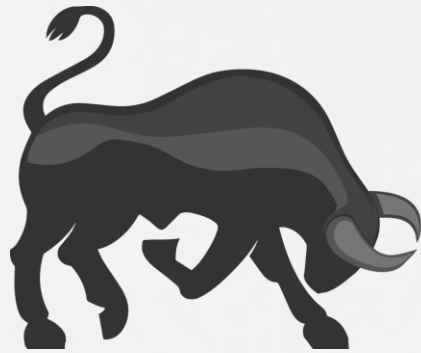


BRAINTEASER

Two investment bankers are leaving the office late one night. As they're walking down the street, a mugger comes up to them with a knife and says "both of you give me all the cash you have right now."

The bankers pull out their wallets and start taking out their cash. One of them suddenly pauses, turns to his friend, and says, "by the way, here is the \$100 I owe you."



QUANTITATIVE
FINANCE
SOCIETY

REGULATORY ARBITRAGE

February 27, 2018

A SURE WAY TO LOSE...

Blackstone

... is to bet against someone smarter than you...

A SURE WAY TO LOSE...

**Goldman
Sachs**

...Or someone with a loose understanding of
morals...

THE “C’S” OF SELL-SIDE TRADING

Client:

- You provide liquidity for these people by posting bid-asks on various financial assets
- You advise them on their positions
- DO NOT RIP OFF EVER

Counterparty:

- Take them for 110% of what they’re worth if they let you
- You take the opposite sides of bets they want to make
- RIP OFF WITH IMPUNITY

FLOW VS. PROP TRADING

Flow Traders have **Clients**:



Prop Traders have **Counterparties**:



BLACKSTONE AND HOVNANIAN

- Traditionally, companies should have aligned incentives with bond investors and CDS sellers
- Play on Cheapest to Deliver Mechanism
- Hovnanian to intentionally default on a bond payment and receive funding from Blackstone GSO
 - Blackstone significantly beating refinancing package of 11.5% for ~500 MM
 - Losing Parties: Solus, Goldman, Different part of Blackstone
- Current legal battle effectively holds the company hostage
- Should CDS purchasers be allowed to influence the reference entities?

Hovnanian Swaps Show Unusual Surge

One-year swaps signal default trigger risk

■ HOV CDS USD SR 1Y D14



Bloomberg

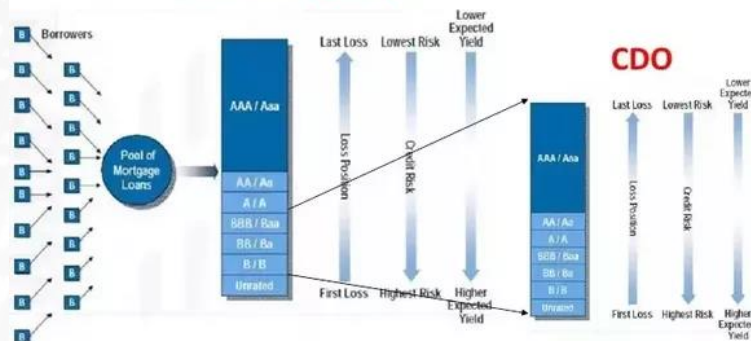
THE MAGNETAR TRADE

- CDOs have underwriters, sponsors, and managers. Typically, the first two are a bank and the last some form of asset manager. Or, the last two could be the asset manager and the bank is only the underwriter

CDO

- The investment banks will package these with other securities and slice them into different categories of CDO

Securities(MBS)



Synthetic CDO

Synthetic CDOs, such as Goldman Sachs's Abacus 2004-1 deal, were complex paper transactions involving credit default swaps.

1. Short investors

Short investors enter into credit default swaps with the CDO, referencing assets such as mortgage-backed securities. The CDO receives swap premiums. If the reference securities do not perform, the CDO pays out to the short investors.

2. Unfunded investors

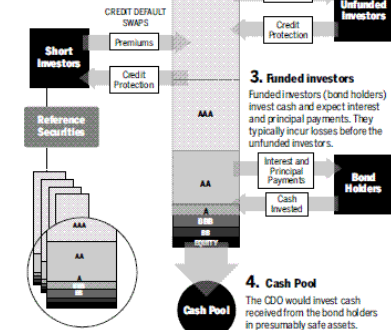
Unfunded investors, who typically buy the super senior tranches, are effectively in a swap with the CDO and receive premiums. If the reference securities do not perform and there are not enough funds within the CDO, the investors pay.

3. Funded investors

Funded investors (bond holders) invest cash and expect interest and principal payments. They typically incur losses before the unfunded investors.

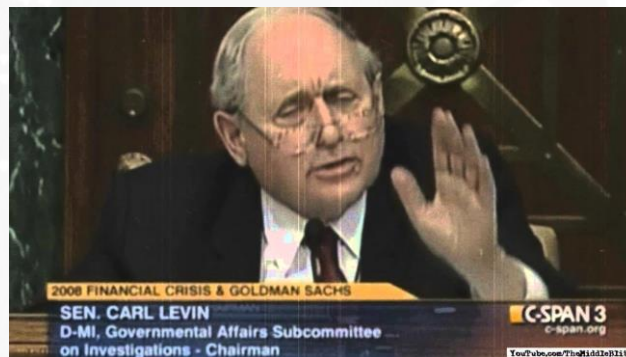
4. Cash Pool

The CDO would invest cash received from the bond holders in presumably safe assets.



THE MAGNETAR TRADE

- Why bet on the riskiest tranche perpetually improving when you can be market neutral?
 - Sponsor the CDOs and manage them, collecting fees
 - Bet against them as well through CDS contracts
 - Do not tell investors in the various tranches that you are short the CDO
 - Did so with the help of Goldman Sachs, Merrill Lynch, JPMorgan, UBS, etc.
- By the end of 2008, of the 30 CDOs Magnetar invested in from Spring 2006 to the peak of the global bull market in Summer 2007, **98% were in default**
 - **The average default rate for all CDOs in the midst of the GFC was 68%**



EUROPEAN BANKS AND TAX ASSETS

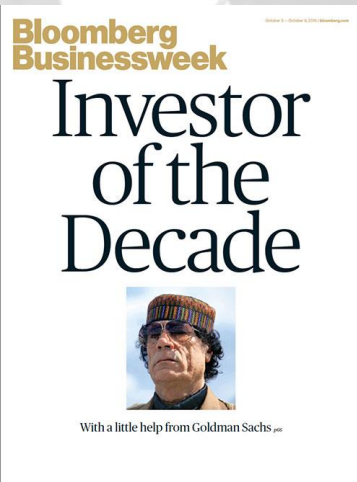
- Deferred Tax Assets are NOT allowed to count towards regulatory capital
 - Banks all have a lot of this from the financial crisis
- These banks aren't allowed to sell DTA's on the open market to another company
- They CAN sell securities (notes) linked to those DTA's and receive cash that does count towards regulatory capital
- Investors receive a fixed coupon, and as DTA's are consumed, their principal becomes more senior bank liabilities

WELLS FARGO BLAMES QUANTS

- “For more than a decade, customers were sometimes charged anywhere from 1% to 4% on basic transactions such as converting euros to dollars”
- “middle-market industry average of 0.15% to 0.5%”
- Most clients did not notice, those that did were told it was the “computer systems that calculate spread” or “time fluctuation” of market conditions
- Defined compensation plan labelled as primary issue

THE LIA

- **Betting on something you don't understand is SMART, right?**
- The LIA invested \$1.2 billion in various derivatives sold to them by two star salesmen: Youssef Kabbaj and Nick Pentreath
- Post-crisis, Goldman profited at least \$200 million while the LIA lost its entire investment
- The LIA sued, claiming GS took advantage of their lack of expertise, but a London court ruled against them, and with British loser-pay rules, the LIA now owes Goldman legal fees

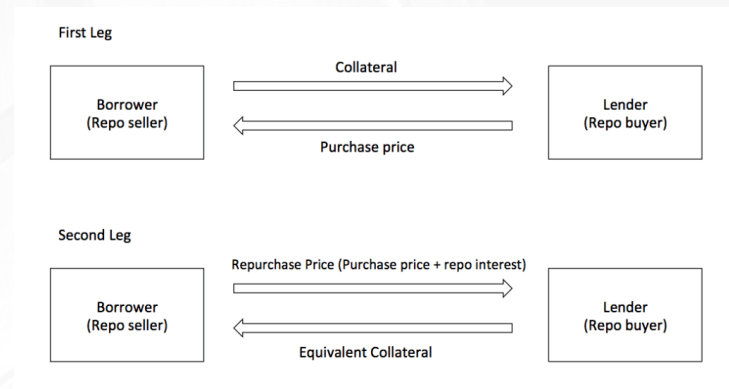


LOWERING DIFFICULTY SETTINGS FOR BOSS BATTLE

- Bank of Tokyo-Mitsubishi was fined by the NYDFS for dealing with countries subject to US economic sanctions
- NYDFS is notoriously brutal in seeking fines, this time asking for \$565 MM
- Bank of Tokyo filed to switch to friendlier federal regulator due to having a presence in four states and was approved in 8 days
- Counter-sued NYDFS for supervising them when they don't have the jurisdiction
- Ongoing legal battle

CHINESE LEVERAGE

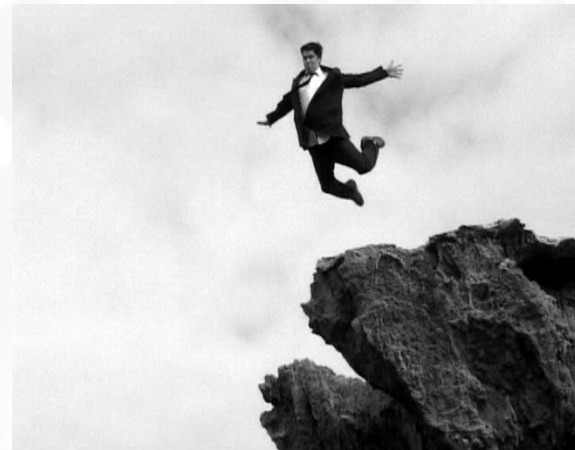
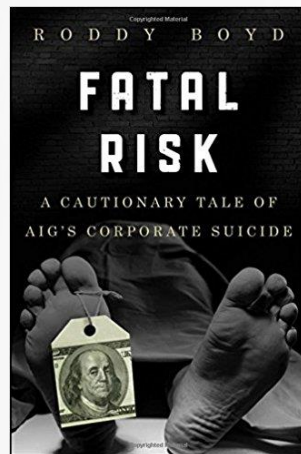
- Repo market involves short-term loans with securities as collateral
 - Typically treasuries



- Repo market blew up during financial crisis, became heavily regulated business with thin margins
- Chinese ICBC keeps US operations under \$50 BN small with netting of reverse repo's
- Effective leverage of 260-to-1 (10x JP's)

THE CORPORATE SUICIDE OF AIG

- **Goldman Sachs Principal Funding & Investments:**
 - Prop. Desk that was a major profit center for the bank
 - Purchased \$2.722 billion in CDS from AIG insuring multiples more in face value of super-senior tranches of CDOs
 - As the GFC intensified and CDOs defaulted, GS demanded \$10.1 billion in collateral from AIG as the company was being collateral called across the board with liquidity disappearing
 - To “hedge” its exposure to AIG, GS entered into CDS contracts insuring AIG as well as a few CDX positions
- This is **Capitalism**: No mercy for the irresponsible



CREDIT SUISSE INSURING THEMSELVES

- Credit Suisse was looking to hedge any losses on their assets (Credit Value Adjustments)
- Purchased a CDS with the reference entity being their own assets and the primary counterparty rumored to be Guggenheim
- Simultaneously offered Guggenheim a large credit facility in order to “fund payments or costs related to amounts due by the entity under the CDS”
- Losses on loan portfolio would be hedged by identical gains on CDS
- Employee Bonus pool also received enhanced protection in this scheme



Regulatory
Compliance

**Inside the
terror ring**

PAGES 6-7



**Black Friday
sales soar!**

PAGES 34-35



GIANT IDIOT

**Plaxico shoots
himself in leg
at city nightclub**

STORIES PLUS MIKE LUPICA - PAGES 2-3 & SPORTS



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