



20th July 2009

Bank impertinence

“Except for con men borrowing money they shouldn’t get and widows visiting handsome young men in the trust department, no sane person ever enjoys visiting a bank.”

- Martin Mayer.

Lewis Carroll would have been proud. “Leading” London bankers are reported to be critical of relatively modest proposals to rein in their executive privileges and to make more transparent the earnings of their best paid employees. One naturally unnamed banker reportedly told the Financial Times,

“Risk should be managed by executives hour by hour, not by non-executives month to month.”

Banks’ risk should be managed, we can all agree on that. But it wasn’t. Not by senior bankers at any rate, many of whom are only enjoying the fruits of employment now thanks to the involuntary appropriation of taxpayer assets. If “leading” bankers want to avoid being kicked to death in the street by a mob they are doing their damndest to outrage, they would do well to keep a lower, humbler, more discriminating and less obviously self-interested public profile. Some hope. More evidence of the ‘Alice Through The Looking Glass’ world we now inhabit comes from Matt Taibbi’s much feted critique of Goldman Sachs. After the biggest banking bust in world history, the most trenchant criticism of investment banking (Rolling Stone’s “[The Great American Bubble Machine](#)” – warning: replete with some colourful expletives) has appeared in a **rock magazine**. Mr. Taibbi has also given us perhaps the most memorable description of an investment bank yet coined: Goldman Sachs as

“a great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money.”

With bank results being filtered through a mostly supine investment media, the public are not necessarily getting the full picture. Some may be interpreting Goldman Sachs’ \$3.4 billion in second quarter profits as indicative of some kind of financial or economic recovery. Mr. Taibbi suggests that these are not so much free market earnings but almost pure state subsidy. (Some might say quid pro quo: Goldman Sachs staff amounted to the largest corporate donors to the Obama presidential campaign.)

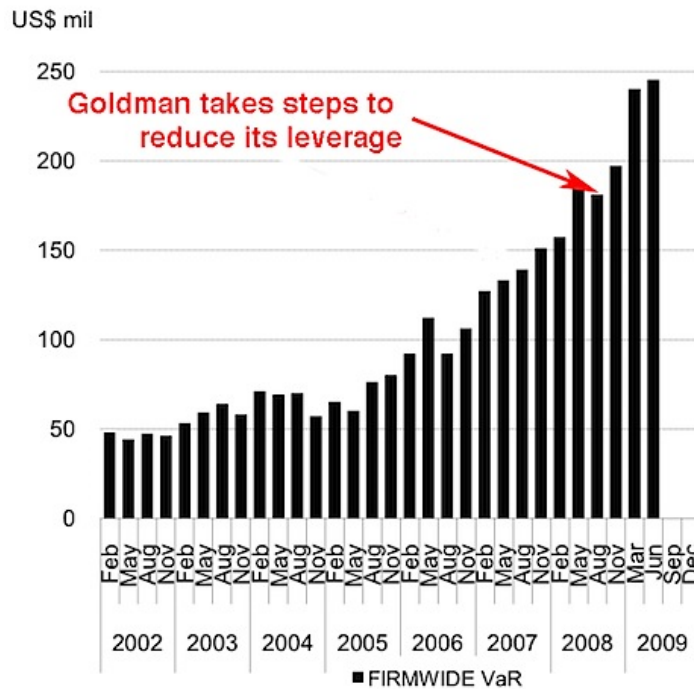
“We constructed this massive bailout infrastructure, and instead of pumping that free money back into the economy, the banks instead simply hoarded it and ate it on the spot, converting it into bonuses.”

Taibbi lists the various iterations of state aid that have padded Goldman’s figures (and others):

- The AIG bailout. If AIG had been allowed to proceed to bankruptcy, Goldman might have gone out of business since AIG owed Goldman about \$20 billion before it failed. Instead, former Goldman CEO Hank Paulson endorsed an \$80 billion bailout for AIG which in turn facilitated a \$12.9 billion payment directly to Goldman. Goldman separately managed to extract \$5.9 billion in collateral calls before AIG’s collapse. Taibbi states the process essentially as follows: Goldman makes ridiculous bets and exploits AIG’s executive ignorance; when the firm is brought near to collapse, it then drives a big stake through AIG’s heart and gets the government to pay them off using US taxpayers’ money. That is not quite the same thing as “an uncompromising determination to achieve excellence in everything we undertake”.
- TARP. Although Goldman has repaid the \$10 billion it got from the US government, the US government still holds warrants from Goldman giving it at least technical authority to prevent lavish bonuses.
- The Temporary Liquidity Guarantee Programme. Goldman converted last year from a brokerage company to a bank holding company, making it eligible for a new programme offering commercial banks FDIC support for unsecured debt. At the risk of stating the blindingly obvious, an investment bank is not a commercial bank, and merely changing nominal status does not change that reality. A more cynical observer might ask how a company with no deposit base and in breach of most of Basel II can qualify as a bank in the first place..
- The Fed Programmes. Following on from the above inherent non-bankness of Goldman Sachs, by converting to a bank holding company structure, Goldman is now eligible for what Taibbi calls “a whole galaxy of new bailout programs administered through the Federal Reserve like the Term Asset-Backed Securities Loan Facility (TALF); it also became eligible to borrow cheap money from the Fed’s discount window”. Believers in democracy and executive accountability, look away now: the Federal Reserve has lent out \$2.2 trillion in “assistance” during the crisis and refused to disclose how much has been given to Goldman or to any other firm.
- The TARP repayment bonanza. Banks that received government money had to issue new equity. Good news for major equity underwriters on Wall Street, who earned that mysteriously sticky 7% underwriting fee (Goldman earned \$736 million in equity underwriting during the last quarter).

Taibbi, in passing, also alludes to the profitability of the remaining US primary dealers (those investment banks, whoops, bank holding companies who make markets in US Treasuries) who are well placed to thrive given the extraordinary debt issuance requirements of the US government, in part due to the loss-making activities of those same banks. And he cites Felix Salmon’s observation that Goldman, on converting to bank holding company status, pledged to take steps to reduce leverage. That does not appear to square with the facts. The chart below, courtesy of Matt Taibbi, points to the increase in the admittedly ridiculous Value At Risk measure at Goldman Sachs, which highlights (at least in theory) the amount of money the bank puts at risk on any given day:

Goldman Sachs Value at Risk: do what I say, not what I do..



[Source: True / Slant; Matt Taibbi](#)

We could reprint what Taibbi reckons as to what the Goldman Sachs profit announcement says to the rest of the US citizenry (two words, and the second one is “you”), but discretion is the better part of valour. At a broader level, bankers are behaving as if a) the events of the last year had never occurred, and that b) they played no role in those events but instead c) deserve to be paid as highly as ever before. Taibbi describes this state of affairs well: beautiful, in a way, but also uniquely disgusting. It is difficult to disagree with his pay-off: “That they’re going to get away with it is bad enough – that they’re getting praised for it, for being **such smart guys**, is damn near intolerable.”

Client focus – well, you could call it that



But then, in extraordinary times, expect extraordinary outcomes. No less extraordinary than the venality of the bankers is the dire state of government finances (these two traits are connected).

Richard Karn, for the [Emerging Trends Report](#), highlights the rising threat of sovereign defaults for those countries whose own financial adventuring has ended in disaster:

Table 1: Emerging Market Vulnerability

<i>Capital Controls in Place</i>	<i>Vulnerable</i>	<i>Vulnerable</i>	<i>Vulnerable</i>
Iceland	South Africa	Ireland	Estonia
Turkey	Pakistan	Croatia	Latvia
Russia	South Korea	Serbia	Lithuania
India	Viet Nam	Czech Republic	Belarus
Indonesia	Mexico	Slovakia	Ukraine
Malaysia	Columbia	Bulgaria	Armenia
Philippines	Brazil	Hungary	Georgia
Venezuela	Peru	Romania	
Ecuador	Chile	Poland	

Source: Bruner,²¹ Reiman,²² Brainard,²³ Evans-Pritchard,²⁴ Cowley,²⁵ Economist²⁶ (Table by FRPitt/ETR)

Karn cites Latvia, whose government on June 3 2009 was unable to raise \$110.7 million, and whose economy is now expected to contract by 18% this year. Latvian house prices have collapsed by 50%. Some figures to spook European bank shareholders.. By late 2008, Austria's emerging market debt exposure to central and eastern Europe amounted to 85% of GDP; Switzerland's to 50%; Sweden's to 25%; the UK's to 24%. US exposure, by comparison, was just 4% of GDP. Those awaiting the next shoe to drop during the financial crisis need not look much further.

Reasons for caution in bond investing part II: Bloomberg reports that Latin America's corporate default rate will quadruple this year, according to Fitch Ratings.

Reasons for caution in bond investing part III: in a fine report by Sprott Asset Management, [Eric Sprott](#) has conducted some exhaustive analysis on the extent of US government indebtedness and the likely purchasing activity of current and prospective holders of US Treasuries. Rather than spoil your week, suffice to say that like that of many other debtor nations, the outlook for the US is hardly what one might call peachy. Each of the institutional debt buyers in Sprott's table will need to buy **three times** the debt that they bought last year, by September 2009, in order to balance the accounts of the United States Government. Probably best not to speculate what might happen if they don't. But worth remembering that the malign actions of investment commercial banks have consequences in the real world that the current debate over executive pay is helping to obscure.

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 20th July 2009.

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