Gambling in the House?

By John Mauldin | July 28, 2012

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> Rick: How can you close me up? On what grounds?
> Captain Renault: I'm shocked, shocked to find that gambling is going on in here!
> – From the classic scene in *Casablanca,* made in 1942

The latest scandal du jour seems to be about what is now called LIBORgate. But is it a scandal or is it really just business as usual? And if we don't know which it is, what does that say about how we organize the financial world, in which $300-800 trillion, give or take, is based on LIBOR? This is actually just the second verse of the old song about derivatives, which is a much larger market. Which of course is a problem that was not solved by Dodd-Frank and that has the potential to once again create true havoc with the markets, whereas LIBOR can only cost a few billion here and there. (Sarcasm intended.)

The problem is the lack of transparency. Why would banks want to reveal how much profit they are making? The last thing they want is transparency. This week I offer a different take on LIBOR, one which may annoy a few readers, but which I hope provokes some thinking about how we should organize our financial world.

There Is Gambling in the House? I Am Shocked…

Let's quickly look at what LIBOR is. The initials stand for London InterBank Offered Rate. It is the rate that is based on what 16 banks based in London (some are US banks) tell Thomson Reuters they expect to pay for overnight loans (and other longer loans). Thomson Reuters throws out the highest four numbers and the lowest four numbers and then gives us an average of the rest. Then that averaged number becomes about 150 other "rates," from overnight to one year and in different currencies. The key is that the number is not what the banks actually paid for loans, it's what they *expect* to pay. Also, please note that the British Banking Association, on its official website, calls this a price "fixing."

Most of the time the number is probably pretty close to real, or close enough for government work. But then, there are other times when it is at best a guess and at worst manipulated.

Back in the banking and credit crisis panic of 2008 the interbank market dried up. No bank was loaning other banks any money at any price. Thus there was clearly no way for the LIBOR number to be anything *but* fictitious. Anyone who was not aware of this was simply not paying attention.

The regulators certainly knew on both sides of the Atlantic. All along there were clear records, we now learn, that bankers were telling the FSA (the Financial Services Authority) that they had problems. Regulators were worried about what was happening but were pointing out that there was a large hole in the ship that was already admitting water, and they didn't want to make it any bigger. Timothy Geithner, then President of the New York Federal Reserve Bank (and now Secretary of the Treasury) wrote a rather pointed letter to the FSA, suggesting the need for better practices.

Some banks reported lower rates, to make it appear they were better off than they were (since no one was actually lending to them), and others might have given higher rates, for other reasons. Remember, this was a British Banking Association number. Whether you personally won or lost money on the probably wrong price information depends on whether you were lending or borrowing and whether you really wanted the entire market to appear worse than it already was.

This was the equivalent of an open-book test where you got to grade your own paper. And we are supposed to be shocked that there might have been a few bad "expectations" here and there by bankers acting in their own self-interest, with the knowledge of the regulators? The more amazing proposition would be that in a time of crisis the number had any close bearing on reality to begin with. Call me skeptical, but I fail to see how we should be surprised.

The larger question that really needs to be asked is how in the name of all that is holy did we get to a place where we base hundreds of trillions of dollars of transactions worldwide on a number whose provenance is not clearly transparent. Yes, I get that the methodology of the creation of the number *after* the banks call in their "expectations" is clear, but the process of getting to that number was evidently not well understood and looks to be even muddier than my rather cynical previous understanding of it.

It now seems that there will be a feeding frenzy as politicians and regulators hammer the various banks for improper practices. And they are pretty easy targets: there is just no way you can explain this that does not sound bad.

You're a big banker. The world is falling down before your eyes. No one trusts anyone. If you put out a bad number (whatever "bad" means in a time of sheer utter blind panic) the markets will kill you even more than they already are and you could lose your job. You have got to come up with a number in ten minutes.

"Hey, Nigel, what do you think we should tell Tommie [Thomson Reuters]?"

"I don't know, Winthorpe, maybe Mortimer has an idea; let's ask him."

Simply fining a few bankers is not going to fix the larger problem: the lack of transparency for arguably the most important number in financial markets. A very clear methodology needs to be developed, along with guidelines for what to do in times of crisis when the interbank market is frozen and there really is no number. Having no number might be worse than having a number that is a guess. But having a number that can be fudged by banks for their benefit is also clearly not in the public's interest.

The point of the rule of law is that it is supposed to level the playing field. But the rule of law means having a very transparent process with very clear rules and guidelines and penalties for breaking the rules.

I had dinner with Dr. Woody Brock this evening in Rockport. We were discussing this issue and he mentioned that he had done a study based on analysis by an institution that looks at all sorts of "fuzzy" data, like how easy it is to start a business in a country, corporate taxes and business structures, levels of free trade and free markets, and the legal system. It turned out that the trait that was most positively correlated with GDP growth was strength of the rule of law. It is also one of the major factors that Niall Ferguson cites in his book *Civilization* as a reason for the ascendency of the West in the last 500 years, and a factor that helps explain why China is rising again as it emerges from chaos.

One of the very real problems we face is the growing feeling that the system is rigged against regular people in favor of "the bankers" or the 1%. And if we are honest with ourselves, we have to admit there is reason for that feeling. Things like LIBOR are structured with a very real potential for manipulation. When the facts come out, there is just one more reason not to trust the system. And if there is no trust, there is no system.

Opacity and Credit Default Swaps

Which brings me to my next point. We just went through a crisis where derivatives were a major part of the problem, and specifically the counterparty risk of over-the counter (OTC) derivatives.

Taxpayers had to back-stop derivatives sold by banks (and specifically AIG) that were clearly undercapitalized. That cost tens of billions. Yet the commissions and bonuses paid for selling those bad derivatives went on being paid. Congress held hearings and expressed outrage, but in the end Dodd-Frank sold out.

"Efforts to create an exchange-traded futures contract tied to credit-default swaps haven't yet gained traction after 18 months of talks, but banks dealing in the private multitrillion-dollar market for credit derivatives believe such contracts will eventually appear for a simple reason: They should attract new players.

"Credit-default swaps function like insurance for bonds and loans. Investors use them to hedge or speculate against changes in a borrower's creditworthiness. If a borrower defaults, sellers of the protection compensate buyers.

"The swaps – traded over the phone or on-screen, with prices known only to trading partners – are the domain of asset managers and hedge funds with the sophistication and financial wherewithal to take on complex risks.

"Futures, by contrast, are more routine instruments used by institutions and individual or "retail" investors. Futures prices are displayed publicly on exchanges, and customers can trade them directly with other customers – unlike in the swaps market, where a dealer is on one side of every trade.

"Dealers have long been fiercely protective of keeping the status quo in credit-default swaps or 'CDS' because they have booked fat profits from customers not being able to see where other customers are trading." (Market Watch)

And that is the issue. Bankers do not want transparency, because it will seriously cut into their profits. And while I like everyone to make a profit, the implicit partner in every trade is the taxpayer and, last time I looked, we do not get a piece of that trade. Derivatives traded on an exchange were not part of the problem during the last credit crisis; OTC derivatives were.

An exchange makes it very clear where the counterparty risk is and what the price mechanism is. It creates a transparent rule of law and places the risk on the backs of those buying and selling derivatives and not on the taxpayer. Exchange-traded derivatives do not pose a potential threat to the economies of the world, while we don't know the extent of the threat posed by OTC trades. JPMorgan has lost around $6 billion on the trading of their "London Whale." If Jamie Dimon and the JPM board couldn't guarantee reasonable corporate governance, then why should we assume that in another crisis we won't find another AIG?

Dodd-Frank needs to be repealed and replaced. The last time, the process was too clearly in the hands of those being regulated and has contributed to their profits. Enough already.

Credit default swaps and any other derivative large enough to put the system at risk must be moved to an exchange, to make clear the counterparty risks.

No Access for Spain

Let me close the letter by noting that Spain has clearly lost access to the bond market, absent intervention by the rest of Europe and more specifically the ECB. Spanish 10-year rates jumped over 7.5%. Then Super Mario Draghi said that the ECB would do whatever it takes to defend the euro, and the market rebounded. Why this was news is not clear, but sometimes the market just needs some hand holding.

Now the ECB is going to be forced to follow through or face a rather violent market correction downward. It will be interesting to see how long the markets will exhibit patience without a clear program from the ECB, while Germany would of course prefer that nothing is done until after its Constitutional Court ruling on September 2.

We are getting closer to the moment when European leaders will be forced to act. Spain is going to need a bailout and not just of its banks. Germany and the other northern-tier nations have not yet agreed on a path.

We will delve further into Europe over the next few weeks. The situation is getting increasingly problematic. There is no plan, and the eurozone lurches from crisis to crisis. One country after another is falling into recession and then depression. Austerity without default (or monetization, default's cousin) produces misery.

I think France is likely to be downgraded within a few months, putting Germany, the Netherlands, and Finland in a very difficult position. Will they put their own balance sheets and ratings at risk? Because that is what will be needed if the eurozone is to hang together. Stay tuned.

Denver, Maine, and Carlsbad

I am in Gloucester, Massachusetts tonight, spending the night in the museum that my economist friend Woody Brock calls his summer home, which is almost hidden at the end of a dirt road and surrounded by trees and enormous granite rocks. The grounds of the estate are an old granite quarry, itself a work of art, with massive, gorgeous works in stone intermingled among the trees and magnificently lit up at night. The quarry lakes are crystal clear, and the reflections of the trees, stone, and profuse flowers blend together like something out of an epic fantasy. It almost makes me want to grow up and become an economist, if they live like this.

Gloucester is an old fishing town and where the movie *The Perfect Storm* was based. Woody drove me around and showed me the home where he grew up, and where his sister and her husband still live. The town is an interesting contrast to Newport, where the really rich from New York built huge mansions and sailed their yachts. The summer homes of Gloucester are wonderful, fitted into the land and, for the most part, with a real family feel to them.

I was in Newport for the past week for a symposium on behalf of the Department of Defense. The Net Assessment Office brought together the most eclectic, diverse group of people I have ever been associated with to develop some alternative scenarios for the purpose of thinking about what might be needed in the future. My mind is still reeling. I am processing what I learned and will write about it at some point.

Interestingly, for me, some past worries about potential problem areas were laid to rest and other areas became of more concern. Five straight days of early mornings and late nights have me a little tired – thus the short letter tonight.

I head back to Dallas tomorrow and then back out on Monday afternoon for Denver, to be with my Altegris Investments partners at *Financial Advisor* magazine's *Innovative Alternative* Strategies *Conference*. I'll then fly back Tuesday evening, only to turn around and fly to New York and then on to Maine with my son Trey, for the annual "Shadow Fed" fishing trip run by David Kotok. There will be so many good friends there again. I think this will be the sixth year Trey and I have gone. David Rosenberg will be there, as will Barry Ritholtz *(The Big Picture),* Martin Barnes, John Silvia (chief economist at Wells) and the usual Fed types. Quite the cast of characters. Bloomberg TV (Mike McKee) will be there, and I am scheduled for an early hit with Tom Keene and perhaps a comment or two on the employment number on Friday morning.

Then I am home for a few weeks, before heading out to Carlsbad, California, to be at an important Casey Research conference called Navigating the Politicized Economy. It has quite the speaker line-up and would be a great way to kick off your fall thought process. You can learn more at http://www.caseyresearch.com/V-2012-fall-summit.

It's time again to hit the send button. Have a great week. And having thought of *Trading Places* tonight (maybe my favorite movie), I think I will go buy the DVD and watch it one more time!

Your "feeling good, Louis" analyst,

John Mauldin

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