



## New Banking environment emerging



**Matthew Hegarty**  
**GVI Senior Equities Analyst**

**May 2009**

The global banking sector had until recently been trading on historical lows when measured on most valuation metrics yet until we see evidence of greater earnings visibility, pre-provision profit trends and further balance sheet stability, we are unlikely to continue to see a sustained re-rating of the sector. However, some positive signals are beginning to emerge for a number of global banks which has been evidenced by the resilience in certain banking segments of first quarter profitability trends and more holistic policy initiatives.

The current operating environment is one of the most challenging for banks ever and although write-downs may be coming closer to an end, provisioning expenses are rising against a deteriorating economic backdrop. In this crisis (when compared to previous banking crises), capital injections from governments have occurred at an earlier stage of the economic downturn. Arguably, the chief reason for this earlier action with this crisis has been the mark-to-market write-downs that has undermined balance sheet stability and produced severe dislocations in credit markets globally. We have squarely moved from a phase of mark-to-market write-downs to a full blown credit and impairment cycle.

In some countries and for some institutions we are now rapidly approaching the end-game, finally having moved away from temporary piecemeal solutions toward comprehensive policy programs aimed at restoring financial market stability and aimed at improving confidence and sentiment. As Ben Bernanke said recently there will be 'no more Lehmans'. What this implies is that in the US at least, large financial institutions are effectively going to be guaranteed by the government.

State capital injections, liquidity provisions and other government liability guarantees are important in restoring confidence in the global financial system. These types of actions and more general regulatory forbearance thus far has served to reduce the solvency risk amongst a number of global banks. The announcement in the US of the Private Public Investment Fund ('PPIF') is another important step in restoring stability to the banking system. The PPIF is essentially a two-pronged approach to purchase 'legacy' assets (in banking speak 'toxic' is now taboo), providing scale (purchasing up to USD\$1tn of assets) and if implemented effectively should serve to inject much needed liquidity into the banking system and also to serve to set prices for these assets and to provide some measure of asset price stability. The PPIF also is voluntary and for it to work it does require participation from both private investors and banks. There are incentives naturally for private investors (access to leverage) and banks (asset disposals) yet there are also tough conditions where private investors would be subject to rigorous oversight by the Federal Deposit Insurance Corporation ('FDIC') while banks would be forced to realize losses on assets that they have not already written down. Assuming the PPIF is a success this should be an important step toward cleaning up bank balance sheets yet it still won't resolve a common held belief that the system still requires more capital. Expect to potentially see a number of standalone banks to announce capital raising plans in this rally and leading up to first quarter results.

Historically, partial or full-scale government intervention that immediately reduced the solvency risk of the banking system has been a catalyst for a sustainable re-rating of the banking sector. Previously, government intervention has



served to stem sharp declines in asset prices, allowed banks to organically strengthen capital bases through retained earnings and to reduce counter-party risks. What remains to be seen currently (for those banks that now have government ownership in particular) is whether governments will use their increased ownership stakes in banks to force banks to lend more or to ease terms of credit. I recently attended a banking conference in London and a key theme was that although overall policy responses have become more holistic, one chief area of concern amongst banks is the politicization of credit and the likely impact that this will have on banks' returns and businesses.

The banks that will be strongly vindicated out of this crisis will be those banks that have stuck to a disciplined approach to banking and that didn't compromise balance sheet quality for the sake of short-term growth. For those banks that can maintain access to funding there will be some tremendous opportunities in banking.

Margins for banks are expanding and for those banks that have money to lend they can lend selectively based on stricter credit criteria. The risk to bank lending is much lower than it was on the average loan during the lending boom years and the future return on equity will be higher.

The banks therefore that have adopted the following priorities will most likely emerge positively and strongly out of this current crisis:

1. More balanced growth profile;
2. Solid retail banking model;
3. Focused on deposit growth (funding stability);
4. Well diversified commercial banking operations;
5. Margin management to reflect the scarcer liquidity and rising spreads; and
6. Conservative balance sheet and credit management.

Complex structural changes will continue to be mooted with regard to the entire global financial framework and the system will only be able to accommodate them over time. We will continue to look closely at and monitor those banks that have these sorts of priorities and those banks that look attractive on a capital adjusted basis.

**Important Information:** The information contained in this report has been prepared with all reasonable care. Global Value Investors Limited (GVI) accepts no responsibility or liability for any errors or omissions or misstatements however caused. This information is not personal advice and is not intended to constitute a securities recommendation. This information does not account for your investment objectives, particular needs or financial situation. Investors should be aware that past performance is not indicative of future performance. Returns can be volatile, reflecting rises and falls in the value of underlying investments. Potential investors should seek independent advice as to the suitability of the Fund to their investment needs. Applications can only be made on the form in the current Product Disclosure Statement dated 16 December 2008, or through IDPS products that include this Fund. The Product Disclosure Statement can be obtained by contacting GVI [www.gvi.com.au](http://www.gvi.com.au). Potential investors should consider the Product Disclosure Statement before deciding whether to invest or continue to invest in the Fund. Treasury Group Investment Services Limited ("TIS") is the responsible entity and issuer of the GVI Global Industrial Share Fund.