The Federal Reserve

The hedge fund of Foggy Bottom

WASHINGTON, DC

If you do not adjust for risk, the Fed is making good money for Uncle Sam

THE Federal Reserve does not set out to make bumper profits. But its 2008 annual accounts, released on April 23rd, would turn many a hedge-fund manager green with envy.

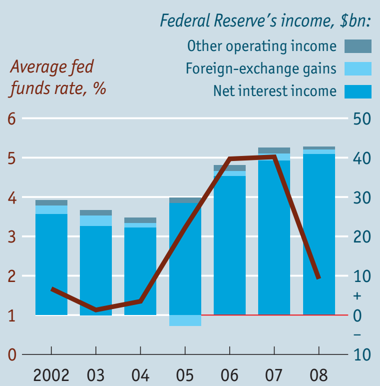
Like Wall Street's finest, the Fed makes money on a spread. Its main source of funds comes from issuing cash, since currency in circulation is, in effect, an interest-free loan by the public to the central bank. The interest it earns on its loans and securities is almost pure profit, or "seigniorage," most of which it remits to the Treasury.

Last year the central bank reported a whopping $43 billion in operating income. That was more or less the same level as in 2007, but meanwhile short-term interest rates had plummeted, ending the year near zero. That should have clobbered Fed income, as rate cuts did in the early days of the last recovery in 2002-04 (see chart).

But it did not, for two reasons. First, to shore up financial markets the Fed has pumped up its balance-sheet—its total assets were $2.2 trillion on December 31st, more than double their level of a year earlier. Second, it has been trading in low-risk, low-return Treasury debt and buying higher-yielding private debt—discount loans to banks, commercial paper, and mortgage-backed securities, for example.

The Fed has, in effect, been adding both risk and return to its portfolio. So far so good, despite mark-to-market losses on the securities it acquired bailing out Bear Stearns and American International Group. But as hedge-fund managers have learnt of late, you "reach for yield" at your peril. The risk is an occasional hit big enough to wipe out years of profits. ■

Making a mint



Source: Federal Reserve

Derivatives

Fashion victim

BERLIN AND ROME

A derivatives scandal in Milan may be the tip of an iceberg

YOU might have expected more from people whose forebears invented the phrase *caveat emptor*. On April 28th it emerged just how unwary city elders of Milan had been when details emerged of staggering sums they have allegedly lost on a derivatives bet.

The disclosures came amid a swoop by the country's financial police on some of the world's biggest banks, seizing €476m ($634m) of their assets. The four banks, UBS, JPMorgan Chase, Deutsche Bank and Hypo Real Estate's DEPFA unit, helped the city take a huge bet on interest rates in 2005 that had lost Milan, by its own estimate, €298m last June.

The banks are declining to comment on the case. In it, Italian prosecutors say they are investigating whether the banks fraudulently made more than €100m in "illicit profits" from the Milan deal and took advantage of naive buyers.

Yet the case has ramifications around the world as other big banks face accusations of mis-selling complex products before the credit crunch. Should there be restrictions on whom they sell such financial dynamite to? And should some institutions, such as local governments, be protected from themselves?

When Milan signed the deal in 2005, it thought (and, investigators suspect, it was assured) that it could barely lose from the deal. In an effort to cut its borrowing costs, it swapped the fixed interest rate it was paying on about €1.6 billion in borrowings for a floating rate. Prosecutors claim that the bankers promised Milan savings of almost €60m. Although the details of the transaction are vague, it seems that the city council agreed on an "interest-rate collar" that meant it would have been paid if rates increased but would have had to pay out if rates fell.

That such big potential penalties were missed by (or, as investigators suspect, concealed from) the council is staggering. A clue as to how this may have happened is found in a revealing deposition by an official involved in the negotiations who, according to *Il Sole 24 Ore*, a newspaper, swore that: "The banks' representatives always presented every operation to me as being in the council's best interests, always underlining—now I realise—only the profitable short-term aspects." This positive spin, investigators suspect, was central to the deal. Under Italian law, councils can restructure their debts only if it leaves them in a better position than before.

Whether Milan was fooled or just plain foolish (people involved in the deals claim it has benefited from offsetting gains), it is not the only public body to have played dangerously with derivatives. Achim Duebel, a consultant in Berlin, reckons that as many as 700 German local authorities could lose money on such instruments as a result of a combination of mis-selling and insufficient financial regulation of local authorities. Such bets could have gone either way for the councils. But they were usually in the interests of the sellers, because they enabled them to offset interest-rate risk that they had accrued elsewhere.

In Italy the problem seems to have been just as widespread. Some estimate that as many as 600 Italian town councils could lose money on derivatives. And in neighbouring Austria the state-owned railway said on April 29th that it had made a loss of almost €1 billion, partly because of a €420m write-down on complex credit derivatives bought from Deutsche Bank in 2005. Bloomberg reported that the railway is appealing against a court judgment in February dismissing the claim that the lender did not disclose the risks.

Given the scale of the losses that are emerging, more such deals will probably end up in court. In America Jefferson County in Alabama is suing JPMorgan Chase for allegedly mis-selling credit derivatives. In most cases, buyers of credit derivatives will claim they were victims. In the case of public bodies, at least, voters should reserve judgment. For such claims to succeed, the officials who agreed to the deals will have to testify convincingly that they had no idea what they were doing. As Milan's elders must be uneasily aware, the price they may have to pay for victory in court could be their jobs in the council. ■