Banks Are Now Too Scared to Even Make Money

Banks have become too regulated and too scared of the risks to do what they should be doing, greasing the flows of money between countries

Traders work on the floor of the New York Stock Exchange on Friday. ENLARGE

Traders work on the floor of the New York Stock Exchange on Friday. PHOTO: BLOOMBERG NEWS

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In early 2009 my bank gave me money for free. The post-Lehman fall in interest rates meant I could earn more from a deposit at the troubled bank then I had to pay them on my mortgage.

Such risk-free profits don't come around very often, and are usually a sign that the financial system isn't working properly. If $10 bills are left lying around in markets, they get picked up pretty quickly.

Not right now. Down in the depths of the financial markets strange things are happening, because banks either can't or won't pick up the free money.

One sign of this is on the foreign exchanges. The flight from negative rates in Europe and Japan has led to a surge in demand for currency hedges into higher-yielding dollars, and driven up the price of those hedges.

In days of yore—that is, before Lehman failed—a Japanese investor wanting to buy Treasurys would do a deal with a U.S. bank sitting on a big pile of dollar deposits. For a fee, they would switch currencies, agreeing to switch back in a year or more at an agreed rate. They would also lock in their interest rates during the period of the contract with Libor in their own currency, so they knew what the cost would be.

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For banks, this used to be treated as free money to be picked up immediately. But now the money is just sitting there.

That is why others are stepping in. Hedge funds, mutual funds and corporate treasurers with spare dollars are increasingly sending them to Japan as they take advantage of the opportunity. These investors buy negative yielding Japanese T-bills in exchange, but they don’t care about that: they are able to offset these losses, and more, by charging evermore for their dollars.

This is known as a cross-currency basis swap, where the basis is the extra interest on top of Libor the bank is able to charge for the currency most in demand—at the moment, the dollar. This is easy money: those lending dollars can lock in an extra 0.8% or so a year to swap them into yen.

Over time, the market will exploit these arbitrages until they disappear. But the odd thing is this: They are not disappearing now.

Why? A new study by the Basel, Switzerland-based Bank for International Settlements shows the close link between aggressive central bank easing and the flight of money across borders. In Japan, investors responded by looking for profit opportunities abroad, while in the eurozone American companies issued a flood of so-called “reverse Yankee” bonds in euros as yields fell far below those in the U.S.

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In both cases, those shifting money across borders want to avoid foreign exchange risk, so they hedge using basis swaps. These involve swapping yen or euros in exchange for dollars, which will be swapped back at the end of the contract at the forward rate, typically a year or more later. Meanwhile they pay each other interest at the Libor rate for their currency, plus (or minus) the basis, which moves with demand.

Without banks willing to take the other side of the trade, the basis has blown out to levels usually only seen when the financial system is in meltdown, as in 2008-9 after Lehman or in 2011-2 as the euro seemed to be failing.

Most investors care as much about basis swaps as they do about cash-settled butter futures, but the shifts in the basis have already had highly visible effects. U.S. companies now have little reason to issue bonds in euros, because the basis cost has risen so much it almost entirely offsets the benefit of issuing at a lower yield in Europe. Japanese investors have no reason to buy U.S. Treasurys, as the extra yield they earn would all be eaten up by the basis when they hedge.

In short, the world's banks aren't doing what they should be doing to grease the flows of money between countries. They're too regulated and too scared of the risks, slight as those are.

We should welcome the fact that banks now try to price such risks, rather than the precrisis practice of simply ignoring them, but perhaps they are going too far the other way.

"If banks put such a high price on balance sheet capacity when the financial environment is largely tranquil, what will happen when volatility picks up?," asked Hyun Song Shin, head of research at the BIS, on Friday.

Investors need to get used to the idea that banks might actually charge for the risks they are running, hard as that is to believe. But there are consequences for the rest of the financial system. And one day, we will learn what they are.

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