

Pointers to the financial sector



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The state of the financial sector and whatever is being reported by way of growth in a few economic parameters in almost every developed country, especially the US and U.K, are linked to government and central bank support in different forms. Remember such support is effectively paid by the citizens, especially tax payers.

Intervention of historic magnitude: The overwhelming importance of this aspect to trends in the financial market over the past few months was touched upon briefly last month in the article 'Play the liquidity-driven rally with care' (Please refer The Wise Investor August 2009 available at www.sundarambnpparibas.in).

The role played by the government and central bank has been so overpowering that one has to go back to the 1930s to find such a similar support cast for the economy.

Even the growth reported by China over the past two quarters is almost solely attributable to government directed bank lending in the first four months of 2009.

Tracking the withdrawal effect: From an investors' perspective, what happens to the financial sector and economic growth in the developed world -if and when- the government and central banks start to withdraw is important, as it will be the critical factor dictating market trends. The reduced role of government directed measures in China also need to be tracked in this context.

To what extent, genuine private sector growth will return is the mirror image of this story. Of course, there is always a government component to growth, and that will have to return to close-to-long-term averages from the present dominant state.

Uncertain and certain elements: How and over what time frame this impacts price of bonds, commodities and stocks cannot be precisely nailed now. What is certain is the withdrawal-syndrome effect on financial sector and government. A two-to-three year window appears to be likely window for this story to play out in full force.

Or if governments ratchet support in the same way as the Japanese did for years, it could be a torture spread over many years. We will try to understand the implications in two parts by focussing on the government and central bank support to the financial sector this month and their influence on economic growth trends in the next edition of this publication.

The known story of trillion + opaque

accounting story: We are aware of the trillion of dollars that have been provided as support by central banks and governments to the financial sector in the US and Europe over the past two years. The balance sheet of the Federal Reserve has expanded almost three fold to \$ 2 trillion plus on account of a variety of support programs by arcane names. There have been changes approved in the accounting practices to permit banks to tuck away assets that are not worth anywhere near the value at which they are shown in the balance sheet of banks.

A court judgment to tell all & a response

that tells all: Yet, to understand the extent to which the financial sector is now beholden to governments and central banks, we focus on a development – a court judgements and reactions - in August 2009, as it is sufficient to understand the extent of life support on which the banking system exists now.

The process of bailing out the financial sector has been accompanied by a complete absence of transparency. In the US, there have been efforts to force the Federal Reserve to disclose information of its lending, guarantee and support programs aggregating to trillion of dollars. The Freedom of Information Act has been invoked to get the courts to direct a disclosure, as the Fed has stonewalled consistently.

After being denied for a year, Bloomberg has succeeded in getting a judgement on August 24, 2009 that requires the Federal Reserve to disclose the information of its lending programs by September 30.

(The Fed has managed an extension of 30 days as the original date was August 31, 2009). There are also other requests pending under the Freedom of Information Act.

Two moves with staggering arguments have taken place after the judgement to try and avoid disclosure as required.

Act I: The U.S. Federal Reserve has appealed to try and avoid enforcement of the judgement. Why?

The Federal Reserve has stated that disclosure would cause irreparable harm to the institutions and threaten the economy. The Fed has also indicated that transparency will cause irreparable harm to its ability to effectively manage the current financial crisis. A reference to future financial crisis has also made for good measure probably as a scare tactic and/or to suggest that similar approach would be preferred in the future, too. Public interest favours a delay as significant harm could befall not only private companies, but the economy as a whole.

This stance of the Federal Reserve tells a tale of what is the real state of affairs with the banking sector in the U.S.

Act II: An even more interesting development was the petition filed as a declaration of support to the Federal Reserve's plea for a stay on the court's order. This petition was filed on behalf of The Clearing House Association, a club of ten major banks.

The key points made in the petition tell the tale in an even more telling manner than the points put forth by the Federal Reserve:

- The court's order threatens to impair the ability of our members to access emergency funds without suffering the severe competitive harm that public disclosure of their identity will cause.
- Members have accessed the New York Fed's Discount Window with the understanding that the Fed will not publicly disclose information about their borrowing, especially their identity.
- Industry experience, including very recent and searing experience, has shown that negative rumours about a bank's financial condition - even completely unfounded rumours - have caused competitive harm, including bank runs and failures.

- In sum, our experience differs from the factual conclusions the court appears to have reached about the nature of competition in the banking industry:

- The competitive harm to institutions that are publicised as needing emergency funding is not 'speculative', but demonstrated by the recent multiple failures of financial institutions whenever information about their funding difficulty has been disclosed.

- The disclosure does not involve mere 'embarrassing publicity', but information that could result in the immediate demise of an institution.

- The disclosure would not merely "stigmatise" the institution or make it "look weak," but goes to its very viability.

- The disclosure of accessing emergency funding is not an "inherent risk" of market participation, but an extraordinary risk in extraordinary circumstances.

- Competitors can use the disclosure to advertise or publicise that they are financially stronger because they don't need emergency funding.

To end its case, The Clearing House Association signs off by stating 'Our concern is not with information that "anyone throughout the entire marketplace might consider to be negative." We respectfully submit that this is information virtually everyone would consider potentially disastrous'.

This is the stance of the big banks. Take a note of the scary language of the Fed as well as The Clearing House, as if they were acting in unison. It is almost an exercise bordering on presenting a no-disclosure or doomsday scenario.

Beyond the Fed's balance sheet: Everybody is aware of the deterioration in the quality of the Fed Balance Sheet. From a stage where treasury securities accounted for about 75%-80% of the Fed's balance sheet, the number has now declined to less than 30%, it has picked up all kinds of paper from the financial sector as part of its bail-out exercise.

What the Fed and The Clearing House Association are fighting for is the too-big-to-fail banks.

We need support, only secret support:

What these scary tales tell us is that the situation is far from normal; support of the Federal Reserve is critical for not just now, but for a long period ahead and that such support must be wrapped in secrecy (it has already been in that state for two years) forever. Citizens who are footing the bill must sacrifice everything for the sake of the too-big-to-fail banks.

Notably, this is the substance of their argument even before the collapse in commercial real estate and increase in defaults in corporate bonds, credit cards and student loans are reflected on bank balance sheets.

Peek into real state of affairs: It is important for investors to keep such developments in mind, as it gives you an idea of the real state of the financial sector in the US (and pretty much most of the developed world). What we have now is a liquidity-driven rally that could have steam but is vulnerable to any pin-prick, including prolonged period of low growth.

The submission of the Fed and The Clearing House Association only confirm that institution-specific risks are buried for now thanks only to the massive support of the governments and central banks. There is no genuine cleaning up.

Effects of fragility can be debilitating: Even if transparency is avoided, a fragile financial sector could act as a drag on the real economy setting back any sustainable recovery of a meaningful kind. Even as investors take advantage of the flows coming the way of emerging markets, they must take note that the financial sector and economic cycle are a long way away from taking a decisive, meaningful and sustainable turn for the better in the developed world.

This may not be the case with emerging markets over the next five-to-ten years. A more robust recovery process is likely in this space. We would examine the issue and what it means for markets and investment in our Market Outlook for Q 4 2009, which will be published in the first week of October.

The views expressed are that of the writer only and do not represent the view of Sundaram BNP Paribas Mutual Fund or Sundaram BNP Paribas Asset Management.