Desperate to be different

Goldman Sachs produced decent earnings in the first quarter, but its fate rests partly on others.

Alamy

Much of the rise in stockmarkets over the past few weeks has reflected optimism about banks' profits. The faster banks' underlying earnings recover, the quicker they can rebuild their capital and get lending again. In mid-March Citigroup and other big American and European lenders made positive noises about their performance. Now Goldman Sachs has begun the reporting season with a set of figures so strong that for a moment it felt like the bear market was just a bad dream. Net income was $1.7 billion in the first quarter, similar to the run rate back in 2005-06. And, signalling a return to normality, Goldman put aside almost $5 billion in salaries and bonuses for employees, while raising new equity to help to pay back the $10 billion of capital that it took, after a bit of strong-arming, from the government.

Under closer examination, the performance looks less rosy. Almost all divisions were weak with the exception of Goldman's fixed income, currency and commodity unit which had a record quarter. Like most surviving investment banks Goldman is enjoying a surge in activity as pent up demand from companies keen to issue bonds, wider spreads and very low short-term interest rates, create a "sweet spot" for big players in debt markets. It may help, too, that some competitors have disappeared. This is probably not sustainable, as Goldman itself hinted. Moreover, as measured by value-at-risk, a yardstick of how big your gambles are, Goldman took twice as much interest-rate risk as a year ago. Bigger profits in part reflect bigger bets, a fact that taxpayers, who have extended an implicit guarantee to big banks such as Goldman, should not be too comfortable about.

It is precisely to escape this conflict that Goldman has raised fresh equity to help repay the $10 billion of bail-out capital. Taxpayer cash brings unwelcome interference, particularly on pay. And with a Tier 1 ratio of 16%, Goldman's capital position is far stronger than most other big banks. Yet the reason why Goldman may struggle to get permission to repay the state immediately is because in a highly contagious banking crisis it is not enough to prosper on your own: things only get back to normal once your peers are on an even keel too. It is politically awkward, too. On Tuesday Reuters reported that a Treasury spokesman saw Goldman's wish to repay government funds as a "sign of strength", but also as a threat, as it risks stigmatising weaker banks that remain dependent on the funds.

That means the upcoming stress-tests for all big banks, due to be published at the end of April, are crucial. Any banks that fail will have several months to find private capital, or face new injections of government money. Until the capital of the system as a whole is at an acceptable level, regulators may err on the side of caution with Goldman and insist that it keeps the government money. Whether the rest of the banking sector passes the stress test

will depend in part on how far their bad debts are forecast to rise, but also on the strength of their core profits. To be free of the government, Goldman may need its peer group to report strong results, not just itself.

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