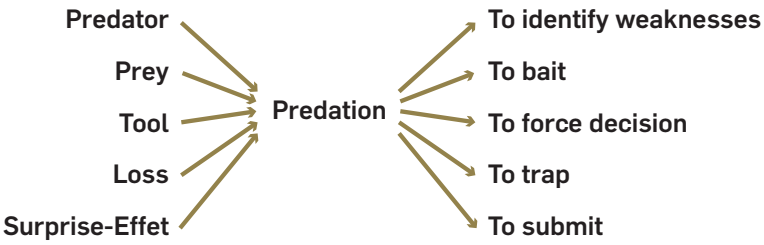
Figure 1. **Predatory Web**

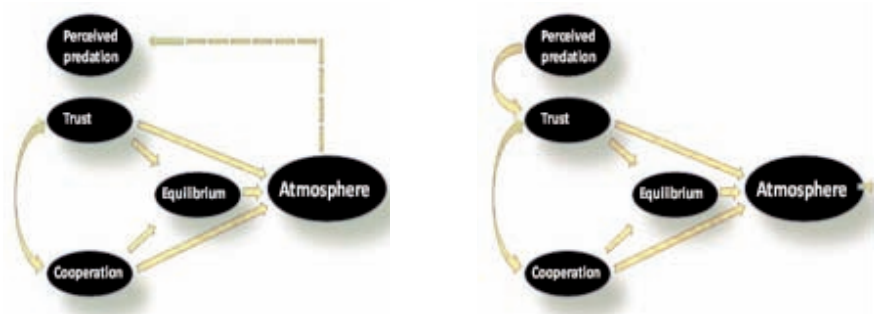


The predatory mortgages at the base of the 2008 market failures are one example of a predatory web.

There are therefore four key characteristics to the financial predator: first, as seen, he targets only the prey's *assets*. Second, he is part of an *ecosystem* of which he desires to take the helm one way or the other (e.g. Madoff at NASDAQ). The third characteristic is *location*: financial predators always track their victims where they are knowledgeable (unlike sexual predators); they work their predatory ways where they have the knowledge, the connections and the ability to act. Finally, financial predators favour *complexity* in order to baffle or intimidate their preys (e.g. endless transactions, overly complex financial instruments), because in the end, financial predation is a mind game played around financial assets meant to baffle others (such as clients and regulators).

Figure 2 below illustrates the concept of financial predation, showing how a financial predator creates an atmosphere of good will by using trust (mostly blind trust) and cooperation in order to minimize any negative perception his clients may have of him. Trust is used as a bait to attract the naive client. In this figure, perceived predation can be considered as an independent or dependent latent variable according to the circumstances. In other words, perceived predation adopts one of two states: either it is a dependent variable or else an independent variable, as follows:

Figure 2. **Mesly d'Arloz Lévy Mangin (MALM) Model**



In the left box (dependent variable), a negative relationship will conclude with a negative perception of the vis-à-vis. In the right box (independent variable), a customer (as an example) walks into a used-car dealership with an *a priori* negativity bias towards salespeople.

2. Specification of the General Mathematical Model

We proceed to analyze Figure 2 (The Mesly d'Arloz-Lévy-Mangin model) using Structural Equation Modeling (SEM) and the general LISREL model whereby trust, cooperation, equilibrium, atmosphere and perceived predation are considered constructs or latent variables. These constructs are specified by manifest variables that are measured through the MESLY I® questionnaire (Mesly, 2010).

The general equation for endogenous manifest variables $\mathbf{Y}$ is expressed as follows:

$$\mathbf{Y} = \mathbf{\Lambda}_y \boldsymbol{\eta} + \boldsymbol{\varepsilon}$$

where $\mathbf{Y}$ is a vector with px1 observed measures for the dependent variable; $\mathbf{\Lambda}_y$ is a matrix of pxm regression coefficients of the latent variable $\boldsymbol{\eta}$ and where $\boldsymbol{\varepsilon}$ represents a px1 vector with the $\mathbf{Y}$ measurement, so that:

$$\mathbf{Y} = \mathbf{\Lambda}_y \boldsymbol{\eta} + \boldsymbol{\varepsilon}$$

$$\begin{bmatrix} y_1 \\ \cdot \\ \cdot \\ \cdot \\ y_p \end{bmatrix} = \begin{bmatrix} \cdot & \cdot & \cdot & \cdot & \cdot \\ \cdot & \cdot & \cdot & \cdot & \cdot \\ \cdot & \cdot & \cdot & \cdot & \cdot \\ \cdot & \cdot & \cdot & \cdot & \cdot \\ \cdot & \cdot & \cdot & \cdot & \cdot \end{bmatrix} \begin{bmatrix} \eta_1 \\ \cdot \\ \cdot \\ \cdot \\ \eta_m \end{bmatrix} + \begin{bmatrix} \varepsilon_1 \\ \cdot \\ \cdot \\ \cdot \\ \varepsilon_p \end{bmatrix}$$

$$(p\text{x}1) \qquad (p\text{x}m) \qquad (m\text{x}1) \quad (p\text{x}1)$$

The measurement procedure is the same, the manifest exogenous (independent) variables, as follows:

$$\mathbf{X} = \mathbf{\Lambda}_x \boldsymbol{\xi} + \boldsymbol{\delta}$$

where $\mathbf{X}$ is a vector with qx1 being observed measures for the independent variables; $\mathbf{\Lambda}_x$ represents a qxn matrix of $\mathbf{X}$ regression coefficients of the latent variable $\boldsymbol{\xi}$, and where $\boldsymbol{\delta}$ is a vector of qx1 measurement of $\mathbf{X}$ so that:

$$\mathbf{X} = \mathbf{\Lambda}_x \boldsymbol{\xi} + \boldsymbol{\delta}$$

$$\begin{bmatrix} x_1 \\ \cdot \\ \cdot \\ \cdot \\ x_q \end{bmatrix} = \begin{bmatrix} \cdot & \cdot & \cdot & \cdot & \cdot \\ \cdot & \cdot & \cdot & \cdot & \cdot \\ \cdot & \cdot & \cdot & \cdot & \cdot \\ \cdot & \cdot & \cdot & \cdot & \cdot \\ \cdot & \cdot & \cdot & \cdot & \cdot \end{bmatrix} \begin{bmatrix} \xi_1 \\ \cdot \\ \cdot \\ \cdot \\ \xi_n \end{bmatrix} + \begin{bmatrix} \delta_1 \\ \cdot \\ \cdot \\ \cdot \\ \delta_n \end{bmatrix}$$

$$(q\text{x}1) \qquad (q\text{x}n) \qquad (n\text{x}1) \quad (q\text{x}1)$$

The structural equation model can then be defined as follows:

$$\boldsymbol{\eta} = \boldsymbol{\beta}\boldsymbol{\eta} + \boldsymbol{\Gamma}\boldsymbol{\xi} + \boldsymbol{\varsigma}$$

$$\underset{(m\text{x}1)}{\begin{bmatrix}\eta_1\\ \cdot\\ \cdot\\ \cdot\\ \eta_m\end{bmatrix}} = \underset{(m\text{x}m)}{\begin{bmatrix}0 & \cdot & \cdot\\ \cdot & 0 & \cdot\\ \cdot & \cdot & 0\end{bmatrix}} \underset{(m\text{x}1)}{\begin{bmatrix}\eta_1\\ \\ \\ \\ \eta_m\end{bmatrix}} + \underset{(m\text{x}n)}{\begin{bmatrix}\cdot & \cdot & \cdot & \cdot & \cdot\\ \cdot & \cdot & \cdot & \cdot & \cdot\\ \cdot & \cdot & \cdot & \cdot & \cdot\\ \cdot & \cdot & \cdot & \cdot & \cdot\\ \cdot & \cdot & \cdot & \cdot & \cdot\end{bmatrix}} \underset{(n\text{x}1)}{\begin{bmatrix}\xi_1\\ \cdot\\ \cdot\\ \cdot\\ \xi_n\end{bmatrix}} + \underset{(m\text{x}1)}{\begin{bmatrix}\varsigma_1\\ \cdot\\ \cdot\\ \cdot\\ \varsigma_m\end{bmatrix}}$$

where $\boldsymbol{\eta}$ represents a vector of mx1 endogenous (dependent) latent variables (factor variables or constructs), $\boldsymbol{\xi}$ a nx1 vector of exogenous latent variables (independent), $\boldsymbol{\beta}$ a mxm regression coefficient matrix or a matrix with the exogenous variables displaying its effects onto endogen variables; $\boldsymbol{\Gamma}$ is a mxn matrix of regression coefficients and finally $\boldsymbol{\zeta}$ a mx1 error vector of the equations.

We suppose that the $\boldsymbol{\beta}$ matrix is not singular and that the $\boldsymbol{\xi}$ and $\boldsymbol{\zeta}$ matrices are not correlated in between themselves. This approach to the model remains to be tested but constitutes an attempt to establish measurement parameters.

3. Conclusion

In this short paper, we have presented the theory of predation. A financial predator gains trust from some key financial institutions and from the average investors, which leads them to believe they can safely cooperate with him, notably in managing their moneys. Madoff's spectacular regularity of returns over many years despite market turmoil put naive investors at ease rather than triggering sounding alarms. This created a business atmosphere that called for growth and as growth took place, the Ponzi-scheme could be maintained to the advantage of the one committing predation. The predatory web was maintained as long as the system kept finding new sources of cash.

In summary, a financial predator uses trust and cooperation to create a web much like a spider in the animal kingdom traps its preys; once caught in the web, the clients find it hard to escape as the financial predator does all he can to promote a positive image of himself.

This analysis was brief and presented for the sole purpose of outlying the main components of the theory of predation. It points to the fact that the theory of financial predation (and its mathematical modeling) deserves to be further developed as it is in its infancy. Practical applications would include the marketing of financial

services and improvements on current regulations aimed at stabilizing the markets and protecting investors large and small. It is only through better management of risks and a better identification of predatory behaviours that the financial sector will benefit from a stronger social image.

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