# GRANT'S

INTEREST RATE OBSERVER®

Vol. 33, No. 06a | Two Wall Street, New York, New York 10005 • www.grantspub.com | MARCH 20 2015

# Operation Barn Door

Incapable of predicting financial crises, our central bankers are doing their all to prevent them. Should you rest easier on that account? You should not, to anticipate the conclusion of the essay now in progress.

Citigroup, of all the accident-prone institutions, last week passed a Federal Reserve-administered stress test with flying colors. What does this fact tell us? It tells us less about the bank (which spent more than $180 million on cramming and test prep) than it does about the Federal Reserve. Long on process but short on imagination, our mandarins strain to understand the nuanced nature of financial risk.

The view from *Grant's* is that risk can usually be found where you aren't looking for it. You get to thinking, for example, that government bonds are perfectly and unconditionally safe. You would so conclude after 33 ½ years of a bond bull market. Yet, the same asset struck many as perfectly and unconditionally unsafe at the 33 ½-year point in the preceding 1946-81 bond bear market. Nothing in investing is for certain or forever. "Many shall be restored that now are fallen, and many shall fall that are now in honor," wrote Horace (65 B.C. to 8 B.C.), anticipating the "dogs of the Dow" approach to stock selection.

You can move risk from here to there—from one kind of institution or one kind of asset to another—but you can't eliminate it. You may think you know what it is, but it turns out to be something else. Citibank, index case of management incompetence turned star test-taker, lifted its nominal exposure to derivative contracts to $59 trillion in 2014 from $39 trillion in 2009. Were derivatives on the test?

Or, to quote the learned Andrew Haldane, chief economist of the Bank of England: "Risk, like energy, tends to be conserved not dissipated, to change its composition but not its quantum. So it is possible the financial system may exhibit a new strain of systemic risk—a greater number of higher-frequency, higher-amplitude cyclical fluctuations in asset prices and financial activity, now originating on the balance sheets of mutual funds, insurance companies and pension funds." In other words, by making the banking system safe—if, indeed, it succeeds in that mission, which we doubt—the Fed may only succeed in making other departments of American finance unsafe.

Fractional reserve banking is risky business even in a setting of positive real interest rates, un-manipulated asset markets and stable exchange rates. It can't be any easier in a setting of negative real interest rates, governmentally swollen asset values and drunkenly oscillating exchange rates. With one hand, the Fed is manipulating interest rates, therefore the value of the myriad financial claims tied to interest rates. With the other hand, it's trying to impose safety and soundness from on high. Left hand and right hand are working at cross-purposes.

"[W]e are all macroprudentialists now," Federal Reserve Governor Daniel K. Tarullo preached to a choir of financial regulators who assembled in Arlington, Va., on Jan. 30 to advance the cause of safety by government fiat. We are, in fact, not quite all macropru-

**Still barely above zero**


source: The Bloomberg

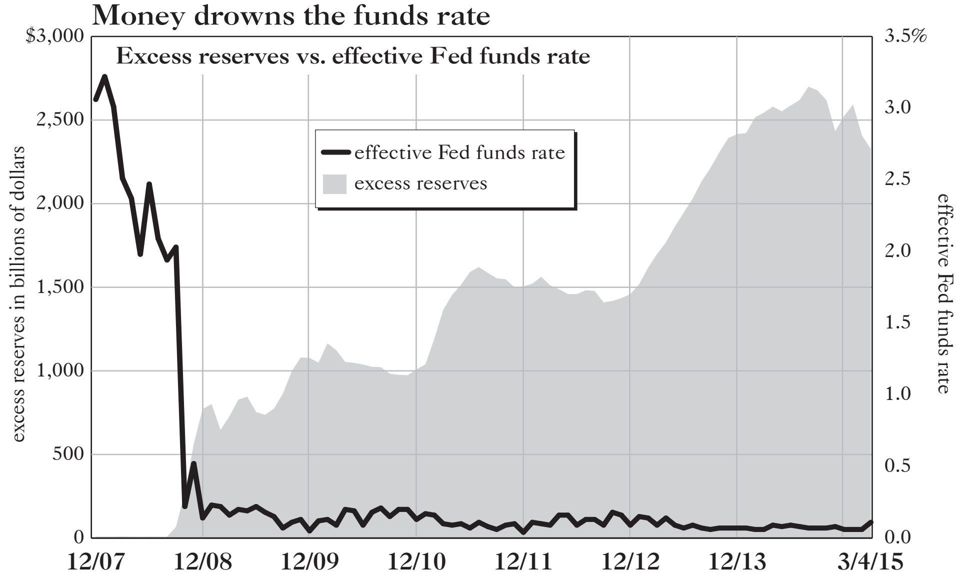
dentialists now. The fixers of interest rates and raisers-up of financial assets—which is to say Tarullo's colleagues on the Federal Reserve Board, at the European Central Bank and at the Bank of Japan—are the unwitting enemies of macro prudence. If price control is a policy that tends to backfire on the governments that implement it (and it is), and if interest rates are among the most critical prices in finance (and they are), 21st century monetary policy is riding for a fall.

Some may protest that interest rates would be just as low in the absence of ZIRP and quantitative easing as they are with them. We can't prove them wrong. We rather observe, for instance, that Treasury yields were higher in the Great Depression than they are today, and that in the wake of the announcement by the ECB that it, too, would begin a massive bond-buying program, the yield on the 10-year German government yield tumbled by 20-odd percent on March 9 and by another 20-odd percent on March 10 ("a market first I am sure," dryly remarks reader Paul Isaac). These precious German pieces of paper are currently priced to yield 0.28%. So we conclude (*a*) that yields are in fact artificially depressed and that (*b*) a future snapback in interest rates will rattle the investment teacups. From which it follows that, in their drive to avoid a repetition of the previous financial crisis, the central bankers could be propagating the next one.

You may say give the regulators credit for trying: Would you have them do nothing? Or you may say, the bankers had it coming: They almost sank the institutions that overpaid them. Besides, the counter-argument could run, it's unhelpful to dwell on problems that seem so well discounted. Monday's *Financial Times* reports that certain asset management companies are already rehearsing for the next downdraft in bond prices, a sell-off which they anticipate will be made especially costly by the illiquid condition of the market. Nor is it exactly front-page news that banks are in bad odor with investors: In relation to the S&P 500, the S&P bank index sits at a post-1941 low (this according to an eye-opening chart book that Michael Hartnett of Bank of America/Merrill Lynch will distribute and read from during lunch at the April 7 *Grant's* Conference —advt.).

Yes, we reply, credit to the regulators

**Money drowns the funds rate**




source: The Bloomberg

for their (misplaced) zeal, and shame on the crony capitalists who, operating in the quasi-socialized industry of too-big-to-fail banking, mismanaged their institutions to the point of failure. If it were up to us, we would restore the capitalistic state of things in which the stockholders of a bank got a capital call if the institution in which they owned a fractional interest became impaired or insolvent. That is by the by. We write to call attention to the changes that the Tarullo-led regulatory drive is effecting in the landscape of finance. "It can't be," the head of the Nordic region's biggest bank, Christian Clausen, CEO of Nordea, told the *Financial Times* last fall, "that the only purpose of banking is to stop banks from going bankrupt." Clausen should tell it to the feds.

Complex financial institutions are hard to manage, we are forever being told. The bankers struggle to understand them. Do the regulators understand them better? How many members of Tarullo's macroprudential battalions have ever managed a bank? If complex financial institutions are unmanageable, how can the sidewalk superintendents presume to manage a "system" of the same?

In the issue dated Jan. 23, *Grant's* quoted Richard Bove, analyst with Rafferty Capital Markets, to the effect that the government has virtually nationalized the banks. "By that I mean," said the analyst, "basically the government tells the banks what the size of their assets should be. If they go above those sizes, the government hits them with capital penalties. Then the government says OK, we're going to tell you how to allocate your assets between loans and other areas. And then the government goes into liquid assets and says, 'Well, these are high-quality liquid assets and these are not'. . . and it goes into your loan portfolio and it tells these banks, 'this is where we're going to allow you to have low-risk weightings and therefore we want you to lend there, and this is where you can't lend.'"

You start to wonder where regulation leaves off and management begins—or if the regulators showed up for work one day while the managers stayed home, whether anyone would notice the difference. Thus, the Fed has pushed banks and money market funds into government securities, and thereby disadvantaged privately issued claims. It has made big banks jump through hoops of stress tests, and so distracted those institutions from the quotidian business of making a living. It has driven big financial institutions out of market-making at the cost of draining liquidity from the fixed-income markets.

Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 to shut the door on frenzied finance (the bulls having already bolted from the barn). No more would Washington confine itself to regulating markets and institutions one by one. It would turn its attention as well to the "system"—"safeguarding financial stability by containing systemic risk," as Tarullo put it to his federal confreres in January.

To forestall a recurrence of the events of 2007-09, the Fed, in harness with a pair of new Dodd-Frank creations, the Office of Financial Research and the Financial Stability Oversight Council, would regulate from the 10,000-foot level as well as at ground zero. The grand plan was—and remains—to eliminate bank runs, liquidity crises and "fire sales," by which the federal guardians would appear to mean "bear markets."

And just how does the government propose to achieve a state of non-combustible finance? Why, it will nudge or shove private actors into approved assets and managerial techniques. The Volcker Rule dispenses with most proprietary trading. The Dodd-Frank Act Stress Test, the Net Stable Funding Ratio (yet to be finalized), the Comprehensive Capital Analysis and Review and the Comprehensive Liquidity Assessment and Review will, under the oversight of the Federal Reserve's Large Institution Supervision Coordinating Committee, supposedly protect the world from the kinds of blunders that made 2008 such fine newspaper copy. And if all else fails, a bankrupt bank can be wound up according to the instructions contained in its own living will (another Dodd-Frank innovation).

Let us see about the consequences of these various policy demarches. The bond market is one early macroprudential casualty. Dealers aren't dealing as they did, and trillions of high-grade securities repose on the central banks' balance sheets rather than in the hands of price-sensitive investors. Dan Fuss, vice chairman of Loomis, Sayles & Co. and manager of the flagship Loomis Sayles Bond Fund, relates that for many a moon, one could sell $200 million to $250 million of Treasury securities without moving the market. Today, that limit is as low as $60 million. "Not only is it harder for the dealer banks to hold inventory for regulatory purposes," Fuss tells colleague Evan Lorenz, "there are fewer of the dealer banks than there used to be."

A fine mess it would be if, in case of an unscripted rise in interest rates, investors in mutual bond funds came running for their money all at the same time. Sell! they would cry, but to whom? Tarullo mused on this kind of scenario in his January remarks. "Considerable work is needed, first, to develop better data on assets under management, liquidity and leverage, in order to fill the information gaps that have concerned so many academics and policy analysts," he said. "Then there is more work to be done in assessing the magnitude of liquidity and redemption risks, including the degree to which those risks vary with the type of assets and fund structure. And finally, we will need tools that will be efficient and effective responses to the risks identified." In short, more regulation is what the doctor orders.

We mentioned the Net Stable Funding Ratio. It measures a bank's "stable" funding in relation to its overall funding. Stability is in the eye of the federal beholder. For the feds' money, most forms of wholesale funding don't make the grade. Repurchase agreements, for example, do not conform to the regulators' ideal; mainly short-dated, they presented problems galore during the financial crisis. The regulators weigh in, too, on the source of bank borrowings; money funds, in general, displease them. Not that the regulators positively forbid a bank from borrowing from a money-market mutual fund. Rather, a money fund's money generally adds nothing to the regulatory definition of "stable" funding.

While no such regulations are yet in place in America, they are thought to be coming soon. The rules will push banks to reduce their short-term borrowing and, whenever possible, to match the maturity of their assets with the maturity of their liabilities. Liabilities of longer than one year's duration will meet with particular regulatory approval.

Money funds, already neutered as to yield and regimented as to asset mix, will be further disadvantaged by NSFR. As it is, some 48% of money fund assets sit in bank-issued paper. Where will the money go come the arrival of formal NSFR rules and regulations? Not necessarily to a safer class of borrower.

You might have expected that the money funds would already be extinct. With assets of $2.5 trillion, they are still very much with us, though yielding an average of just three basis points pretax. People do still possess cash. For regulatory reasons, the big banks don't want it. The money funds accept it. What do they do with it?

"What you've seen, historically, is when money seeks to be invested, Wall Street finds a way," Peter G. Crane, president and publisher of Crane Data LLC, tells Lorenz. "It's like the *Jurassic Park* line, 'life finds a way.' Money finds a way. Maturity transformation is not a new business."

"Maybe," Lorenz speculates, "the money funds will beat a path back to asset-backed commercial paper, to which they were heavily exposed before the bust. Or maybe to Chinese banks or to industrial credits of various kinds. More likely, they will flock to the federal government. Fidelity Investments, for one, is converting its prime money funds into government funds—no more bank investments for them, just obligations of the United States. So it is that Fidelity Cash Reserve, which has $110 billion under its wing and yields one whole basis point before tax, is on its way to being rechristened Fidelity Government Cash Reserves."

Constant readers will recall the existence of a Federal Reserve RRP facility. The acronym stands for "reverse repurchase agreement," or, more colloquially, "reverse repo." The RRP is the Fed's receptacle for surplus cash. It came into the world in 2013 and owes its existence to QE. In December 2007, excess reserves—dollar balances over and above the sum that banks are legally obliged to keep idle—totaled $1.8 billion. Now they foot to $2.3 trillion. This enormous weight of money has marginalized the old fed funds market. The funds rate is zero (or nearly so) not just because the Fed, for now, wants it to be. It's as low as it is because the supply of lendable reserves overwhelms the demand for lendable reserves.

How, then, can the Fed raise the level of money market interest rates, assuming it ever wants to? For starters, it can raise the rate it pays on excess reserves, which is currently 25 basis points. For another, it can raise the rate it pays on money it borrows through the RRP facility, which is currently five basis points.

If you are scratching your head, keep right on scratching. It's not at all clear why the Fed would need to borrow dollars—for Pete's sake, it prints them. What it does need is to smooth over the distortions that QE has wrought. In building its $4.5 trillion balance sheet, the Fed removed—in round numbers—$3.5 trillion of notes, bills and bonds that would otherwise be afloat in the market. The Bank of Yellen may not need dollars, but the private sector periodically needs securities. Money funds, especially, feel the need. Today, the funds can lend against Treasury collateral at 22.9 basis points per annum. At other times—especially at quarter-end—no such opportunity presents itself and the fund managers fairly beat down the RRP's door. It's not so far-fetched that, come the next financial pileup, the funds will go running to the RRP, to which no credit risk attaches, leaving the private sector in the lurch.

"As things stand," Lorenz notes, "the size of the RRP is capped at $300 billion. Let's suppose that the Fed expands it in the course of pushing interest rates back to normal. Say that it grows to $1.5 trillion. And say that a new crisis erupts. Money funds, looking to their own survival, would very likely yank funds from non-guaranteed borrowers and port them over to the Fed. Thus the net stable funding regimen, which was designed to make the system safe, could very well have the perverse effect of making the system unsafe."

In response to a reporter's question about the secret of his success, the turn of the 20th-century president of the old Chemical Bank, George Williams, responded, "The fear of God." Substitute, today, the fear of the government. Tarullo seemingly tries to think of everything. Similarly—as a reader of his recent speeches may conclude—it seems as if he were out to regulate everything.

But, of course, borrowing from Haldane, you can't regulate everything. At least, you can't regulate risk out of existence. You can only move it around. Christopher Whalen, senior managing director of Kroll Bond Rating Agency, takes the feds to task for allowing the banks to continue to expand the commitments and derivatives they park off-balance sheet. "The whole notion of 'off balance liabilities' is an oxymoron," Whalen, along with his colleague Joe Scott, write in a March 9 comment headed: "For Bond Investors, the Bank Stress Test Process is Beside the Point." "Why is any liability 'off balance sheet,' and if it is 'off balance sheet,' why is it a 'liability'? Nobody at the Fed, or other regulatory agencies it seems, can answer that question."

One regulatory push begets another and then another—as the liquidity coverage ratio initiative and net stable funding ratio have brought us something called the Comprehensive Liquidity Assessment Review. You listen to Tarullo acknowledging the mischievous power of unintended consequences and you think, "Aha! He's too smart to be doing what he seems to be doing." Perhaps, but he's doing it.

"Risk," writes John Adams in his wonderful 1995 book of the same title, "is constantly in motion and it moves in response to attempts to measure it. The problems of measuring risk are akin to those of physical measurement in a world where everything is moving at the speed of light, where the act of measurement alters that which is being measured, and where there are as many frames of reference as there are observers."

Markets provide innumerable frames of reference. A government-banking potentate brings one to the table. "Fire sales?" They are in our financial future.

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# Vacation delectation

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AUGUST 19, 2014

## Not such a lock

(February 6, 2015) A wave of identity theft and computer-borne financial fraud has hoisted LifeLock—LOCK on the New York Stock Exchange—into the elite ranks of American growth stocks. "Elite" is no part of the LifeLock corporate story, *Grant's* is about to contend. On the company whose CEO famously paraded his own Social Security number in front of the TV cameras just to dare bad actors to steal it (which the taunted thieves actually proceeded to do), this publication is bearish.

Anxiety is LifeLock's stock in trade. If North Korea (let us say) can hack Sony Pictures Entertainment, and if JP Morgan Chase, Home Depot and Target are likewise vulnerable to digital intruders, which ordinary citizen is safe? Some 3.5 million Americans, deciding that they, at least, are unsafe, have signed on. In the 12 months through Sept. 30, LifeLock's revenues jumped by 30% from the year- earlier period. From 2007 through 2013, compound annual growth in the LifeLock top line amounted to no less than 64%; results for the final quarter and full-year 2014 are due on Feb. 10.

Between five and 15 million Americans are annually hacked, according to estimates by Forrester Research and the Department of Justice. "Let's assume," Richard Davis Jr., analyst with Canaccord Genuity, muses with colleague Evan Lorenz, "the only people who have any interest in this product is someone who actually had their identity hacked. So, that's seven million people per year. With LifeLock's churn, which is about 18%, they have to land about 1.2 million of that seven million, so they have to get 17% of those people in that narrowly defined universe of people who had their identities hacked. If that's all they won, a 17% win rate is not that bad. It's not like they need 50% to 60%."

The argument appears to have carried the day with all but one of the nine analysts who follow the company. The shares are valued at 28.9 times trailing net income and 22.7 times the 2015 estimate. Cash per share works out to $2.55; the balance sheet is debt-free. Not since going public in October 2012 has management produced a disappointing quarter. Boldface names—Goldman Sachs, Bessemer Venture Partners, Kleiner Perkins Caufield & Byers—furnished venture capital. Tom Ridge, former head of the Department of Homeland Security, sits on the board of directors.

What, exactly, does LifeLock deliver? Less than the "comprehensive identity theft protection" that it claims. The standard LifeLock protection plan, which sells for $9.99 a month, buys you notification if a credit card account (or mortgage or mobile phone application) is opened in your name. It promises assistance in canceling lost or stolen credit cards. It guards against attempts to tamper with your address. It scans Web sites for signs that someone is filching your vital data, and it blocks pre-approved credit card offers and offers a $1 million service guarantee in case of fraud. For the customer who wants to know if a registered sex offender has moved into his neighborhood or who demands instant notification of major corporate data breaches, higher and costlier levels of service are available. Except for a small enterprise division that verifies customer bona fides for corporate clients, consumer protection is LifeLock's beating heart.

You might suppose that the anti-identity theft industry is thriving. In fact, annual average top-line growth over the past five years amounted to just 0.5%, according to Sarah Kahn, analyst at IBISWorld. Revenue at the only other public company focused on identity-theft protection—Intersections Inc. (INTX on the Nasdaq)—slipped to $262 million in the 12 months ended Sept. 30, 2014, from $373 million in calendar 2011. Intersections markets through banks, where it has collided with the Consumer Financial Protection Bureau. LifeLock has had no such difficulty issuing ads to the hack-wary public.

Many a business in the Internet age has foundered in failing to compete with services that someone, somewhere can deliver for free. Perhaps such a fateful encounter awaits LifeLock. "Consumers can request their credit reports once

*"Fiat, boys! I found fiat!"*

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