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CENTRAL BANKS

by Gordon Kerr and John Butler, with Enrico Colombatto

Is the standoff between the ECB and Greece in any sense subtle, or simply a car crash waiting to happen? We explain why being the first to defect may in fact benefit Greece. With low sympathy for formal (fiscal) debt forgiveness, we expect pressure to increase further on the ECB.

After its January 25th elevation to power in Greece, Syriza's top ministers wasted no time in demanding that the troika write off a substantial chunk of Greece's $300 billion debt. Given that almost every senior European politician had in the previous three weeks reiterated his/her nation's implacable opposition to debt forgiveness, such a crude strategy was seized upon by mainstream media as proof that Syriza was run by impertinent political novices.

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Regulations: Love them or loathe them, they haven't cleaned up the banking business.

FINANCIAL MARKETS

by Gordon Kerr and John Butler, with Enrico Colombatto

Deutsche Bank's CEO hails the new banking regulations. His counterpart at JP Morgan denigrates them. This, and further misconduct news just confirm that banking is still in worse shape than nearly all commentators and regulators appear to recognise.

Deutsche: Regulations are good

At the annual meeting of the World Economic Forum in Davos, the head of Deutsche Bank gave a speech praising the welter of post-crisis bank regulations. "The bulk of regulatory reform was much needed….Did banks have enough capital for the risk they were carrying? No, I would say not." Observing that banks would, absent the regulations, have in any event "changed their models" since the crisis, he doubted whether "we would have moved this fast or by this quantum" without them.

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CENTRAL BANKS

(cont'd) ECB versus Syriza: Game Afoot…

What Greeks proposed

Yanis Varoufakis, who describes his own position in modern economic thinking as akin to "an atheist theologian in a Middle Ages monastery," has just completed a whistle stop tour of fellow EU finance ministries to explain his presentational recommendations for the debt write off. To enable his creditors to save face, he proposes that instead of a formal debt write off, the ECB, IMF and EU should agree to

- **(a)** a menu of instruments with coupons linked to Greece's GDP growth, and
- **(b)** perpetual bonds with very low coupons.

This announcement was widely misreported. Whilst we sympathise with non-bankers' mistakenly concluding that, by maintaining the prior quantums of nominal principal indebtedness, Syriza was now offering to honour the debt and renege on electioneering promises to tear it up, specialist financial commentators should not have been so easily duped.

But most of them were. For example, London's most read financial daily paper, "City AM" on February 5th:

"Greece has abandoned demands for a write-off of foreign debt and has instead proposed swapping the outstanding debt for growth-linked bonds."

What proposals actually mean

The universal metric by which bankers measure exposure is by calculating the present value of the future promised cash-flows. In the case of proposition b), even your authors could personally afford to assume the entire national debt of Greece were it "swapped" for \$300 billion of zero coupon perpetual debt. It is true that the actual Varoufakis proposition is not of a "zero coupon" literally, but it is still unrealistically small and time discounting makes it pretty much on par with zero anyway.

Regarding proposed perpetual bonds, even your authors could personally afford to assume the entire national debt of Greece were it "swapped" for \$300 billion of zero coupon perpetual debt.

As for proposition a), offering to issue bonds with coupons linked to Greek GDP growth shows Syriza's confidence in its negotiating position. The ECB parried by announcing that as of February 11th it will no longer treat Greek sovereign bonds as eligible collateral for its repo activities. These words were longhand for stating that it will henceforth exclude Greek banks from the club of struggling institutions that can rely on the ECB to keep them afloat.

The mainstream view is that, if neither side blinks, the ECB will be damaged in the impending head-on collision. Yet, Greece will come off much worse. For the ECB a Grexit will of course represent a potentially fatal setback on the pathway to completion of monetary, banking and perhaps fiscal union. But for Greece, the only conceivable next move will be to revive its drachma which would devalue (given lack of investor confidence in the currency of a newly defaulted country), thus exacerbating economic hardship due to the country's reliance on imports.

Advantages of being the first to defect

We suspect that Varoufakis is considerably shrewder than many believe. With unemployment at 25% and an economy that has shrunk 23% since 2008, Syriza have neither any realistic hope, nor political mandate, to honour the bulk of foreign debt. But the Greeks surely believe that an advantage could be gained by being the first to defect for the following reasons:

Why a country may find it advantageous to leave the Euro *NOW*:

❶ The ECB's July 2012 fix, promising to "do whatever it takes" to save the euro, was never backed by any actual policy and is now exposed as toothless. Its January 2015 €1 trillion QE was a measure even the ECB was reluctant to take, and will achieve nothing except buying time. Problems are building in Spain and Italy, so Greece will be doing everyone a favour by being the first to renege on unaffordable debt.

❷ Europe's political leaders, refusing to countenance a fiscal bailout of Greece (formal debt forgiveness), are hoping for some magic from the financial engineers at the ECB. Yet, the current German position suggests that this option is unlikely to materialize.

❸ Banking systems of many countries in the Eurozone are in far worse shape than nearly all financial analysts, rating agencies, economists and commentators believe. It would be good to get out before they realise and panic ensues.

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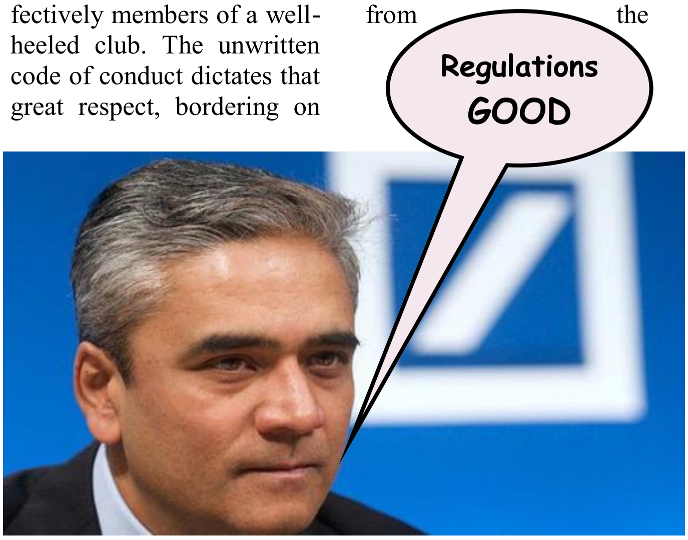
FINANCIAL MARKETS

(cont'd) Regulations haven't cleaned up banking...

Given the scale of systemic meltdown, is it not rather obvious that banks had insufficient capital for their risks? Leaving aside the failure of anyone to put this point to Deutsche's Chief Executive, the statement was perhaps more noteworthy in revealing that most senior bankers are effectively members of a well-heeled club. The unwritten code of conduct dictates that great respect, bordering on deference, is paid to regulators and central bankers.



Deference is a façade

However, two events in January supported the interpretation of such speeches as pure custard pie sops for the consumption of politicians and regulators.

Firstly, when the Swiss National Bank abandoned its policy of enforcing a ceiling on its exchange rate to the euro, within days Deutsche, Barclays and Citibank announced that they had lost $400 million between them. But wasn't the Volcker Rule supposed to ban proprietary trading?

Well, it banned *some*. But how many politicians and regulators knew that FX trading is actually *excluded* from the strictures of the Volcker Rule, which was supposed to have made banks safer by banning proprietary trading?

> *Deutsche's CEO's statement was more noteworthy in revealing that most senior bankers are effectively members of a well-heeled club which that great respect, bordering on deference, is paid to regulators and central bankers*

Secondly, the otherwise cosy feel to the club was ruffled mid-month by an outburst from its de facto leader, JP Morgan CEO Jamie Dimon. The wave of fines and new regulations constituted an "assault" that might undermine the entire US economy, he claimed.

JP Morgan: Regulations are bad

What prompted this statement? An announcement by the US Justice Department that it appears to have uncovered multiple examples of much worse foreign-exchange market manipulation than previously thought. Dimon referred to this sort of behaviour as "stepping in dogshit, which we do every now and then". Perhaps he has been spooked by the realisation that criminal proceedings for fraud, if brought, will target individuals: a somewhat less enjoyable experience for bankers than writing out the cheque for the latest mega-fine.

It is perhaps understandable that following years of lawsuits Mr Dimon would prefer to get some closure around the myriad disputes. Of course, this is self-serving.

Reality: Regulations haven't cleaned up banking

There is no concrete evidence that the "Too Big To Fail" banks have fundamentally cleaned up their acts; sufficiently recapitalised, reformed opaque and misleading accounting practices; properly investigated allegations of malpractice; or generally embraced the spirit, let alone the letter, of the various new regulations such as the Volcker Rule.

> *There is no concrete evidence that the "Too Big To Fail" banks have fundamentally cleaned up their acts; sufficiently recapitalised, reformed opaque and misleading accounting practices.*

Banking is today more dangerously leveraged, fraudulent and dishonest than it was prior to the Global Financial Crisis. The fact that many bank chiefs unabashedly contend otherwise provides strong circumstantial evidence to this effect.

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What is the Volcker Rule?

The rules, formally known as section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, went into effect April 1, 2014, with banks' full compliance required by July 21, 2015.

The rule allows banks to continue market making, underwriting, hedging, trading of government securities, insurance company activities, offering hedge funds and private equity funds, and acting as agents, brokers or custodians. Banks may continue to offer these services to their customers and generate profits from providing these services. However, banks cannot engage in these activities if doing so would create a material conflict of interest, expose the institution to high-risk assets or trading strategies, or generate instability within the bank or within the overall U.S. financial system. *(investopedia.com)*

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