



FINANCIAL NEWS



Banks should finance recovery

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It was to have been a glorious summer of economic recovery but instead it produced bitter disappointment. The recovery has petered out and markets have become gloomy again.

As of mid-year, global capital markets were functioning at less than two-thirds of their 2006 capacity when \$10 trillion of new issues of stocks and bonds were completed. Much of the shortfall has to do with reduced demand because of the economic slowdown, but a spate of official hostility towards banks and a continuing fog of regulatory uncertainty and delay have taken their toll as well.

There is a lot of heavy lifting for capital markets to do if the recovery is to succeed. Securitised mortgage markets have to be overhauled and vast quantities of commercial real estate debt refinanced. Dodgy [sovereign](#) debt has to be restructured, probably through the issuance of dollar-denominated Brady Bonds, as was done in the 1990s.

The re-regulated derivatives market has to be launched and a backlog of corporate mergers, spin-offs and asset sales has to be processed. Also huge amounts of government bonds must be sold to finance fiscal deficits.

Yet the US and UK governments have put formidable obstacles in the way of market recovery. Both have undertaken major reform efforts in highly political environments and made a mess of them.

The Dodd-Frank Act offers no structural reform other than setting up a new council of über-regulators to oversee the others, but requires more than 240 new operational rules to be written by five different regulatory bodies over the next three to four years before the actual impact and the many unexpected consequences of the law can be gauged.

Some of these consequences are just beginning to appear. For example, the new statute makes rating agencies legally liable for their opinions as experts, but agencies will not permit their bond ratings to be used in public offerings – even though many institutional investors require them and the US [Securities and Exchange Commission](#) insists they be disclosed. Their refusal shut the still-struggling asset-backed bond market until the SEC came up with a six-month, temporary fix.

Also, the Federal Deposit [Insurance](#) Corporation was forced to postpone announcing long-awaited new capital standards for smaller banks, because it cannot do so without finding a way to classify loan quality without using credit ratings, which the law now prohibits.

Dodd-Frank also requires systemically important financial services companies to be identified so they can be subjected to enhanced regulatory scrutiny and capital requirements to be set by a new 10-person Financial Stability Oversight Council that has yet to be formed or staffed, let alone started to deliberate.

Presumably, the new enhancements will be tied to the Basel III capital adequacy standards – to include new leverage and liquidity ratios – but these may not be fully implemented for another eight to 10 years. So, what these enhancements will be, to whom they are to apply, and when, are still not known.

Elsewhere, important, market-sensitive Bush-era cuts in income, dividend, capital gains and estate taxes will expire this year unless US [Congress](#) acts to extend them, which is not likely to happen before the November elections.

The UK's one-off bank bonus tax has turned out to be a nightmare, costing six times its original £500m estimate, with three-quarters of it being paid by non-UK banks operating in London. Goldman Sachs announced that it had paid \$550m to settle untried SEC charges and \$600m in UK bonus taxes. The forthcoming £2bn annual UK bank tax (which rises substantially in future years) has been sold as a deficit-reduction measure that also punishes banks for their past sins.

The Treasury and the Bank of England are to fill the vacuum left by the defunct FSA with a collection of new policymaking committees, but what this will lead to is still unclear. In a recent interview, Andrew Haldane, the Bank's executive director of financial stability, proposed, even now, going back to the roots of financial regulatory design for a complete redo.

Will the banks be forced to chop themselves up into more manageable units, or into separate high-street and [investment banking](#) units? Will such measures apply to City-based foreign banks as well? And, when will we know?

After their first-half results this year, the 10 largest US and [European capital](#) market banks had an average Tier-1 capital ratio of 13.2% (well above the 4% minimum required by Basel), a return on investment of 10.4% and a deeply depressed market-to-book value ratio of less than one.

This suggests an excess of capital reserves and a cost of capital no less than the return on it, indicating that the business model for large banks may no longer be economic. This does not augur well for their re-emergence as engines of recovery. Boutique investment banks are hoping to play a big role in all the [restructuring](#) that has to be done, but of course they lack both the global reach and the financial resources to do so.

It is difficult for the large banks to plan new initiatives when they face lingering regulatory and strategic uncertainties with expensive compliance costs. So they hunker down, cut costs further, avoid further controversy, lobby where they can and wait for things to clear up.

This is not the profile of the aggressive, innovative, financial players that are needed in the recovery effort. Governments, in attempts to secure political support, have gone too far in constraining the banks that make the markets, which become weaker as a result.

Instead, governments must convince legislators quickly to clarify essential policies, tie up loose ends, remove inconsistencies and eliminate mistakes and to accelerate putting at least the most important of the new rules in place. To do this, it will have to bring the banks back on to the team and work with

them.

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