

Ben Bernanke: The REPO Man and Castles Made of Sand

[The Institutional Risk Analyst](#)

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Our system evolved from one funded by intermediaries, to one largely financed by markets. The traditional ties between borrower and creditor were weakened as credit risk became just another commodity to be traded and distributed.

Terrence Checki
Executive Vice President
Federal Reserve Bank of New York
Speech to the Foreign Policy Association
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A little Indian brave who before he was ten,
Played war games in the woods with his Indian friends
And he built up a dream that when he grew up
He would be a fearless warrior Indian Chief
Many moons past and more the dream grew strong until
Tomorrow he would sing his first war song and fight his first battle
But something went wrong, surprise attack killed him in his sleep that night
And so castles made of sand melts into the sea, eventually
"Castles Made of Sand"
Jimi Hendrix
Axis: Bold as Love (1967)

This week in [The IRA Advisory Service](#), we talk about the SEC meeting on Wednesday, April 7th, to consider revising rules that govern asset-backed securities. We see the SEC rule as being potentially a big setback for the forces of evil among the Sell Side firms who've been fighting reform and want to go back to the bad old days of rape and pillage in the market for private label ABS. Members of the Buy Side are already having a very positive effect on this process. All investors should comment on and support the rule change to Reg AB proposed by the SEC on Wednesday. Looks like the FDIC is no longer alone in the fight for reform of the securitization markets.

Sorry to say, the new SEC rule will probably not provide a badly needed shot in the arm for the proponents of a certain dialect of XML. The key issue with ABS and all corporate disclosure is standardization and frequency, not how the data is tagged. Whichever flavor of XML is selected or not by SEC for this new disclosure is a business issue and has nothing to do with making the data useful to investors or analysts. One of our readers will be addressing these and other issues regards the need for better disclosure around private label ABS in an upcoming comment in *The Institutional Risk Analyst*.

The holiday provided a number of juicy titbits upon which to dwell. We don't *really* need to add to the ample commentary in response to the statement by Larry Summers that the

economy was reaching "escape velocity." But we can only hope that, in the case of Summers, an exit strategy is implemented by President Barack Obama sooner rather than later. Along with an escape launch plan for Secretary of Treasury Tim Geithner, a timely departure by Summers will signal renewed awareness of risk management by the White House as the November election approaches. Any bets on which Wall Street hedge fund or dealer will employ Summers?

The letter to his firm's shareholders from JP Morgan (JPM) CEO Jamie Dimon was also released during the holiday. Dimon defended the need for global banks: "In the current political environment, size in the business community has been demonized, but the fact is that some businesses require size in order to make necessary investments, take extraordinary risks and provide vital support globally. America's largest companies operate around the world and employ millions of people."

Hogwash. A large fraction of JPM's business on the trading side of the book is speculative and does not have any connection to corporate business or the real economy. The very large JPM banking and corporate finance book that is real and tangible is still dwarfed by the flow of speculative and gratuitous OTC derivatives activity which courses through JPM every day. And speaking of the Sherman Antitrust Act, through its OTC derivatives business JPM exercises the same overall monopoly power as its namesake did a century ago in the years just before the creation of the Federal Reserve System. This is one reason why we agree with members of the Federal Reserve System and others who've called for the orderly breakup of the large banks and a separation between the deposit-taking business and the trading and underwriting activities, the latter which should be housed in a separate broker dealer.

The other reason we favor the breakup of large banks is op-risk. If Jamie Dimon wants to run a big bank, fine and dandy, but we'd like to see all of the OTC derivatives move out of the bank and onto an exchange. To concentrate a large fraction of global OTC derivatives exposures inside one bank, namely JPM, is systemically unstable and makes our case all day long for exchange trading of all OTC instruments. Dimon supports the enhanced resolution authority contained in the several legislative proposals on Capitol Hill and says that "a failure should be based on a company's inability to finance itself," but his bank is a single point of failure for the entire OTC derivatives complex.

Of course, the idea of the Fortress being made of sand is not an easy concept for many. JP Morgan has always been in the enviable position of deciding whether or not to extend funding to or buy a troubled bank or company, rather than the opposite. Bear, Stearns & Co., Washington Mutual and the Tennessee Iron & Coal Company all belong on the list of firms bought for pennies on the dollar by the House of Morgan in times of market crisis and tight money. To imagine the systemic demise of JPM is difficult or even impossible for many investors. But the fact of the OTC derivatives book makes the unthinkable very possible. That was the point of rescuing Bear, Stearns -- to save JPM, Deutsche Bank (DB), the heir to the Bankers Trust derivative legacy, and the rest of the OTC market.

To say, as Mr. Dimon does, that JPM is necessary to serve the needs of multinational commerce and trade is a bit of an overstatement. By definition, the size of the derivative footprint in exchange and OTC products is an order of magnitude larger than the real economy. Part of the rationale for imposing punitive taxes on Wall Street and in the City of London is the fact that so much of the activities in the banking market today are derivative and not linked to any true business and commerce whatsoever. But ever nimble, Dimon then does a pirouette and attempts to dissuade the Congress from punishing the actions of the large banks such as JPM because these companies are publicly owned.

"Very often, when the public or politicians take punitive efforts against banks like ours, they think they are punishing only the senior management team, when, in fact, they are punishing ordinary shareholders as well. Contrary to popular perception, Main Street owns our biggest banks and corporations through savings and retirement funds," Dimon reveals.

In legal terms, large, complex institutions such as JPM may be "owned" by the shareholding public, but the zombie banks operate at the forbearance and through the active support of the US government. Keep in mind that most of the large dealers have negative or near-zero risk adjusted returns, while regional banks had double digit risk adjusted returns on capital or RAROCs. Without the implicit backing of the US Treasury and Federal Reserve System, the remaining large dealers of OTC assets and derivatives could not function in the post-crisis marketplace. This reality is most visible in the "tripartite" market for repurchase agreements or REPOs, the basic way in which the Street finances its working capital book.

For those of you who have not been reading the front-page stories about accounting fraud at Lehman Brothers through what is called "REPO 105," a repurchase agreement is a way for dealers and other market participants to finance securities, mostly by lending the securities overnight but sometimes for longer periods of weeks or months. Figure that 70% of the REPO market is for securities lending over 90 days or less and 90% of all REPO trades have maturities inside a year, according to the COO of one of the largest dealers in New York.

In the case of Lehman Brothers, a REPO was *over-collateralized* to disguise the net indebtedness of the firm, truly an example of innovation in financial markets. In a normal REPO, the paper which is loaned is haircut by a certain percentage of par depending on the credit quality of the paper and the counterparty, and the volatility of the markets. This is done by lending the bonds to another party in return for cash. The terms of the REPO, particularly the discount to the face value of the bonds, describe the cost of the loan *and* the credit quality assigned to the entire trade by the lender of cash.

At present, the tri-party REPO market is comprised of three easy pieces: the Federal Reserve Bank of New York, aka the party of the first part; the Bank of New York (BK), which acts as the custodian; and everyone else, also known as the parties of the second part. Everyone in the REPO market faces the Fed and clears through BK in a situation

that is a close analog to the post-Geithner OTC swaps market. The participation of BK as custodian/counterparty assures that the collateral does not need to be delivered or returned. The old days of banks and funds bilaterally lending and borrowing collateral, and delivering same, is but a fading memory.

Like the OTC derivatives markets, in the REPO market of today everyone faces the Fed, raising a practical question as to what extent the private "market" has ever really recovered. In basic market terms, the Fed's purchase of \$2 trillion plus in securities via quantitative easing or "QE" and the tri-party REPO book described above are all the same in terms of the Fed managing or perhaps more accurately *simulating* the level of demand for government and agency securities, not to mention private label MBS. The film *The Matrix* comes to mind, but more John Adams, who always wanted a single *public* bank to operate in the US. Under the kindly direction of the Federal Reserve Board, that is precisely where we are headed.

Now that it's April and the Fed's QE purchase program is ending (albeit with settlement extending through June, please note), it seems fair to ask: What trick is Fed Chairman Ben Bernanke going to perform next to maintain the stability of market prices? Purchases of defaulted collateral by Frannie Mae will tend to bolster short-term demand in the bond market as QE ends. But given the tentative tenor of the fixed income community, most of the observers we know in and out of the regulatory community wonder whether QE can really go away. Thus the search for politically attractive alternatives continues.

As we've noted in past comments, the visible volatility in the financial markets measured by the VIX and other derivative products is depressed due to Fed market intervention via QE. While the Fed did not sterilize these massive market adjustment operations in the options market, that does not mean that the central bank is indifferent to the issue of duration. No, what we hear in the REPO market is that the Fed is considering making changes that would force banks and dealers to duration match their REPO book. The objective here is to avoid another "run on REPO" a la Lehman Brothers, etc. This would be an alteration in market practice that, to put it mildly, would imply significant reductions in the margins under which dealers operate.

But we have trouble understanding the point of such an exercise since we already have the Fed as REPO counterparty to the known world. Where is the liquidity risk that a duration matched book will address? While it is possible in theory for the participants in the REPO market to hedge duration, they cannot hedge the liquidity risk -- the issue we think really drives thinking on REPO among regulators with whom we speak. There is a significant amount of attention focused at the Fed in terms of "fixing" the REPO market these days, but unfortunately we think the end result so far is that the Fed has nationalized the problem instead of restoring private market function.

Several market participants contacted by The IRA also wonder if a Fed mandate on REPO is not simply a way to hide losses on the Fed's portfolio as and when interest rates rise. Since the central bank did not hedge any of its duration risk as part of QE purchases, a topic that will be discussed in a future comment by a reader, the bank will lose money

on its \$2 trillion book as rates rise. Putting part of the \$2 trillion in securities purchased by the Fed out as REPO, instead of selling the securities as Chairman Bernanke has suggested from time to time, would help to take pressure off of the cash market for bonds and also would conceal losses on the Fed portfolio.

Fact is, while you can get irate at Jaime Dimon for claiming that his monopoly bank/derivatives exchange did not need a bailout from the Fed and Treasury during the financial meltdown of 2008, Ben Bernanke deserves greater critical heat for his massive market and political manipulation in the period leading up to his Senate confirmation. With QE, the Fed bought time at the cost of trillions of dollars in currency expansion and debt, and without really repairing the underlying private market dysfunction. When you are buying time, there is supposed to be some object, some underlying goal to be achieved. QE seems to us a very great deal of means without any clear end in sight -- except assuring the Senate confirmation of Ben Bernanke.

We note in that regard that our friend Jim Grant, editor of *Grant's Interest Rate Observer*, has just issued a prospectus for the credit quality of the United States (see note from [Zero Hedge](#)). His analysis, to us, is the best indictment of the Fed we've heard in some time and asks the question we hear every week: When will the foreign investors say "no more" dollar debt? Grant noted on *Bloomberg Television* last week that yields on Treasury debt actually traded through swaps recently, suggesting that the banks like JPM who trade these derivatives are better risks than the Treasury itself. More evidence of Fed market distortion?

We recall that the last time a fixed income asset class like corporate debt or Treasury bonds traded through swaps we were in the midst of a bubble, something like 2006-2007 time frame. At that juncture, the backwardation of the swaps vs. cash bond implied that the pricing of the reference security was seriously out of line with fundamentals, but of course nobody wanted to hear bad news. Listening to Jim Grant on *Bloomberg Television*, we have to wonder whether the massive market intervention known as QE which was engineered by Chairman Bernanke during 2009 will be viewed kindly in years hence. We think not.

To us, the Fed's QE was a form of public consideration to the Congress which ensured Chairman Bernanke's Senate confirmation, all ostensibly done in the name of helping the economy, the financial markets and/or the housing sector -- take your pick. But QE does not seem to have actually helped to repair either the economy or the markets, regardless of the implied velocity of Larry Summers. More, the Fed QE purchases may also be a cul-de-sac in financial terms and the volatile precursor for the next financial bubble and market crisis. The shame of it all for incumbent members of Congress is that by ending QE so early in 2010, Chairman Bernanke and the Federal Open Market Committee may ensure that interest rates begin to rise and that the November election is very memorable indeed.

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