British banks

Spurious shoots

British banks are making big profits, so why are their shares so cheap?

FROM the daffodils exploding in gushes of yellow to the budding pink on its trees, London is drenched with the signs of rebirth. A joyful mood of spring has also infused the boardrooms of the country's biggest banks, most of which have just reported blooming profits.

Despite writing down billions of pounds-worth of exotic credit instruments linked to bad mortgages, most British banks revealed earnings that were higher than or close to those they posted for 2006. This is in sharp contrast to America, for example, where one in four banks lost money in the fourth quarter and full-year results were the worst since 2002. Big British banks have also fared better than many of their rivals in other parts of Europe. UBS, for instance, posted a loss of $11.4 billion (£5.6 billion) for the fourth quarter.

Even when taking losses on assets that proved to be worth less than they had been thought to be, Britain's banks seem to have felt less pain than others. Barclays, for example, wrote down just £1.6 billion ($3.2 billion) of mainly derivatives and leveraged loans in 2007, compared with a hit of $18.4 billion at UBS and $4 billion at Credit Suisse, a fellow Swiss bank.

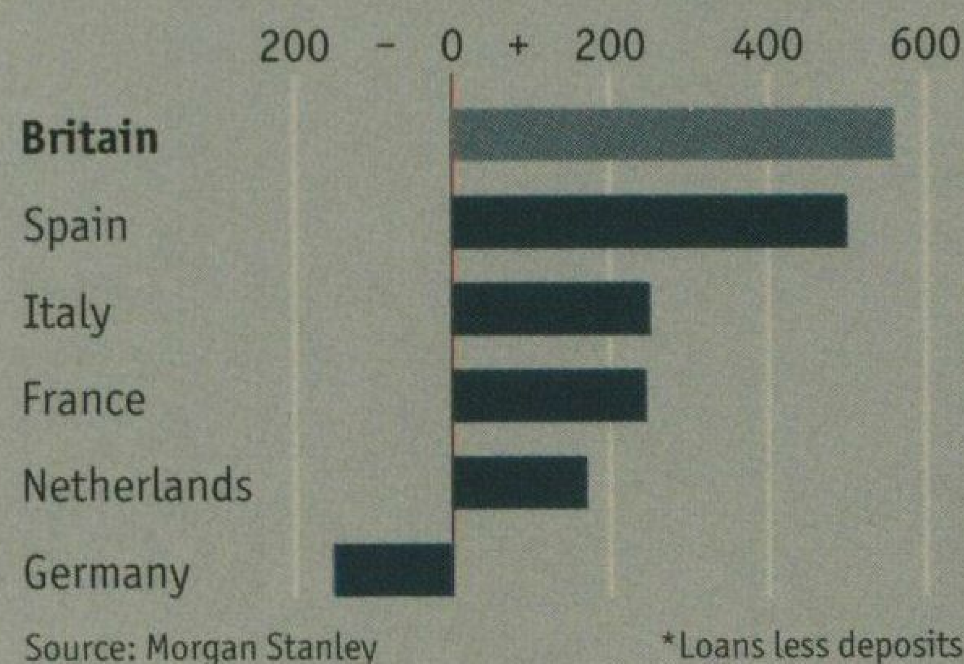
This seems odd. The world's credit markets are in crisis, and have been since August. British banks such as Barclays and Royal Bank of Scotland (RBS) have big capital-markets businesses and are at least waist-deep in the sorts of securities that have caused huge losses elsewhere. Can they have emerged from the credit crunch so lightly?

Critics are sceptical. By March 3rd, when the last of Britain's big banks reported, investors had concluded that results across the sector were disturbingly like lingerie: what they concealed was more interesting than what they revealed.

"Investors feel there's been a lot of huff, puff and bluff to calm the funding markets and gain breathing space," says Huw van Steenis of Morgan Stanley, an investment bank. "Most just don't believe it." Analysts at Citigroup, an American bank, complain about RBS's "complete lack of useful disclosure" as to how it had stretched its balance-sheet with the purchase last year of ABN Amro, a Dutch bank.

There are three main reasons why British banks look vulnerable. The first is funding. Last year Northern Rock, which relied heavily on wholesale markets for money rather than on depositors, ran into trouble when credit dried up around the world; it proved unable to raise money from the banks that used to lend to it and from securitising its loans (bundling them up and floating bonds on the back of them). Investors are beginning to wonder just how widespread this problem is. Britain's banks as a whole lend far more than they collect in deposits. Their funding gap had widened from almost nothing in 2000 to some £550 billion by the end of 2006, more than that of banks in other big European countries (see chart). The gap is likely to be wider now—and the market for securitisations is effectively closed.

Capital is another worry. Banks on balance have seen their "core capital"—a cushion composed mainly of shareholders' money that regulators insist they hold against bad times—deflate. Carla Antunes da Silva of JP Morgan, an investment bank, reckons that by the end of 2009 Britain's biggest banks will have to find about £35 billion to meet the Basle II capital-adequacy rules.



Yet British banks are cavalier with their cash. Rivals around the world are hoarding capital to rebuild balance-sheets hammered by credit losses and to get ready for harder times ahead. In America, for example, at least 18 large banks have cut their dividends or raised new share capital. Yet British banks, it seems, cannot hand out money fast enough: Barclays, RBS, Lloyds TSB and HBOS have raised their dividends.

All this is particularly worrying at a time when the British economy is finally slowing, its housing market subsiding and over-indebted consumers beginning to stagger under the weight of their mortgages and overdrafts. Banks' shares, unsurprisingly, have taken a pounding: Barclays, for example, is trading on just over six times historic earnings, down from about 11 times earnings a year ago. The index of FTSE banking shares has dropped by 30% since January 2007, compared with a 7% drop for the market as a whole. What matters more than investors' pain is that credit is tight and will remain so until the worst is known. It is time for plainer speaking. ■

The coming budget

Debt reckoning

The chancellor faces a tricky decision about a crucial fiscal rule

AS ALISTAIR DARLING has been preparing his first budget, due on March 12th, troubles have crowded in on him. Despite the chancellor's unstinting efforts to escape the inevitable, he eventually had to nationalise Northern Rock. Businesses remain vexed about botched tax proposals. Above all, the public finances are running a big deficit, which will swell as the economy slows over the next year or so.

Budget-watchers will pay especially close attention to what Mr Darling has to say about debt. Until now the government has stipulated that public debt (net of liquid assets such as foreign-exchange reserves) should be held below 40% of GDP. The most recent figures show that it has been meeting the rule. However, the bail-out of Northern Rock will smash through the ceiling by adding liabilities of around £90 billion—6% of GDP—to existing debt of £512 billion—36% of GDP.

Mr Darling can quite reasonably argue that the mortgage lender's debt should be disregarded for the purposes of the fiscal rule. The easiest way to do this would be to publish the debt figures with and without Northern Rock, as the Institute for Fiscal Studies (IFS), a think-tank, has suggested. But this would in effect provide a running update on the bank's balance-sheet, something the government may prefer to avoid.

As he labours with this thorny issue, Mr Darling has been grappling with another. Over the past decade, the Treasury has increasingly turned to the private sector not just to build and operate but also to finance new public investment through the "private-finance initiative". Under a PFI deal, a private consortium raises money to fund the capital expense of, say, a new hospital. The government then pays a regular charge, typically for 25-30 years, that bundles together debt repayment with interest and operating expenses. The Treasury insists the policy is all about getting better value for money. It also pushes debt off the public books, however.

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A new hospital with a long bill attached

At the end of last year, 620 PFI deals involving a total capital commitment of £57 billion had been agreed. In some of the deals, the investment has been made; in others, especially three contracts to renovate the London Underground, years of capital spending lie ahead. Under current government accounting rules, only 13% of the deals and 42% of the total value—most of it arising from the Underground deals—were recorded as public liabilities.

This unsatisfactory position, which has allowed some deals to be off both public and private balance-sheets, was due to change soon. In his last budget a year ago Gordon Brown said that the public sector would adopt international accounting rules from April 2008. This would be likely to bring most of the PFI deals on to the government's balance-sheet, says Ken Wild, a member of the Financial Reporting Advisory Board, which offers independent guidance to the government.

It now looks as if Mr Darling will delay adopting the new rules for a year, but that merely postpones the agony. Quite how sharp the pain will be hinges on the response of the Office for National Statistics (ONS), which applies different concepts and procedures to measure the figure for public debt used for the fiscal rule.

The ONS took a first step towards including PFI liabilities in public debt in September 2006, when it came up with a surprisingly low figure of £5 billion for them. But the deals that gave rise to this estimate—those already recorded on the public books—were skewed by the big Tube contracts, much of the spending on which has still to be done. Excluding these, deals worth £7 billion resulted in some £3 billion of PFI debt being included in the fiscal numbers. If this pattern is repeated when the remaining deals, worth over £30 billion, are properly accounted for, around £15 billion—1% of GDP—might be added to the statisticians' figure for debt.

That may seem a relatively small amount but, as the public finances deteriorate, it could be enough to push debt through the 40% ceiling even if Northern Rock is excluded. The accounting changes will also remove the present incentive for public-sector bodies to go down the PFI route, says David Heald of Aberdeen University. That will further exacerbate the strains on the public finances.

The simplest way out would be to raise the ceiling, even though that would dent the government's already battered fiscal credibility. Whatever he does, Mr Darling is likely to face "presentational difficulties", says Carl Emmerson of the IFS. ■

London politics

Mud wrestling

The mayoral race gets dirty

CITY governments the world over are notoriously corrupt. Alas, London's is developing a shifty reputation of its own. On March 4th Lee Jasper, a close ally of Ken Livingstone, London's mayor, resigned after the publication in the *Evening Standard* of snippets of intimate e-mails he had sent to Karen Chouhan ("gorgeous, wonderful, sexy Kazzi"). Mrs Chouhan is the company secretary of the 1990 Trust, a black lobbying group, and the director of the Black Londoners Forum, both of which have received money from the London Development Agency, a grant-giving body on which Mr Jasper sat.

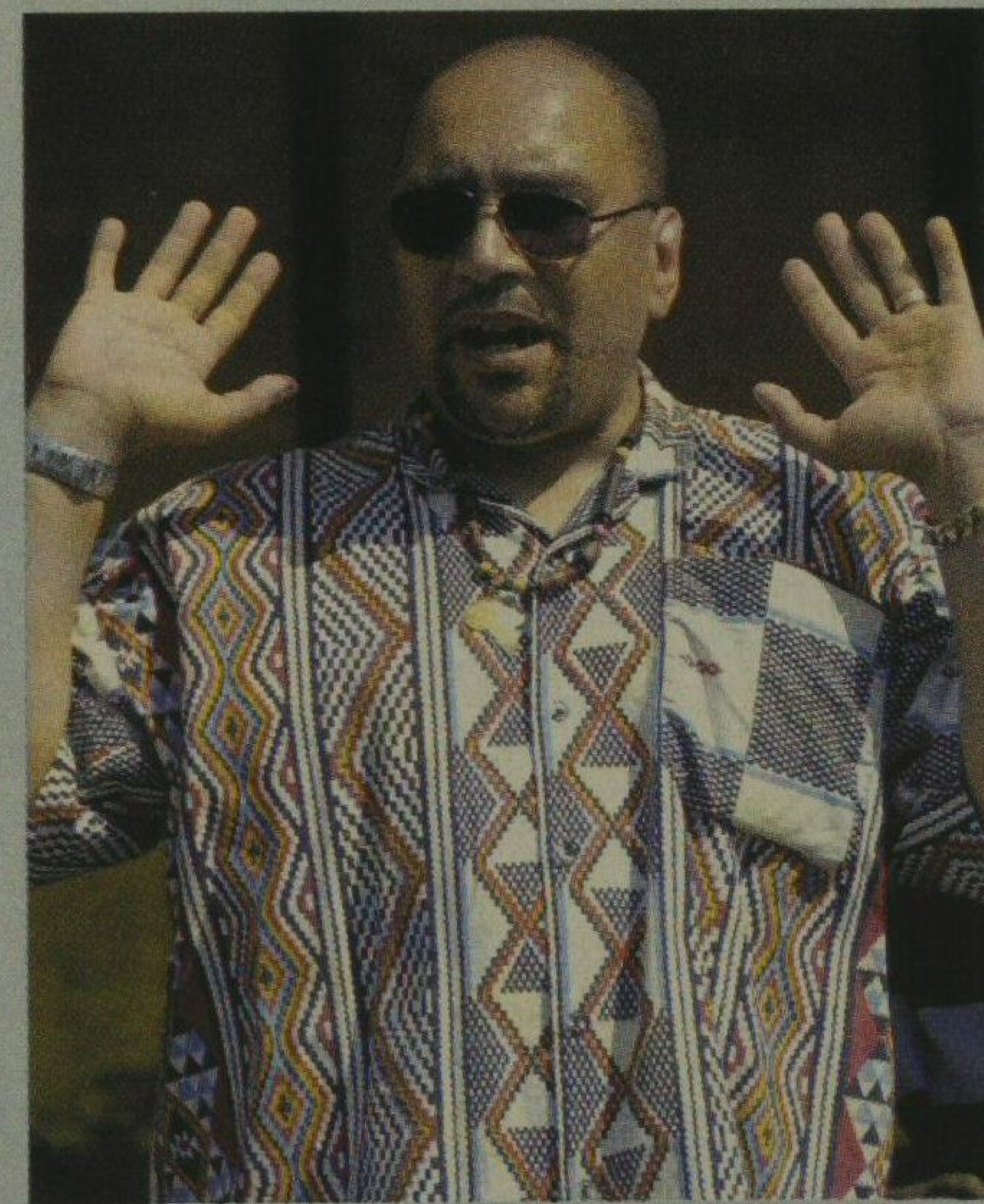
Mr Jasper had been under pressure from the *Standard* and others for months. He had already been suspended from his job on February 15th, after separate allegations that other groups with which he has connections had received large amounts of city money, with little to show for it.

Though an internal review found no evidence of "corruption and collusion", the mayor asked the police to investigate further—perhaps in the hope that a lengthy investigation would ease the pressure. It didn't. Mr Jasper's deputy had been forced to quit in January after she accepted a free trip to Nigeria, then lied about it. By resigning when he did, Mr Jasper avoided being questioned by the London Assembly on March 5th.

In the circumstances, the mayor has been strikingly loyal. He lambasted the prying members of the assembly as "sanctimonious hypocrites", and, on the night Mr Jasper resigned, declared that he would "bet my own life that they will clear Lee Jasper, and I will reappoint him when they do". Both men have alleged that the criticism of Mr Jasper is motivated by racism. There is, Mr Livingstone told the *Guardian*, "a racist stereotype that no black person can be trusted with public money". Mr Jasper's resignation letter complains of the "racist nature of a relentless media campaign".

A more credible line of defence is that the row over Mr Jasper is part of an effort to discredit Mr Livingstone before London's mayoral election on May 1st. It was already a colourful race. Mr Livingstone, elected in the first such election, in 2000, is a former ultra-left-winger who now keeps company with an eclectic set of businessmen, radical Muslims and Hugo Chávez of Venezuela. His Tory rival, the improbably coiffed Boris Johnson, once cultivated an image as an endearingly gaffe-prone bicycling buffoon, which he is now trying to leaven with transport policy. The Liberal Democrat candidate, Brian Paddick, is a gay ex-policeman with a libertarian line on drugs. It is becoming a nasty race too.

The mayoral vote is a big test for the three main parties' newish national leaders. It once looked as if Mr Livingstone would cruise to re-election. But a poll by YouGov in February put him on 39%, behind Mr Johnson on 44%. Mr Livingstone may have calculated that clinging to Mr Jasper would be less damaging to his electoral prospects than axing him. If so, he seems to have been wrong.



Jasper goes while the going's good

"Debt reckoning." Economist, 8 Mar. 2008, p. 40+. The Economist Historical Archive, 1843-2015, https://link.gale.com/apps/doc/GP4100373682/ECON?u=glasuni&sid=ECON&xid=44f39889. Accessed 27 May 2020.