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News, Views and Analysis

Zombie Love: Barclays and Citigroup? On OTC Derivatives: Interview With Bill King

March 15, 2010

And so the path to reform and success is clear. We know what it is. We just have to have the courage to go there. What we are doing is showing people that government can work again for them, not for us. Government has worked for the political class for much too long.

There's no time left. We have no room left to borrow. We have no room left to tax. So we merely have room left now, to do this. We are all reaching the edge of a cliff. And it reminds me a bit of that part of *Butch Cassidy and the Sundance Kid* where the had a seminal decision to make. So what did they do? They held hands and they jumped off the cliff.

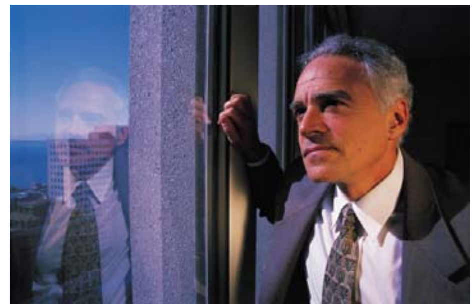
We have to hold hands at every level of government, state county, municipal, school board. We have to hold hands and jump off the cliff.

I firmly believe we will land and we will be fine. It does not mean it will not be a scary ride on the way down. And it does not mean there won't be moments of fear and moments of apprehension.

But for certain, the troops of the decades of overspending and overborrowing and overtaxing have gained on us. So the ruination of New Jersey's economy, and of the quality of life we want all our citizens to have, is certain if we do not take this course.

It's time for us to hold hands and jump off the cliff. It's time for us to do the difficult things that need to be done and to stop playing the petty politics of yesterday, of lying to the people telling them they do not have to pay for it because someone else will.

Governor Chris Christie of New Jersey
"Time to Hold Hands and Jump off the Cliff"
c/o Mish's Global Economic Analysis



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This week in The IRA we feature a conversation with Bill King, who along with his wife and business partner Mary works in the world of derivatives broadly defined via their Chicago-based firm, M. Ramsey King Securities. We first started taking with Bill in the 1980s, during the political wrangle - we won't call it a battle - over free trade with and democracy in Mexico. That was about the time of the first appearance of "Too Big to Fail" for the large banks following the Mexican peso meltdown. *Un fuerte abrazo a nuestros amigos en Mexico!*

But before we go to our feature, a few comments on current events. First and foremost we remind one and all about the impending start of the FDIC's rule make effort regarding the reform of bank securitizations. Last week, the FDIC approved an extension through September 30, 2010 of the Safe Harbor Protection for Treatment by the FDIC as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection With a Securitization or Participation.

We hear that the FDIC rule making process could start as soon as next month, but more likely will wait till the FDIC's board meeting in May. We also hear that the President's Working Group (PWG) on Financial Services is preparing a "white paper," in cooperation with the Federal Reserve Board and the Office of the Comptroller, to block the FDIC reform effort. This campaign, which apparently was orchestrated by the largest dealer banks, is intended to derail the new rules proposed by the FDIC mandating greater transparency and disclosure for bank sponsored residential mortgage securitization deals.

The PWG, in case you don't know, is an informal group created in 1988 by President Ronald Reagan that allows the executives of the biggest banks to influence public policy in Washington, but without going through the trouble of registering as lobbyists or other public disclosure. Sometimes referred to the "plunge protection team," the PWG is part of the invisible government of Washington," an agency which operates within the government, but at the behest of private interests.

Barry Ritholtz has a nice summary on the PWG in his book, Bailout Nation, and also in his Blog, "The Big Picture." As Barry notes, the PWG is every bit as incompetent as most other people in Washington, but they do have one special skill: pushing the banking industry's agenda in Washington via informal "guidance" and white papers that are written by and for compliant regulators. The PWG essentially acts as a super-lobbying channel for the largest banks focused right at regulators. Only "team players" need apply.

Public Service Announcements

FDIC Foreclosure Prevention Tool Kit

"The FDIC -- along with fellow regulators and the banking industry -- continues the urgent search for workable solutions to our nation's serious subprime mortgage and foreclosure problems."

FDIC Failed Banks List

The official page listing banks that have failed.

The Federal Reserve Bank of New York and the OCC in Washington are reportedly drafting the "guidance" on reform of bank securitizations and at the request of the PWG. No clue whether the White House is involved directly yet or if this is merely a Tim Geithner operation. These PWG white papers are never released to the public even though the Treasury acts as the *de facto* public affairs organ for this corporate influence group.

We called out former Wachovia Bank CEO and Goldman Sachs (GS) banker Robert Steel on the subject of the PWG last year at the Chicago Fed's international banking conference. He was unapologetic and more than a little offended, or so he claimed. The PWG acts with impunity in Washington, in part because the members of Congress understand their subordinate role. We hear that Senator John Warner (D-VA) is now competing with Judd Gregg (R-NH) to be the next "Senator from Wall Street" and specifically seems to be angling to join a private equity firm. Gregg's tastes seem to run more along the lines of a large OTC derivative dealer bank.

The fact that the PWG is in league with the Fed and Treasury against the FDIC board is all you need to know about the politics of reforming private label mortgage securitization. If Barack Obama were really interested in reforming Washington, he would rescind President Reagan's executive order and disband the PWG for good. Allowing the big banks which participate in the PWG to lobby financial regulators and members of Congress without any public disclosure is a national scandal and makes a mockery of any claim by Barrack Obama to be changing the business of Washington.

We noted in our comment last Tuesday in *American Banker*, "Viewpoint: Stop Blocking FDIC Securitization Effort," that "the practical policy issue is the losses observed in failed banks over the past two years, averaging over 30% of total assets, versus just 11% on average in the S&L crisis. The common factor in failed banks with high loss rates is unsafe and unsound securitizations practices, thus the FDIC initiative on securitization."

It is very telling to us that the FDIC is advocating greater openness and transparency in bank sales of mortgage loans to securitizations, but the Fed and OCC are standing with the larger dealer banks that arguably caused the financial crisis in complex structured assets. Hopefully these federal agencies and the industry groups they seem to be allied with will realize that the FDIC's rule making process holds the potential to revive private label mortgage finance and that they can influence the outcome - but only if they participate constructively.

One mortgage market veteran who ran risk for one of the largest private conduits in the business put the situation succinctly last

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- Dennis on HuffPost "Moving Big Money", Jan 23, 2010 http://bit.ly/8k9c53 48 days ago
- IRA Analyst "A Tale of Two Banks: Florence Savings and JPMorgan Chase", January 19, 2010 http://bit.ly/Qkxzz 54 days ago
- Whalen on TV -- Scheduled for CNBC's "Squawk Box" at 8:00 AM ET Friday, January15, 2010 58 days ago
- IRA Analyst, "Why Big is Bad; Alex Pollock on Sarbanes-Oxley and the Financial Crisis", January 12, 2010 http://bit.ly/Qkxzz 61 days ago
- Dennis on HuffPost, "Ordinary People Matter", January 10, 2010 http://bit.ly/5ulWfh 61 days ago
- IRA "Ariana Huffington: Move Your Money!; Skin in the Game: Interview With FASB Chairman Bob Herz", January 4, 2010 http://bit.ly/Qkxzz 69 days ago
- IRA Picking Nits "Failed Banks: The December 18th Group", December 21, 2009 http://bit.ly/9111Ey 82 days ago
- IRA "Predictions for 2010: The Best is Yet to Come", December 21, 2009 http://bit.ly/5tt4At 82 days ago
- IRA Picking Nits "Failed Banks: What was knowable

week: "You can argue against the FDIC securitization proposals, looking at them in a bundle, as perhaps being overkill, but each piece of their proposal, taken separately, is pretty compelling. The other bank regulators and industry groups could easily negotiate a better, more streamlined deal that would help the market if they bothered to push back and participate constructively, instead of simply attacking the FDIC."

Zombie Love: Barclays and Citigroup?

The other development which really caught our eye in the past week is the rally in Citigroup (C) and other large cap financials. Even with the 5% drop in C on Friday, the name is up 25% in the past 30 days and has outperformed larger peers such as JPMorgan Chase (JPM) and Bank of America (BAC), both of which have done less house cleaning that the much maligned C.

While we attribute much of the up move in C and the other financials to market momentum driven by misplaced enthusiasm regarding the timing of the rebound of large cap bank earnings, we think there is another factor possibly pushing up the value of C, namely a possible acquisition. You may have in the past heard us say that there is nobody big enough or dumb enough to buy C this side of an FDIC receivership, but we may be corrected.

We hear well-informed speculation in the credit channel that Barclays Bank PLC (BCS) may be considering an acquisition of C, this in order to bolster its diminished business model after selling its Barclays Adviser unit to BlackRock (BLK) last year. Of note, BCS bought the Italian credit card business of C in a transaction announced in February. But you know, once a zombie starts to nibble it is really hard to get them to stop short of a full meal, including dessert and a beverage.

BCS eating a zombie the size of C may seem like a really bad idea for the former, but C has arguably written down and reserved more for future loss than any of its large bank peers. And a purchase event would provide yet another opportunity for BCS to clean house and write-down C's assets even further. We have always believed that a sale of C, either in whole or in part, is the best exit strategy for the US government and the taxpayer generally, so let's ponder the possibility.

The first real question is what happens to C shareholders in a transaction where a buyer demands a large, additional asset write-down prior to the close. Wachovia Bank is the operative example here. At $4 per common share, C has a market cap of $100 billion which is roughly 0.75 x book value. In 2009, C lost $8.08 per share and, without generous subsidies from Washington, we've got to believe another losing year is possible in 2010, perhaps along the same lines. Compared with a $50 billion loss in 2008, a

when?", December 14, 2009 http://bit.ly/4WYBmJ 89 days ago

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List of Bank Holding Companies

List of FDIC Certificate Unit Institutions repeat of 2009 would hardly be a disaster. We described our thoughts on C's 2009 results in a recent report in The IRA Advisory Service.

To us, any rational buyer looking at C's on and off-balance sheet exposures has got to look to C shareholders for another chunk of flesh in terms of asset write-downs pre-close. Securitizations, second-lien exposures, and the remaining family heirlooms inside C have got to be worth $100 billion in additional write downs, even after the $40 billion C added to loss reserves last year. On the other hand, the global business net of credit losses and other adjustments has to be worth more than 0.50 x book, especially if C CEO Vakrim Pandit is able to generate $20 billion per year in pretax earnings as he claims. A 10x multiple on those earnings puts the C business north of $200 MVE or close to $8 per common share.

Somewhere in between the valuations implied by these two positions may be a deal. Maybe 0.5-0.6 x book is about the right place for BCS to start, but whether a deal can be struck is another matter. And a C acquisition may be bad financial news for the Treasury, which would barely get out of the deal whole at say $3.50 per share. Indeed, our guess is that an asset purchase haircut in any C acquisition implies a loss for the taxpayer and maybe a lower price than Friday's close for common. But for Washington, maybe getting this zombie off the dance floor now is worth a little fiscal sacrifice.

BCS has a little more than half of C's *current* market cap, but the bank is profitable and trades on a $21 handle vs. $4 for C, which is the biggest stock on the NYSE. Price to book for BCS is just 0.8:1 as of Friday, but the UK clearing bank has been much more stable in terms of trading range than C, this even with a 2.8 beta. The thing which we find of interest, however, is that BCS basically has no commercial banking presence in the US.

BCS has only one FDIC-insured bank unit in the IRA Bank Monitor, the $12 billion asset Barclay's Bank of Delaware. As of December 2009, we rated the sole BCS bank subsidiary in the US "F" based on elevated stress for net credit losses and ROE as shown below.

IRA Bank Stress Index Rating -- Barclays Bank Delaware � Q4 2009

IRA Letter Grade		Overall	ROE >	Loan Defaults	Capital	Lending Capacity	Efficiency
	Stress Score	24.2	100.0 *Negative ROE*	14.3	0.7	5.5	0.6

F Shows stress levels slightly above the industry average stress point.						
Industry Benchmark	21.5	100.0	4.4	0.9	1.0	1.2

Source: FDIC/IRA Bank Monitor

Indeed, BCS has a higher stress score in the IRA Bank Stress Index than do the bank units of C. Remember, though, that the BCS banking business in the US is tiny compared with the $1.3 trillion total consolidated assets of the parent, which holds its stake in the US broker-dealer separately from its US banking operations.

Due to its corporate structure and being a foreign filer for 1934 Act purposes, BCS has very limited public disclosure of its financial results. Virtually nothing is available electronically via EDGAR, both in terms of parent financials and the FOCUS report for the Barcap broker dealer. There is only summary information on its web site. BCS does not file a consolidated Form Y-9 with the Federal Reserve Board, so the top level parent filer for FDIC insurance purposes is merely the holding company for Barclays Bank Delaware.

A combination between C and BCS might not be a thing of great beauty, but there is a certain geographic and political logic to the idea that demands attention IOHO. Merging a shrinking C into BCS might be just the ticket to get the former, our beloved zombie dance queen, off the very full financial dance floor being managed, and we mean managed, by the Fed and US Treasury.

On OTC Derivatives: Interview With Bill King

Now to our feature. We spoke to Bill King last Thursday after the close and spoke about OTC derivatives and old friends long gone. The conversation was especially timely because of the release of the report by the bankruptcy court examiner in the Lehman liquidation, a staggering piece of forensic work that provides another piece of evidence regarding the link between OTC derivative structures and accounting fraud a la Enron and WorldCom. Now Lehman Brothers is added to that proud pantheon, but it seems that the bankruptcy court reporter's conclusions point only to possible civil claims.

The IRA: Bill, good to talk to you again after too many years. We first connected with you when IRA co-founder Christopher Whalen was writing regularly for *Barron's*. If memory serves us still it was John Crudele at the *New York Post* who introduced us. Makes us also remember our departed friend John Liscio, a great reporter who knew a good conspiracy when he saw it. When we spoke yesterday, you started talking about how the expansion of OTC derivatives had enabled a new way for banks and corporations to essentially manufacturer earnings synthetically, basically the same sort of fiscal operations as are described in the report from the Lehman bankruptcy court examiner.

King: The interesting thing with derivatives is that it gives you the ability to steal future earnings and bring them into the present. It also allows you to push current earnings and push them into the future.

The IRA: Sounds like securities fraud to us. Please continue.

King: Yes. In the 1980s, the big thing with commodity traders was indefinitely rolling their income and not paying taxes on it. Eventually the feds changed the tax laws to force the dealers to pay taxes on part of the forward gain in the "roll." Part of earnings is now LT cap gains and part is reported as regular income. The trading in silver spreads was traditionally a favorite here, where you would buy March silver and sell December. At some point you would get a big up move in silver, so you would lift the losing trade and simply sell another out month to roll the spread. So you are still hedged but you have realized the loss. You can also do the opposite, left the leg with the gain and take a LT cap gain on the proceeds. Either way, you have the option. And these are exchange traded products I am using about here. I have not even started to talk about OTC products.

The IRA: We remember clearing in Germany in the bunds years ago. That was a party as well. You could play the float for weeks and nobody in the *Kassenverein* would notice. Our clearing team enabled us to run a naked short in bunds for weeks.

King: In Chicago, when you had a tough month and needed to pay the bills, we used to short a large cap stock with a big dividend, a $1 or $1.50 dividend. And we'd buy the stock synthetically to create a straddle. So you were working for the spread between the two positions. But what would happen in those days is that stock would go ex-dividend and the stock would fall the $1.50 and your sheet with the clearing house would show the gain. The dividend would sit there for a couple of weeks and would not be debited, so you could use the float to make payroll. These sorts of things were being done 30 years ago with exchange listed Option Clearing Corp options.

The IRA: So, nothing has changed, just the magnitude of the game?

King: Correct. Another really funny example was the way in which traders at the exchange would fight over closing prices. People would put on spreads and they would try to tick their spreads in a favorable direction. Prices were made in 1/8 point increments in those days, so a tick either way could mean a lot of money. The exchanges tried to limit the games, but there was always some give in the system. But once you moved over-the-counter (OTC), you are off to the races. It is not that these products are impossibly esoteric, that implies that they cannot be understood. OTC products are complicated. In terms of transparency, it is one thing to have a call on IBM and entirely another for somebody to say that they want a call on the volumes from IBM's mainframe business, with or without a knock-in provision, and I want it denominated in Deustche marks.

The IRA: Yes, the endless peeling of the onion. We see these instruments as deceptive gaming contracts, but people in the OTC markets say we are old fashioned. Martin Mayer says the dealers which sell them are "bucket shops" and we must agree. But you have described a bigger game. How do Wall Street's dealers and fund synthesize profits and losses with OTC?

King: Well the beauty of OTC is that these are typically considered level two or three assets under the rules for fair value accounting, so we are operating in the world of mark to model. This is the world where both parties, say a dealer and a fund, have done an OTC trade in a complex credit product. But because nobody in the house can describe the optionality in the structure much less price it, each party does their own valuation. And often times both parties use significantly different prices and are even both reporting profits. In an exchange traded product, you cannot do that. One side is down and one side is up. OTC fuzzes up the pricing, makes it very inexact, and thereby creates huge avenues for "interpretation" in terms of pricing and therefore fraud.

The IRA: We have focused on lot on the issue of investor suitability, but you are raising the old Enron problem, again, namely that the combination of OTC contracts and the accounting rules do great evil. It does not seem to matter which accounting rules are in place because the dealers always figure out a new way to game the system. You differ?

King: No, totally agree. In OTC, we live in a world of mark to model, so obviously the dealers don't want to lose this business. Let me give you another example. Going from the examples I gave you about "give" in the exchange traded world, things go even better with OTC contracts and credit default swaps. You have an agency relationship between a broker dealer and a hedge fund, and then it could come out that the dealer had an ownership stake in the fund. And people on both sides are marking OTC positions using models.

The IRA: Maybe this is why the proposal by former Fed Chairman Paul Volcker to outlaw investments in hedge funds go such a chilly response from Goldman Sachs (GS), JPMorgan (JPM) and Citigroup (C). All of these firms have historically been big investors in funds. And even the funds that are truly arms length from the dealers in terms of ownership are still effectively part of their inventory. The base of clearing customers of a prime broker is effectively a storage and sales for the dealer.

King: That is a great point and it makes me think of the issue of when and why Alan Greenspan stepped on the monetary gas in 2002-2003. Paul Volcker made a couple of speeches in 2003 around the time that Alan Greenspan brought on Ben Bernanke at the Fed to assist in the crisis management task. Chairman Bernanke was a member of the Board of Governors of the Federal Reserve System from 2002 to 2005, and became Chairman in 2006.

The IRA: Chairman Greenspan headed for the door just in time.

King: If you go back and look at the speeches on the Fed web site and Google Paul Volcker, you will find that people were worried about a financial system meltdown in the earlier period. Greenspan stepped on the gas in terms of low interest rates to avoid a meltdown in the banks and OTC, and in doing so goosed the housing sector. Remember that there were people in the media and on the Street talking about how much more weight in terms of economic benefit came from rising housing prices as opposed to the stock market, so there was definitely a deliberate effort to target housing.

The IRA: We seem to go from one speculative binge to another. You have mentioned that this is a legacy of the era of free trade. Can you expand?

King: Of course, our nation has exported its jobs to foreign countries and attempted to make up the difference first in a tech bubble, then with a bubble in housing, all fueled by cash settlement OTC derivatives. The cynic in me believes that these were deliberate efforts by our political class to buy time. In that same period, one of the Fed banks, I think it was Dallas, speculated about the appropriate policy response if the Fed created a lot of liquidity but nobody wanted it.

The IRA: Well, that's where we are now, right? Nobody wanted the ABS and the agency paper so the Fed came to the rescue with quantitative easing. Solved a liquidity problem and a valuation process in one fell swoop. But did not really solve the underlying problems.

King: The folks at the Fed were clearly worried about deflation in the financial sector in 2002-2003, but if you run the charts on oil and gold, both were starting to break out to the upside in that period. When Bernanke cited Milton Freidman's helicopter speech in 2002, "Deflation: Making Sure "It" Doesn't Happen Here," about that time Volker also gave a speech about his years at the Fed and said that Wall Street is always going to game whatever structures regulators put in place.

The IRA: The boys can only game the system if there are no rules, like the difference between an exchange and the OTC markets. Yes, you can play games in the clearing house of an exchange, but they are not games that will destroy the entire house and its members. Even with the imperfections of any exchange you still have the discipline of multilateral credit surveillance and joint and several liability. There is collective risk sharing and risk monitoring.

King: Yeah, sometimes you'd pick up you sheet in the morning at the exchange and see a loss because a price ticked down at the close. You could swear that the price was higher, but the final price at the close was what matters.

The IRA: So is it fair to say that the application of fair value accounting to OTC has created rather than solved a problem?

King: No question. It is not just for the derivatives but also for the structured investment vehicles. Each year a manager can recognize enough gains to take the 2 and 20, or two points in management fees and 20% of the profits, and simply collect fees for a couple of years, then let the fund go to hell when losses are realized. The same thing goes on at the investment banks because they can cherry pick the gains and leave the losses to accumulate.

The IRA: Sounds like a pretty good description of Lehman Brothers and even C and its Citi Holdings unit, which is in liquidation. Some of those exposures go back more than a decade. You know as well as we do that Wall Street is about plausible denial. They see a lot of profit coming from one area and they highlight the winners but hide the problems. The evolution of the big firms from being banking and brokerage focused to trading focused highlights this issue.

King: In the old firms, the old white shoe Wall Street partnerships, the number one partner was the big cheese, the banker, the guy with the rolodex and the corporate relationships. He had all of the corporate connections, belonged to the same clubs, etc. Partner number two was the bond guy, who ran sales and trading and executed on mandates that the banker brought in. And then partner number three was equity sales trading. Where the old equation started to change was when firms like Salomon and GS, which did not have the corporate connections, got involved in all of the trading of cash and options. These new firms forced their way into the game and supplanted the Anglo, white shoe corporate bankers. These insurgents had started in merchant banking.

The IRA: Look, in the early 1950s, when Henry Ford wanted to save his family's fortune, he went to Sidney Weinberg, the managing partner of Goldman Sachs. Weinberg designed the masterful scheme to split of vote and economics in Ford Motor Co (F) asymmetrically between the Ford family and the Ford Foundation. But the white shoe firms still owned the equity business. The Boston stock brokers Blyth & Co. took out the Ford IPO in 1956. It priced at $64.50, including $1.50 for the dealers. Decades later, GS helped F to effectively restructure its operations years before GM and Chrysler and without bankruptcy, so that corporate banking relationship continues. There were two former GS bankers on the F board until recently, Robert Rubin and John Thornton. All of the great trading firms on Wall Street Salomon, GS, Lehman and Bear, started out in the basic business discounting commercial paper, essentially competing with the banks for the commercial trade's business, but became some of the greatest bankers before the age of the traders destroyed them.

King: In the 1980s, these new firms started to trade equities aggressively and do risk arbitrage. They took the power away from the old firms. Then Lehman went a step further and Lewis Gluckmans overtly took control of Lehman Brothers from the bankers in 1983 in a very bitter battle.

The IRA: Glucksman passed away in 2006. The New York Times obit quoted Ken Auletta, whose book "Greed and Glory on Wall Street" (Random House, 1986) depicted the struggle, as saying: "Symbolically, it was the clash between bankers and traders carried to extremes. But it became very personal on both sides."

King: He gave the traders the big bonuses and provoked a battle for control over the firm. But of course Glucksman's mistake was that at some point the traders blow up. And they did. Lehman blew up later in the decade in the same way that John Gutfruend blew up at Phibro.

The IRA: So the move toward a more trading oriented business model for the firms has actually encouraged more gaming with respect to earnings and profits? This is an enormous problem for analysts and regulators who follow banks.

King: We have forgotten the basic rules. In the old days, I am talking the 1970s, when I traded OTC and then on Wall Street and finally derivatives on the CBOE here in Chicago, is every trader every day gets a statement. The first key thing is your hurdle rate, what your leverage is costing you. Then you have your daily mark, your month to date and your year to date. There are two columns.

Your realized gains and unrealized gains. And anybody who has money in a hedge fund or another vehicle needs both of these numbers to understand what is really going on.

The IRA: You only see part of that now. The gains and losses on the trading book show you net marks, but you cannot see the type of games you have described.

King: This is why having level two and level three assets under fair value accounting causes such problems. I am convinced that is why the Fed has put up the veil around the OTC markets, because they know that these positions are so problematic and involve such leverage as to threatened the entire system. The crisis of 2008 was really about the Fed and Treasury losing control over the OTC game in a way that was nor anticipated. The Fed does not want anybody to really look at the inter-dealer positions on OTC credit products, for example, because the valuations are such a mess.

The IRA: We have always believed that the Corrigan Group effort to fix the back office issues with OTC credit contracts was a convenient diversion from the nasty issues like valuation and counterparty risk in the front office. The Fed of New York and the DTCC did fix the operational issues to a degree, but nothing has been done to end the practice of "mark to model" in the front office. This is why JPM, GS and the other big banks fight so hard to avoid standardization of CDS. If you standardize the contracts, the ability to game the pricing and manipulate earnings also disappears.

King: I don't think you will ever see standardization. There are trillions of dollars in notional involved and none of these contracts are fungible. To make this work, you would need to mandate a degree of standardization that this market would reject. There are thousands of permutation of these contracts in the marketplace and that is precisely the problem. The complexity creates a screen for financial misdeeds. The customization is infinite. There is no way to display all of the permutations on a screen. This is what killed floor trading. You need to be in an office to trade OTC derivatives.

The IRA: So Bill, how did we as a nation convince ourselves that running a bucket shop or a hedge fund was better than making steel or other real goods? It seems like Washington believes that an increasingly speculative financial market can be an engine for economic growth.

King: To me, the country started to go to hell in the 1970s, with the first oil shocks and the resulting inflation. Paul Volcker and Ronald Regan bought us 20 years of stability and growth, but with Bill Clinton and free trade, living standards began to slide and they have not stopped. China came online, Brazil and the tigers, so now we have been exporting jobs and growth for nearly two decades. The only response by Washington has been a tech bubble and a housing bubble financed with easy money from the Fed. The New Economy was not tech; the new economy was financial engineering and speculation; leverage, bubbles, swaps. I am convinced that the people who run our country saw no alternative to gunning the markets because of the huge transfer of wealth overseas which had occurred from the US to emerging countries. We had this discussion in the 1980s. The Rockefeller wing of the Republican Party never accepted that is was Volcker's attack on inflation and Reagan's deregulation that boosted growth, not any innate growth caused by the financial markets. The technocrats in Washington decided that the stability of the financial markets was a matter of national security.

The IRA: We have been hearing a lot from the intelligence community lately. One of our friends in the economics profession just resurfaced in the community with a mandate to focus on financial markets.

King: I think that the political class has decided that manipulating financial assets and derivatives is the way to generate growth. You are certainly not going to see job or wage growth in manufacturing so long as we are exporting jobs and keeping the dollar artificially high to please our foreign creditors. Tech, biotech are some of the few areas where we still have world class companies, but we cannot run an economy on these areas alone.

The IRA: We'll leave it there. Thanks Bill.

Questions? Comments? info@institutionalriskanalytics.com

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