The Colgate Economist

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Bankers Behaving Badly:
Recent Developments in Compliance and Regulation

Is Bigger Better?
An Analysis of Glass Steagall Following The Financial Crisis

Jeopardized Netflix Board Swallows The "Poison Pill"

Schooling the Natives

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Europe Under Water?

From the Editor

To the Colgate Community

With the third launch of The Colgate Economist, the editors continueto hope that this magazine will serve the greater Colgate Community byproviding students, professors, and staff with an objective and detailed source of information regarding important economic events of the past year. At the time these articles were written, Europe was still deep in a sovereign debt crisis, with markets doubting the ability of many European states to generate future revenue sufficient to repay their debt burdens. Meanwhile, this past year also saw a large number of banks and financial institutions rocked by scandals at a time when they were most vulnerable to populist rhetoric and the challenges presented by new and strange market environments. We hope that this issue will provide a reader with a broad range of information exploring these issues, and will leave him or her with a more detailed understanding of what is currently changing the world and how these changes are manifesting themselves.

Sincerely,
James Belardo '14, *Editor in Chief*

Anyone interested in writing for the Spring addition should contact Sam Daulton, sdaulton@colgate.edu

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Bankers Behaving Badly:
Recent Developments in Compliance and Regulation

Charles Onis '14

Since the financial crisis, the degree to which banks have been scrutinized for the role that "greed" plays in their operations has only increased. From the Occupy Wall Street movement to Greg Smith's public resignation from Goldman Sachs, the finance industry has been the focus of intense criticism over the more rudimentary "vices" of its trade: high salaries and compensation, manipulation of clients, and perceived favoritism from the government. While there is certainly room for criticism of the financial industry for such qualities, what I find fascinating is that so little of this anger is reserved for the occasions when financial institutions truly give into their greed and involve themselves in blatantly illicit activities. While I don't mean to say that such events go unreported, it is clear that the media's sustained attention lies with the ongoing debate over income inequality and corruption in the finance industry, and not in the more blatant violations in both law and morality that the employees of banks commit in the pursuit of a good return.

Over the course of the past summer, the British banking industry has seen its share of costly scandals: the manipulation of the Libor (London Interbank Offered Rate) by Barclays Bank and members of the British Bankers' Association, the investigation of HSBC for money laundering, drugs, and terrorist financing offenses by the U.S. Senate Subcommittee on Investigations (and the subsequent resignation of the bank's compliance head, David Bagley, at the same Senate hearing), and Standard Chartered's fine for conducting transactions involving Iran. The fines imposed on the banks by regulators as a result of these actions made for a likewise noteworthy summer: Standard Chartered was fined $340 million by the New York Department of Financial Services (DFS), Barclays paid the largest fines ever imposed by both the U.S. Commodity Futures Trading Commission, the Justice Department, and the UK Financial Services Authority at $450 million total, and. HSBC has set aside $700 million for a settlement with the U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) that could go up to $1 billion. If paid, HSBC's settlement would beat the record set by the $619 million settlement made this June by Dutch financial-services company ING Group. Though some banks with strong financial positions, like Standard Chartered, can easily put the burden of the fines behind them, the ramp up in fines over the course of the summer, and the resignation of company executives along with them, does prove that, to paraphrase the famous Wall Street quote, while greed can be good, it is becoming increasingly more costly.

HSBC provides a wonderful case study in examining both the compliance and regulatory failures that lead to such corruption, not only because of the unprecedented size of its fine, but also breadth of its violations. Simply put, if one could imagine a possible list of legal violations a bank could perform, HSBC committed most of them over the course of the past decade. It should be noted that that not all of these violations come from conscious efforts on HSBC's part; organized criminals probably wouldn't have money to launder if they weren't at least somewhat competent at gaming the system to their advantage. Ultimately, these failings occurred due to a lack of diligence on HSBC part, as a well as a lack of government action in the face of clear violations of law, with tragic consequences occurring as a result.

First, a quick primer on the role of regulators and compliance within the finance industry: regulators create the laws to prevent banks from pursuing certain actions and it falls to a bank's compliance department to create the internal controls necessary to ensure that those laws are followed. A compliance department becomes even more important when considering the finance industry's global status; laws are not always consistent amongst all the countries in which a company does business, and while there is always some overlap, compliance departments make it easier for employees of such companies to fulfill all of their legal obligations, even if they don't have an in depth knowledge of applicable laws in all the countries they work with.

The most intentional violations perpetrated by HSBC come from their deliberate violations of OFAC prohibitions with regards to sanctioned countries, entities, and individuals. There are certain parts of U.S. law that companies conducting business within U.S. borders are expected to follow at all times in all countries, even if the action is not illegal within the country it is being performed. Sanctions are the most prominent example of this expectation: should a company with business in the U.S. conduct a transaction with a U.S.-designated rouge jurisdiction like Iran, North Korea, or Sudan from outside the U.S., it potentially exposes U.S. currency and assets to that sanctioned country, thereby undermining the purpose of the sanctions themselves. This expectation is a point of contention for some financial institutions conducting business within the U.S. as it closes them off from potential markets. The DFS's investigation into Standard Charted captured one executive's choice opinion of the U.S.'s expectations: "You f---ing Americans. Who are you to tell us, the rest of the world, that we're not going to deal with Iranians?"

To implement such laws, OFAC developed a list of the prohibited countries, persons, and entities so that banks could "filter" their transactions to identify and halt potentially prohibited transactions. Because this filter can end up delaying or blocking transactions that are legal in the U.S. and elsewhere, some non-U.S. institutions have used tactics to circumvent it. Such methods include stripping information related to the prohibited party from the transaction and altering the transaction details entirely to make it appear that a prohibited transaction was occurring within approved jurisdictions. HSBC was guilty of utilizing both of these tactics to circumvent OFAC regulations to conduct business in countries such as Iran. HSBC's European and Middle Eastern affiliates systematically altered transaction details to ensure that prohibited transactions could still pass through the bank's U.S. affiliates, with senior HSBC U.S. officials being aware of the activity. Likewise, HSBC conducted business with private institutions with known ties to terrorist organizations like the Saudi Arabian Al Rajhi Bank. After going back on an internal announcement to sever all ties with banks like Al Rajhi, the threat of losing Al Rajhi's business was too great and later, when Al Rajhi threated to pull its business from the bank, HSBC's Middle East affiliate pressured its U.S. affiliate into resuming its relationship with the banks like Al Rajhi, in spite of the blatant possibilities of terrorist financing involved.

In fairness, members of HSBC's compliance department did make attempts to prevent such practices, but were ultimately ignored in favor of the greater return. The lax nature of HSBC's compliance department becomes a reoccurring feature in a number of the bank's other violations. Such compliance failures are reflected in HSBC's alarming willingness to expose its U.S. affiliate to high-risk environments with little or no pause. Despite the organized drug crime endemic to the country, HSBC's U.S. affiliate would clear bulk shipments of cash, sometimes as high as $7 billion, from Mexico to the U.S. despite a widespread lack of client information regarding the shipments. The obvious risks associated with business in the region were ignored, allowing HSBC to become the bagman for Mexican drug cartels' illicit earnings into the United States. More forgivable but equally as mind-boggling is HSBC U.S.'s clearing of more than $290 million of bulk travellers cheques on a daily basis for a Japanese regional bank over a four year period. Despite the suspicious nature of these transactions and the Japanese bank's evasive answers regarding its client base, HSBC U.S. continued to convert the cheques into U.S. currency. It took an investigation by the U.S. Department of the Treasury's Office of the Comptroller of the Currency (OCC) for HSBC to sever the relationship with the Japanese bank. The same OCC investigation showed that the cheques were being purchased in bulk by Russian criminals in Russia, moved to Japan for clearing by way of the bank's relationship HSBC, and finally the cleared U.S. currency would then be funneled into a used automobile company back that served as a front for the Russian criminal organization.

To a certain extent, one should not expect HSBC to be able to ascertain the deepest levels of truth regarding all of the transactions it processes, but what one should expect is that when a transaction deals in such high amounts of both money and such little client information as these, an eyebrow should be raised at some point and transaction in question investigated. The inattention to basic compliance practices becomes the trend for much of HSBC's behavior over a 10-year period, where potential and overt risks to the bank's legal standing are ignored in favor of the promise of profit. The company's AML deficiencies did not happen overnight, and just as HSBC's compliance department was lax in dealing with suspicious transactions, so too were regulators like OFAC and the OCC lax in their formal and informal actions against the company's violations. Despite knowledge of some of the bank's failings, the issues at HSBC were allowed to fester over years through laziness on the part of regulators.

All of this is not to point out where HSBC went wrong along its path, those points were numerous and evident and I imagine the fines it has received and faces in the months ahead are already the wakeup call the bank needed to address its compliance issues, but to illustrate the horrific consequences of both greed and laziness in their most true forms. HSBC's actions directly lead to the funding of terrorist groups and criminal organizations through U.S. currency, with government regulators resigning themselves to the sidelines for an extended period of time despite direct knowledge of the violations at hand. While the severity HSBC's violations now force it into a position of prominence within any discussion of compliance failures in the banking industry, it isn't alone in the discussion, many other banks – Credit Suisse, Lloyds, Barclays, ING, and Standard Chartered among them – have all been brought up on similar charges. Perhaps the biggest problem that such public breaches of present is that they give credence to the notion that the financial industry acts on greed alone, and will ignore internal and external ethics to pursue that end. That sentiment, true or not, is more powerful in enabling repressive regulation against the financial industry than any number of protest movements could ever hope to achieve. ■

Is Bigger Better?

An Analysis of Glass Steagall Following The Financial Crisis

John Beam

This past July, Sanford Weil, the former Chairman and CEO of Citigroup, publically advocated the breakup of the big banks he had once lauded. In 1998, as the head of Travelers Group, which offered brokerage, consumer finance, and insurance services, Weil orchestrated the 76 billion dollar merger between his company and Citicorp, a multi-national banking operation. At the time, it was one of the largest financial mergers in history, and posed a number of regulatory concerns regarding its compliance with the Glass-Steagall Act.

During the Great Depression, when banks runs were common, the government implemented several provisions of the Glass Steagall act in order to stabilize the financial system. The first, the FDIC, posited that the government would guarantee bank deposits held in commercial banks up to a certain dollar amount. In order to prevent banks from engaging in risky activities with government guaranteed deposits, another provision of Glass-Steagall prevented commercial, deposit taking banks from merging with underwriters.

With the passing of the Gramm-Leach-Biley act in November of 1999, the floodgates for merger activity were opened, allowing large financial service companies to house commercial banking, investment banking, insurance underwriting, and brokerage services all under one unified umbrella.

Financial behemoths such as JP Morgan, Citigroup, and Bank of America currently offer these services, along with other global banks. These banks are currently able to provide a vast array of products and services for clients, ranging from corporate advisory, to commercial lending, to wealth management. These larger banks benefit from economies of scale, which reduce fixed costs, especially within infrastructure and technology departments. One estimate states that these benefits of scale equate to an additional 15 to 35 billion dollars in annual direct value to customers. But are the positives of banks engaged in such economies of scale, worth an estimated 25-45 billion dollars, greater than the associated risks?

Fast forward fourteen years. Weill's merger has by many, been considered a failure. Citigroup has suffered numerous problems, ranging from political infighting within the firm, extensive operational costs, and a stock price that has dropped to (currently) $37.73 from $527.15 in September of 2000. In the eyes of many, Citi's reputation and financial health have actually deteriorated since the merger. On July 25th, 2012, Weill spoke in an interview on CNBC, saying that "What we should probably do is go and split up investment banking from banking, have banks be deposit takers, have banks make commercial loans and real estate loans, have banks do something that's not going to risk the tax payer dollars". As the man who essentially created the paradigm of the modern financial behemoth, Weill was calling for the return of the Glass-Steagall Act. Clearly, hindsight is 20-20, but if Weill was wrong in 1999, could he be wrong again?

Weill is not alone in calling for the breakup of these large financial groups. John Reed, former CEO of Citi, and Phil Purcell, the former CEO of Morgan Stanley, have both echoed Weill's sentiments. What does it mean for the future of banking, both in the US and globally, if the accepted model must drastically adapt? The times have changed since the global financial crisis, and it appears that legislation, and a decreased appetite for risk, may transform the banking world as we know it. Large numbers of high profile investment bankers have departed from larger global firms in favor of client-driven, independent, and specialized advisory firms such as Evercore, Houlihan Lokey, and Greenhill. Ken Moelis and Blair Effron, both highly respected bankers who were formerly employed by UBS, set out to start their own firms, Moelis & Co, and Centerview, respectively. Their vast rolodex of client relationships has enabled their smaller firms to gain traction in the corporate advisory space, taking away revenue from larger competitors.

If talented, career investment bankers are leaving their former global banks in search of new opportunities at smaller advisory firms, and regulation continues to tighten following the global financial crisis, maybe Weill is correct this time around. While total breakups of these large and diversified firms is unlikely, it isn't unrealistic to speculate that the current model will have to adapt to further future changes. If Weill's comments this past July tell us anything, it's that even the most successful and intelligent leaders of financial service firms can't predict the future, and that an idea that seems good at the time, may not work out so well down the line. ■

Jeopardized Netflix Board Swallows The "Poison Pill"

Shivika Seksaria

A poison pill is a defensive tactic used by a corporation's board of directors in order to prevent its takeover by any shareholder who may have acquired a great number of shares. It usually involves a scheme in which other shareholders have the right to buy more shares of the corporation at a discount because one of the shareholder's holds a high percentage of the shares.

For example, if a person holds over 15-20% of a corporation's shares, he is known to be a potential takeover bidder, meaning decision making authority may shift from the current board towards a shareholder steadily expanding his own stake, paving the way for a potential acquisition. In order to prevent the takeover, the board of directors issues new shares at a discount and sells them to other shareholders to dilute the value of shares held by the potential threat.

Poison pills became popularly used during the 1980s because of the activities of business magnates such as Carl Icahn. Even today Icahn continues to do business in the same field. After purchasing significant stock in Mylan Industries, Philip Services, Time Warner and several other corporations, on October 31st 2012, Icahn purchased 5.5 million shares of Netflix. The share value of Netflix Inc. rose by 14% in Nasdaq after Icahn's reported a stake of nearly 10% in the company. On November 5th, Netflix Inc. adopted a poison pill to prevent Icahn from expanding his stakes in the corporation, fearing his intention was to sell the enterprise to a tech giant that may find it appealing. Under their new plan, shareholders have the right to purchase new stock if any individual shareholder possesses over a 10% stake in the corporation. "The plan was adopted unanimously by the board, which includes the CEO," says Reed Hastings, Netflix CEO and board member. While this plan was adopted to prevent Icahn from purchasing the company, Icahn's plans seemed rather different. (He wanted to flush out other buyers, like Amazon or Apple.) Icahn believes that Netflix's poison pill is "an example of poor corporate governance" since the shareholders votes were not taken into consideration. He criticized the system of election followed by the Netflix board of directors in which only a portion of the board stands for election each year instead of allowing a full slate of new directors.

Until recently, Netflix was known to be a stock market darling. But over the last one year it's reputation has tarnished. A market capitalization of $15 billion fell to about $3.3 billion. The California-based, streaming video and DVD-by-mail company had lost nearly three quarters of its value after several unwelcome moves, which included a rise in prices for its subscribers in July 2011 and a plan to separate the DVD-by-mail business from the Internet streaming business. Amazon's foray into the video streaming business, particularly it's tie up with Epix contributed in worsening Netflix's situation in the stock market. Losing nearly a million customers following the activities in the past year, investors welcomed Icahn's move, which increased the value of Netflix's shares on speculation that he may lay the groundwork for a take-over by a larger company that could provide much needed financial backing, product integration, and benefits of diversification. Over the last few months Netflix's recovery process has begun, but only time will tell whether Icahn is the antidote. ■

Schooling the Natives

Professor Chad Sparber

Immigration leads to increased high school graduation rates among native-born Americans. US immigration policy has long favored migrants seeking family reunification as opposed to those motivated by economic and employment opportunities. In 2010, 86% of US legal permanent status visas were awarded to individuals with immediate relatives or other family members currently residing in the US; only 2.6% were awarded based upon employment-related preferences. Political sentiment for existing policy is changing, however. In June 2012, President Obama issued an executive order allowing illegal immigrants who arrived to the United States as children to live, work, and attend school in the country temporarily. President Obama also wants to increase immigration among individuals with science, technology, engineering, and math degrees (the so-called "STEM" majors) and has argued for lifting caps on high-skilled immigrants. The hope is that such individuals would be innovative and entrepreneurial job-creators that could help stimulate the American economy.

What is curious about proposals to move toward skill-based immigration policies is that they sometimes ignore discussions about the costs and benefits of current US immigration. Evidence across US states suggests that immigrants have little to no effect on wages paid to native workers. This is true even within education groups. Native workers are rational; when confronted with increased competition with foreign-born workers, they respond by embracing their comparative advantage in English-language skills. Natives "upgrade" their occupations by choosing new lines of work that demand greater use of communication skills – jobs that generally offer higher wages.

A recent paper by Jennifer Hunt at Rutgers University has uncovered a new source of native skill upgrading —American-born children are responding to immigration by increasing their secondary school completion rates. This effect is not as obvious as it might sound. On the one hand, immigrant children could lead to deteriorating primary and secondary school quality if teachers slow the rate of instruction or if financial resources are diverted away from native students. Reduced education quality should lower the rate of return to education, and hence the incentive to complete school. On the other hand, a disproportionate number of US immigrants do not possess a high school degree. An influx of such immigrants would signal increased labor market competition among less-educated workers, providing an incentive for natives to continue their schooling.

Ms. Hunt finds evidence that both effects exist, but that the labor market effect dominates. A one percentage-point increase in the foreign-born share of the population increases the probability that natives aged 11-17 will have completed high school within the following ten years by 0.3 percentage points. These effects are not large given that the average native high school completion rate across states in her sample is 87.8%, while the average immigrant share is 8.9%. Nonetheless, it is a benefit from immigration that has been overlooked in policy debates. Moreover, effects are larger for black students – a demographic group typically subject to greater labor market competition with immigrant groups.

Several questions remain. Ms. Hunt does not examine whether immigration affects college enrollment or completion of natives, nor does she test whether immigrant children respond to higher immigration rates (and increased labor market competition) by finishing high school. Nonetheless, the work provides interesting insights into potential gains from immigration previously unexplored. ■

Special Report: *The Eurozone Crisis*

Background: Wiggs Civitillo '13

The earliest signs of the European Economic crisis appeared as several European Union members began to observe persistent fiscal deficits in their economies in the late 2000s. A strong Euro combined with incredibly low interest rates due to lose monetary policies provided countries with the availability of easy credit for much of the past decade. Greece took full advantage of this "easy money," borrowing until their domestic debt reached a value of 400 billion dollars. Although other countries such as Spain and Ireland kept their spending under control, domestic lenders and developers took advantage of low rates to fuel real-estate bubbles. This spending was only sustainable so long as external creditors continued to express a willingness to lend at cheap levels.

The European Sovereign Debt Crisis was arguably sparked in October of 2009, when George Papakonstantinou, Greece's newly elected Minister of Finance, revealed that his predecessor had misstated the budget deficit—it was not the previously believed 3.6% of GDP, but actually 12.8%, a number far higher. This destroyed investor confidence in the European Bond Markets and put countries who had grown to rely on cheap credit under incredible pressure. According to the Economist, in 2009, Greece's budget deficit eventually reached 15.4% of GDP, Ireland's 14.3%, Spain's 11.2%, Portugal's 9.3%, and Italy's 5.3%.

Through the bond market's, the international community had been exposed to poor and short-sighted governance in both Greece and the EU as a whole. The Council of Ministers of the European Union and European Central Bank failed to quell fears as they never offered a clear signal regarding aid for the now-distressed European Countries.

As Rating Agencies continued to research Greek institutions and slowly began to downgrade their debt towards "junk" ratings, it became apparent that Greece's institutions were completely dysfunctional and replete with corruption. Markets appreciate certainty—something that was absolutely lacking in the unfolding crisis, with investors speculating about outcomes ranging from a bailout, exit from the EU, the issuance of Eurobonds, or even the disintegration of the monetary union.

In early 2010, Greece committed to an extreme austerity program in order to avoid default. The European Commission and the Financial and Economic Ministers of the EU soon approved a stability program laid out to reduce Greece's public deficit to 3% of GDP by 2012. The plan included large cutbacks in expenditures, increases in taxes, a raise in petroleum product duties, and an increase in the retirement age limit. Additionally, previously privileged public employees would no longer receive wage increases. This program temporarily raised confidence in Greece until it became apparent that the politics of the country would prevent such programs from seeing the light of day in the originally intended form. Markets once again turned on Greece.

As markets were willing to bid less and less for Greek Sovereign Debt, thereby increasing the effective interest rates that Greece had to pay in order to borrow, the EU and IMF deemed it necessary to help Greece in order to avoid systematic contagion into other economies. In early 2010, they created a series of bailout packages totaling 110 billion euros. This still failed to increase market confidence, and in May, European leaders approved a contingency fund of 500 billion euros in the hope that this tour de force would calm investors and never actually be spent.

In the fall of 2010, interest rates once again began to increase, and Ireland soon needed to be bailed out. This still failed to ward off the crisis, and the Spring of 2011 ushered in the fall of both Ireland, Portugal, and Spain's governments, the latter of which now suffered unemployment rates of 20%. The ECB responded by purchasing (and bidding up the prices of) Italian and Spanish bonds, with the intention of keeping borrowing rates low, and EU leaders soon put together a plan to increase the powers of the European Financial Stability Facility (essentially an emergency bailout fund).

It soon became apparent that these aid policies were not working as intended, as growth across the EU slowed and even reversed. Soon, discussion arose about the creation of a central financial authority, which could control fiscal policy, bond issuance, and budget approval powers, (essentially a federal government for Europe.) This, however, was politically difficult, and never saw fruition, as logical as it may have been.

As Greece once again ran out of money in August, a new drastic round of Austerity was implemented, including the sale of state assets as a fundraising mechanism. Private lenders were now forced to accept extended maturities on their debt holdings (their principal wouldn't be redeemed at the time they had initially agreed to, extending damage outside of the troubled countries to foreign banks and lenders.) Concurrently, interest rates were rising in Italy and Spain, which the EFSF didn't have the capability of bailing out. The ECB extended its bond-buying operations, attempting to restore market confidence.

In the October of 2011, European lenders announced a three-part plan to recapitalize European banks, increase the size and scope of the rescue fund, and pressure private lenders to accept a 50% write down on Greek Bond holdings. By early December, realizing that a coordinated effort was necessary, leaders implemented a new series of treaties stipulating strict budget rules and sanctions that would ensue should they fail to be followed.

Negotiations between private lenders and the "troika" consisting of the European Commission, Central Bank, and IMF continued with Greece, pushing further austerity as a pre-condition to a debt write off – meaning that Greece would not have to pay back the full value it borrowed initially. As the crisis continues to spread to Italy and Spain, the situation remains incredibly dubious, as lenders spar with politicians across the Euro over unpopular austerity measures and structural reform. ■

Analysis: *An Inherent Flaw in the European Model?*

James Belardo '14

From its inception, the European Union has faced an enormous short-coming: the fact that a currency or monetary union cannot effectively exist without the centralized ability to implement fiscal transfers that can offset regional shocks. The afflicted European countries can tax in an attempt to increase revenue, but there is no over-arching federal institution capable of counter-acting the negative economic effects associated with increased taxation during a time of recession. As tax rates increase, individuals receive less income. As income decreases, tax revenues further decrease. This leads to a vicious cycle and a race towards bankruptcy.

The United States faced a similar crisis in 2008, and member states within the federation did, like the European Countries, increase taxes and cut spending, which drove down economic activity. The difference between these two cases begins with the fact that the federal government can also tax or alter spending, something notably absent from the European Monetary Union. In other words, as states began to spend less and take in more money through taxation, thereby buffering their own balance sheets at the expense of their economies, the federal government counter-acted these negative effects by cutting federal taxes while raising federal spending. This prevented economic collapse and addressed the revenue paradox facing Eurozone countries today.

Conversely, there are no "EU" taxes, nor is there "EU" spending, and the union was thus flawed from the start because it relied on the good faith of other healthier countries and tax-payers in order to address regional shocks. Unlike the EU, the USA has an institution capable of fiscal policy that can both print money and run huge deficits without requiring sacrifice on the behalf of more prosperous states.

Evaluating Euro-Zone Withdrawal as a Solution:
So what can be done? Although it is just an opinion, I actually think that re-denomination, in other words, removal of certain countries from the Euro currency, would be the only plausible solution short of politically implausible fiscal union a la USA. While this option also seems politically far-fetched, due to its perception as a step away from European integration, it makes much sense if continued integration implied unsustainable support and demands from the ECB and other member states.

One thing European policy-makers agree about is that the debt burden in many of the suffering countries must be eased. The solution currently being pushed for is debt restructuring, meaning that creditors would receive a haircut, and only be paid back a portion of the debt that they originally lent (Wiggs alluded to the 50% write-down imposed on private Greek creditors.) Redenomination, however, has distinct advantages over this approach.

First, like a haircut agreed to through restructuring, losses to creditors can be capped during redenomination through initially currency controls, limiting the initial extent of depreciation by establishing capital controls or an extended bank holiday in order to prevent capital flight. This is necessary because a withdrawing country would evidently view Euro denominated accounts as safer, and would thus begin to move money to foreign denominated accounts, thus exacerbating any decrease in their own currency.

Another means of limiting losses during bond redenomination would be through a pegging of the newly formed currency to the Euro in order to prevent catastrophic losses to creditors, which would likely move the entire world towards recession. This would be done by fixing the exchange rate within a certain band width.

Furthermore, redenomination bypasses the negotiations necessitated by restructuring and prevents holdout creditors or "vulture funds" from purchasing debt at deflated values and then refusing to participate in negotiations regarding haircuts while demanding a country's assets, the seizure of which could have a further negligible effect on the economy.

Unlike with restructuring, where private investors were forced to accept haircuts at the benefit of public creditors, redenomination is more economically efficient in that it treats both parties as equal. Lastly, this system eases or eliminates the politically unpopular burden of support faced by tax-payers in stronger Eurozone countries, such as Germany, in supporting such measures.

The last benefit to such a maneuver would be a further automatic (independent of democratic processes) step towards increasing structural competitiveness, something that has been difficult to address in Europe given its political climate. A weaker currency would imply greater demand for exports and tourism, something that could help domestic workers expand in a manner they couldn't under a stronger currency. Although imports would be more expensive, this would address the issue of demand shortfalls that are associated with austerity. Such withdrawal and its associated operational and legal problems would require significant technical and legal changes and input, and thus may be initially difficult to implement. However, Eurozone withdrawal, if implemented properly, would be far from catastrophic, and may actually be beneficial as a solution.

Is The Complete Disintegration of the Euro Zone Necessary?

Provided a legal framework is established for Euro zone withdrawal, and weaker members choose to redenominate their currency, would the Euro Zone still remain viable in its current form? As mentioned, the underlying issue is the impossibility of fiscal transfers within this monetary union, a structural issue that the withdrawal of weaker members would not address.

While fiscal integration of remaining countries based on the model of the United States would be most preferable, it is far from practical or politically feasible. One solution to this problem would be the issuance of Euro-Bonds —bonds that the remainder of the Euro Zone would be responsible for paying. This would be a move towards a nation-state rather than a union, and a legal framework could be established stipulating debt limits for each member, or voting procedures in order to raise debt beyond a certain percentage of each country's GDP. This would force countries to establish sustainable finances and fiscal discipline, and would additionally remove the moral hazard that allowed individual member states to borrow at the future expense of other states.

It would additionally allow fiscal transfers in response to regional shocks, thereby addressing one of the main flaws of the European Monetary Union. A member state in a weakened condition could finance increased expenditure or decreased taxes through a carefully negotiated or voted upon bond issuance, subject to certain fiscal changes in the future, thus avoiding the vicious cycle associated with increasing taxes on a shrinking pool of income. ■

Speculative Sneakerheads: *Shoes As An Investment*

Jake Pulver

Ah...New York City. Home to the NASDAQ building, abundant ports, and all of the firms on Wall Street. All one has to do to get a feel for the entrepreneurial spirit is take the escalator up from Penn Station to 34th St and inhale the city's distinct air. However, if people do this on a Saturday morning, they might see a pretty unusual sight when they turn towards the intersection of 34th St and 7th Ave: one pretty long line, and no, not a bus line.

On this corner lies Footaction, a retail chain of sneaker stores. The aforementioned line stems from this shop, as sneaker connoisseurs gear up to buy the latest Nike or Jordan models. The average person might go up to the line and ask what everyone is waiting for. A typical response would be something like "the new Olympic LeBrons," but that is not what everyone says. Hidden among the actual sneaker lovers are the " resellers," as they are known by sneakerheads at large. When resellers are asked about what they are waiting for, their answer might be "a payday." These people have taken on the buying and selling of limited sneakers for profit.

Wait. Speculative buying. . . of sneakers? You got it.

When people mention speculative trading, they usually reference stocks or natural commodities, but with the advent of the Internet, a market for buying, selling, and trading sneakers has emerged. Nowadays, people do not just buy their shoes at chain stores and mom-and-pop shops that sell the shoes for retail price. When there aren't enough pairs of a specific sneaker to go around to everyone, the sneaker usually ends up on multiple listings on eBay, Craigslist, and sneaker-centric marketplaces like Sole Collector.

Now, one question remains. What kind of profit might one get from selling sneakers? Well, it varies. Most new, high-in-demand releases could net a seller around $50 (if not a little more) if sold on or right after the release date. If a seller can get his hands on more than one pair and can sell whatever he or she gets, there is an even higher profit. However, one gets the most profit from selling the most extremely limited, highest-demand pairs right after the release date. These are the sneakers that can cause riots. Take the Nike Air Yeezy 2, a sneaker designed by famed rapper Kanye West. It was released in only a select few retail locations, and in very limited numbers, for $245. In order to get a pair now, one might have to shell out upwards of $2000 to resellers on eBay. Immediately after the sneaker's release, that amount was even several hundred dollars higher.

As with any speculative trading, successfully buying and selling sneakers requires knowledge on several fronts: what sneakers to buy, where to buy them with the least hassle, and when to sell them. Once the prospective reseller has that knowledge and proper capital, he or she can, well, just do it. ■

Taming Mother Nature:
How Commodity Hedging Mitigates Unpredictable Weather

Sam Daulton

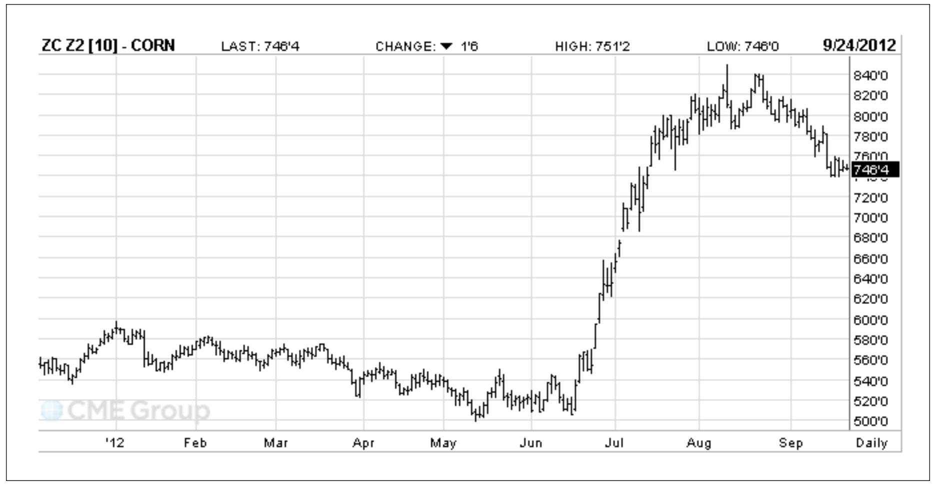

Figure 1:*
This is a CME Group Daily chart showing Nov 2011–Sept 2012 prices for a Dec 2012 corn future contract. The chart shows a steady, oscillating decline in price from the beginning of 2012 through about the middle of May. However, in the middle of June, a month and a half long rally of over 3000 points rocketed prices from about $5.10 a bushel to about $8.50 a bushel.

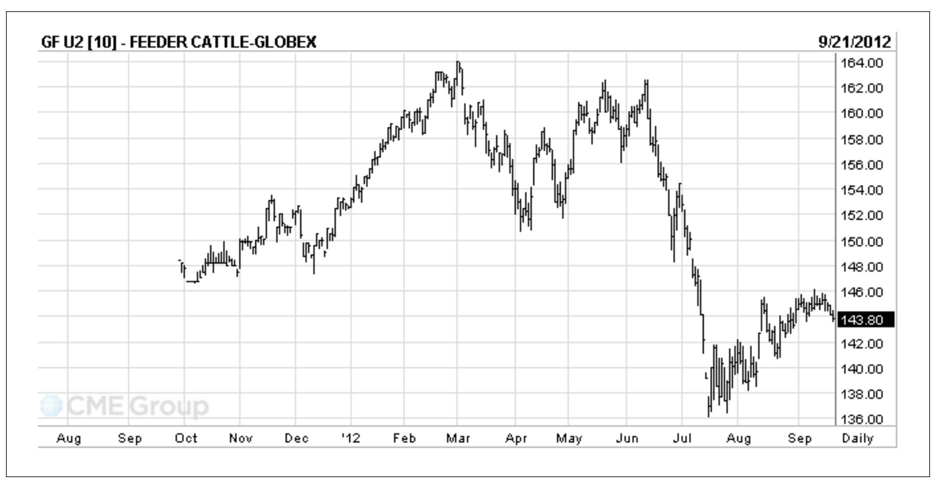

Figure 2:*
This is another CME Group Daily chart showing the prices for September 2012 Feeder Cattle futures since the contracts inception. Note that the feeder cattle futures have an inverse reaction to that of the corn in the middle of June. Here prices drop from about $1.63 per pound to about $1.36 per pound.
Note: a Feeder Cattle futures contract is 50,000 lbs.

**Figures 1 and 2 are property of CME Group Inc.*

A futures contract is a standardized agreement between two people to buy or sell a good of specified quality and quantity on a specified date at a specified price. Futures contract prices for the front month (the contract closest to expiration or the transaction date) for a particular good tend to follow the prices of that good in the cash market more closely than contract prices for the back months (contracts further from expiration).

There are two types of participants in futures markets: hedgers and speculators. Hedgers are producers or consumers who buy and sell futures contracts to lock-in a particular price for a certain good in the future, regardless of market movement. Thus, hedgers manage their risk of price fluctuation, which may lead to decreased revenue or increased costs. Speculators assume that risk in an attempt to profit off market movements and in doing so, provide market liquidity and fair prices for hedgers. To buy or a sell a futures contract, a party is only required to present a small percentage of the contract value, which is called margin. This allows speculators to control a large quantity of a good with a relatively small amount of money. A clearing firm guarantees individual customer accounts, and a clearing house processes the trades and makes sure customer accounts are appropriately credited or debited.

The size of a corn futures contract is 5,000 bushels (where a bushel literally represents how much corn can fit in a bushel), and a contract price is in terms of cents per bushel, with a minimum price fluctuation (tick size) of a ¼ cent per bushel (or $12.50 a contract). So if a 2012 Dec corn future were traded at 746'4, that would mean 746.5 (the digit after the apostrophe is 1/8 of a cent or ½ a tick) points or cents per bushel, which is equivalent to $37,325 per contract.

During the summer of 2012, drought left typically lush Midwestern fields barren. On September 1st, the US Department of Agriculture declared the US corn supply below 1 billion bushels, the lowest since 2004 (Chicago Tribune). With a reduced harvest and no change in demand, corn, soybean, and other grain prices rallied (increased). As the lack of rain continued, demand did not falter and prices soared creating new all-time price highs (The Times of Oman).

The drought of 2012 caused corn futures prices to skyrocket in months beyond the harvest. A vast majority of the corn produced, 80%, is used as livestock feed, followed by food, and then ethanol (U.S. EPA). The December corn futures, just past the harvest, rallied significantly as a crippled harvest was predicted and now is a reality. This is because cattle hedgers wanted to guarantee lower corn prices for feed come December, expecting that the supply would be substantially reduced, and at the same time, speculators, predicting a large rally, wanted to buy futures and profit off the rally. Few were inclined to sell against the rally given the severity of the drought, which only perpetuated the upward price movement. Prices rallied substantially due to the decreased supply of corn without any decrease in demand. The price difference between mid June and mid August is roughly $3.40 a bushel or $17000 per contract as displayed in Figure 1.

This drought did not just affect grain markets, but livestock as well. Figure 2 shows that feeder cattle (juvenile cattle, which need to be fattened and raised) futures broke (decreased) approximately 2,700 points. Higher grain prices meant more expensive feed for the feeder cattle, so parties were less inclined to buy feeder cattle. As Figures 1 and 2 show, feeder cattle futures broke nearly simultaneously as corn future rallied.

The goal of hedging is to lock-in prices in the future to manage the risk of large price movements leading to decreased profits. But hedging is a two-sided coin; by guaranteeing a certain price in the future, hedgers eliminate the potential for increased profits if the market moves in a favorable direction. This past summer, corn farmers who hedged, sold corn futures before the season, so that if cash market corn prices decreased by selling time, the futures profit would offset the decreased profit from the corn sale. However, when corn prices increased $3.40 per bushel, these hedgers lost as much money on the futures as they made from the increased cash market prices. While the hedge served its purpose of managing risk, with hindsight, the farmers would have been better off had they not hedged this time.

For both corn and feeder cattle futures, there are two types of hedgers: those who have the commodity and those who need the commodity. Corn farmers have the risk that cash market corn prices decrease when it comes time to sell, which would decrease their profits. To manage this risk, corn farmers can sell corn futures early in the season and buy those futures back when it is time to sell their corn. Thus if the cash market corn prices decrease while the corn is maturing, the loss of profit when farmers sell the corn is offset by the profit from the futures. Therefore, the corn farmers earn the same profits as if no price fluctuation occurred.

Those who need the commodity, in this case livestock raisers, employ an opposite hedge. Livestock raisers would buy corn futures and sell them when it is actually time to buy the corn. The livestock raisers would manage the risk of corn prices increasing which would cause decreased profits.

This past summer, the corn farmers' hedges lost money, but still worked. Corn prices increased in both cash and futures markets. The farmers could sell their corn for a higher price in the cash market, but would have to buy back their short corn futures position. The cash market profit would be offset, by the futures loss. So with hindsight, the corn farmers would have been better off not hedging. But, it is crucial to note that even though the hedge lost money, it worked. The purpose of a hedge is risk management. Because of the hedge, the farmers were not at risk of a decrease in corn prices leading to decreased profits.

Similarly with the feeder cattle raisers, the hedge worked. The feeder cattle cash and futures prices plummeted, but those feeder cattle raisers who hedged had a short futures position that made profits comparable to the deficit in the price the feeder cattle raiser received from the actual sale of the feeder cattle.

Futures markets give hedgers a legitimate tool for managing their risk. While the futures position may not always make money, the hedge always works in its true function of controlling risk when properly implemented. Hedging is not about maximizing profit. The futures markets are highly volatile by nature, and this is only another example of an extraordinary movement. ■

The Trade Heard 'Round the World

Keith England

Many stories on Wall Street do not make it past the informed readers and watchers of the standard financial media—*The Wall Street Journal, Bloomberg, Reuters, The Financial Times, CNBC,* etc. But oh-so-often a story is leaked that becomes larger than "the street" itself, combining intertwining plot lines of intrigue, risky speculation, political consequence, financial celebrities, SEC and FBI investigations, and, of course, lots—and lots—of money. Such are the factors that brought to the forefront the disastrous trade loss suffered by JP Morgan. Although the background, timeline, financial instruments, and major players involved in the story are complex, when the role of each piece is examined carefully, a winding narrative of the trade can be constructed.

In 2005, a year when firms across Wall Street produced record profits, JP Morgan Chase promoted the newly acquired Bank One's president, James "Jamie" Dimon, to Chief Executive Officer. Dimon has since become the "golden boy" of Wall Street, earning a seat on the Federal Reserve Bank of New York in 2008 and representing the strong Wall Street push against government bank regulation, sitting before Congress on numerous occasions. Why does this matter? The philosophy Dimon has instilled at JP Morgan has led them to become the largest bank in America (by deposits) and world leader in the structuring and issuance of securitized products. This meant that by 2011 and 2012, traders and salesmen across JP Morgan were not only very familiar with a diverse range of securitized products, but also had large amounts of resources to work with.

Two more crucial components of the trade developed in 2007. As billions of dollars of securitized mortgages, and the various derivatives on which they were based, began to default simultaneously, a man named Boaz Weinstein was pushed out of Deutsche Bank as the former rising star accumulated a $1.1 billion loss. In late 2007, Weinstein took his fallen compatriots and opened the hedge fund Saba Capital Management. A notorious trader and aggressive dealmaker, Weinstein started his fund with $5.5 million and an eye on the credit markets, which were at this time enjoying the last months of their boom. It was at this time that the Markit CDX North America Investment Grade Series 9 10-Year Index, also known as IG9, was created.

IG9 is a credit default swap (CDS) index that matures on December 20, 2017, and also contains 5-Year positions that mature on December 20, 2012. In essence, the index tracks the perceived risk of default of 121 "Investment Grade" companies as their credit spread moves. In basic terms, if one were to sell protection on the tranches, they would receive 20% of their sale up front, and 5% a year in premiums, quite a large sum for a CDS on investment grade debt in today's market. This seller would have to pay out to the buyer only if a certain number of companies defaulted. In 2011, Bruno Iksil of JP Morgan's Chief Investment Office in London used IG9 to hedge JP Morgan's credit risk and various trading positions.

In November 2011, JP Morgan faced two problems: first, the Eurozone debt crisis continued to drag on, and second, the U.S. economy still remained in bad shape. Unfortunately, neither issue presented an easy solution. Regarding the Eurozone, the simplest short-term solution would have been for JP Morgan to take the short (opposite) position on European credit. However, because of the high risk of default in certain Eurozone nations, protection on this debt was in high demand, making it costly to own much. In addition, volatility in the credit markets made it extremely risky to take a heavy position in just one direction. In the U.S., the lack of improvement in the economy meant that many of the companies in the IG9 index still presented a notable default risk. So, Iksil and others at the JP Morgan CIO made two counter-balancing trades.

In the first trade, which was much smaller than the second, JP Morgan bought protection in the form of CDS's on tranches of subordinated debt. This trade took the position that lower quality debt would default, and was not only expensive, but also highly prone to volatility. Thus, in the second trade, hedging (offsetting the risk of) the first, JP Morgan sold a much larger amount of cheaper protection on the IG9, attempting to make themselves market neutral because this trade took the position that companies in this index would not default in high volume. In late 2011, the hedges seemed to be working, as American Airlines went bankrupt and the first trade paid off. However, at the end of the year, the European Central Bank initiated a stimulus program and European credit rallied, hurting JP's position in the first trade, and leading Iksil to start selling even more protection on IG9 in order to continue to remain market neutral in his aggregate position.

From the other side of the looking glass, during the time from late 2011 to early 2012, Boaz Weinstein noticed the IG9 index was not moving as it should given the relationships it represented. By February of 2012, it became clear that someone was selling huge amounts of CDS protection in IG9, effectively shorting the index and betting that credit would grow stronger in the coming months. Weinstein saw this, and more importantly saw a huge opportunity to take large positions against this mystery seller, buying huge amounts of this protection and waiting for credit to fall. In an investment conference on February 2nd, 2012, Weinstein picked the IG9 long position as his "best bet." The conference was abuzz; who was this mystery trader? Why was he taking such an enormous position in the index? Was Weinstein right to position himself against the man?

The mystery man was, of course, Bruno Iksil, now known as the "London Whale" for the huge trades he made while at JP Morgan's offices in London. Under the direction of Ina Drew amongst others, Iksil had been pushed to make big trades in derivative markets for multiple years. In this context, the IG9 trades were only the most recent of many similar ventures for this branch of the bank. Yet, to those outside the bank, the IG9 trade remained enigmatic for many months.

In February and March, the hedge fund managers that had followed Weinstein's lead incurred losses, as Iksil's bosses pressured him to increase the prices of the protection JP Morgan was selling, which meant taking an even larger position in the market. Eventually, Iksil had sold so much protection on IG9 that he essentially became the market, and hedge fund managers hoped that if they continued to buy this protection Iksil's position would eventually deteriorate. Unfortunately, into April, this had yet to occur, and a frustrated hedge fund manager leaked to Bloomberg that JP Morgan was manipulating the credit market in their favor. In May, finally, the Euro debt crisis exploded, and JP Morgan began to suffer heavy losses on Iksil's second trade. Although the firm attempted to delay the release of its quarterly report, the bank soon revealed $2 billion in losses from the trade. With the financial media already on the scent, the loss became a major story. At this time, Ina Drew, the head of JP Morgan's CIO and one the most successful women to ever work on Wall Street, resigned. Dimon attempted to play down the losses, but they continued to climb, reaching 3 billion in June. At this point, JP Morgan rushed to unwind their heavily long position on IG9, but this was a timely and expensive process.

By the end of August, JP Morgan had incurred 5.8 billion dollars in losses from the trade, and worst-case figures estimate the potential total losses to be around 9 billion. Given JP Morgan's preeminent status amongst other banks on Wall Street, the massive loss has become a cautionary tale of the potential dangers of taking extremely heavy positions in one direction, no matter how strong your bank's assets are. Furthermore, this story shows how even strategies that pursue technical risk neutrality can induce far greater risk if not carefully reanalyzed as market conditions shift. However, most importantly, it has reminded traders at large banks that there are always men and women on the other side, in offices from Short hills, New Jersey to the lower East side of Manhattan, who used to work at those same banks and are waiting to prey on their replacements. ■