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NIKKEI	8,383.31	-96.32	-1.14%
TOPIX	719.78	-7.93	-1.09%
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JPMorgan Joins Goldman Keeping Italy Derivatives Risk in Dark

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By Christine Harper and Michael J. Moore - Nov 15, 2011 6:01 PM CT

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JPMorgan Chase & Co. (JPM) and Goldman Sachs Group Inc. (GS), among the world's biggest traders of credit derivatives, disclosed to shareholders that they have sold protection on more than $5 trillion of debt globally.

Just don't ask them how much of that was issued by Greece, Italy, Ireland, Portugal and Spain, known as the GIIPS.

As concerns mount that those countries may not be creditworthy, investors are being kept in the dark about how much risk U.S. banks face from a default. Firms including Goldman Sachs and JPMorgan don't provide a full picture of potential losses and gains in such a scenario, giving only net numbers or excluding some derivatives altogether.

"If you don't have to, generally people don't see the advantage to doing it," said Richard Lindsey, a former director of market regulation at the U.S. Securities and Exchange Commission who worked at Bear Stearns Cos. from 1999 through 2006. "On the other hand, if there were a run on Goldman Sachs tomorrow because the rumor was that they had exposure to Greece, you'd see them produce those numbers."

A case in point: Jefferies Group Inc. (JEF), the New York-based securities firm, disclosed every long and short position it held on European debt earlier this month after its shares plunged more than 20 percent. Jefferies also said it wasn't relying on credit-default

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JPMorgan said in its third-quarter SEC filing that more than 98 percent of the credit-default swaps the New York-based bank has written on GIIPS debt is balanced by CDS contracts purchased on the same bonds. Photographer: Michael

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Nov. 16 (Bloomberg) -- Laurent Fransolet, head of European fixed-income strategy at Barclays Capital, talks about the outlook for Italian bond yields and

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swaps, contracts that promise to pay the buyer if the underlying debt defaults, as a hedge on European holdings.

'Funded' Exposure

By contrast, Goldman Sachs discloses only what it calls "funded" exposure to GIIPS debt -- $4.16 billion before hedges and $2.46 billion after, as of Sept. 30. Those amounts exclude commitments or contingent payments, such as credit-default swaps, said Lucas van Praag, a spokesman for the bank.

Goldman Sachs includes CDS in its market-risk calculations, of which value-at-risk is one measure, and it hedges the swaps and holds collateral against the hedges, primarily cash and U.S. Treasuries, van Praag said. The firm doesn't break out its estimate of the market risk related to the five countries.

JPMorgan said in its third-quarter SEC filing that more than 98 percent of the credit-default swaps the New York-based bank has written on GIIPS debt is balanced by CDS contracts purchased on the same bonds. The bank said its net exposure was no more than $1.5 billion, with a portion coming from debt and equity securities. The company didn't disclose gross numbers or how much of the $1.5 billion came from swaps, leaving investors wondering whether the notional value of CDS sold could be as high as $150 billion or as low as zero.

Counterparty Clarity

"Their position is you don't need to know the risks, which is why they're giving you net numbers," said Nomi Prins, a managing director at New York-based Goldman Sachs until she left in 2002 to become a writer. "Net is only as good as the counterparties on each side of the net -- that's why it's misleading in a fluid, dynamic market."

Investors should want to know how much defaulted debt the banks could be forced to repay because of credit derivatives and how much they'd be in line to receive from other counterparties, Prins said. In addition, they should seek to find out who those counterparties are, she said.

JPMorgan sought to allay concerns that its counterparties are unreliable by saying in the filing that it buys protection only from firms outside the five countries that are "either investment-grade or well-supported by collateral arrangements." The bank doesn't identify

the role of the European Central Bank in supporting indebted nations. He speaks from London with Maryam Nemazee on Bloomberg Television's "The

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Nov. 16 (Bloomberg) -- Charles Mounts, a managing director at Knight Capital, talks about Spain's bank turmoil and the contrast to other European sovereign debt problems. Mounts speaks with Sara Eisen and Stephanie Ruhle on Bloomberg Television's "InsideTrack." (Source: Bloomberg)

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Bank of America, Citigroup Inc. and Morgan Stanley also don't list gross amounts of CDS on GIIPS debt in their filings. Photographer: Scott Eells/Bloomberg

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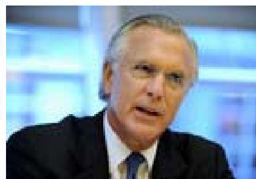

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Federal Reserve Bank of Dallas, said "They should report both their gross and their net CDS exposure, and they should do it country-by-country." Photographer: Peter Foley/Bloomberg

the counterparties.

Citigroup, Morgan Stanley

Bank of America, Citigroup Inc. (C) and Morgan Stanley also don't list gross amounts of CDS on GIIPS debt in their filings. All three banks provide figures within their disclosures that they say include a net of their credit-default swaps bought and sold on the five countries.

Citigroup's net funded exposure as of Sept. 30 was $7.2 billion, and its unfunded commitments were $9.2 billion, the New York-based bank said in a filing and a presentation. Bank of America, based in Charlotte, North Carolina, said total net exposure was $14.6 billion for the five countries, while New York-based Morgan Stanley (MS) listed $2.1 billion.

Jon Diat, a Citigroup spokesman, declined to comment, as did Bank of America's Jerry Dubrowski, JPMorgan's Howard Opinsky and Morgan Stanley's Mark Lake.

Banks exchange collateral, usually cash or liquid securities such as U.S. government debt, with trading partners as the value of their credit-default swaps fluctuates and their perception of one another's ability to repay changes.

Bungee Cords

If the value of Italian bonds drops, as it did last week, a U.S. firm that sold a credit-default swap on that debt to a French bank would have to provide more collateral. The same U.S. company might be collecting collateral from a British bank because it bought a swap from that firm.

As long as all three banks can make good on their promises, the trade doesn't have much risk. It could all unravel if the British firm runs into trouble because it's waiting for a payment from an Italian company that defaults. The collapse of Lehman Brothers Holdings Inc. in 2008 demonstrated some of the ripple effects that one failure can have in the market.

"We learned from Lehman that all of these firms are tied together with bungee cords -- you can't just lift one out without it affecting everyone else in the group," said Brad Hintz, an analyst at Sanford C. Bernstein & Co. in New York who previously worked at Lehman Brothers and Morgan Stanley. More disclosure "may push the stock prices down when it becomes clear how big the bungee cords are. But it certainly would be a welcome addition for an analyst."

FASB Rule

The Financial Accounting Standards Board in 2008 started requiring companies to disclose the worldwide gross notional credit protection they've written and bought. As of Sept. 30, JPMorgan said it had sold $3.13 trillion of credit-derivative protection and purchased $3.07

trillion, up from $2.75 trillion sold and $2.72 trillion bought at the end of 2010, filings show. Goldman Sachs disclosed it had written $2.07 trillion and bought $2.20 trillion, about the same amount it reported at year-end.

At the end of the second quarter, those two firms accounted for 43 percent of the $24 trillion of credit derivatives sold and bought by the 25 largest banks in the U.S., according to the Office of the Comptroller of the Currency. The top five account for 97 percent of the total, the data show.

Guarantees provided by U.S. lenders on government, bank and corporate debt in Greece, Italy, Ireland, Portugal and Spain rose by $80.7 billion to $518 billion in the first half of 2011, according to the Bank for International Settlements.

'Ultra-Transparency'

Neither FASB nor the SEC requires banks to disclose how many of those derivatives are written by country or region. That's something Richard Fisher, president of the Federal Reserve Bank of Dallas, would like to see changed.

"We should have ultra-transparency on those institutions," Fisher said of the biggest financial firms in a Nov. 14 interview at Bloomberg headquarters in New York. "They should report both their gross and their net CDS exposure, and they should do it country-by-country. After all, they need to inform their shareholders."

Banks are reluctant to provide the figures in part because doing so would reveal too much information about their positions and operations, said Jon Fisher, a portfolio manager at Fifth Third Asset Management in Minneapolis, which manages more than $16 billion. The sheer size of the numbers may also be a deterrent, investors said.

'Biggest Fear'

"I think the biggest fear is the numbers are so large that even though they offset, it would maybe shock people," said Ralph Cole, a senior vice president in research at Ferguson Wellman Inc. in Portland, Oregon, which manages $2.8 billion including JPMorgan stock. "Maybe they don't think that disclosure will be treated fairly or understood well."

Still, "they need to give us a good reason why we shouldn't see that," he said. "More disclosure is better, and you can see that in their valuations right now."

Bank of America, Citigroup, Goldman Sachs and Morgan Stanley have each fallen more than 40 percent this year, while JPMorgan has dropped 23 percent. Each of the lenders trades at least 24 percent below book value, indicating investors are questioning the assets on the firms' balance sheets.

Lloyd C. Blankfein, 57, Goldman Sachs's chairman and chief executive officer, said in an

interview with the Financial Crisis Inquiry Commission staff last year that the amount of the firm's derivatives trades shouldn't be a cause for alarm.

'Longs and Shorts'

"We either have netting agreements, or they foot, or they cancel each other out, or they're longs and shorts on the same instrument," he said, answering a question about how the firm manages so many contracts in a crisis. "The only way you can run a business like that is to have these systems work so they can aggregate stuff, so you can run the business on a macro basis, and also so you can get the details quickly if you need them. And that's all systems and technology."

Lindsey, the former SEC official who's now president of New York-based Callcott Group LLC, which consults on markets and market operations, said few firms have systems that can portray their real-time exposure to trading partners.

"That's very difficult for any firm to have a good handle on all of that -- you know large positions and you know what certain positions are, but to be able to say I've adequately aggregated all of my long exposure and all of my short exposure to a specific counterparty may be very difficult," Lindsey said. "I don't know of a firm where it's not pulled together by a phone call, where somebody says, 'OK, we need to know our exposure to X,' and a lot of people stop their day jobs and try to find an answer."

'Needlessly Cause Reaction'

Lindsey said banks may be wary of disclosures that could confuse investors. Figures such as gross notional exposure -- the total amount of debt insured by credit derivatives -- give investors an exaggerated sense of the risk and could "needlessly cause reaction," he said.

Other methods, such as stress-testing, scenario analysis or so-called value-at-risk estimates, rely on models that may underestimate risk because historical data on sovereign defaults show them to be unlikely.

"If you're looking at your exposure to a defaulting sovereign, there's a relatively low frequency rate," Lindsey said. "So it really depends on what they've done internally to back up their ideas of what their assessment of the probability of default is."

To contact the reporters on this story: Christine Harper in New York at charper@bloomberg.net; Michael J. Moore in New York at mmoore55@bloomberg.net

To contact the editor responsible for this story: Rick Green at rgreen18@bloomberg.net

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