BREAKINGVIEWS
Agenda-setting financial insight

REUTERS

Chancellor: Pensions are a bubble waiting to burst

15 April 2016

The United States is not a “bubble economy”. That’s the official view of the Federal Reserve expressed by Chair Janet Yellen earlier this month. Yellen describes a bubble as a combination of “clearly overvalued” asset prices, strong credit growth and rising leverage. In other words, the type of financial fragility the central bank, with its vast research staff, failed to spot prior to the subprime crisis.

The Fed’s definition of a bubble is too narrow. Bubbles are, in essence, illusions of wealth. The last two great bubbles – internet stocks and U.S. real estate – involved inflated asset prices. The great current bubble is centered around liabilities, or promises to make future cash payments. The owners of these claims consider them part of their current wealth. But what if they cannot be paid?

These thoughts are provoked by a gloomy note on pensions by Andy Lees of the independent research outfit MacroStrategy Partnership. Lees is worried that the assumptions involved in calculating pensions are as flawed as the valuations prevalent during the dot-com bubble.

The present value of a pension is arrived at by discounting future cash payments. As interest rates have fallen, this discount rate has declined, increasing pension liabilities. As a result, many pensions find their liabilities exceed assets. In pensions-speak, they are “underfunded”.

For instance, the current deficits of U.S. corporate “defined benefit” pension plans are estimated at around $425 billion, by Citigroup. UK and European corporate pension plans also sport large deficits. The aggregate shortfall of American public-sector pension plans – state and local government – is somewhere between $1 trillion and $3 trillion, according to Citi.

The true extent of the mismatch between pension assets and liabilities is greater than reported. Let’s start with the assets. U.S. corporate pensions assume a return of 7.1 percent on plan assets. The assumed rate of return for American public pension plans is somewhat higher. The retirement industry will find it difficult, nay impossible, to achieve these returns.

The U.S. stock market is currently expensive by historic standards. GMO, the Boston-based asset manager (and my former employer), expects U.S. stocks to return minus 1.2 percent annualized over the next seven years.

Government bonds in developed economies, sporting minuscule and in some cases negative yields, won’t make up the difference. A traditional portfolio of 60 percent equities and 40 percent bonds is likely to return a mere 2 percent over the long run, according to MacroStrategy. Given that pension plans have a higher weighting to bonds their returns are likely to be even lower.

Then there’s an issue with the discount rate used to arrive at the present value of pension liabilities. American states and local governments apply an average discount rate of around 7.5

percent to value these liabilities. U.S. corporate pension plans use a 4 percent to 4.5 percent discount rate. By contrast, the current yield on the 10-year Treasury is less than 2 percent. These “discount rates are totally unrealistic”, says Lees. If realistic discount rates were applied, pension liabilities would balloon.

The adverse consequences of the pensions bubble are already evident. Several municipalities and towns, including Detroit and San Bernardino, have declared bankruptcy. The Pension Benefit Guaranty Corp, the quasi-state body which insures corporate pensions, has liabilities roughly twice the size of its assets and will run out of money in the next few years. Entitlements will have to be cut, taxes raised, and public services reduced. None of these actions will be popular.

Pensioners and taxpayers are not the only stakeholders in danger. Moody’s points to risks to U.S. municipal bonds should the pension crisis persist. Last year, the International Monetary Fund warned that the European life-insurance industry – which also applies above-market discount rates to its liabilities in order to maintain the appearance of solvency - poses a potential threat to financial stability.

Then there’s the impact on the real economy to consider. If corporate pension deficits increase, cash flow will have to be diverted away from investment. Uncertainty about future pension payouts may undermine consumer confidence.

Underfunded pensions are only the tip of the iceberg. The liabilities from unfunded government pensions dwarf everything else. Citi estimates that pension costs for 20 OECD countries will come to $78 trillion in current money, which is nearly twice their aggregate reported national debt.

Ben Bernanke, Yellen’s predecessor at the Fed, liked to talk about the global “savings glut”. In truth, there’s been a dearth of saving in the United States and the UK since the turn of the century. That should come as no surprise. Interest rates, after all, provide an inducement to save. Zero interest rates diminish that incentive.

Over the past decade, the net savings of Americans have averaged little more than 1 percent of gross domestic product. The collapse in the savings rate has been accompanied by declines in investment and productivity growth. All this means less money in the pot for tomorrow’s pensions. The gap between the belief in those pension promises and the ability to pay looks very much like a bubble.

China and India reform hopes are on hold

15 April 2016

Reform hopes in China and India have been placed on hold. When Chinese President Xi Jinping and Indian Prime Minister Narendra Modi took charge of their respective countries they were seen as both more decisive and more powerful than their predecessors. Early actions raised expectations that China might be able to overcome its addiction to investment while India might finally take steps to get its cumbersome laws out of the way of employers. Yet in the three and a half years since Xi's elevation, and two years after Modi's landslide election victory, not enough has changed.

With growth slowing, Beijing has returned to doing what it knows best: ramping up investment. The official goal is to boost total lending by 13 percent in nominal terms this year. That's double the target rate for economic expansion, and implies that avoiding a sharper slowdown, not cutting China's already-high levels of debt, is the priority. First-quarter data released on April 15 showed GDP growing 6.7 percent year on year but fixed-asset investment rising by 10.7 percent.

Additional stimulus in a country dotted with overcapacity seems certain to lead to more bad debts. Any restructuring is limited: though the government said in February that it will lay off 1.8 million coal and steel workers, there is no clear timetable. On April 14, International Monetary Fund Managing Director Christine Lagarde said the IMF was "concerned" about China following through on revamping struggling state-owned enterprises.

New Delhi's politicians are equally shy about privatising public enterprises or laying off employees. Under Modi, the government has continued the weak-kneed practice of setting targets for selling small stakes in government-owned companies – and then failing to hit them.

Modi has made a start tackling the problem of state-owned banks, the main source of a bad debt problem. Credit Suisse estimates that total problem loans account for as much as 17.8 percent of overall loans. But a long-term fix requires independent management of public sector banks, which seems as distant a prospect as under Modi's predecessors. Meanwhile, the government has directed banks to extend loans to startups and to provide a backstop for a poorly designed crop insurance scheme.

Leading and decisive roles

Neither regime has been totally inactive. Beijing deserves credit for letting foreign investors buy into the Shanghai stock market and for widening the trading band for the renminbi - even if that move was clumsily handled. New Delhi attracted record foreign direct investment in January and the government is once again pushing to get its overdue goods and services tax through parliament.

Even so, these moves have fallen far short of initial hopes. Investors fixated on the Chinese leadership's 2013 promise of a "decisive role" for markets, while paying less attention to the accompanying pledge of a continued "leading role of the state-owned economy". In practice, the state leads every time, as shown by its efforts to prop up the stock market last summer.

Modi's previous leadership of the intrinsically entrepreneurial Indian province of Gujarat, meanwhile, was the reason for optimists to cast him as an Indian version of Margaret Thatcher. But this ignored that, as chief minister, he was

Context News

China's first-quarter GDP grew 6.7 percent, its weakest pace since the global financial crisis, official statistics showed on April 15. The year-on-year increase was exactly in line with a Reuters poll, while indicators such as fixed-asset investment beat forecasts.

Speaking in Washington, D.C. a day earlier, IMF Managing Director Christine Lagarde said the IMF was "concerned" about China following through on the restructuring of its struggling state-owned enterprises.

content with making state-owned enterprises more efficient, but not privatising them.

These days, China’s Communist Party and India’s Bharatiya Janata Party rally around nationalism rather than privatisation. Under Xi, China has rattled neighbours in the South China Sea by claiming nearly all of it.

Meanwhile Modi’s party is growing increasing intolerant of dissent, and now says criticising India is unacceptable. This seems a long way off from Modi’s winning campaign two years ago. That promised jobs and economic development and was a hit in a country which produces 12 million new job-seekers each year and far too few factory jobs. In India, as in China, politics is once again trumping economics.

Brexit job risk threatens more than just bankers

15 April 2016

The spectre of higher unemployment is a valid reason for the UK to vote to stay in the European Union. Britain might be down 100,000 finance roles by 2020 if it quits Europe, says TheCityUK, a trade group. In isolation, that could be manageable. The reason non-bankers should care is that the real impact could be wider.

Big numbers like the one crunched by PwC on behalf of the TheCityUK can deceive. There are around 1.2 million financial sector jobs in Britain, according to the new report. For the City of London alone, the Centre for Cities and Cambridge Econometrics pencil in 3 percent employment growth between now and 2020. Scale that up to the UK's financial services industry as a whole and there might be 36,000 new jobs created over that period. That implies Brexit might eliminate 64,000 financial sector jobs that currently exist - or about 5 percent of the total. That sounds bad, but hardly apocalyptic.

Focusing too narrowly on finance is misleading, however. The sector's spending power creates jobs in many other industries. Banks, insurers and their employees buy everything from legal and accounting services to white goods and food. It is hard to put an exact number on the contribution to labour markets of the Canary Wharf morning latte run, or its denizens' Crossfit sessions. That doesn't mean it is negligible.

The trouble is, redundancies elsewhere may grab the headlines. The UK's steel industry had around 16,000 employees in 2015, according to the ISSB. But a crisis brought on by low prices has led to a reduction of about a quarter of the workforce in the past 12 months. That pain is real and current.

It seems probable that Brexit would trigger bigger job losses both in the financial sector and elsewhere. A report from the London School of Economics on April 15 estimated that foreign investment into the UK could fall 22 percent over the next decade. It is of course feasible that business and investment will later return to Britain. It is also possible that the pain could be prolonged.

Context News

A vote by Britain to leave the European Union could mean up to 100,000 job losses in the country's financial services industry over the next five years, relative to a scenario where it chooses to stay, a study said on April 14.

If Britain voted for Brexit in a June referendum this would lead to lower growth and investment and undermine London's position as a leading centre of trade and commerce, according to the PwC study, commissioned by TheCityUK, which represents the City of London's finance industry.

Capital markets across Europe could be significantly disrupted if the UK votes to leave the EU, said a report published on April 14 by thinktank New Financial.

It would create uncertainty, and increase cost and complexity for market participants, investors and issuers, New Financial said.

Mike Corbat now entangled in banking Catch-22

15 April 2016

Mike Corbat is entangled in a banking Catch-22. The chief executive of Citigroup aced the living will and stress tests. He also has fashioned an efficient operation, evidenced by the mega-bank's latest results. Returns remain subpar, however. Improving on them requires leaning on tax breaks. And to do that will depend on finding more profit in tough times.

There's no mistaking the work Corbat has done patching up Citi's relationship with regulators, strained by a $45 billion taxpayer bailout during the financial crisis. That was followed by two failures of the Federal Reserve's annual exam on how the bank would perform in a hypothetical calamity.

Last year, Citi passed with ease after Corbat invested $180 million to upgrade the bank's processes. He even staked his job on the grades. This week, Citi was the only one of the eight largest U.S. banks to get a thumbs-up from both the Fed and the Federal Deposit Insurance Corp for its plan to dissolve in an orderly manner in a crisis.

Earnings, however, remain elusive. The first-quarter showing is a case in point. The megabank earned $3.5 billion, equating to an annualized return on equity of just 6.4 percent. Corbat can't cut a significant amount of costs any time soon: Citi is already one of the leaner banks in the business, spending $60 for every $100 of revenue.

Its big impediment is a legacy of the crisis: tax breaks from all the losses Citi suffered. The bank currently has around $30 billion of capital tied up in these deferred tax assets. The only way to get rid of them is to earn money that can be applied against them.

Had Citi been completely free of its deferred tax assets, annualized return on equity for the three months to March would have been around 7.5 percent – and for 2015 just shy of a theoretical 10 percent cost of capital.

With earnings so low, however, offloading the deferred tax assets is a slow and painful process. Citi reduced the stockpile by almost $7 billion last year. With industry revenue in a rut because of low interest rates, volatile markets and nervous chief executives, there's little sign of improvement. And therein lies the catch.

Context News

Citigroup on April 15 reported first-quarter net income of $3.5 billion. At $1.10 per share, it beat the consensus estimate of analysts of $1.03 per share. Revenue of $17.6 billion also exceeded expectations of $17.4 billion. Annualized return on equity was 6.4 percent.

Citi was the only institution among America's eight largest banks whose living will plan did not receive a "not credible" grade from at least one of the Federal Reserve and Federal Deposit Insurance Corp on April 13.

Workplace diversity will take more than markets

15 April 2016

Companies that put an emphasis on equality for gay and lesbian employees perform better in the market. This finding, revealed by Credit Suisse in a report on April 15, is heartening. Many workers, regardless of their sexual orientation, would like to believe the profit motive can be a strong incentive for corporate kindness. It’s just not that simple.

The Swiss bank discovered that its basket of 270 companies, selected for their lesbian, gay, bisexual and transgender representation and engagement, outperformed the wider market by 3 percent a year over six years. They also generated cash returns on investment that were as much as 21 percent higher. By that measure, inclusive policies are a no-brainer. The activism of companies speaking up against anti-LGBT legislation, like PayPal in North Carolina or Salesforce in Missouri, would be justifiable as a straightforward financial decision.

The big problem with the research is one that haunts most arguments for workplace diversity: establishing cause and effect. To take an absurd example, companies in the FTSE 100 whose names include the letter K have performed 31 percent worse over the past decade than the broad index. Presumably, that’s coincidence. Sometimes numbers can lead in bad directions. Credit Suisse also found its 270 LGBT-friendly companies traded at a 10 percent price-to-earnings discount to the others.

It’s nice to think that happy employees, even if they cost more at first, will deliver more value in the future. Maybe they don’t always, though. British sportswear retailer Sports Direct and U.S. online retail titan Amazon, both criticised publicly for tough working practices, have given investors one-and-a-half times better annual returns than Google over the past five years.

Being a good corporate citizen thus requires something more than a free market and selfish investors. One thing that works is a leader prepared to stick their neck out. Take Google’s decision to pull out of China in 2010 rather than censor its search results, driven by the strong free speech beliefs of its founders Sergey Brin and Larry Page. Investors had previously resisted motions to stop self-censorship. The sexuality of openly gay Apple boss Tim Cook, or HSBC UK chief Antonio Simoes, are entirely incidental to their jobs, but their decision to be visible sends an encouraging message.

Elsewhere, there are examples of how companies need a push from the outside. Auto emissions are a clear case of companies being forced to do good. Volkswagen got into trouble for faking emissions data from U.S. environmental regulators, but there was an economic incentive to cheat: consumers don’t pay more for cleaner cars. Low-emissions vehicles are becoming the norm because regulators insist on it – not because it’s more profitable.

Tax avoidance is similar. It’s perfectly rational for companies to move profit into lower-tax jurisdictions. Shareholders would be disgruntled if they didn’t, which is why the Tax Justice Network reckons a quarter of all U.S. multinationals’ gross profit is funneled to companies with no or low tax. A push to make multinationals show their tax breakdown is sensible. While it doesn’t outlaw aggressive tax planning, it may invoke the profit motive in another way, by creating the fear of being shamed.

Context News

Companies that emphasise equality for gay, lesbian, bisexual or transgender employees have outperformed the MSCI All Country World Index by 3 percent a year over the past six years, according to a study by Credit Suisse published on April 15.

The Swiss bank’s analysts constructed a basket of 270 companies with LGBT leaders, high rankings in diversity-related indices or employees with high-profile membership of LGBT business networks, and found that the basket’s performance beat the broader index, and a separate sub-index of North American, European and Australian companies.

The study also found that the 270 companies generated a higher rate of cash return on investment, beating other companies by 10 percent to 21 percent. Their stock market valuations, however, were lower. The companies traded at a 10 percent discount on forward price-to-earnings multiples, and were neck-and-neck in price-to-book multiples, despite having higher returns and profitability.

Society's views on LGBT equality have been changing dramatically, and with any luck will continue to do so. Rather than wait for investors to make it so, regulators could help by asking for better disclosure, so that companies feel more pressure to keep up with rivals. A start would be to make them publish in their annual reports how many of their staff anonymously identify as LGBT, at least in countries where asking is permitted. They could say how many of their board identifies as LGBT too.

No one number can tell the full story, and perhaps the free market really will one day reward companies for being virtuous. Until then, a shove would help.

OPEC freeze failure could hasten oil's recovery

18 April 2016

Saudi Arabia’s increasingly bitter dispute with Iran is now being played out in the oil market. The kingdom has stubbornly blocked a deal among major oil powers to freeze production, primarily because it refused to allow the Islamic republic to be exempted. The breakdown of talks will almost certainly lead to another rout in oil prices over the next few weeks - but the pain could be short-lived.

There are already signs that output is falling sharply among higher cost producers, and the economic pain caused by cheap oil could eventually lead to price-inflating output cuts instead of a freeze to production when OPEC next meets again in June. In its last market report the cartel said it expects production from outside OPEC to drop by 730,000 barrels per day, a 4.2 percent increase on its previous estimate.

Analysts had widely expected the talks held in Doha on April 17 to fail. Their skepticism was fueled by Saudi Arabia’s powerful deputy Crown Prince Mohammed bin Salman insisting that the kingdom would only rein in its output if Iran also participated in a freeze, thus preventing the latter gaining from higher oil prices. Riyadh is at loggerheads with Tehran across the Middle East, mainly because the two sides oppose each other’s political goals and influence.

But a freeze was never an option for Tehran. It has just emerged from the isolation of trade sanctions and is determined to restore its output to pre-embargo levels before it agrees to any production limits within OPEC.

Meanwhile, major oil producers from Iraq to Nigeria and Venezuela are suffering severe economic pain. At current export levels these three OPEC members – among the most economically strained in the cartel – are losing around $465 million in gross daily revenue at today’s prices compared to when they were around $115 per barrel in mid 2014. The longer Saudi Arabia blocks any deal in order to wage economic war on Iran the more it endangers the economies of other OPEC members.

All of this could hasten a recovery in oil prices by the end of the year. Crude trading around $40 per barrel throughout the summer will force more marginal producers in the United States out of business and crank up the pressure on Russia to tone down its sabre-rattling in the Middle East. It could also force Saudi and Iran to back down in their proxy war, which is now the biggest obstacle to the oil deal the market needs for long term recovery.

Context News

Major oil producers from the Organization of the Petroleum Exporting Countries (OPEC) and outside the cartel failed to agree terms of a freeze to output at a meeting in Doha on April 17.

Saudi Arabia’s refusal to allow Iran to be exempt from any agreement was a significant factor in the breakdown of talks in the Gulf state, Reuters reported.

Failure of talks is expected to bring a rally in oil price to a halt. Brent crude has risen to nearly $45, up 60 percent from January lows, on optimism that a deal between major producers could be achieved.

Dixon: Vote to quit EU could tip UK into recession

18 April 2016

A vote to quit the European Union could tip the UK into recession. This is no longer an academic possibility. Opinion polls show British people evenly divided on whether they want to remain in the EU or leave; betting odds suggest there is a one in three chance that the pro-Brexit camp will prevail in the June 23 referendum.

Such a vote would trigger political turmoil and acrimonious divorce talks. Investment would grind to a halt as firms wait for the fog to clear. Consumer confidence could also be hit.

The long-term impact of a vote to leave the EU would also be damaging. After all, the EU accounts for half Britain's trade. It would be impossible to retain full access to that market if the Leave camp sticks to its goal of ending free movement of people between the EU and the UK and stopping budget contributions to Brussels. This "has never happened in Europe", Klaus Regling, head of the European Stability Mechanism, was quoted by the FT as saying at the International Monetary Fund meetings last week. The UK government is predicting the economy will be 6 percent smaller by 2030 than if it stayed in the bloc.

But it is the short-term impact of a Brexit vote that will be at the forefront of investors' minds. This is likely to be nasty.

For a start, David Cameron, who is campaigning for Britain to stay in the EU, would probably have to resign as prime minister. Boris Johnson, the popular mayor of London who is campaigning to quit, would be in pole position to replace him.

Wolfgang Schaeuble, the German finance minister, told his British counterpart, George Osborne, at the IMF meetings that the divorce talks would be tough, according to the FT. There are several reasons to believe this.

One is that the UK's partners wouldn't want other EU countries to think it was easy to quit. Otherwise, the whole bloc might unravel as, say, the French said they didn't want to abide by competition law, the Italians said they wouldn't stick to the budget rules, and so forth.

Another reason is that some countries would want to use Brexit to grab business that until now has been transacted by the UK. The French economy minister has already promised to roll out the red carpet to bankers. The way to do that would be to stop Britain having full access to the EU market.

Yet another reason is the electoral timetable. French presidential elections are held in May next year, while the German federal election is next autumn. Neither government would want to give an inch to Britain before those were out of the way.

The pro-Brexit camp disagrees. It says the EU would be desperate to do a trade deal because it sells more to the UK than vice versa. The snag is that this argument ignores proportionality. Exports to the EU account for 13 percent of UK GDP; exports from the EU to Britain account for just 3 percent of its GDP. As such, the UK needs the EU more than the bloc needs Britain.

What's more, if worst came to worst, the EU could fall back on World Trade Organisation trading terms. These limit the tariffs

Context News

Chancellor George Osborne said on April 18 that a vote to leave the European Union in June's referendum would do permanent damage to the country's economy, which he warned would be 6 percent smaller by 2030 than if it stayed in the bloc.

Wolfgang Schaeuble, Germany's finance minister, has told Osborne that Berlin would be a tough negotiator if the UK votes to leave the European Union, the Financial Times said.

The International Monetary Fund said in its latest World Economic Outlook that negotiation on Britain's exit from the EU "would likely be protracted… resulting in an extended period of heightened uncertainty that could weigh heavily on confidence and investment".

An overwhelming majority of economists said that a Brexit vote would hurt the economy, in a Reuters poll.

Britain could impose on imports of goods from the EU. Unfortunately, the UK’s comparative advantage is in services, including financial services, and the WTO does virtually nothing to protect its exports of these.

If the Leave camp was preparing the electorate for tough times ahead, that would be bad enough. But its wild promises about how easy it would be to clinch a deal with the EU mean the negotiations could be especially bitter.

Britain’s post-Brexit government would be in some ways like the radical left-wing party Syriza just after it took power in Greece last year. It would have made promises it couldn’t deliver. And, because it would be hard to tell the British people that they had been conned, the new administration would probably respond by taking a confrontational approach to the EU and blaming its former partners.

Such a government would also be under tight deadline pressure. The EU’s divorce process is set out in Article 50 of the Treaty. This says a deal has to be done within two years of the article being triggered, or Britain has to leave without any agreement.

If little was achieved in the first year because of the French and German elections, the heat would be on. The deadline could be extended with the unanimous approval of the other 27 countries. But, as the Greeks have discovered, negotiating with one’s back to the wall isn’t fun.

Unsurprisingly, the IMF predicts the divorce talks “would likely be protracted… resulting in an extended period of heightened uncertainty that could weigh heavily on confidence and investment.” Equally, 31 out of 35 economists polled by Reuters think Brexit would hurt the economy. None of them think it would be good. They are right.

Morgan Stanley growth plays 2016 version of Godot

18 April 2016

Morgan Stanley is already waiting for this year's Godot. The Wall Street firm earned $1.1 billion in the first three months of the year. While that beat estimates, it amounts to an annualized return on equity of just 6.2 percent, well short of the 10 percent target that Chief Executive James Gorman set long ago but still hasn't managed to hit in any full year's earnings since. Given the first-quarter showing, he's unlikely to get there in 2016 either.

The three months to March are usually the best of the year for investment banks. Morgan Stanley, for example, made almost a third of its net income in the same period last year. It's usually when fixed-income trading performs well, too. The less that capital-intensive business brings in, the harder it will probably be to make up returns over the following nine months. Gorman's traders pulled in just $839 million last quarter, a 59 percent drop from the same period a year earlier – and the weakest performance so far for any of the big players.

One lever Gorman hopes to pull is giving more capital back to shareholders. Morgan Stanley has, on paper, a surfeit of capital: its Tier 1 common equity ratio of 14.5 percent is way above the 10 percent minimum it needs to hold by 2019.

Even were the Federal Reserve to let Gorman hand all the excess back to investors – and it's highly unlikely he'd even ask – the bank's annualized return on equity last quarter would, at 8.4 percent, still fall short of his goal.

Cutting costs would help but alone couldn't bridge the gap. Morgan Stanley, after all, let 1,200 employees go in December, yet results remain subpar.

That puts the onus on growing the top line. Gorman sensibly expects the wealth-management division to do the heavy lifting. It requires less capital than trading, so can deliver a bigger bang for the buck. Its pre-tax margin is decent, and its banking unit offers a way to boost income, especially as interest rates rise.

Trouble is, the Fed is taking its time hiking rates, and tricky markets hurt wealth management as well as underwriting and trading. Meanwhile, the firm's low and volatile trading results often more than offset any gains. All in, that leaves growth a long way off.

Context News

Morgan Stanley on April 18 reported net income of $1.1 billion. At 55 cents per share, it beat the consensus estimate of sell-side analysts of 46 cents per share. Revenue of $7.8 billion missed the consensus estimate of $7.9 billion. Annualized return on equity was 6.2 percent.

Net income fell 54.4 percent from last year's first quarter, when the bank had a tax benefit of $564 million. Excluding that, earnings fell 39 percent.

Give OPEC more power and let Iran and Saudi bicker

19 April 2016

Saudi Arabia and Iran are playing politics with oil. Their bickering was the main factor behind the collapse of a deal on April 17 to freeze output, despite many of OPEC's 13 oil-producing members supporting an agreement with producers outside the group to boost prices. The Middle East's oldest rivals in Tehran and Riyadh now pose a risk to the stability of global energy markets.

OPEC has so far proved a poor arbiter of the feud, which is ultimately about who is top dog in the Middle East. Critics argue the group is a cartel, which adjusts oil supplies to suit the political motives of its most powerful members and not the needs of the market. In its current form they have a point.

OPEC's power to influence prices is largely due to the vast oil production of its largest member, Saudi Arabia. With the ability to pump 12.5 million barrels per day of crude – enough to meet about 13 percent of world demand – the kingdom has the loudest voice within the group. The cartel's lack of executive authority has allowed the kingdom's inexperienced but powerful Deputy Crown Prince Mohammed bin Salman to play politics with oil by blocking a deal in Doha on April 17 unless Iran cooperated.

In its current form, the organisation is too dependent on decisions taken in Riyadh instead of its secretariat in Vienna. But if reformed, expanded and handed greater powers the organisation could take the politics out of oil and act as the global policeman that the petroleum industry lacks.

Instead of being a talking shop, which sets vague, non-binding guidelines for the production of about a third of the world's crude, OPEC should set robust targets. That might make its efforts to maintain quotas and set production limits more effective at managing the boom/bust cycle of the oil industry.

The group also needs authority. Its secretary general lacks the power to impose significant punitive fines, or enforce agreements. Members retain sovereign rights to determine their own oil policies regardless of OPEC decisions. It would be better if this power was binding, like that of the banking sector's Financial Stability Board.

Saudi and Iran are welcome to bicker. But given the threats from shale and non-OPEC members like Russia, they'd be better off doing so in a cartel with a reinforced core.

Context News

Major oil producers from the Organization of the Petroleum Exporting Countries (OPEC) and outside the cartel failed to agree terms of a freeze to output at a meeting in Doha on April 17.

Saudi Arabia's refusal to allow Iran to be exempt from any agreement was a significant factor in the breakdown of talks, Reuters reported.

After initially falling on the news oil prices have rebounded. Brent crude was trading up almost 1 percent at over $43 per barrel on April 19.

Finance wakes up to fintech's systemic dangers

19 April 2016

Talking shops should do more than simply gloomily prognosticate or ardently cheer, even for fintech. The Bank of England’s Andy Haldane and Deutsche Bank boss John Cryan are among 53 luminaries backing a new forum to debate financial technology. Data abuse is a concern, as they note in a paper published by the World Economic Forum. They also want new standards to stay ahead of the game. But the biggest risk is how fast and obscurely money can move. Monitoring that should be the forum’s main task.

Technological advances since 2008 rebut former head of the Federal Reserve Paul Volcker’s quip that the only successful financial innovation is the ATM. Recent inventions offer greater financial inclusion and a potential check on inequality. Mobile phone credits now give remote rural households access to virtual bank accounts. Online automation has brought down the cost of wealth management services that only the rich could afford. Small and medium-sized businesses in Spain can now get access to funding in as little as 10 minutes from peer-to-peer lender Kabbage, says Ralph Hamers, the boss of its partner in the country, Dutch bank ING.

But while fintech promises much, it also poses systemic risks. Regardless of the whizzy technology behind it, lending is always likely to carry the danger that borrowers won’t be able to pay. Even if many P2P operators now have bank-like capital requirements, insufficient regulatory oversight could allow mountains of bad debts to pile up. The risk could be compounded given that the vast majority of these startups launched during a period of historically low default rates.

The threat posed by payment operators is of a different hue. Take Chinese mobile payments firm Alipay, which now provides almost half a billion users with access to 50,000 stores in Asia. The failure of a firm with that scope could potentially cripple trade and commerce.

This new fintech initiative has some of the world’s best financial minds behind it. Yet so does the Bank for International Settlements, which warned of the impending financial crisis at the start of the last decade to no avail. The challenge for fintech’s talking shop will be to translate similar insights into careful scrutiny and action.

Context News

A group of more than 50 financial executives, regulators and economists have joined forces to argue that a common set of standards as well as a global forum are needed to monitor the impact of new technology on financial stability.

In a paper published by the World Economic Forum and Oliver Wyman on April 19, the group argued that there was a need for public-private dialogue on the way technology was changing the financial industry. It also called for new standards governing data usage and emerging technologies, as well as new regulation.

ING Chief Executive Ralph Hamers told Dutch business daily Het Financieele Dagblad in an interview published by the bank on April 18 that upcoming changes to payment rules in Europe would speed up lending.

“A business can arrange funding from this lender [Kabbage] in a matter of 10 minutes. Without [the Payments Services Directive 2] that process takes two weeks.”

Saudi U.S. selloff threat not to be trifled with

20 April 2016

Saudi Arabia rarely jokes about money. So investors can’t easily dismiss a threat that the kingdom will dump its American assets if the U.S. Congress passes a bill allowing victims of the Sept. 11, 2001 attacks to sue it for damages. Though a fire-sale would be devastating, it suggests the alternative - an Iran-style freezing of assets - would be an even worse outcome.

The warning to Washington lawmakers that the kingdom would sell its U.S. securities portfolio to prevent it from being seized was delivered by Foreign Minister Adel al-Jubeir, according to The New York Times. The report claimed Saudi would be forced to offload up to $750 billion of dollar assets if a bill became law that would strip immunity from foreign governments in cases “arising from a terrorist attack that kills an American on American soil.”

The holdings, mainly in Treasury securities, represent Saudi Arabia’s last line of economic defense to lower oil prices, which have weakened its finances. Last year the kingdom ran a budget deficit equal to 15 percent of GDP. If oil prices average $30 per barrel over the next five years, it would need to borrow $580 billion to cover losses, Citi estimates. That’s almost equal to the remaining reserves at the Saudi Arabian Monetary Agency, or central bank.

SAMA, which also acts as a form of sovereign wealth fund, has sold assets to offset a steep decline in oil revenue over the past year. The size of its reserves has fallen by 17 percent to $593 billion in the year to February, according to its last financial report. At this rate, Riyadh could burn through most of SAMA’s booty by 2020 unless crude rebounds. Without access to those funds, the Saudi royal family would struggle to keep the peace at home.

That is why Al-Jubeir’s threat is not to be taken lightly. Sure, jettisoning assets on this scale in a hurry is incredibly risky. The Saudi riyal is tied to the dollar, and a rapid exit would test the central bank’s ability to maintain the currency peg. A hurried sale could also freak out global financial markets, too, which might further squeeze demand for oil.

That Riyadh is willing to ponder such a messy outcome suggests just how existentially it needs money to keep its hold on power. That’s perhaps the scariest message from the whole kerfuffle.

Context News

The U.S. White House expressed confidence on April 18 that Saudi Arabia would not follow through on a reported threat to sell U.S. assets if Congress passed a bill that could hold the kingdom responsible for any role in al Qaeda’s Sept. 11, 2001 attacks.

The New York Times reported on April 15 that Saudi Foreign Minister Adel al-Jubeir told U.S. lawmakers that the country would be forced to sell up to $750 billion in Treasury securities and other U.S. assets in response to the bill if it passed.

White House spokesman Josh Earnest said President Barack Obama did not support the legislation and would not sign it. The bill would allow the Saudi government to be sued in a U.S. court for any role in the Sept. 11 attacks.

“I’m confident that the Saudis recognise, just as much as we do, our shared interest in preserving the stability of the global financial system,” Earnest told reporters.

Obama, who is traveling to Saudi Arabia later this week, said he opposes the bill because it could expose the United States to lawsuits from citizens of other countries.

Saudi's sweet debt deal could rebound on banks

21 April 2016

Bankers should be punching the air. Saudi Arabia is close to agreeing terms on a $10 billion loan with a syndicate of banks including JPMorgan, HSBC and Bank of Tokyo-Mitsubishi. Normally, getting the nod to lend to the Middle East's largest holder of crude oil reserves for the first time in 25 years would be easy money. But banks may be ignoring the risks.

Despite running up a 15 percent budget deficit last year, which is expected to grow further in 2016, the Saudi government has found it easy to borrow money. It is likely to borrow at 120 basis points over Libor, a rate far below the risk implied by its credit-default swaps, according to a Reuters report on April 20. The terms may be in line with recent debt deals secured by neighbors Qatar and Oman, but the risks associated with the kingdom could be much bigger.

Pushed on by its energetic but inexperienced Deputy Crown Prince Mohammed bin Salman, the kingdom is fighting on four fronts. The thirty-something prince wants to win a global oil price war which is stretching the kingdom's finances to breaking point, while opposing Iran in proxy conflicts in Syria and Yemen.

At the same time, he aims to restructure the kingdom's inefficient economy by cutting state subsidies and selling government assets, simultaneously suppressing internal dissent. Although Mohammed bin Salman's Al-Saud dynasty is secure, these problems could pose a threat to its future. Moody's has placed Saudi's Aa3 issuer rating on downgrade review as the challenges facing the kingdom stack up.

There are external risks too, not least its changing relationship with the United States, which appears uninterested, despite President Barack Obama's recent visit, in guaranteeing Riyadh's security in the region.

Sovereign defaults are rare in the region, but not inconceivable. Iran renounced its $15 billion of foreign borrowing racked up by the Shah's regime after the revolution in 1979, which led to the seizure of its assets in the United States. Bankers dismiss the possibility that the same nightmare scenario could one day unfold in Riyadh. They do so at their peril.

Context News

JPMorgan, HSBC and Bank of Tokyo-Mitsubishi are among a group of international banks close to agreeing a $10 billion loan to Saudi Arabia, Reuters reported on April 20, citing unidentified sources.

The issuance of government debt comes as the kingdom grapples with lower oil prices and a budget deficit equal to 15 percent of gross domestic product in 2015, which is set to widen this year.

Saudi is also seeking to mandate banks to help it IPO state-owned companies. The FT reported that JPMorgan has been working with state-run Saudi Aramco on how its shares could be listed.