

RCM offers 10 lessons so far in the financial crisis

Neil Dwane, CIO Europe at RCM, offers his 10 lessons so far in the financial crisis:

Lesson I - Northern Rock

“When credit and money markets lose confidence in a counterparty, business models collapse even in relatively safe mortgage-lending businesses.”

Conclusion: “Managements and regulators had become overly relaxed about the levels of leverage used in banking business models and when liquidity dried up during the bursting of the sub-prime crisis, the banks most affected were those reliant on wholesale funding. The Federal Reserve and the Bank of England were slow to recognise this liquidity trap whilst the European Central Bank (ECB) got on the case immediately. Clearly the public solution to Northern Rock was unsatisfactory and ironically was unnecessary at the time with Lloyds standing available to assist.”

Lesson II - Bear Stearns

“When your balance sheet is ludicrously leveraged and you can no longer find cash and collateral, you can be bailed out by the Federal Reserve, provided that you pose a systemic threat to the Financial system.”

Conclusion: “At the time, policy makers felt able to arrange a rescue of an important counterparty in the financial markets whilst reigniting some moral hazard through the effective wiping out of Bear Stearns' equity. A message was sent to others that the toxic waste of overleveraged CLOs and CDOs must be dealt with, but a shorter term fix for their liquidity problems was offered as well as an encouragement to raise more capital ...but who has been listening? Little new capital has been raised by the banks except Merrills and the investment and commercial banks have swapped in nearly a trillion US dollars of toxic bonds for the Federal Reserve's good old Treasuries. No wonder the US Treasury needs to bolster the Federal Reserve's balance sheet!”

Lesson III - The conservation of Fannie Mae and Freddie Mac

“When you are the lender and holder of last resort of 4 trillion US dollars of US housing mortgages, you are an essential key to the management of, and vital part in the solution to, the on-going housing crisis in the US, as well as being one of the largest bond issuers held by many Governments around the world.”

Conclusion: “US housing and other property markets (both residential and commercial) have suffered not only from excessive leverage but also from excessive optimism on the returns which could be generated. History teaches that the housing booms of the USA, UK and Spain/Ireland will revert to the mean and RCM would suggest that this is a 4 year

process, so we could see a bottoming of the US housing market towards the end of next year. Oh, and an aggregate fall of c30 to 35% - i.e. we are half-way there today. Interestingly, the UK and Ireland have seen a fall of c10% so far with Spain yet to show any fall in housing prices at all.

“The importance of the housing and commercial property markets is that they are where the largest banking assets are held both in CDOs, loans etc, and where the US citizens draw the largest part of their net worth from. Thus the bank balance sheets are under considerable write-down strain which is forcing them to hold onto their liquidity such that the policy makers have made no real progress after 12 months of getting the bank-to-bank financial artery pumping again. Indeed the recent Auction Rate Securities debacle has hastened many billions back onto unwilling balance sheets. Moreover, in the second half of 2008, the Financials sector will see enormous requirements to roll-over much short term funding, c 500 billion US dollars, so we anticipate much more Central Bank generosity as banks gasp for liquidity. The functioning of the Government Sponsored Enterprises has been much debated over the years and this property crisis will allow the next administration to put in place a sustainable model for funding and encouraging home ownership in the USA.

Lesson IV - Lehman Brothers

“When you have failed to take any coherent management action to raise new capital and have not really tried to deleverage your balance sheet, policy makers will not tolerate such complacency and you are allowed to go bust, even if your are bigger than Bear Stearns.”

Conclusion: “The clear implication from this is that policy makers will not bail out those who do not help themselves, who are not crucial to the citizenry and tax payers of the USA or who are no longer deemed essential to the global financial system. This lesson has become all too clear to the management of Merrills, who, having looked inside the Lehman's balance sheet, realised they needed a bigger parent and sold themselves overnight to Bank of America, who clearly were more interested in the private broking and asset management subsidiaries than the investment bank. Moral hazard continues to rise for all market participants as patience from policy makers runs thin.”

Lesson V - AIG

“When you have specialised in managing risk in life and property and casualty insurance, you may have thought that you could underwrite risk in sophisticated financial products. But this logic was clearly full of delusionary thinking in AIG's case, who could not and especially not on the scale which had been undertaken and underwritten.”

Conclusion: “The Federal Reserve clearly saw huge counterparty and systemic risk in the failure of AIG to meet collateral cash calls and has offered an onerous loan and taken control of the company. More importantly, the Federal Reserve has made it plain to all market participants that the level of credit insurance currently enjoyed by the players would be wound down substantially within 2 years or sooner. So all should conclude that the securitisation, leverage and repackaging of products made eligible by credit insurance will now cease, at least in the size and scale of current assets. Industry estimates that leverage ratios will fall from 30x to 20x equity would lead to asset sales of c 6 trillion US dollars and with few buyers, prices and collateral levels must fall further.”

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Lesson VI - HBOS and Lloyds: Lesson I revisited but with a different solution

“When credit and money markets become concerned again over liquidity issues, your bank can have a crisis of confidence. HBOS had such a crisis and, before the citizens of the UK created a run on the bank by withdrawing their deposits, policy makers and Lloyds stepped in to rescue it.

Conclusion: “UK policy makers had to respond to the impending fate of one of its largest banks and its largest mortgage provider and engineered a private solution which will create a domestic superbank. It has forestalled a major run on a bank and raised the stakes on defending the integrity of the UK financial system. Indeed all central banks have responded by coordinating liquidity infusions into all banking markets. Was this HBOS disaster self-inflicted? Or is it the defining evidence that the banking system is now seriously impaired as deleveraging and risk aversion, as well as the slowing economic cycle take their toll?”

Lesson VII - Morgan Stanley and Goldman Sachs

“When all your nearest competitors have failed or rushed to find bigger brothers with deeper pockets, the markets will force you to either do the same or go bust.”

Conclusion: “Although painful, the markets targeting of Morgan Stanley and Goldman Sachs seems tellingly logical given the fates of Bear Stearns, Lehman and Merrills. All the global investment banks have swum in the same pools and have similarly overleveraged low quality, thinly capitalised balance sheets where liquidity should not have been the problem but solvency – i.e. there is insufficient profitability left in the winding-down of these balance sheets for the underlying entity to survive, unless carried by a larger and broader entity. Perhaps an sovereign wealth funds will emerge to underwrite one of these two great franchises but if not, another superbank will be born or liquidation may be contemplated.

“Longer term, policy makers must consider whether having some superbanks is beneficial to the economy or whether some Glass-Stiegel rules may be enforced once the worst is over. Additionally, regulators will enforce much stricter levels of gearing, leverage and transparency on all Financials as well as mandating utility-like returns on consumer facing financial activities. Thus banks and their managements must become prepared for lower return on equity in the future and significantly higher levels of transparency with more modest levels of remuneration.”

Lesson VIII - The markets, short-selling and the hedge funds

“When interest rates have been low, liquidity for free, risk and return expectations shift dramatically.”

Conclusion: “Equity markets are currently whipsawed by the deleveraging of the financial positions of many investors, not just equity investors. Perversely, the equity markets, unlike many credit, CDS, CDO, CLO, SIV and other non-equity markets, have traded and have cleared the markets' business every day; thus taking much more strain than the non-traded bond and illiquid credit markets and the Level 3 marked-to-myth assets of many financial institutions, which still total over a trillion US Dollars. Equities themselves have also been impacted by short-selling from many investors, not

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just hedge funds, which has also impaired market confidence but, please be sure, a company with strong management, good products and clean accounts can see off a bear squeeze.

“Lastly, we are now experiencing the worst performance in memory of the hedge funds as they suffer not only from the dramatic market moves against their positions, but also the threat of both huge redemptions as client return expectations are crushed and also as global investment banks withdraw their own lines of credit (as they need to them to survive). All of these factors are leading to strong selling pressures of long positions and the closing of short positions which is creating a haphazard pastiche of market moves from one hour to the next, with no relevance to fundamental drivers and valuations. Perhaps the hedge fund performance bubble is now headed the same way, as the US housing market and the credit bubble – i.e. down.”

Lesson IX – The reaction of policy makers

“Policy makers are responding in a piecemeal fashion so far but the cost of intervention is getting bigger and the reaction time faster - we should expect much more financial shock and awe to come.”

Conclusion: “Policy makers have not got ahead of the financial train wreck yet and until they do so on a global basis all financial sentiment will remain highly charged and fragile. It seems obvious to conclude that the deleveraging must and will continue alongside both aggressive recapitalisations of banks and also the restructuring of the financial industry, post AIG and Lehman/Merrills.

“Policy makers must also be conscious that global GDP is slowing quickly as the financial travails now pervade deeply into the real world and thus the time is fast approaching for the Great Global Reflation Response (GGRR). How and when will the GGRR kick in? Bit by bit it is already happening, but the GGRR in shock and awe terms will become more evident as the next President of the US launches his inaugural policies in early 2009, aided by coordinated interest rate cuts from the US, ECB, BOE, as well as China (who will engineer to kick start their economic momentum post the Olympics). Deflation caused through this financial deleveraging is easily the worst prospective outcome that policy makers can behold, so the GGRR will be big enough and sustained enough to turn economies around into 2010, but the cost will be both rising inflation, as RCM has forecast for the last few years, and an unavoidably weaker US dollar.”

Lesson X - Expect more of the unexpected

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Notes to Editors:

About RCM

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