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SCHOOLYARD RULES & SELF-DEALING DAMAGE CONFIDENCE, FUTURE EARNINGS POWER OF FINANCIALS

Anyone who's ever participated or watched kids' schoolyard pick-up games knows that the rules are always subject to change, often being set by the most quick-witted, the shameless, or the child who actually owns the ball. Yesterday Johnny insisted that the ball that bounced off of Dominic's book bag was a goal. Today, on defense, he swears that it hit the post. One might think that after 20 years of education and socialization, Johnny, now a Managing Director in structured products at FancyPants & Co. and living in a co-op off Park Avenue, might have developed a greater sense of fair play. Sadly, as we are finding out in the post-financial modernization world, he has not.

Given the problems facing the global economy, it may seem misguided to worry about whether Greece's private sector involvement (PSI) should have triggered payouts on credit default swaps. Still, there's something about the issue, writ large, that might say quite a bit about the current crisis of confidence gripping the global economy and the financial markets. On these pages, we have not been shy in linking the propensity of policymakers to capriciously change the rules for the economy and the markets with the current capital strike. It would seem only fair, then, that we call out Wall Street for changing its own rules on its customers when it suits them. Here again, the biggest loser is the rest of us – the companies and government entities who rely on access to the capital markets.

As a quick reminder, credit default swaps are a form of insurance against a default. The current controversy over what exactly constitutes a sovereign credit default was triggered by the "voluntary" haircuts imposed on Greek debt as a result of both the July 21st and October 26th Eurozone agreements. The organization that will help inform this decision is the International Swaps and Derivatives Association (ISDA), the governing body of the structured products business, which, according to its website, is made up of "a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers."

A closer inspection of the organization's leadership would suggest that this is a charitable description of those who guide its mission – only four of ISDA's 25 officers and directors hail from the buy-side. The rest, somewhat unsurprisingly, is made up of a dog's breakfast of managing directors of sell-side firms that structure these "products" for their "clients." In the tradition of those who peddled the unparalleled investment management services of Long Term Capital Management and the benefits of purchasing subprime mortgage-backed securities, ISDA's own explanation of why a "voluntary" 50% haircut on Greek sovereign debt wouldn't actually constitute a "credit event" comes down to this: "those that disagree with us are clearly too stupid and unsophisticated to be buying these products in the first place." To be fair, a final ruling on whether the Greek PSI will actually result in a credit event could involve the courts for years, but all indications suggest that ISDA will side with those who underwrote, rather than purchased, this insurance.

While this may seem arcane to some, there are serious real-world implications of this latest example of Wall Street's self-dealing:

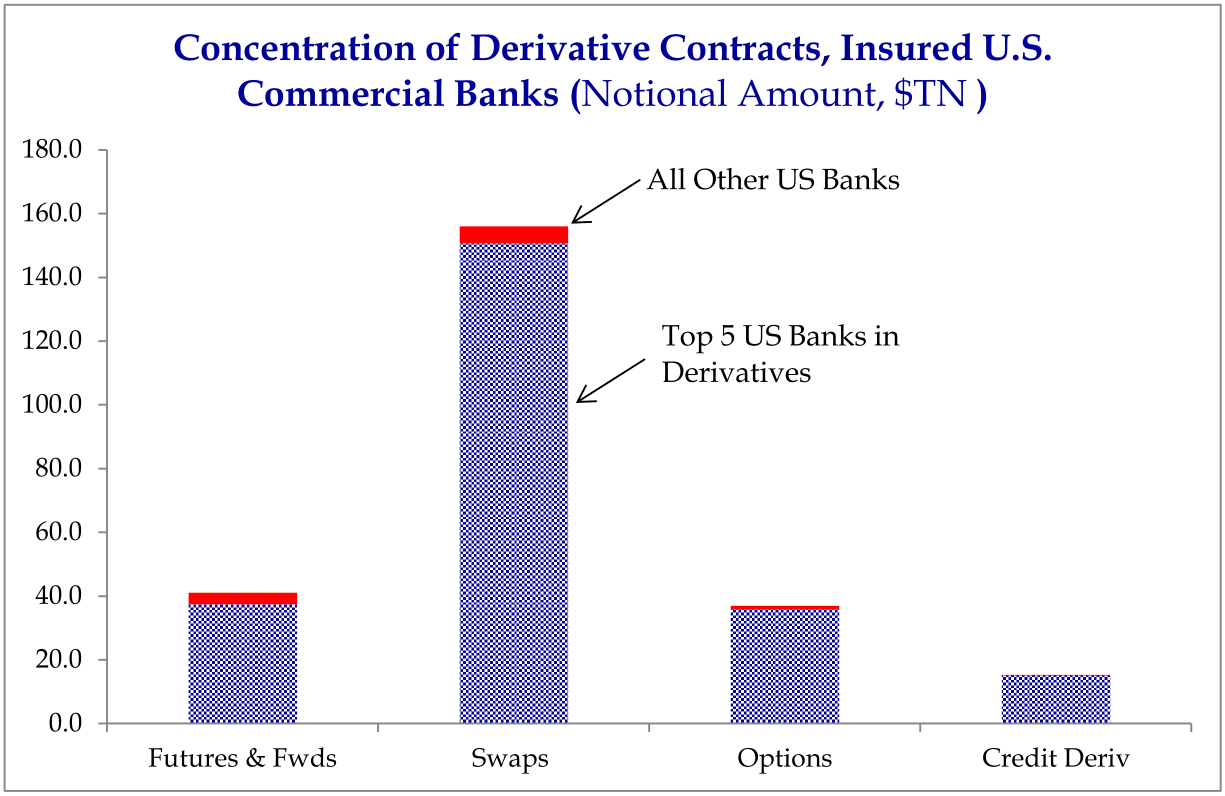
1) it serves as yet another reminder that the large, modern publicly-traded investment bank is incapable of acting as both principal and agent – at least honorably;
2) in the absence of confidence that the vendors of these products will make good on their markers, real money purchasers of credit products will either choose to sit on the sidelines or demand far higher interest rates to buy them. Speculators will simply short the underlying securities – let's say Italian bonds – to make their trades. In either case, the net result will be a higher cost of capital for those seeking to access the credit markets;
3) the "tails I win, heads you lose" attitude of those who underwrite these products will likely curtail their use and, ultimately, deprive the dealers themselves of an ability to sell what were previously high-margin products to their institutional clients. This may be yet another reason to be cautious on the financials despite already deep discounts to book value.

Few people will shed a tear for buyers of seemingly arcane financial products. If history is any guide, this piece will engender kudos from old-timers and calumny from dealers and recent business school graduates. In truth, I have never read a credit default swap agreement or ever purchased over-the-counter protection against a "credit event." But I have been around long enough to know when something seems wrong, a distinction that is often lost on lawyers but is crucial to keeping the capital markets functioning properly. For dealers, I would recognize that you can only screw your own clients for so long before you damage your own franchise. As the house, sometimes you have to lose to keep the casino open.

Jason DeSena Trennert

For the other side of the story please consult: http://www2.isda.org/

HIGH CONCENTRATION OF DERIVATIVE CONTRACTS AMONG U.S. BANKS



Source: OCC Quarterly Report, Q2 2011

Top 5 U.S. Commercial Banks & Trust Companies in Derivatives (6/30/11, $Mil.)

Bank	Total CDS	Bought	Sold
JP Morgan	5,925,507	2,951,495	2,974,012
Citibank	2,715,016	1,398,639	1,316,377
Bank of America	4,968,641	2,503,906	2,464,735
Goldman Sachs	431,143	235,019	196,124
HSBC	644,360	314,254	330,106

Source: OCC Quarterly Report

ISDA Determinations Committee (EMEA)

Voting Dealers
Bank of America / Merrill Lynch
Barclays
BNP Paribas
Credit Suisse
Deutsche Bank
Goldman Sachs
JPMorgan Chase
Morgan Stanley
Société Générale
UBS
Consultative Dealers
Citibank
The Royal Bank of Scotland
Voting Non-dealers
BlackRock
BlueMountain Capital
Citadel Investment Group
D.E. Shaw Group
Pacific Investment Management Co.

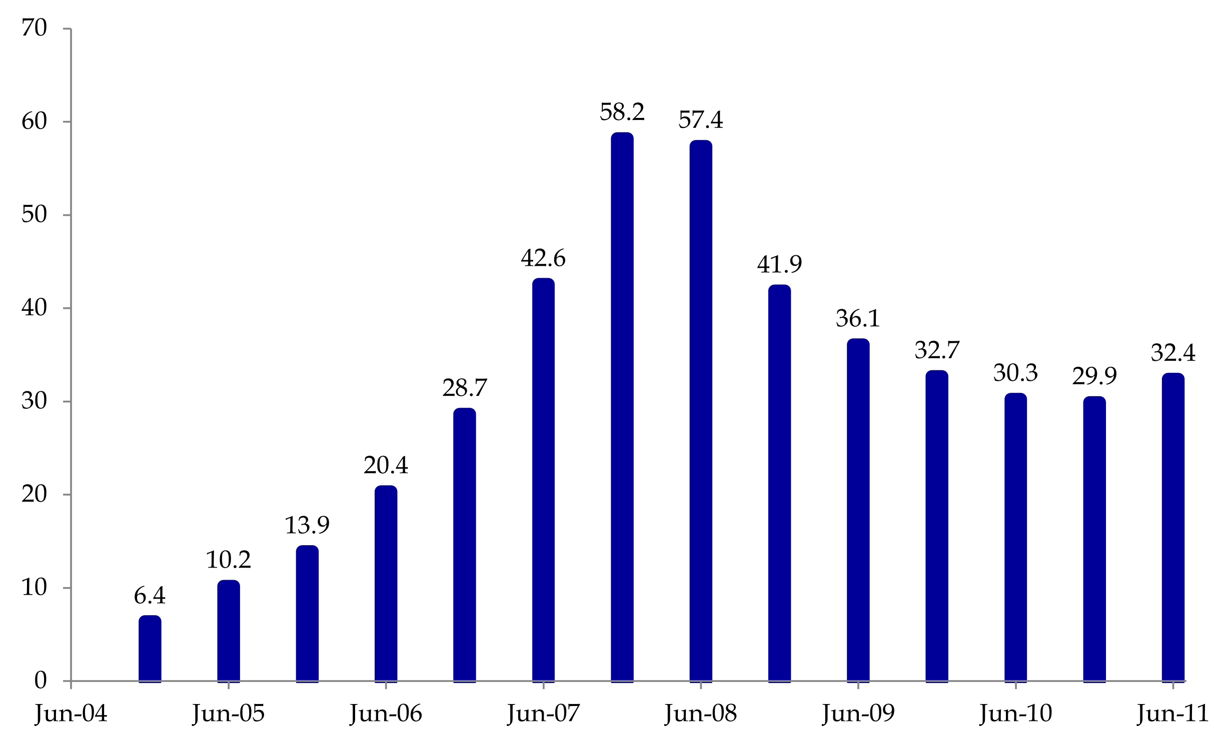
4 of the 5 largest U.S. banks in derivatives are on the ISDA Determinations Committee that determines whether or not a Credit Event has occurred with respect to Greece.

Top Sovereign CDS Positions (Net Notional, $Mil.)

Country	Net Notional	Contracts
FRANCE	23,377	7,228
ITALY	20,530	9,881
GERMANY	19,751	4,531
BRAZIL	17,796	12,012
SPAIN	16,159	7,764
UK	12,557	5,042
CHINA	9,679	7,269
JAPAN	8,934	6,323
MEXICO	8,758	9,660
AUSTRIA	6,337	2,543
BELGIUM	6,184	3,325
PORTUGAL	5,660	3,908
USA	5,529	1,492
AUSTRALIA	5,309	3,067
KOREA	4,988	7,371
RUSSIA	4,457	8,690
TURKEY	4,390	9,110
IRELAND	3,797	2,869
GREECE	3,559	4,467
INDONESIA	3,181	5,229

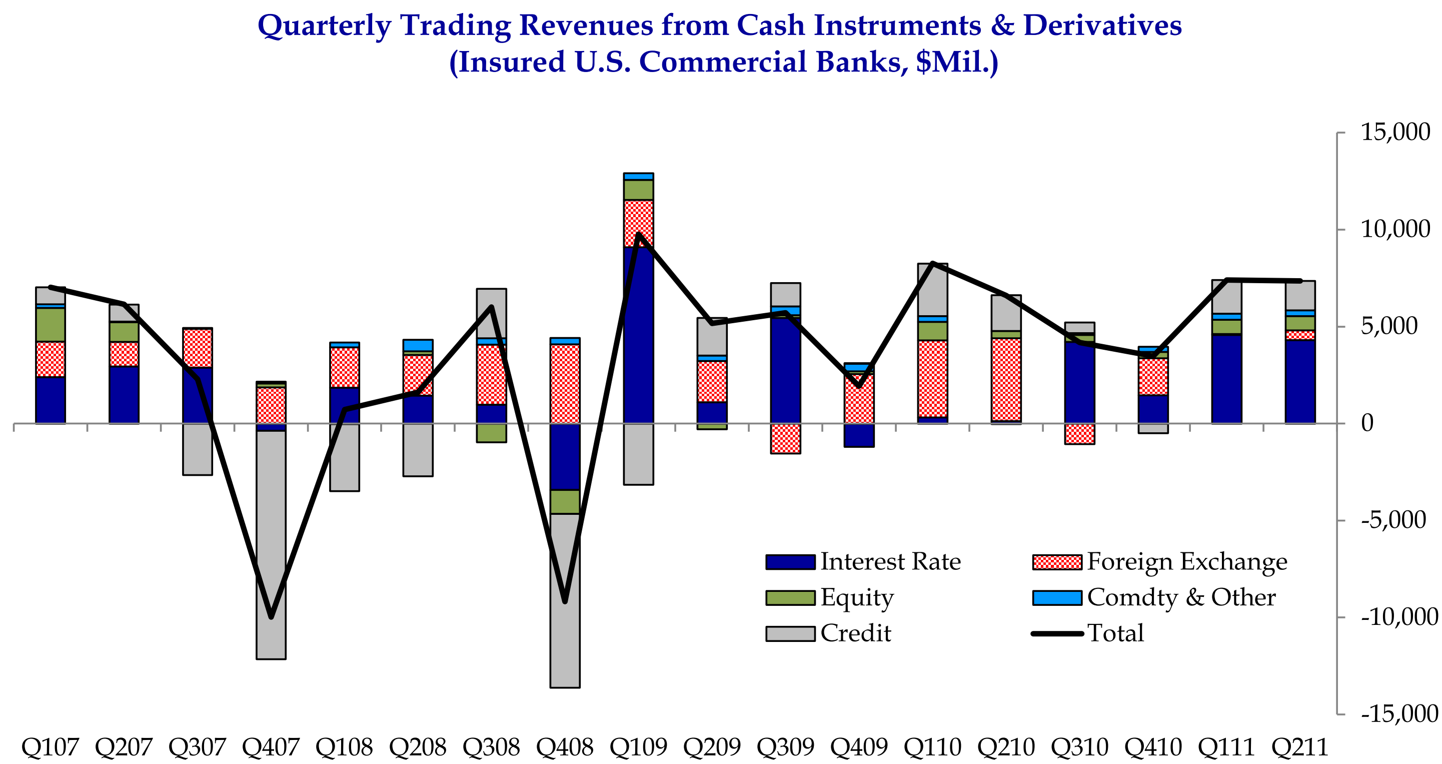
Source: DTCC

Credit Default Swaps: Notional Amount Outstanding ($TN)



Source: BIS

BANK REVENUES FROM CREDIT DERIVATIVES NOT INSIGNIFICANT



Source: OCC Quarterly Report