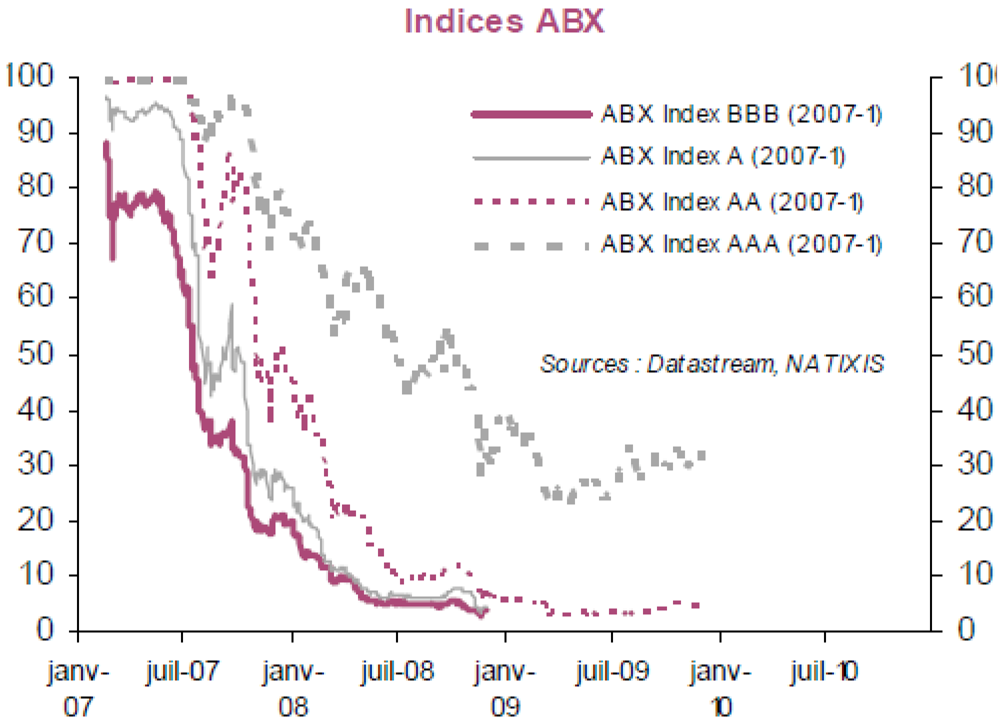
ETUC CRISIS PAPER 2010/2

BANKS, BAIL - OUTS AND BONUSES

Where did all the value go? Securitized paper has now become more commonly known as 'toxic assets'. The picture below shows why. The ABX-index which basically tracks the market value of securitized assets totally collapsed since the outbreak of the financial crisis. Even triple A rated securitized paper is valued by the market at a fraction (30% or so) of its initial value, whereas below triple A rated paper is basically worth nothing anymore on the market.

It is this collapse in the market value of securitized paper that set in motion a diabolical process in the course of 2008: After getting hit by the collapse in the market price of asset backed securities and to maintain compliance with the capital reserve requirements of the so called Basle II agreement, banks were forced to dump assets in the market. This pushed asset prices further down, causing in turn an even higher destruction of capital. In this process, credit flows to the real economy got hit as well. As we know, all of this ended up in the worst recession since the founding of the European Union.



This picture is also telling us that, even now, the problem isn't really solved. It is certainly the case that, thanks to unconventional monetary policies, banks are again lending money to each other. However, financial market players still distrust securitized assets and look upon them as contaminated by a high risk of default. Demand for these assets on financial markets is so low that banks are forced to hold on to them in the hope that sooner or later the market recovers or that the future cash flows which these securitised papers generate will not suffer from rising defaults.

To allow banks to keep holding on to these assets, policy makers have taken exceptional measures. International accounting standards forcing the use of the 'mark-to-market' principle are temporarily suspended so that banks can ignore for the time being the zero- market value of the asset backed securities in their balance sheets.

Meanwhile, central banks have flooded banks with liquidity. Whereas the Federal Reserve and the Bank of England went as far as playing 'buyer of last resort' by directly purchasing certain types of asset backed securities from the banks, the European Central Bank has substantially loosened its requirements for collateral to be posted in repurchase agreements. At the end of 2008, an amount of almost 900 billion of asset backed securities and uncovered banking debt has been accumulated by the ECB[1]. In practice, the latter means that 'toxic assets' are transferred from the

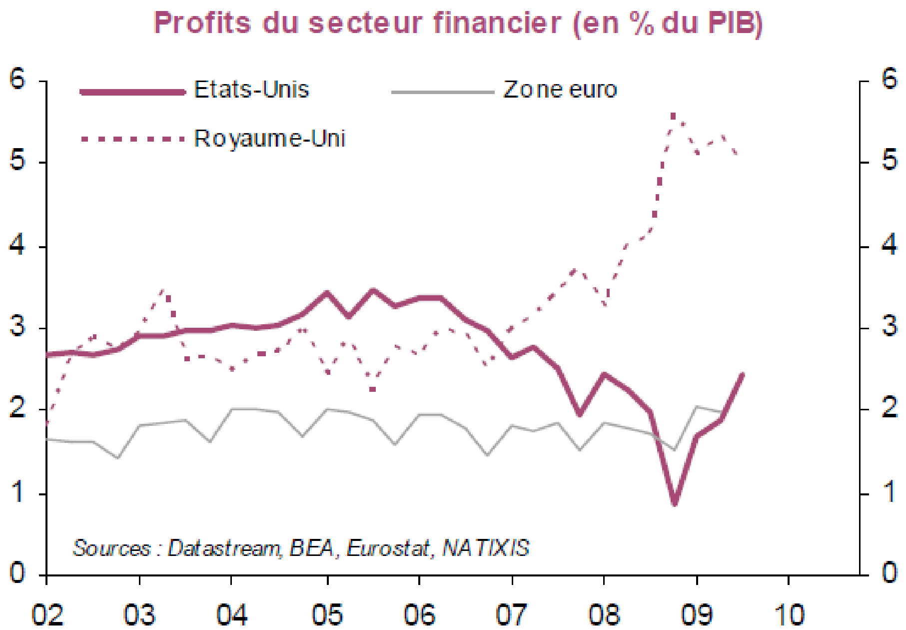
[1] Source : ECB 2008 Annual report

balance sheet of the banks to the balance sheet of the European Central Bank's and this for a period as long as up to one year. In this way, banks are – for the time being - relieved from these 'toxic assets' while in return getting fresh money at record low interest rates.

The bottom line is that the sense that finance has now returned to a state of 'normality' is misleading. If the situation seems to be under control this is because exceptional policy measures, in particular from the side of the central banks, allow the banks to hide the big potential capital losses that are still there in their balance sheets.

Finance sector: Crisis? What crisis?

Central banks have also supported the banking system by pushing monetary policy interest rates down to historically low levels. Banks now enjoy high profit margins by investing the liquidity that is borrowed from the central bank at an almost zero interest rate in assets yielding substantially higher returns. These high interest rate margins, together with the fact that potential losses on asset backed papers are not recorded for the time being, explain the next picture of financial sector profitability not suffering from what almost was a complete meltdown of global finance. In the US, the share of financial sector profits in GDP went down but is now growing back to pre crisis levels. In the Euro Area, the profit share of finance never really went down. The case of the UK seems to be spectacular: Throughout the crisis, banking profits as a share of GDP have shot upwards in the UK to reach more than 5% of GDP mid 2009. Besides the Bank of England providing the banking sector with almost zero cost liquidity, an additional explanation may be that global banking is transferring profits into the UK for the purpose of avoiding taxes: In the UK, it would be allowed to offset profits in the tax base by past losses. Given the extent of past losses, UK banks would now enjoy substantial tax credits, implying in practice that banks over there are free of paying taxes for several years to come. The irony in this is that the financial sector profit share (6 to 7% of GDP) is not that much dissimilar from the share of the UK public deficit (12% of GDP), with the latter leading in the UK to a heated discussion about wage, public services and social security cuts…..



Déjà vu: Exorbitant bonuses continue.

All of this explains why banking bonuses are thriving despite the financial crisis. The traditional 'logic' of things is that if profits are recorded (or are even increasing), then banks will continue with the policy of bonuses. It also sheds light on the decision of UK banks to pay the one off 50% tax the government intends to levy on bonuses over 27.000 pound. If profits are indeed booming, UK banks can easily afford to finance the temporary taxation of bonuses themselves.

Save the banks, not the bankers!

The massive support that banks are getting from governments and central banks is no doubt necessary. However, the developments described above show that the design of the banking rescue package is seriously flawed: Governments have stepped in with enormous amounts of fresh capital and public guarantees (3 trillions of euro in Europe!) with basically no or little strings attached. Still biased by the orthodox/liberal belief that policy should let 'the market do its work', governments have refrained from seeking to influence the banking business, let alone banks' strategic decisions and behaviour. Instead, the principle underlying banks' rescue packages is for the public actor to leave the banking sector as quickly as possible[2].

In other words, the banking rescue package has more the characteristics of an enormous but almost unconditional bail out[3]. It should therefore not come as a surprise that bankers, not being hindered by much new regulation or policy, and after being saved by taxpayers' money, return to the usual business of going for excessive profitability, paying out obscene bonuses while at the same time restricting credit to flow to investment and jobs in the real economy.

ETUC/rjanssen/january2010

[2] This is actually almost the only conditionality being forced upon the banking sector. Fresh capital and public guarantees carry a relatively high interest rate cost so that banks have indeed the incentive to pay back the government support as soon as possible.

[3] France did force its banks to keep credit flowing to the economy in return for public support. This was looked upon critically by the European Commission and, in the end, it seems that French banks prioritised lending to big companies while letting small and medium companies in the cold.