

Deutsche Bank's "Trillion Dollar Mean Reversion"

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Summary

Many thanks to Jim Reid of Deutsche Bank for updating and reissuing his graphical illustration of bank profits over the last 40 years. As well as putting the bank bust/boom of 2008-9 into context, it also helps to explain the political challenges bank reform poses within democratic societies.

Analysis

Deutsche's graph of profits relative to GDP in the US is startling. A complete disconnect of financial firms' profits emerged towards the end of the 1990s, peaking in 2006. Whereas both financials and non-financials profits tracked GDP until the mid-1990s, financials profits began to accelerate relative to GDP from that point. To quote from Reid:

"...when we looked at this chart in 2007/2008, the world made little sense to us. Over a decade Financial profits had decoupled from history, the rest of the economy and reality".

The crash of 2008 returned the \$1.2 trillion of excess profit apparently earned over the previous 10 years or so by the financial sector. It did this very rapidly, probably over no more than 3 or 4 quarters. Actually, it appeared to overshoot, but that is the way of markets: reversion around a mean but with periods that do not neatly follow the trend.

Deutsche's view, shared by many of us, was that post-crash, banks would look much more utility-like and, by implication, profits would return to trend, ie in aggregate equal to nominal GDP. In 2009, however, financials profits reverted back to a level significantly above nominal GDP. Profitability is more like the level of 2004, already way out of line with long terms trends

The purpose of this analysis is not to explain why this happened, but rather to consider all the political implications. The most basic implication is that government support for "Main Street" (very loose monetary policy including quantitative easing, high government borrowing and deficits) automatically feeds through into financials profits. This can be on many levels, ranging from higher margin on lending, through to super profits on securities trading financed using cheap and plentiful central bank credit. Whilst this is a positive in terms of rebuilding banks' capital base, the political cost is simply too high to appeal to most political parties. Today's mob anger is directed towards excessive bonuses, paid out on the trading profits derived from access to cheap and effectively limitless central bank funding. As such it is an easy one to support. Very little skill has been required, hence it is hard to see what skill is being rewarded.

Other criticisms are harder to support, and governments as a consequence face the challenge of allowing banks to rebuild profitability whilst deflecting voter anger. In the UK there has been plenty of comment on banks' increasing their interest rates on loans, and/or reducing interest paid on deposits. We cannot have it all ways: if risk, and hence credit, were underpriced in the years leading up to the crash, then margins ought to widen in order to price risk correctly. That is a difficult political "sell", though, when historically high numbers of homeowners are struggling to maintain mortgage repayments and banks are increasing interest rates. There is thus a fine dividing line, probably handled by government support programs to mitigate the risk of foreclosure in this particular example. This, though, essentially subsidises financials profits at the expense of somebody else (by depressing consumer spending because taxes remain higher for longer to support such programs perhaps).

The long term political issue, though, is how do governments encourage (or force) the financial sector to return to historical profit trends? By implication, this requires them to be more utility-like. President Obama has provided us with one approach: take a random set of non-utility activities, and ban registered banks with access to Fed funding from undertaking them. Unfortunately the list of activities appears to be based on bashing Goldman Sachs hardest (because they are paying the biggest bonuses presumably), without offering any real assurance that the system as a whole will return to trend.

Can anyone come up with anything better? Well I like a challenge, and at the very least this might start a debate. So how about the following:

- Identify and define "utility" services/products. I would suggest these are simply the ones that impact large numbers of individuals (aka "voters"). Examples would be retail deposits, and large market share of transaction processing. Not being able to use ATMs or credit cards is systemically important to the mass of voters.
- Having identified banks that have significant exposure to the above markets, regulate them like other utilities, a key regulatory metric of which is a limit on return on equity ("ROE"). Deutsche's excess of financial profits relative to GDP coincides with a step increase in banks' ROE, so let's regulate this away.
- ROE is easily established if target aggregate financials profits is set equal to forecast nominal GDP
- The above then allows maximum gearing to be derived on a risk weighted assets basis
- Add in some anti-avoidance measures, eg utilities banks cannot invest in, or provide credit to, any entity whose gearing exceeds that allowed for a utility bank. Note, though, that there is nothing to stop them operating such funds within their regulatory gearing ratios
- Set a cap on personnel costs relative to revenue (a bit like salary capping in professional sport). This prevents excess ROE being paid away to those that caused it.

Does the above work both politically and commercially? Politically it can be sold along the lines of controlling profits, limiting the activities of systemically vital institutions (ie those where insolvency could lead to direct loss of large numbers of votes), and we have some nice bonus bashing provisions. Commercially the above rules do not prevent any organisation from conducting hedge fund, private equity, or proprietary trading. Whether or not the returns from those activities would be deemed attractive whilst still maintaining the low overall ROE is debateable, though ROE on trading will naturally fall as proposed increased capital requirements are introduced on trading activity. The fact is, though, that no activities are specifically precluded, thus maximising commercial freedom.

Deutsche's analysis is compelling. Financials profits have been too high for an extended period. The 2008 crash returned these profits. The current challenge is to prevent a similar aberration in future, whilst in the short term allowing latitude in support of "Main Street". At its simplest, if there is a need to accept the kind of "unjustifiable" financials profits we have seen in 2009, then governments need a simple framework for the longer term to present to their essentially non-financial voter majorities. The framework itself needs to allow maximum commercial freedom but within a strict profitability restraint. Cherry picking undesirable activities is not the way to go. If one thing has come out of this crisis, it is how creative the financial industry can be in product development. Banning something simply encourages imagination in morphing the banned product into something new.