# Weekly Report

## Macroeconomic Analysis

### Regulation, Regulation, Regulation

By Zacchaeus Ssempa

Six years after the collapse of Lehman Brothers and the subsequent global meltdown, the financial turmoil that ensued is still very much poignant in the memories of those most harshly affected – not least disgruntled taxpayers who effectively bailed out financial institutions such as Northern Rock in the UK. Meanwhile, it has become incumbent on regulators around the world to respond with more stringent measures to prevent a repeat of the worst financial crisis since the Great Depression. Consequently, financial markets have been bombarded with a barrage of global regulatory changes such as the enhanced capital, funding and liquidity requirements under Basel III. Whilst at the country level, banks are subject to scrutiny from their National Competent Authorities. The latest addition to the regulatory arsenal concerns the way in which banks will be dealt with should they fail.

Under new rules proposed by the Financial Stability Board (FSB), twenty-seven Global Systemically Important Banks (G-SIBs) will be required to hold minimum Total Loss Absorbing Capacity (TLAC) equivalent to 16-20% of their risk weighted assets (RWA). This mirrors a similar structure being developed for European banks under the single supervisory mechanism. In this new "bail-in" structure the "extra" capacity will then be available to be written down in the event of a bank's failure, sparing taxpayer's funds, and ostensibly, doing away with the idea of the "Too Big To Fail" financial institution. This figure could swell if additional global requirements are considered. Compliance can be achieved either by holding more equity and rather significantly, by issuing debt that can be written down in stressed scenarios, such as contingent convertible (coco) bonds (which counts as debt in good times but converts to equity when capital ratios reach below a certain level). Partly in response, the coco bond market has burgeoned of late, growing to $150bn from almost nothing in 2010. In the past creditors were safe in the knowledge that they were all but guaranteed a repayment of their investment and were further guarded by the costly and lengthy litigation process required to force them to take haircuts on their investments.

Banks are likely to face stark challenges in restructuring and reducing costs with analysts at Citi predicting European banks to fare worst, potentially losing 3% of profits in 2016. The ability to jump these hurdles is largely dependent on banks' internal structures. British and Swiss financial institutions look set to benefit from their holding company structures from which they can issue senior debt. Overall, banks will undoubtedly face higher funding costs as investors demand a healthy return to account for potential loss of their funds. Although, this is hardly a bad thing given pre-crisis bloated profits were made based on the assumption of governments providing a back stop.

Meanwhile, Christian Clausen, President of the European Banking Federation and Chairman at the Nordic region's largest lender Nordea, has recently criticised the regulators for "diverting scarce risk capital" from the Small and Medium-sized enterprises (SME) and young entrepreneurs into the hands of banks. With many SME's unable to afford the high interest rates that banks are being forced to offer, Clausen believes European economies in

particular are missing out on a key source of growth. Given the current European environment of subdued output growth and the threat of deflationary pressures, with inflation at a meagre 0.4%, this is a deeply worrying prospect.

The effectiveness of these increased regulatory measures are a worthy concern given their costly nature. Despite the positive rhetoric from regulators, the issue of taxpayer bail outs has not been mitigated just yet. One "failed" institution may very well lead to contagion spurring a flurry of litigation from dissenting creditors. While the FSB, chaired by Bank of England Chairman Mark Carney, will curtail banks' ability to count debt sold on the wholesale market towards TLAC in an effort to counter this, it remains to be seen whether this structure will be able to withstand failure en masse. Ultimately, large scale bankruptcy poses the threat of initiating a liquidity crisis in the coco bond market. According to the Peterson Institute for International Economics (IIE) short term, leveraged institutions will buy-up these bail-in securities in the boom years, driving down their yield and subsequently increase their balance sheets creating an artificial impression of safety. Conversely, any hint of things turning sour will likely rush investors to rid themselves of these securities in good time, having the opposite effect of driving yields through the roof and risking potential rating downgrades. Meanwhile, given the interconnected nature of financial markets, should these instruments also act as the collateral on which other transactions are based – adding this to the likelihood that these securities would probably be held by pension funds and insurance companies – we could see a build-up of the characteristics of another systemic disaster.

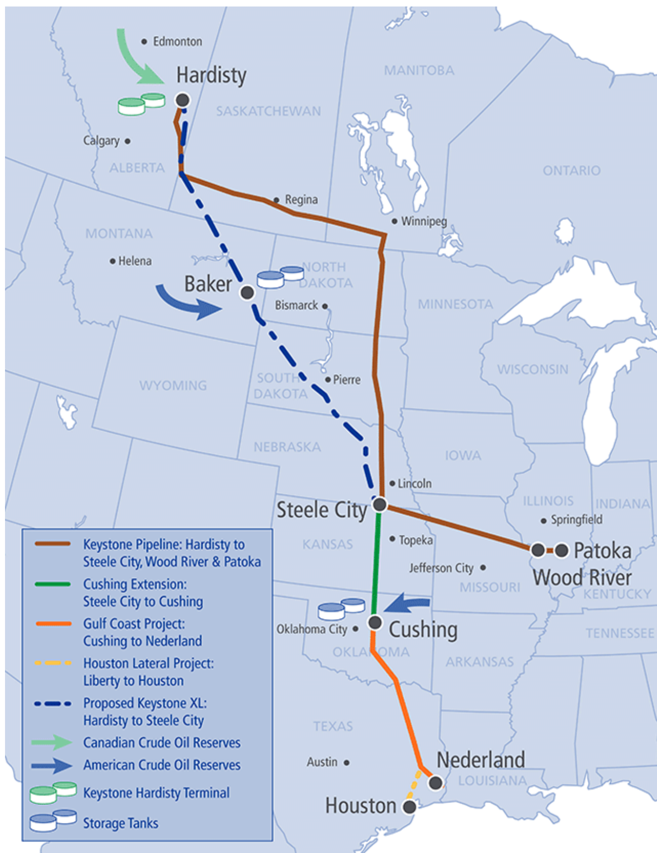
In conclusion, whilst the gravitation towards more unified regulatory measures may increase the ease and transparency with which ailing financial institutions can be dealt with, it is still rather premature to predict a positive outcome. Akin to the case with Dodd Frank, with rule makers still finalising additions to the rule books, we have a long way to go before we can gauge the strength of these defense mechanisms. The author would argue that whilst regulatory reform is welcomed, assurance that new measures attack the right deficiencies in the old framework is all the more essential.

## Politics or Economics of Keystone XL

By Jan Chalupny

The Keystone XL is part of a larger Keystone Pipeline System, which distributes crude oil across North America, from Alberta through Nebraska to oil refineries in Illinois and to storage and distribution facilities in Texas. Pipeline construction started in 2008 connecting Hardisty, Alberta to oil refineries in Wood River and Patoka, Illinois composing a total length of 3,456km. Second phase followed in 2010 between Steele City, Nebraska and Cushing, Oklahoma joining the pipeline with US crude oil reserves facilities located 480km south of the original "phase one pipeline". The newest, 784km long, part of Keystone was finished in January 2014 connecting Cushing, Oklahoma to refineries in Nederland and Port Arthur, Texas, with an extension pipeline to Houston being currently under construction.

For a long time, the pipeline has been a symbolic issue for Republicans, who point mainly to job creation, decreasing dependence on foreign oil and safe means of transportation of Canadian and US oil. In 2013, US Oil consumption was almost 19m barrels per day (bpd), with total oil production of 12m bpd, resulting in net import of additional 7bpd. It reveals US reliance on imports from the Middle East, Venezuela and Canada.




Proponents of Keystone XL argue that construction of the pipeline would create up to 42,000 direct and indirect jobs nationwide during the construction process. In full operational mode it would transport an additional 0.8m bpd to the US fuelling regional economic growth in states along the pipeline, notably in oil producing and processing states such as Louisiana and Texas. Currently Gulf Coast refineries import about 1.5m bpd from Venezuela and Mexico; however, the competing Canadian oil would lower the price thereby decreasing refineries production costs. This will in the medium run drive down US gas prices, boosting the American economy. On the other hand, critics argue that an increase in Canadian oil sands development would raise greenhouse gas emissions by millions of tons, which would otherwise stay in the ground.

Even President Obama raised his concerns saying that Keystone XL would create only 50 permanent jobs and would only have limited effect on US gas prices; instead, it will allow Canada to "pump their oil, send it through our land, down to the Gulf, where it will be sold everywhere else."

Even though Keystone XL is a high profile issue at the moment, its significance has lowered since it has been brought up six years ago for the first time. It is affected by rising US Energy production and falling global oil prices, which are less than $80 a barrel for the first time in four years. Moreover, a demand-induced price increase is unlikely, as Chinese and Eurozone growth falls behind expectations.

On the other side, for Canadian oil developers Keystone XL remains a highly important project as oil transportation infrastructure is underdeveloped in western Canada, which forces producers to use railroads or barges for oil shipping, which are estimated to be about $7 to $8 more expensive per barrel. Furthermore, it would allow the development of Canada's oil sands and open up their production to the Northern American market.

On 18th of November, the US Senate failed by one vote (59-41) to approve the fast-track of Keystone XL straight to Obama's table. Since the first phase of pipeline construction in 2008, the Keystone project "became a proxy in a broader debate over jobs, U.S. energy security and climate change" and it seems it will carry on over next few months.

Despite the rejection, the bill is expected to appear on agenda again early next year, when US Congress will be controlled by Republicans, who take over after the recent mid-term elections. The fast-track approval failure only postpones fierce fight on the issue, as President Obama publicly criticized Keystone XL project mentioning environmental concerns and deepening dependence on fossil fuels.

## Events

### StockConnect: A one-day hype

By Rossella Rubini

On Wednesday the 17th, the Shanghai Stock Exchange and the Stock Exchange of Hong Hong joined to form StockConnect. The aim of this scheme is giving China a controlled mechanism to open up its equity markets, enabling mainlanders to access Hong Kong's H-shares through the Shanghai Exchange, and enabling foreigners to access China's A-shares through the Hong Kong Exchange. Traditionally, strict quotas were limiting trade and investment in these markets. StockConnect has increased these quotas by 50%, together with giving international investors access to 568 stocks on the Shanghai Stock Exchange. This was expected to attract a flood of new opportunities for both Chinese and foreign individual investors and companies. Analysts estimated that StockConnect had the potential of becoming the world's third-largest stock market, and Goldman Sachs computed even more positive prospects: they estimated that, if successful, the scheme would expand to include the Shenzhen Stock Exchange and would become the second-largest stock exchange after the NYSE, with an overall $7.5 trillion market capitalisation.

On the opening day, global investors swarmed to buy shares in Chinese companies, filling the daily $2.1billion quota by early afternoon. However, the hype only lasted for one day. Already on the next day only 37% of the quota was reached, and on Thursday just a mere 18%. What went wrong? Clearly, opening the gates to investors is not a sufficient condition to attract foreign capital, however necessary.

First of all, the scheme was only formally approved just a week before its launch, giving little time to investors to prepare. Secondly, Beijing unveiled at the very last minute that foreign investors would be exempted from a 10% capital gains tax when buying stocks in China, which had been a grey area since the beginning of the talks in April. Uncertainty, surprises and lack of clarity obviously undermine market confidence and investments. Moreover, highly appealing Chinese "new economy" stocks in technology, health care and environment protection tend to be listed on the Shenzhen Stock Exchange, which is not yet part of StockConnect.

Another detrimental factor is the lack of reforms in the Chinese financial system. Firstly, state-owned companies are much undervalued as they are sold at around 70% of their price to private investors. Secondly, the government still implicitly backs up wealth-management products and bonds, deducting investment that could flow to the stock market.

To conclude, the Beijing government holds most of the responsibility for the lack of foreign participation in the Chinese market and stock exchange; it should therefore undertake the bold reforms the market has so long been waiting for.

### Mexico: Further problems unravelling

By Alex Williams-Baffoe

Tens of thousands of protesters converged on Mexico City on Thursday to vent their frustration and displeasure over the disappearance of 43 university students (presumed by many to be dead) and widespread political corruption in what is the worst crisis of Enrique Peña Nieto's presidency.

Students, union workers and supporters from around the country gathered in the Mexican capital's main square, Zocalo, for a demonstration that, while initially peaceful, ended in violent exchanges between riot police and groups of protesters hurling rocks and Molotov Cocktails. The images of protestors hurling cocktails at the President's so-called ceremonial seat of power (The National Palace in Mexico City) without anyone opposing is symbolic of what many Mexicans believe to be the passivity of government in the face of crisis.

Just days before the clash in the Mexican capital, the attorney-general on November 7th laid out in grim detail how gangsters in league with police had apparently killed the young student teachers in the southwestern state of Guerrero, incinerated them on a rubbish tip and tossed their bones into a river. The bad news got worse as social unrest ensued in the Mexican capital with demonstrators setting the door of the National Palace ablaze on the 8th November; taking to a new level the pattern of arson that has accompanied mass protests since the students went missing.

The case has turned into the biggest challenge of Peña Nieto's nearly two-year-old presidency, on top of another scandal over a mansion his wife bought from a government contractor. The president's wife, Angélica Rivera is buying the $7 million home on credit from Ingeniería Immobiliaria del Centro, whose owner is the boss of Grupo Higa. Prior to this, a Grupo Higa construction firm was part of a China-led consortium that had won the railway contract without facing rival bidders. Due to the apparent monopsony at play, Mr Peña abruptly cancelled the contract on 6th November.

Although he denies wrongdoing and his spokesman has pointed out that Ms Rivera is paying off the loan on the house out of her own pocket, the revelation has added to the public's disenchantment with the regime. The cancellation of the high-speed rail contract also overshadowed his recent visit to China. Mr Peña, who has sought to attract foreign investment through an ambitious set of energy reforms and has assiduously courted Chinese President Xi Jinping, arrived to negative headlines. China Railway Construction Corp, which led the Mexico consortium, was "extremely shocked", according to China's state news agency Xinhua. "The Mexican side bears the whole responsibility for scrapping the deal. It has nothing to do with our company," it stated.

The president's domestic popularity was already historically low before the crisis. It is likely to suffer more not least because of recent developments, but also due to the continuing stagnant economic recovery and especially feeble levels of consumer confidence at 90.60 (1.2 points lower than the previous month's level). Analysts believe that Mr Peña needs to reform industries such as oil and gas in Mexico to encourage the influx of private investment. However, businessmen say that economic reform alone won't be enough if criminality scares investors away from bidding for big contracts and smaller firms continue to have to pay extortion money to gangs and corrupt public servants. It seems that Mr Peña has problems aplenty to deal with in Mexico as he battles to regain control over both society, and the economy alike. All while battling the apparent cultural deficiencies in Mexico.

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**Nikhil Kuplish**
**COO**
nk652@york.ac.uk

**Anna Murray**
**CEO**
avm508@york.ac.uk

**Ludger Pahler**
**CIO**
lp870@york.ac.uk

**Austė Vyšniauskaitė**
**CIO**
av638@york.ac.uk

**Lorna Simmonds**
Co-editor of the Weekly
ls958@york.ac.uk

**Thomas Falco**
Co-editor of the Weekly
tf613@york.ac.uk

**Sources used:**
*Wall Street Journal, Reuters, the Economist, Bloomberg, Financial Times, The Peterson Institute for International Economics, The Telegraph, CNN, Trading Economics, Energy Information Administration*

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