

Banks Making Big Bets to Boost Profits

By Steven Marlin and Riley McDermid
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Blockbuster profits at several large banks have been accompanied by increased portfolio risk as measured by average daily value at risk (VaR). Robust earnings at JP Morgan Chase and Goldman Sachs have been bolstered by making big bets in trading activities, earnings data show.

Goldman Sachs reported net investment banking revenue of \$1.44 billion, down 15 percent from a year earlier but up 75 percent from the first quarter. At the same time, its average daily VaR was \$245 million, up from \$240 million in the first quarter.

Regardless of the increased risk profiles that are accompanying these earning numbers, sellside professionals are more bullish on the prospects of the financial services industry than they were coming into this week.

“The concern today among industry participants is much more about missing any upside left in this financials rally by sitting on the sidelines than about what the increased VAR calculations might foretell as to how the results are being generated or what it might mean for future quarters,” Randy Cass, founder and vice chairman at First Coverage, told Markets Media Friday.

VaR is a widely used measure of the risk of loss on a specific portfolio of financial assets. For a given portfolio, confidence level and time horizon, VaR is defined as a threshold value such that the probability that the mark-to-market loss on the portfolio over the given time horizon exceeds this value (assuming normal markets and no trading in the portfolio) is the given confidence level.

Goldman Sachs uses a 95 percent confidence level and a one-day time horizon in its VaR calculation, meaning that during the second quarter there was a 5 percent chance that the potential losses on its trading positions would exceed \$245 million.

JP Morgan Chase reported second-quarter 2009 net income of \$2.7 billion, an increase of 36 percent from a year earlier. Its average daily VaR at a 99 percent confidence level for the year was \$301 million, meaning there was a 1 percent chance that its losses would exceed \$301 million over a one-day interval; that was up more than 90 percent from a year earlier. Its average daily VaR at a 95 percent confidence level was \$250 million. The company plans to report VaR only at the 95 percent confidence level in the future.

Credit Suisse was an exception: it posted robust gains while also lowering its risk. Its second-quarter profit rose 29 percent, buoyed by healthy investment banking profits.

Its average daily VaR, at a 99 percent confidence level, was 134 million Swiss francs year to date, down 29 percent from 2008.

“Blockbuster profits at Goldman and JP Morgan were helped in part by higher trading profits,” Jeff Matthews, general partner at Ram Partners, told Markets Media. “But the key reason those two players were able to generate those profits was thanks to a return to health in credit markets. It was not merely taking a flier on some risky trades.” Neither Goldman nor JP Morgan ramped up their leverage ratios significantly, he noted.

“The fact that the few banks left standing are starting to make money again in trading activity is actually healthy,” he said.