

“A bad bank is the only solution”

Neil Dwane, CIO Europe at RCM, the specialist global equity company within Allianz Global Investors, comments on the banks and their toxic assets:

“It is now nearly 2 years since the emergence of the first signs of toxic assets, leverage and bank funding and liquidity issues arose to undermine the financial sector and eventually the global economy. Solutions so far seem to remain elusive even as the economic cost on a global scale becomes more and more evident.

“Central banks around the world have reacted successfully to the liquidity needs of the banking industry through the re-disintermediation of the SIVs (structured investment vehicles) and other off-balance sheet vehicles and also to the needs of many corporates by acquiring debt directly from issuers. Politicians in many economies have now forced banks to accept public share capital on a variety of financial terms not only to stabilise the system and protect their voters' deposits, but also on the premise that the banks would then re-supply credit to those who need it. With the funding and the liquidity solved, credit would flow and the economies would return to their normal upward course.

“However, policymakers and politicians have overlooked the scale and size of the balance sheets of many of the major banks. Barclays and Deutsche Bank both have balance sheet assets considerably larger than the US Federal Reserve itself: two privately quoted banks with very finite resources against the unlimited power of the USA. Indeed, I think it is interesting to note that the hardest rescues of banks so far have been those where the banks are so much larger than the underlying national economy in which they started their life. For example, the three large Icelandic banks, most of the UK and Swiss banks, and many others to boot. So given the sheer scale of the challenge and the pace at which banks have grown their balance sheets over the last decade, it would seem that even the banks' management were uncertain as to what they owned and what they owed.

“Credit cannot flow if customers don't want to borrow, or are too leveraged to borrow, or more importantly if the banks won't or can't lend.

“Why won't they lend? Generally because the banks are programmed not to lend to bad risks; although clearly they lost sight of this on the way to where we are now. They are programmed not to lend especially when things are tough and they are losing money on their loans.

“Why can’t they lend? Banks are unable to lend when their solvency has been compromised and they are in effect paralysed from lending because they have no capital to lend out. But why are they still in this situation after nearly 2 years? Almost all banking managements, auditors and non executive directors have been in denial about the valuation of many assets held on their balance sheets as marked-to-market or level 3 assets, marked to directors’ myth valuations. These assets are now seen to be toxic because they are in the process of killing the banks, and the mechanism of death is clear. If these assets are written off or down to their appropriate real value (and the delicious irony here is that many are simply incapable of being valued, because the maths supporting them does not work in these new world days) then the banks are bust, pure and simple. In the UK at least, directors of companies found to be trading when insolvent can go to jail.

“History shows that almost every banking crisis has had a good bank/bad bank as part of the solution, such as Japan and Sweden in the 1990s, or the Savings & Loans crisis in the USA. This solution works because the toxic assets are placed in a vehicle, underwritten by the State, which can cope with the toxicity over time and importantly allows the clean bank to do what the body politic wants its banks to do; namely facilitate commerce, provide credit and hold deposits. This solution in many economies is now far more complex because most banks are not just building societies or commercial banks, but huge financial conglomerates; thus if one card falls, down comes the house. This was fuelled some years ago in the USA by the repeal of the Glass-Steagall Act, which allowed commercial and investment banks to share balance sheets. Thus politicians want to save the role the banks play in the economy but have little interest in saving the overpaid investment bankers that fuelled this credit boom and paid themselves extortionate amounts of remuneration on what are now clearly imaginary, paper profits.

“Mr Geithner, the US Treasury Secretary, and others now face this dilemma because it is clear that politicians and the public at large will not countenance the bail-out of more parts of the finance industry. And whilst nationalisation of the banks is political anathema and also a shocking increase in the liabilities of many countries’ balance sheets, it is our belief that there is no alternative. Mr Geithner highlighted that the toxic assets and their valuation remains a significant hurdle to resolving the crisis. But what is remarkable about this is that the external auditors and the non-executive directors are about to sign off their second ‘true and fair’ balance sheets. If the 2007 accounts were just about acceptable, then there can be no chance that these accounts are unqualified. Surely not? Mr Geithner has just told all shareholders and stakeholders that the balance sheets are too tricky to value. It is also interesting to note that many bondholders believe their rights will be honoured.

“So why a bad bank in national hands? Once under the full control of government, these banking assets can be treated ‘privately’ and on a long-term basis where remuneration, disclosure and risk are all less or no longer relevant. Bad banks allow the swift recapitalisation of the essential banks, which in turn increase the reliability and functioning of the economy at large, lowering risk aversion of both consumers and corporates. Semi-nationalisation continues to run the risks that moral hazard, political interference and incorrect incentives will all prolong the establishment of a satisfactory solution.

“Nationalisation allows policymakers to make it clear to all participants of the banking industry and their clients and depositors, just who will survive in current form and who is being taken into the State's control. Sweden notably achieved this with the result that only one bank remained in private hands. This clarity then allows all users of the industry to assess their risks and relationships and allows the false market in ‘back-handed help’ through liquidity schemes and loss protection plans to be abandoned, as the bank and its assets belong to the nation. Moreover all compensation and risk attitudes can be instantaneously changed by the new owners; bank managements still don't seem to get it, so let's ring the changes!

So what is the solution?

1. Make clear what the minimum capital requirements are for all banks in the banking system (as global standards will be hard to obtain) and, for these purposes write-off all the ‘hard-to-value’ assets
2. Make a debt for equity swap with all banks to reach the minimum capital levels and ensure that there is no double counting of capital via insurance and other businesses
3. Produce full and clear accounts for all banks, highlighting the toxic assets
4. Put in place a new and fully independent board of directors for all banks post-refinancing who will oversee the correct balance of returns between depositors, shareholders and lastly employees
5. Promote a competitive return for depositors which rewards prudent savers for leaving their money with a bank, with a kind of lending success ‘return’ rather than just the national bank rate (i.e. depositors benefit from the successful lending of their banks, like the old building societies, rather than just the employees), so that depositors are no longer disadvantaged for being prudent
6. Ensure shareholder returns rank above employees, so there can be no longer a mis-match of risk and reward
7. Agree long-term employee remuneration to balance bonus versus malus and scale of returns earned
8. Separate the citizen-facing commercial banks activities from the highly speculative investment banking activities, and remove all guarantees from the latter
9. Initiate a long-term, tax advantaged scheme to induce greater saving into equities and bonds by the public using ISAs and similar instruments, as the costs of this bail-out will limit most economies ability to pay for healthcare and pensions in the years to come.

- Ends -

For more information:

Roger Miners, Head of Institutional Business Development & Client Service, RCM, Phone 020 7065 1491

Emma Taylor, Press Office, RCM, Phone 020 7065 1526

Amy Butler, Lansons Communications, Phone 020 7566 9709

.. / 4

Notes to Editors:

Past performance is not a reliable indicator of future performance. You should not make any assumptions on the future on the basis of performance information. The value of an investment and the income from it can fall as well as rise as a result of market and currency fluctuations and you may not get back the amount originally invested. The information contained herein including any expression of opinion is for information purposes only and is given on the understanding that it is not a recommendation and anyone who acts on it, or changes their opinion thereon, does so entirely at their own risk. The opinions expressed are based on information which we believe to be accurate and reliable, however, these opinions may change without notice.

About RCM (all data source: RCM as at 30/09/08; latest available)

RCM is a global asset manager operating from six international offices - San Francisco, London, Frankfurt, Hong Kong, Tokyo and Sydney - with assets under management of over €75 billion/\$105 billion worldwide. The firm provides a range of investment management solutions to institutions and individual clients. At RCM we believe that by generating and exploiting an information advantage, we will be able to deliver superior and consistent investment results for the benefit of our clients - a philosophy we call RCM informed. RCM is a company of Allianz Global Investors, a pre-eminent global asset management group committed to helping clients achieve sustainable success. As a company of Allianz Global Investors, RCM offers a distinctive investment philosophy and culture, while benefiting from the scale and substantial resources of our parent; including business support, industry best-practices and financial investment. This enhances our ability to attract and retain talent, and provide superior insight and investment performance.

This press release is intended for journalists in their professional capacity and is not intended to be a financial promotion. Issued in the UK by RCM (UK) Ltd, 155 Bishopsgate, London, EC2M 3AD. Authorised and regulated by the Financial Services Authority.