HARGREAVEHALE

INVESTMENT BULLETIN

"Soon the poor will have nothing left to eat but the rich"

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People started to gather around Wall Street about two weeks ago and they have stopped going away. There was limited press coverage until some heads were banged together on Brooklyn Bridge. Initially mainstream journalists laughed the protestors off as a bunch of incoherent individuals with no common message.

They only started to take things more seriously when the protests went nationwide and President Obama and Ben Bernanke, Chairman of the Federal Reserve expressed some sympathy with the deep frustrations, however inchoate, expressed towards the investment banks. But, mainstream media is still broadly dismissive.

Nothing equivalent has happened in the UK, although within Europe, there have been large public sector demonstrations, whilst riots in Greece have been getting increasingly violent. But however incoherent the frustration on the streets there is perhaps a simple point to consider. It does seem quite extraordinary, and when you consider the figures getting on for unbelievable, that current banking industry structures post the 2008 crash broadly remain intact.

The simple question increasingly being asked is: what are banks for? Perhaps a clue from history books: What bankers used to do during daylight hours was to lend money to companies and individuals using their judgement, hopefully much honed by experience, to determine whether prospective borrowers were good credit risks, able to pay the interest rates on the outstanding debt and return the principal on the specified date. That's what bankers used to do.

To get a clue what Bankers do now, it is instructive to stand at the top of the escalator at Canary Wharf Tube and watch the "bankers" emerge into the early morning gloom. Tragically, there are no bowler hats or pinstripe suits on show. Certainly no discount house top hats. More is the pity. The dress code appears to be suitable for reasonably upmarket clubbing. But maybe it is too early for the potentially better dressed top brass but they would be helicoptered or limo'ed in anyway.

I was trying to remember where I had seen similar crowds, similarly attired and in a similar sort of slightly feverish mood. It was in Hong Kong amongst the crowds swarming onto the ferries and hydrofoils en route for the sumptuous gambling palaces of Macau, not unlike the equally sumptuous gambling palaces of Canary Wharf.

Figures, kindly provided by the recent Vickers Independent Commission on Banking (page three) suggest that two thirds of the work time of bankers is spent on gambling. Bankers are now primarily, short term gamblers rolling the dice, punting customer deposits with what recent history tells us amounts to little more than gay abandon. The products being bought and sold, broadly a nil sum game until of course the public have to pay up, are wide and varied and lots more are being thought up all the time. Currencies, derivatives, options, mortgage backed securities, sliced and diced, flash trading, the latter allegedly creating a two tier market in which a certain class of traders are able to front run. Again allegedly.

The scale of this punting is truly extraordinary. Credit default swaps, interest rate swaps, securitisation extending to all sorts of assets, the application of sophisticated mathematical techniques to financial markets have all generated a massive amount of activity but to what end? Take the growth of Exchange Traded Funds, (ETFs). They started off in 1989 as baskets of securities that could be bought and sold in the market, to give clients a spread of stocks, not unlike investment trusts. The product has expanded rapidly particularly in the last couple of years and the offering has expanded to include currencies, commodities, bonds and mortgages. There are now 4000 ETFs worth some $1.5 trillion including synthetic ETFs based on derivatives rather than underlying securities or commodities, set up by entities which could pose serious counter party risk. Even the practitioners are now concerned saying that some banks may be using ETFs as a cheap source of funding, filling them up with illiquid product and taking the cash. A lot of this activity has taken place since the 2008 crash which shows how little has been learned. The latest accident related to the small matter of an alleged $2.3 billion lost in a week by a UBS trader. Only a few per cent of the Group's capital in one hit, so not to worry. How extraordinary that politicians in the West can allow such things to happen.

The major investment banks entered the global financial crisis in 2008 badly undercapitalised. Under Basle II rules, European banks were not even subject to a gross leverage ratio and were given incentives to stuff their balance sheets with highly toxic assets which under the old rules were deemed to be risk free. For toxic, read sub prime mortgage securitisations as well as, wait for it, Euro zone government bonds. At the time some banks were said to be leveraging 25 to 30 times off their balance sheets. Literally incredible, particularly as much tighter rules as to capital requirements, known as Basle III, drawn up after the 2008 banking crisis, do not have to be implemented until 2019.

In reaction to the 2008 financial crash, the Authorities in the UK set up an independent Commission on banking which reported in September. The intent was to create a banking system that in the words of Sir John Vickers, the Chairman of the Commission, "was much less likely to cause or succumb to financial crises and the huge costs they bring...... is self reliant, so the taxpayer is never again on the hook for the losses that banks make and ..... is effective and efficient at providing the basic banking services of safeguarding retail deposits, operating secure payment systems and efficiently channelling savings to productive investments in the economy."

The main proposal was to ring fence rather than totally separate the activities of retail banking and casino banking. The Commission felt that a strong ring fence can get the same, if not more stability benefits at much lower economic cost than total legal separation. In particular if one part of a bank is doing well, it can support the other. Only retail ring fenced banks could take deposits from individuals and SMEs and such banks could not undertake trading or markets business.

In addition, the Commission recommended the creation of additional buffer capital .The main rulings are that large ring fenced banks should have equity capital of at least 10% of risk weighted assets and corresponding limits on overall leverage, and that the retail and other activities of large banks should have primary loss absorbing capacity, being equity plus long term unsecured debt amounting to between 17% and 20% of risk weighted assets. The Commission states that there is a strong case for higher capital requirements internationally but that such recommendations should not run ahead of the Basle III recommendations due for implementation by 2019.

One of the most interesting parts of the report related to the Commission's estimate of the size of the risk that the banking system poses to UKPLC. The Commission estimated that the aggregate balance sheets of UK banks exceeds £6 trillion, more than four times annual UK output. They estimate that between a sixth and a third of this balance sheet would be ring fenced for retail and commercial loans. The amazing suggestion therefore is that a minimum of two thirds of UK banks assets are still used for trading activities.

Paul Volker, the ex US Federal Reserve Chairman has a reputation untarnished by relationships with the big integrated banks and is recognised very much as an independent thinker. Aged 82 he is no careerist. More to the point, he is currently advising President Obama on financial regulation. Interestingly he was critical of the conclusions of the Vickers Report. In a lecture he recently gave to the Cass Business School in London, he made the point that although ring fenced, retail banking activities in the UK would still be a small part of "what in most cases would appear to be much larger, highly diversified and systemically significant organisations". He would appear to have hit the nail on the head if the Vicker's Commission's figures of allocation of capital for trading activities within integrated banks are correct.

Volker applauded the move to tighten rules on equity capital and leverage in line with Basle III. But, he said; "the nagging overriding question will be how to deal with the imminent or actual failure of a large, systemically important institution whether or not it is a retail bank". He continued;" true reform would require structural change.....change that requires altering business practice, management incentives ......bankers fortunes have run far beyond reasonable expectations with no benefits visible to the naked eye, or even to professional analysis....in national productivity or gains in income for average workers". He added;" I wonder whether the boards of Directors of these banks fully understand their responsibilities to oversee the corporations financial and ethical practices".

In the US, Volker and Obama are moving the goal posts much faster than the Europeans. They are not going the whole hog in separating retail and investment banking. But what they are doing is what the Vickers report sadly failed to recommend. They are proposing a total ban on proprietary trading as well as the ownership by investment banks of hedge funds and private equity. The dangers of proprietary trading, the conflicts of interest implied by ownership of hedge funds are just too great. They are seeking full conformity with Basle III rules. There is even talk that directors should be made personally liable for trading losses incurred, a reversion to old style partnership banking. The determination is make investment bank activities much less profitable and as a result to reduce sharply the proportion of capital invested such activities. Western taxpayers are now becoming fully aware that it is their wallets that are financing these extraordinary activities. The casino banking tail is wagging the dog called gross national product to a ludicrous degree.

Just to put this into perspective. European taxpayers are being asked to put up probably around 400 billion Euros to recapitalise the banks in the event of sovereign debt defaults. In the UK, according to a recent report by the New Economics Foundation, high street banks enjoy a taxpayer subsidy of £46 billion a year, equivalent to £1840 for every household in the country. In the 2008 financial meltdown, the Bank of England estimated that UK Banks enjoyed equivalent to a £100 billion a year benefit from its own guarantees. This compares with UK spending on defence of £38 billion, or UK spending on the education budget of £66 billion.

Unfortunately, cutting the integrated banks down to size is a delicate process because of the continued vulnerability of their loan books. The Europeans have called for a tax on financial transactions, known as the "Tobin" tax, a seemingly excellent idea which could raise an estimated 50 billion Euros annually but the effects on profits and therefore the ability to lend to business, could make such a tax counterproductive. In addition, policy makers have suddenly been faced with the European Sovereign debt crisis, which has flared rapidly into a big problem. Under Basle 11, bank holdings of Sovereign debt in Europe were encouraged in terms of asset quality and the majority of European banks have not written down the value of these assets in their balance sheets. They cannot afford to because a lot of other "assets" in their loan books, such as derivative portfolios, remain toxic.

There is no doubt that European banks remain in a parlous state. It is not just that the anticipation of Basle III is causing them to shrink their loan books. It is that their holdings of Sovereign debt in the sunnier parts of Mediterranean Europe are causing them to lose sleep big time. Depending on all sorts of variables including estimates of percentage haircuts taken on debt, the range of analyst’s estimates of new capital required by European Banks to meet the Basle 111 deadline is between Euros 230 billion and worst case Euros 675 billion. The latter assumes a 60% write-down on Greece, Ireland, Portugal, Spain and Italy, unduly pessimistic perhaps but not totally so.

When the Governor of the Bank of England says this is the worst crisis ever maybe he is stating the truth. And the question is what to do about it. There are a number of policy options available to the Central Banks. Policy option one is to shrink the capital used up by the trading activities of the integrated banks by imposing a tax on transactions which renders such activities uneconomic, as well as making directors personally liable for trading activities. This would free up capital for industrial and individual loans. This has to be a carefully orchestrated process in view of the impact on balance sheets of marking to market the ragbag of derivative and other assets lying dormant. Policy option two would be to delay compliance with Basle III until say 2025, because loan growth is now being impeded by the anticipation of stricter capital requirements by 2019. In addition, ring fencing rather than separating banking activities creates the need for much greater" buffer" capital going forward.

Policy option three would be to continue to buy up peripheral sovereign debt using the EFSF (European Financial Stability Fund). This is OK as far as it goes, which is Euros 440 billion. However much of this fund has already been used in the past year to support Sovereign debt markets and the fund would be too small to make much impact on the Spanish and Italian Government bond markets.

Policy option four originally sounded promising. It was to "soup up" the EFSF fund by granting it a banking licence and gearing up the facility. This however is rumoured to have been vetoed by Germany. Policy option five was a Eurobond Bazooka issue guaranteed by all European states used to buy up Sovereign debt. This looked like a good idea but it is rumoured to have been vetoed by Germany and France. Certainly such open ended guarantees would not be popular.

Policy option six is either Germany leaves the Euro or there is a default by one of the weaker states such as Greece or Portugal/Ireland. These options look the most likely but remain improbable because of the political consequences. However, the combination of austerity and lack of fiscal progress will make an exodus likely at some point. The problem for investors here is the timing uncertainties connected with such a move.

At the moment therefore it appears that existing policy options are limited. Interestingly there are rumours that policy makers in Europe have decided that, all else failing or "faut de mieux" the best immediate option is a European version of quantitative easing. The ECB finances its deficits by buying government bonds outright or via lending to banks against collateral. Banks buy government bonds because they know it is preferred collateral at the ECB. By pledging the bonds as collateral, banks receive new reserves and can expand credit again. It is said that this process will soon start in earnest and it is also said that the European Central Bank is no longer pledged to defend the AAA rating of the Euro. The end of Trichet's reign will ease this process further. At the same time, a big programme of quantitative easing is now said to be planned in the US, possibly sooner than consensus expectations for mid November. It is equally said that the Bank of England would not have recommenced its £75 billion QE programme and risk the financial isolation and potential impact on Sterling without being aware of a coordinated policy change by Western Central Bankers. The least painful policy option is clearly an attempt to inflate away debt.

In a revealing interview following the announcement of QE, the Governor of the Bank of England effectively apologised to savers and pensioners about the impact that QE has on deposit rates and annuities. He basically said that he had little alternative. He emphasized that he was very concerned about deflation, in particular the possibility that inflation would fall in the next year to less than the target 2%. He spoke about the shrinking now taking place in the velocity of money, with less borrowing and less lending activity a harbinger of tough times to come.

But the gamble with QE that the Governor took last week looks well timed. Both the US and Europe look to reactivate QE programmes imminently, so Sterling should not be out on a limb for too long. And commodity prices have been falling, in some cases like Copper they are 40% off their highs. So printing notes to boost asset values is not so dangerous in terms of spiking inflation.

The question remains whether QE in the West will work. Last time around QE impacted favourably on asset values, property and the Stockmarket, the values of commodities and emerging market currencies. There is little evidence that it boosted GDP growth other than at the margin. This time around yields on Government bonds are much lower although deflationary forces seem to be stronger as Government imposed fiscal disciplines start to impact on consumer demand in the West and as delays build up in the recapitalisation of banks, lowering loan growth. According to the chief Economist of Prosperity Capital management; "QE policies will debase Sterling... imposing soft default on the UK's creditors..... the policy is designed to avoid the real problem... which remains the gridlocked banking sector..... UK growth is low because credit channels are blocked, the result of massive counterparty risk in the interbank market.....That’s because our banks, disgracefully and despite massive taxpayer bailouts have not been forced to disclose the full extent of their trading losses...QE is just a backdoor way to refloat insolvent banks".

As things stand, it looks as though Western Central Banks, having failed to persuade politicians to act decisively and speedily will opt for a policy action which is not subject to a longwinded democratic process. QE is that policy and it will be back because Western Economies cannot cope with being saddled with huge debt burdens and Western politicians cannot cope with persistently high unemployment. Equally important, Western politicians seem unable to deal in a sensible and decisive manner with the integrated banks. Debt must either be defaulted or more probably devalued as an easier way out.

The dangers of such a policy is that it risks, to be blunt, a trade war. As the printing presses get going in the West, so the Dollar and the Euro and Sterling should devalue. There is a need to encourage a global rebalancing of trade flows which means in the long term much higher Asian and emerging market currencies, and an increased reliance on internal consumption, rather than export led growth by China and other Emerging market economies.

This has been happening. From October 2010 to July 2011, the Renminbi, (RMB) rose by 7% against the Dollar as China increased interest rates to slow inflation. However since July, the RMB has started to fall against the Dollar as a slowdown in the Chinese economy grows more pronounced. It is only a marginal fall that has happened, around 0.5% but it has set off alarm bells in the US democratic controlled Senate with twelve republicans joining 50 democrats to pass last week the Currency Exchange Rate Oversight Act, which proposes to impose tariffs on Chinese goods unless the Chinese Government allows the RMB to appreciate faster, perhaps by a further 15% over the next year.

This sort of stuff plays well with the population and that is the danger. There are cynics who suggest that blaming the Chinese, rather than the failures of the lending policies of US Banks for sluggish GDP growth is a great pre election ploy. It is a danger because it remains critical for US, European and UK corporates to be able to access the growing consumer markets of China.
And China remains a key buyer of Western Sovereign debt, owning at present an estimated $1.2 trillion of US Treasuries. The current imbalances can be reduced over time and certainly further doses of QE in Europe, and the US will serve to weaken Western currencies. Although the RMB is partly tied to the Dollar via the RMB "basket", recession in the West should accelerate the Chinese Government's well publicised effort to rebalance its economy. What is really needed to stimulate GDP growth in the US, is what is needed in Europe and the UK. It is to rebalance banking activity away from gambling financial instruments towards responsible banking activities. That said, the integrated banks are hard nuts to crack.

But the protestors on Wall Street appear to have recognised the truth that "people power" has to confront the power of vested interests, because the politicians won't do it for them. But there is some hope that Volker and Obama in the US are prepared for a confrontation.

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