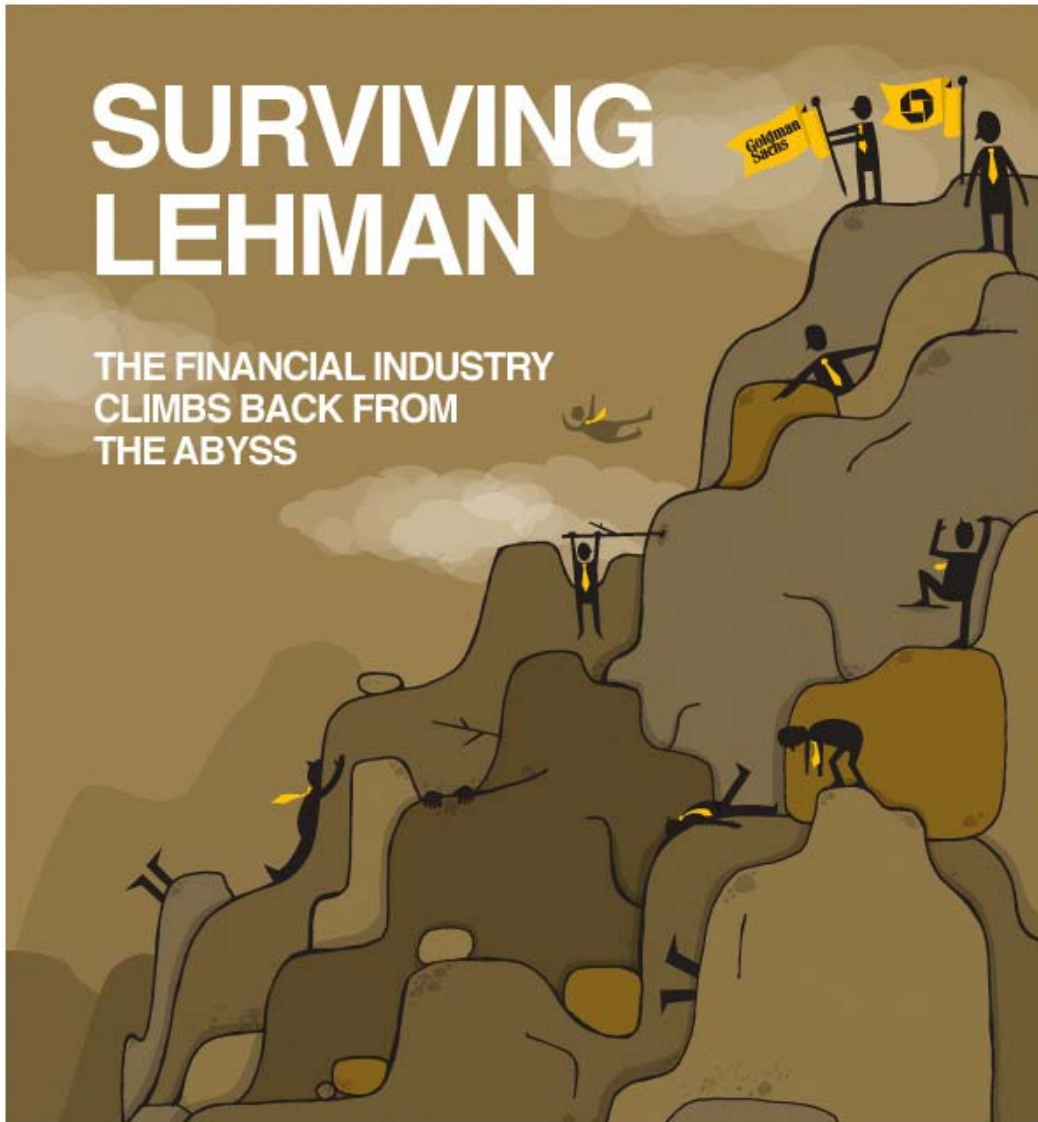


# SURVIVING LEHMAN

THE FINANCIAL INDUSTRY  
CLIMBS BACK FROM  
THE ABYSS



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## SURVIVING LEHMAN The financial industry climbs back from the abyss

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## PREFACE

### Surviving Lehman: The financial industry climbs back from the abyss.

After all the carnage that followed the bankruptcy of Lehman Brothers a year ago, it would be easy to discard long-treasured investment theories like the efficient markets hypothesis as so much hock and soda water. Clearly if markets were remotely efficient, stock prices would have factored in the possibility of a collapse of the kind that ensued from the US investment bank's failure, right?

Of course, they didn't – and the rest is history. But at least in one respect the stock market does provide something approaching an efficient read on the state of the financial industry one year on (see chart on page 4). Generally speaking these institutions fall into four broad categories: winners, survivors, the strategically challenged and those who exist today only through the grace of governments and taxpayers. To help investors take stock of the financial landscape on this inauspicious anniversary, we've assembled a collection of Breakingviews.com articles on the banks.

The market's verdict is clear on who the winners are. Goldman Sachs stock has gained 25% since Lehman went kaput. Shares in JPMorgan and Barclays are up about 15% each. Santander and Credit Suisse follow, with gains of around 8% in their stock prices. And BlackRock, the big fund manager overseen by Larry Fink, has held its value over the year.

Broadly speaking, the victors share a few common attributes. First, they appear to have made relatively prudent decisions to limit risk before the credit bubble burst. This may reflect strong management – in all cases, the same executives who ran the firms before the crisis are still in their jobs. Moreover, thanks to their prescience, natural conservatism or plain luck, these banks all found themselves in positions to prey upon the fallen to strengthen their own businesses.

JPMorgan, for example, swooped less than two weeks after Lehman's demise to acquire Washington Mutual, with its \$296bn of assets and nationwide branch system, out of receivership for a song. The bank led by Jamie Dimon also used its position as one of the few strong US lenders to capture market share in underwriting and financial advisory.

Goldman did the same with its trading businesses, where revenues surged by 79% in the first half of this year to \$18.5bn, compared to the first six months of its 2008 financial year. And prime brokerage and private banking clients switched to Credit Suisse from the bank's US and European rivals, lured by its solid financial footing.

Barclays acquired the core North American businesses of bankrupt Lehman while avoiding the temptation to accept UK government funding and its many attached

strings. Spain's Santander gained market share in the UK by acquiring Alliance & Leicester from the edge of insolvency and purchasing the cleaned-up remnants of another failed lender, Bradford & Bingley.

Then there are the survivors: UBS, Deutsche Bank, Wells Fargo, BNP Paribas and Morgan Stanley fall into this camp. These are banks whose business models were tested – in some cases severely – by the crisis. But all seem to be on the mend to a greater or lesser extent, for some of them thanks to large dollops of government intervention. Indeed, though their stock prices are all down, they did not do worse than the S&P 500 Index, which slumped some 13%.

It wasn't easy for them. Morgan Stanley nearly went under in the middle of October 2008 as it scrambled to pull together a capital injection from Mitsubishi UFG before the US government's Troubled Asset Relief Programme became a full-on bailout fund. It's now on firmer ground and even managed to take control of the Smith Barney broker network from Citigroup. But its returns look anaemic and it still faces questions over how it will execute its risk-light strategy and who will lead the organization when John Mack retires.

Wells Fargo also took advantage of competitors' adversity by snatching Wachovia away from Citi. The deal, brokered in part by banking regulators, played a role in exposing Citi's weaknesses. But it also weighed Wells down with a portfolio of dodgy assets, particularly funky adjustable-rate mortgages in California.

Deutsche jumped into US subprime mortgage lending too late to be badly hit and anticipated the bonus backlash ahead of rivals. Chief executive Josef Ackermann foresaw the dangers of accepting government capital and positioned Deutsche to exploit weakened rivals weighed down by the strategic restrictions that go with taxpayer funds. But while Deutsche is far less exposed than peers to ailing US and UK consumers, it still has to deal with a reeling German economy.

Behind the survivors come the strategically challenged. Squarely falling in this camp – at least according to the stock market – are Bank of America, which is down 35%, as well as General Electric, with its big finance arm, and Lloyds Banking Group both of which have dropped by half. All three have valuable assets. But investors remain concerned about potential writedowns.

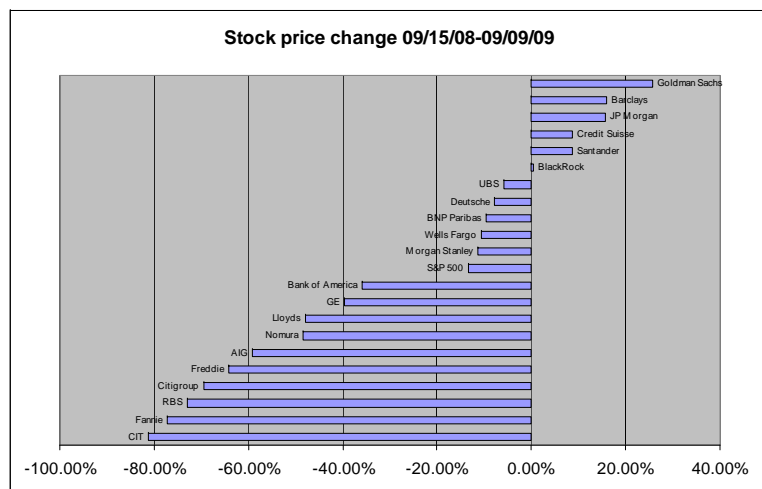
That's particularly true of the Merrill Lynch and HBOS franchises that BofA and Lloyds, respectively, picked up with the blessing of regulators. Meantime, GE's investors are worried about the health of assets inside its \$600bn financial unit, which has not had to mark everything to market prices. Concerns like these overshadow the value of the good assets at all three companies.

The final bucket of financial survivors consists of those on life support. These are institutions that have largely become wards of the state and have the share price

performances to reflect it: American International Group, Freddie Mac, Fannie Mae and the wounded behemoths Royal Bank of Scotland and Citigroup have lost between 59% and 77% in value.

Rob Cox  
US Editor  
Breakingviews.com

September 10 2009



Fannie Mae and Freddie Mac starting prices as of 09/03/08  
Nomura starting price as of 09/12/08

## THE WINNERS

### Goldman Sachs

#### Boom time?

By Antony Currie

Goldman Sachs has solidified its status as the winner of the credit crisis. The Wall Street firm had already demonstrated its relative success at managing risk ahead of and during the meltdown. Now it's at the vanguard of those cranking out healthy earnings again.

Some of Goldman's success was relatively easy to spot ahead of time: its fees as one of the lead underwriters in last quarter's boom in equity deals jumped an eye-popping 1433% to \$736m. But most of the juice came from its trading desks. Both its equities and its fixed income, currency and commodities divisions posted record revenues – and, combined with principal investments, accounted for almost 80% of the firm's top line.

But that's not necessarily the result of Goldman ramping up its bets – aside from a jump in equities, the firm's value-at-risk stayed pretty flat in the second quarter. Rather, it's the fact that Goldman is one of the few firms left that is willing and able to put its own capital at stake, be it for clients or its own book. Rival Morgan Stanley, for example, nixed much of its risk-taking businesses at the end of last year.

That means Goldman is better placed to take advantage of the kind of activity that characterised the three months to the end of June: rallies in equity, debt and mortgage markets made perfect fodder for the Goldman money machine, especially with spreads in many instruments still wide compared to the days of the boom.

The question is whether Goldman can maintain such a heady performance. The firm is operating with leverage of 14.2 times shareholders' equity – almost half its peak in the first quarter of 2008. That's fine as long as spreads stay relatively wide. But as they narrow, Goldman is either going to have to win a lot more business, take a good deal more risk or ramp up its leverage. Otherwise, last quarter's 23% return on equity is going to be hard to replicate.

**Context news:** Goldman Sachs reported second-quarter earnings of \$3.44bn, or \$4.58 a share, beating consensus analysts' estimates of \$3.54 a share. Revenue was a record \$13.76bn. Return on equity was 23% for the quarter and 18.3% for the first half of the year.

Goldman reported record quarterly revenues in equity underwriting (\$736m), equities trading and commissions (\$3.18bn) and fixed income, currency and commodities (\$6.8bn). Mergers and advisory reported revenue of just \$368m.

Securities services, which includes the firm's prime brokerage business, brought in revenue of \$615m, more than a third less than the same quarter last year but 22% more than in this year's first quarter.

The value of Goldman's stake in ICBC rose \$948m. The firm took a \$700m revenue hit on commercial mortgage loans in FICC and a loss of \$499m in real estate principal investments. The firm also paid a one-time dividend of \$426m related to repurchasing preferred stock from the US government.

Book value rose 8% to \$106.41 and tangible book value rose 10% to \$96.94. Assets declined 4% to \$890bn.

Compensation costs were \$6.65bn for the quarter, or 48.3% of revenue.

- [Goldman Sachs earnings release](#)

July 14 2009

### Golden stacks

By Rob Cox and Antony Currie

It would be easy for Goldman Sachs employees to forget there's a financial crisis still going on. The Wall Street firm posted stunning second-quarter earnings and set aside a record amount of treasure to pay staff. But Goldman's minions would be wise to tip their hats to the contributory role of the very visible hand of the taxpayer. Markets may still be rough, but the biggest remaining risk to Goldman's franchise could be a political and public backlash against the group's profits - and particularly its pay.

That's because the compensation numbers are staggering from almost every perspective. During one of the worst six-month periods in the history of finance, Goldman squirreled away \$11.36bn in compensation and benefits - that's more acorns than it put aside in the first half of boom years 2006 and 2007. True, the pay is mostly just accrued, rather than paid, at this stage. And even during those earlier boom years, the firm failed to replicate its first half performance in the second six months.

It's also true that on a per capita basis the numbers look a little less gilded than during the credit bubble. The first-half figures work out to around \$386,000 for six months'

work averaged across every banker, trader, mailman and janitor at the firm. Since Goldman has 29,400 employees today, compensation per staffer is actually below the \$433,000 at which it peaked in the first half of 2006.

Goldman's corporate tax rate is running at a defensible 31% compared to last year's single digits. On top of that, its employees should be poised to hand over income taxes of some \$4bn should their first-half accruals turn into hard cash. And with competition for people hotting up again on Wall Street - even from banks in much worse shape than Goldman - the firm does have to pay enough to keep the best and the brightest.

But the firm would be foolhardy to believe that these arguments will necessarily placate a restive public undergoing double-digit unemployment and politicians with ambitious and underfunded legislative priorities. And although Goldman showed a steely willingness to extend and manage risk through turbulent markets while many rivals did not or could not, it is hard to imagine the firm doing so well without the extraordinary lifelines extended by the government, at taxpayers' expense, to Wall Street at large. Goldman boss Lloyd Blankfein has been notably contrite and appreciative in his public remarks on this matter. It remains to be seen whether that's enough to head off Congressional ire.

**Context news:** Goldman Sachs set aside \$11.36bn in compensation and benefits in the first six months of the year, up from \$8,523 in the first six months of the previous year. Goldman said it had 29,400 staff at the end of the second quarter.

- [Goldman Sachs earnings release](#)

July 14 2009

### JPMorgan

#### Wheel of fortune

By Antony Currie

JPMorgan has put on a pretty solid performance during the credit crisis. That should give struggling rivals some hope. After all, in the last big downturn, the bank was laid low by a poorly performing investment bank and a muddled retail banking strategy. Under Jamie Dimon's leadership JPMorgan has learned from its mistakes and fixed both.

In the dog days after the dotcom bubble burst, it was a fair bet that whatever problem hit the market next, JPMorgan would be in the thick of it - whether it was loan losses,

private equity portfolios overexposed to telecoms and technology companies, or volatile markets catching out proprietary trading desks. It got so bad that JPMorgan

was one of the few financial firms at the time whose shares traded below tangible book value.

Better risk management has changed that. The obvious evidence is that the trading desks now routinely do a good job – in fact, fixed income trading raked in a record \$4.9bn of revenue last quarter. But it also shows in the business the firm doesn't do: despite its derivatives and structured finance prowess, for example, JPMorgan largely stayed away from the kind of collateralised debt obligations that got others into hot water. In fact, the firm's reputation has had such a makeover that its investment bankers brought in \$2.2bn in fees – 50% more than Goldman Sachs did and more than any bank ever has in a quarter.

As for retail banking, the problem with the old Chase was that executives had grown increasingly unsure what to do with it even before it merged with JPMorgan in 2000. But eventually its earnings power as the investment bank suffered demonstrated its worth. JPMorgan's 2004 merger with Bank One, which brought Dimon on board, added heft. And now, with Washington Mutual's business rolled in, retail is churning out almost \$1bn of net income a quarter.

JPMorgan has hardly gone untouched by the crisis: mortgages and leveraged loans hurt all firms involved, and credit cards and consumer lending lost the bank more than \$1.6bn between them in the recent quarter. But JPMorgan appears to have dealt with these problem areas effectively. That's left Dimon's bank as one of the winners of the crisis. The next big test for him will be to keep it that way.

**Context news:** JPMorgan Chase reported second-quarter net income of \$2.7bn, or 28 cents a share, on record revenue of \$27.7bn.

The investment bank recorded net income of \$1.5bn. Equity underwriting reported record revenue of \$1.1bn, debt underwriting revenue was \$743m and M&A fees were \$393m. Fixed income markets revenue was a record \$4.9bn even after allowing for a \$773m hit from spreads tightening on the bank's own liabilities. Equity markets revenue was \$708m, impacted by weak trading results and a \$326m loss on the firm's own liabilities.

Retail financial services posted net income of \$15m as retail banking earnings of \$970m were largely offset by a loss of \$955m in consumer lending. The credit card business posted a loss of \$672m.

Commercial banking net income was \$368m, Treasury and Securities Services made \$379m and asset management earned \$352m. Corporate and private equity made \$808m, much of which stemmed from good trading and investment income from

managing the balance sheet as well as a \$150m gain from selling some MasterCard shares, partially offset by a \$419m post-tax special assessment from the FDIC.

- [Earnings release](#)

July 16 2009

### Fighting talk

By Antony Currie

Jamie Dimon isn't one to pull his punches. In fact, the JPMorgan chief's willingness to criticise, for example, the shortcomings of retroactively changing government bailout programmes can be refreshing – and often spot-on. It's hard to quibble with his recent dubbing of the Troubled Asset Relief Programme as the “scarlet letter” and the “Tarp baby” – though few peers have the chutzpah to say so publicly. And many understand his reluctance to participate in the Public-Private Investment Programme on the ground that “we've learned our lesson about” borrowing from the government.

But at times Dimon risks sailing a bit too close to the wind. Some wonder whether his assertion in April that JPMorgan didn't need to raise equity to pay back Tarp cash played a role in the US deciding even healthy banks would have to do just that – JPMorgan has just had to raise \$5bn. Sure, his comment was perceived to be more of a dig at Goldman Sachs, which had just raised its own capital, and came with the caveat that regulators might think otherwise anyway. But it's instructive that some rivals ascribe that much power to the man, rightly or wrongly.

This week, though, he has taken another swing at government intervention, first by reading out a fictitious letter to US Treasury Secretary Tim Geithner at a conference: “Dear Timmy, we are happy to be able to pay back the \$25bn you lent us. We hope you enjoyed the experience as much as we did”.

That's no more than a bit of ribald humour, perhaps. But he later followed it up by saying the US should cancel half the warrants tied to Tarp investments in banks “out of fairness”. That may resonate with some – why should a bank that didn't need Tarp cash and that should be one of the first to pay it back be forced to make good on one of the attached strings that will dilute its shareholders?

But it's not as clear cut as bashing barmy changes to Tarp and PPIP. The warrants were part of the original Tarp package back in October – and, all else aside, JPMorgan has enjoyed almost nine months of cheap money from the taxpayer. Perhaps it's just another bold Dimon gamble – and if the US caves and cancels a portion, he'll be

hailed as a hero. But sometimes staying silent on some issues can be the greater virtue.

**Context news:** JPMorgan is raising \$5bn to comply with the latest stipulation from the Federal Reserve that banks seeking to repay government preferred stock invested under the Troubled Asset Relief Programme should demonstrate an ability to tap the public equity markets.

*June 2 2009*

### **The price of success**

*By Richard Beales*

Goldman Sachs knows when to fold its hand. The Wall Street firm has bought back its Troubled Asset Relief Programme warrants for \$1.1bn – probably a very full price. The company, which had initially offered around \$650m, says it took the US Treasury's figure rather than haggling. JPMorgan's Jamie Dimon is taking a less acquiescent tack. But then, his firm isn't under quite the same politically-charged spotlight as Lloyd Blankfein's.

Goldman turned in bumper second-quarter earnings on the back of government support for financial firms and markets. It's on track to pay giant year-end bonuses. That success has brought renewed criticism – on the heels of recently aired conspiracy theories and a charge that the firm is like a “vampire squid”. Blankfein has already sounded humble notes. Avoiding horse-trading over the warrant buyback is another move that may help soothe political and popular indignation.

Goldman even noted that when the interest it paid before repaying the Treasury's \$10bn of actual Tarp investment is combined with the warrant payment, taxpayers earned an annualised 23% return – conveniently the same as the firm's return on equity in its blowout second quarter.

The amount paid by Goldman for the warrants was shy of a theoretical option value, but a discount for the illiquidity of the unusual 10-year instruments is legitimate. Pluris Valuation Advisors reckons Goldman paid something close to a fair market price. The figure was also 17% above the most recent best estimate of the warrants' value produced by the Congressional Oversight Panel.

Dimon, by contrast, recently refused to buy his firm's warrants back at Treasury's valuation, instead proposing – as was his right – that they be auctioned. His firm has arguably had the best crisis of any rival bar Goldman. Dimon may be right that the Treasury is over-valuing JPMorgan's warrants – but Blankfein's move could still make him appear churlish by comparison.

Dimon, though, knows that Goldman, with its record accruals for employee pay and its influential alumni network, is first in line for any backlash, justified or not. For now at least, he can afford to be less eager than Blankfein to roll over.

**Context news:** Goldman Sachs said on July 22 it had bought back warrants issued to the US Treasury for \$1.1bn. Treasury received warrants over shares that were worth \$1.5bn last October when it invested \$10bn in Goldman preferred stock under the Troubled Asset Relief Programme.

The warrants could have been exercised at any time for 10 years, and had a strike price of \$122.90 against the Wall Street firm's current share price of around \$160.

In a July 10 report, the Congressional Oversight Panel estimated the value of the Treasury's Goldman warrants at \$940m to \$1.25bn, with a best estimate of \$940m.

A February 4 report by Duff & Phelps for the COP estimated the value of the Goldman warrants at \$436m-\$558m at the time they were issued. Adjusting for a cancellation feature that is no longer available, that valuation - still based on Goldman's share price at the time the warrants were issued - would have been \$738m.

- [Goldman release](#)
- [COP report dated July 10](#)

*July 22 2009*

### **Barclays**

#### **Construction zone**

*By Jeffrey Goldfarb*

It rarely pays to bet against Bob Diamond. That's just one reason why the Barclays Capital boss deserves the benefit of the doubt in his ambitions to transform Barcap from a European fixed-income shop into a top-tier, full-service global investment bank. But while there are reasons to believe Diamond will succeed, it may take him quite a while to do so – and at a considerable price.

Diamond's strategy for the investment banking business at Barclays was less ambitious before the financial crisis. The collapse of Lehman Brothers changed all that. September's deal to snap up the core US business of the Wall Street bank was a cheap, one-off opportunity to accelerate Barcap's growth.

That was the easy bit. Now Barcap is going full throttle with the creation of an equities and advisory business in Europe. It's a much-needed extension of the Lehman deal.

Without a more rounded global offering, Diamond knows Barcap can't hope to achieve the true greatness he desires for it.

Diamond likes to tout his accomplishments as a business builder. It's a boast to which he is entitled. But not all construction projects are the same. And this one poses some big challenges, even for Diamond.

His successful creation of a top-three fixed-income business from scratch is partly down to Diamond's own experience in the debt world. But equities and corporate finance aren't in his DNA. The equities side occupies the less racy, lower-margin corner of investment banking and is arguably a harder market to crack than fixed income. Equities is becoming an all-or-nothing high-volume business and is therefore increasingly people and systems intensive. That means hiring the right analysts and salespeople, while staying ahead in the aggressive technology arms race that keeps costs so high.

Diamond has very little margin for error. And one area where he cannot afford mistakes is in getting the right people. Even though Barcap is based in London, it looks to be driving its European equities and M&A push out of the former Lehman business in New York. That plays to the expertise residing there. But it presents a danger that personnel decisions could fail to anticipate some of the local sensitivities needed in recruitment. This could lead to many false starts building a functioning team that works well together – especially when trying to expand so quickly.

Pay issues could also prove an impediment, getting in the way of the unity needed to instill a collegial culture – one of the hallmarks of a truly successful investment bank. Guarantees offered to Lehman staff in the US may already have offended bankers who have suffered bonus cuts elsewhere. This discrepancy could be exacerbated by additional recruits in Europe. Many of Barcap's initial 450 equities hires will have been done on the cheap, but Barclays is now running into stiffer competition for talent. The 250 planned additions in equities and 65 in advisory stand to be far pricier.

Finally, the crossover benefits from Barcap's existing fixed-income team might not bear as much fruit as anticipated. The debt bankers may have great relationships with corporate treasurers and finance directors. And by avoiding state support, Barclays has more flexibility with its balance sheet, which will open some doors as rivals regroup. But to secure long-term capital-markets and merger-advisory mandates requires deep ties with chief executives and directors. These will take years to build, even if Barclays poaches top bankers from competitors. Relationships do not always travel. All this could mean a long wait before a positive cost-revenue gap opens, and then widens.

In one sense, Diamond is reinventing the wheel first chiseled by Jeremy Isaacs, Lehman's former European chief. Isaacs tried, and largely succeeded, in building an investment bank in London that piggybacked off an established US business. It took

him about a decade, and the job wasn't nearly complete. Diamond has the added advantage of an already-made fixed-income business.

Before its collapse, Lehman had managed to generate more than half its revenue from outside the US – thanks largely to its leading role as a broker on the London Stock Exchange, the success of the London-anchored prop trading desk and some big deal financing. But in the boom year of 2007, three years into Isaacs' final phase of building the advisory arm, Lehman still wasn't a top-10 player in equities, debt or M&A in Europe.

Barcap expects to have in place all the technology and people it requires by the end of 2009 and to hit its stride before long, perhaps in a year or two. Expectations are sounding optimistic about when revenues will catch up to all the costs Barclays is piling on in investment banking.

Given the upheaval occurring in the industry, Diamond may indeed have the chips stacked in his favour for such grand thinking. But even he may not be able to achieve success quite as quickly as he seems to believe he can.

*June 1 2009*

## **Santander**

### **The great escape**

*By Fiona Maharg-Bravo*

BBVA and Santander continue to exhibit a Houdini-like ability to escape recession at home and abroad. Spain's two biggest lenders made a combined net profit of E7.3bn in the first half, down only 4.5% from last year, after stripping out one-off gains from asset sales.

The strong performance is partly thanks to sharply higher net-interest income assisted by cheap wholesale funding. This won't last forever, but it should underpin net income for the rest of the year. Meanwhile, both banks found further costs to cut – especially BBVA, whose cost-to-income ratio fell to 39.4% from 43.2% a year ago.

Emerging-markets exposure has also helped. For BBVA, its business in Mexico did better than feared given the country's virtual shut-down in response to swine flu. The rate at which loan-loss provisions are growing slowed for the second consecutive quarter. And Santander had a decent showing from its Latin American operations, whose net profits fell only 4% to E1.8bn. They were powered by a strong performance in Brazil, which augurs well for the mooted spin-off of its operations there. Back in Europe, Santander's UK operations also put in another stellar performance.

Both banks are suffering from rising bad loans in their domestic businesses. Santander's non-performing loans doubled year-on-year, to 2.8% of its book. The bank set aside 60% more in loan-loss provisions than it did a year ago, although the total was up just 7% from the preceding quarter. Like other Spanish banks, Santander and BBVA have been busy restructuring loans and buying property in debt-for-asset swaps to keep the number of NPLs down. The true state of credit quality remains a somewhat tricky question for investors.

Still, it is becoming safer to assume that Spain's banking giants have what it takes to deal with worsening conditions at home. Both have succeeded in strengthening their capital ratios while increasing provisions. Even with a Spanish economy in extreme difficulty, the bear case for both banks is getting harder to make.

**Context news:** Santander said net profits for the six months to the end of June were E4.5bn, 4.5% lower than the same period last year, but beating analyst expectations. The Spanish bank said it was on track to deliver net income of E8.9bn for the year.

Net-interest income was up 24%, while costs remained flat, excluding exchange rate impacts. The bank's cost-income ratio was 41.6% at the end of the period, an improvement of 2.3 basis points. Non-performing loans as a percentage of total lending rose to 2.8% in the quarter, from 2.5% in the first quarter, and 1.4% in the second quarter of last year.

BBVA, Santander's domestic rival, said on July 28 that net profits for the six months to the end of June were E2.8bn, against E3.1bn for the same period last year. After stripping out one-off gains from asset sales last year, the decline was 4.4%, the bank said. Net interest income grew 24% in the quarter compared with the same period last year.

*July 29 2009*

## **Credit Suisse**

### **Late riser**

*By Jeffrey Goldfarb*

It hasn't been easy to squeeze past the crisis-time flexing shown by Goldman Sachs and JPMorgan. But Credit Suisse seems to have managed. The Swiss group has muscled its way into the big leagues with a second straight quarter of solid results.

In some ways, the second quarter wasn't as good as the first. Headline net profit fell by 22% to SFr1.6bn (E1.1bn) and return on equity slipped five percentage points to

17%. Those figures are still impressive, especially compared to many of its rivals including Morgan Stanley. But they also don't tell the whole story.

Narrowing credit spreads on its own debt – a perverse piece of accounting – sliced SFr1.1bn off the reported profit. Credit Suisse also shelled out SFr500m to get rid of a headache from a botched buyout, of chemical producer Huntsman. Add those back and Credit Suisse had a first half that matched Goldman's – and with considerably less risk-taking.

Revenue at the private bank was higher in the second quarter than in the first, and both inflows of funds and profit margins ticked up. But the investment bank is doing the heavy lifting. Revenue from stock and bond trading doubled, as the bank gained market share in a range of businesses, including prime brokerage and foreign exchange.

That's a big accomplishment. Credit Suisse has been trying to crack the top tier of investment banking for decades. It struggled with the once great US firm First Boston, both as a leading shareholder and after buying it out completely in 1988. Donaldson, Lufkin & Jenrette, bought at the market peak in 2000, was an almost total waste of shareholders' money.

But Credit Suisse has had a good crisis. Brady Dougan, the chief executive, cut back fast on risky positions and businesses. He refocused the bank on trading for clients. It helps to have a fortress-like 15.5% Tier 1 capital ratio.

There are challenges ahead, whenever trading volumes and spreads shrink. Then Dougan will have to decide whether to take more risks. And Credit Suisse will face the real test of whether it can stay in the top tier.

**Context news:** Credit Suisse reported a 29% rise in second-quarter net income to SFr1.57bn. Included in the results was a SFr1.1bn charge related to improved credit spreads on Credit Suisse's debt and a SFr500m charge to settle a lawsuit from Huntsman Corp. because of a failed buyout.

The bank's return on equity was 17.5%. Stripping out one-off items, including a tax benefit, it was 27.4%.

The investment bank reduced its risk-weighted assets by 10% to \$139bn, and also cut its average one-day 99% value-at-risk by 10%.

"We expect the global economic environment to remain challenging and uneven business conditions to persist," chief executive Brady Dougan said. "However, if markets continue to improve we expect to see further momentum across our

businesses, and if markets become more difficult, we believe Credit Suisse is positioned to perform well".

- [Credit Suisse Q2](#)

July 23 2009

### Subprime brokerage

By Richard Beales

One aftershock of the collapse of Lehman Brothers twelve months ago was the dramatic reshaping of the prime brokerage business. The firm's failure shook confidence in Morgan Stanley and Goldman Sachs, driving away hedge fund clients. A year on, Deutsche Bank and Credit Suisse have emerged among the winners.

It's meaningful business, too. Sanford Bernstein put global prime brokerage revenues at a peak of \$12.4bn last year. The relationships also help attract hedge fund trading business, which spins off another \$12bn or so of revenue. All told, that amounts to nearly a tenth of global investment banking revenues in boom year 2007.

Morgan Stanley and Goldman used to share over half the prime brokerage market – helping hedge funds manage, borrow against and trade their holdings. Plenty of eager rivals found breaking in tough going.

Then came the credit crunch and the collapse of Bear Stearns, another big prime broker, into the arms of JPMorgan. The near-failure of the smallest of the fully-formed Wall Street firms scared some hedge funds. But Lehman's bankruptcy filing last September hit the hardest.

The bad news arrived on two fronts. First, the appearance of financial solidity at the larger investment banks like Morgan Stanley and Goldman suddenly looked illusory. By the end of the month, both had become bank holding companies, bringing them a safer-seeming regulatory framework and access to government rescue funds.

Second, hedge funds that had lodged assets with Lehman's international prime brokerage found them tied up in the London end of the firm's bankruptcy. Lehman had lent the assets on, a practice known as "rehypothecation," and it turned out that under English law this made it difficult for funds to recover them. The fallout damaged many funds.

The grip Morgan Stanley and Goldman still had on the market quickly loosened. Hedge funds couldn't risk leaving too big a slice of their assets with vulnerable institutions. They didn't necessarily take everything away, but many handed more to

other prime brokers – especially those backed by big balance sheets. Morgan Stanley reported a 65 percent decline in prime brokerage balances during the quarter ending in November 2008. Some business is returning, but the firm's market share is unlikely to recover fully.

This shift favoured prime brokerages at big banks including Deutsche Bank and Credit Suisse – neither of which has taken direct government help – along with JPMorgan with the legacy Bear franchise.

Throw in hedge fund investor concerns about where their assets are held – exacerbated by Bernard Madoff's giant Ponzi scheme – and the turmoil has also benefited banks more traditionally focused on custodial services (where assets are carefully ring-fenced to protect their owners) such as BNP Paribas, which agreed to buy Bank of America's prime brokerage in mid-2008 and was in the process of integrating it when Lehman collapsed.

Barclays Capital has also gained market share. Citigroup, meanwhile, has continued to work at the business despite its own woes, while Swiss bank UBS has lost ground as the crisis has taken its toll on the bank's finances and people.

A survey earlier this summer from Global Custodian illustrates the upheaval. More than 70% of hedge fund respondents said they had reduced their balances with Morgan Stanley in the past year; for Goldman the figure was 44%. The biggest reason was concern about their trading partners' credit.

JPMorgan added 200 large fund accounts in the year leading up to the survey, as well as taking on Bear's business. Deutsche added 80, and Credit Suisse 50. Morgan Stanley and Goldman, perhaps not surprisingly, didn't disclose what happened to their customer numbers. Bank of America, which now owns Merrill Lynch, appears to be in the game again too.

For chastened hedge funds, it's no longer simply about borrowing as much as possible. Many now want to spread their business more evenly among more prime brokers – but not too many, because deeper relationships bring trading benefits. They'll also distinguish more carefully between different competitors' creditworthiness and expertise.

Among prime brokers, the Morgan Stanley-Goldman near-duopoly is probably gone for good, although they're far from out of the business. Granted, differences in product and geographical focus make it a little simplistic to talk about a single market for hedge fund services. Even so, as the dust settles it's clear the prime brokerage world has been reshaped – perhaps as much as any other – by the Lehman debacle.

**Context news:** After Lehman Brothers collapsed in September 2008, hedge funds

that used the investment bank's prime brokerage services found some of their assets trapped in the firm's European bankruptcy process.

In addition, the survival of investment banks with prime brokerage businesses like Morgan Stanley and Goldman Sachs was, for a time, in doubt. Both firms adopted US bank holding company charters as part of their efforts to remain afloat.

A survey released on July 1 by Global Custodian underlined the dramatic weakening of the prime brokerage "duopoly" previously enjoyed by Morgan Stanley and Goldman.

The magazine highlighted Credit Suisse, Deutsche Bank and JPMorgan – which absorbed Bear Stearns' prime brokerage business earlier last year – as beneficiaries, along with Barclays Capital, BNP Paribas and Pershing, which is owned by Bank of New York Mellon.

The top rankings in the survey went to Credit Suisse, Deutsche, Citigroup and JPMorgan, with Barclays Capital, Bank of America, Goldman and Morgan Stanley in the next four slots.

In March, Sanford Bernstein reckoned "the prime brokerage market of tomorrow" would feature the following top 10 banks, in approximately this order: JPMorgan; Goldman; UBS; Morgan Stanley; Deutsche; BNP Paribas; Credit Suisse; Bank of America; Barclays; and Citigroup.

- [Global Custodian survey](#)

*September 7 2009*

## **Blackrock**

### **BlackRockin'**

*By Richard Beales*

BlackRock's \$13.5bn deal to buy Barclays Global Investors pleased almost everyone. But Larry Fink, the US fund manager's chief executive, had to plug a \$2bn-plus funding gap at the eleventh hour after an investment brokered by British financier Amanda Staveley didn't fit the bill. The tale underlines the powerful rationale of the BlackRock-BGI deal. Fink's firm is emerging as a crisis winner – and as the one to beat.

With more than \$2.7 trillion of assets under management, BlackRock plus BGI will be twice as big as its nearest competitor – and double the size of the entire hedge fund industry. Fink, who has steered BlackRock for more than 20 years, had the firm positioned to snap up BGI despite the financial crisis. But he still needed funding, and that was where Staveley came in. The financier, widely viewed as sharp-witted and something of a celebrity, supposedly lined up Middle Eastern investors – but BlackRock pulled the plug when they couldn't be clearly identified.

So the forceful Fink hit the phones. He ended up, only a day later, with \$2.8bn of new investment in BlackRock from a group that included existing shareholder PNC Financial and several sovereign wealth funds, enabling him to announce the agreement to buy BGI from Barclays.

The success of the last-minute whip-round is partly due to BlackRock's clout. But investors were ultimately persuaded by the logic of the deal, which appears to have satisfied almost everyone from stock analysts to BlackRock's institutional clients.

As a clear market leader, BlackRock can probably now expect more sniping from rivals. The company could, say, face closer scrutiny of its relationships with governments. For instance, Fink knows US officials including Tim Geithner, the Treasury secretary, while BlackRock is managing assets for the New York Federal Reserve and has advised Treasury on its aid to Citigroup.

Fink has shown a deft touch before. For one thing, he sidestepped the top job at struggling Merrill Lynch, a role that turned somewhat toxic for John Thain. Filling the hole left by Staveley is another example. So he may well keep the new, larger BlackRock on course. In any event, in an industry where scale matters, becoming large enough to be an obvious target is the right kind of problem to have.

**Context news:** Barclays accepted BlackRock's \$13.5bn offer for Barclays Global Investors on June 16. The deal, announced on June 11, was accompanied by a \$2.8bn investment in BlackRock by institutional investors.

The deal was originally intended to be unveiled a day earlier, but was delayed. The details of a \$2bn-plus Middle Eastern investment brokered by PCP Partners' Amanda Staveley, the British facilitator of Gulf investments in companies including Barclays, didn't meet BlackRock's requirements, the Wall Street Journal reported on June 23.

BlackRock chief executive Larry Fink was able to drum up the cash from other investors including existing shareholder PNC Financial and several sovereign wealth funds, the newspaper said.

*June 23 2009*

## THE SURVIVORS

### UBS

#### True to form

*By Jeffrey Goldfarb*

The Swiss have managed the financial crisis with a certain delicate precision. The latest sign is the government's quick exit of UBS, a decision that puts the country's largest bank back on its own feet, without further state hand-holding. That's no small accomplishment.

Last October, Swiss officials decided to inject SFr6bn (\$5.3bn) into then-ailing UBS as part of a broader rescue package. The recapitalisation, executed in December, gave the government a potential 9.3% stake in the bank through mandatory convertible notes that carried a harsh but fair 12.5% annual coupon.

Since then, UBS has charted a recovery. It replaced top management, set a new strategic course and raised fresh capital on its own. On Wednesday, it settled a long-running dispute with US tax authorities. That was enough for the Swiss government to decide UBS could abandon the state's embrace, the first bank in Europe to do so.

Investors were pleased enough to devour the 332m shares on offer at a mere 2.7% discount to the market price. UBS also will hand over to the government the present value of all the interest payments on the convertible bond – SFr1.8bn. Add that to the SFr5.5bn to be raised from the share sale, and Swiss taxpayers secure an impressive 32% annualised rate of return for their nine-month investment.

The bank's turnaround is far from complete. The investment bank is still shrinking and underperforming many rivals. The exodus of private banking customers isn't finished either. But UBS stills looks ahead of fellow crisis mega-losers. Neither Citigroup nor Royal Bank of Scotland is close to shaking off government investments and both can be jealous of UBS's strategic clarity and progress.

But if Swiss handling of the crisis resembles one of the country's prized Rolexes, its approach to bank secrecy looks more like a street-corner fake. For too long the authorities rejected demands that Swiss banks be more open with taxmen elsewhere. Pressure from the G20 – and the admitted crimes of UBS – made that position untenable.

The Swiss have been renowned for carefully minding domestic banking policy while resisting foreign meddling. Both positions proved hallmarks of the crisis.

**Context news:** The Swiss Confederation announced plans to convert and sell all SFr6bn (\$5.3bn) of its 2011 mandatory convertible notes in UBS. Investors took up the 332m shares at SFr16.50 each, according to Reuters.

As part of the conversion, UBS plans to pay the government the present value of future coupon payments on the notes, SFr1.8bn, on August 25. This payment will not affect third-quarter earnings but will reduce UBS's Tier 1 capital ratio by 60 basis points, the bank said.

- [UBS statement](#)
- [SNB statement](#)

*August 20 2009*

### Deutsche Bank

#### Reeling in the years

*By Jeffrey Goldfarb*

Josef Ackermann has been a crisis contrarian in many ways. So it makes sense that the Deutsche Bank chief executive should defy the trend among banking bosses too. While many of his counterparts have been pushed into early retirement by their incompetent or even reckless ways, Ackermann has been asked by his board to stick around for an extra three years beyond his planned 2010 leaving date. It's little surprise that he has agreed.

Putting aside some early overconfidence about a quick recovery, Ackermann has had a relatively good crisis. He steered Deutsche Bank away from the siren call of US sub-prime housing and anticipated the bonus backlash ahead of rivals. He saw the dangers of accepting state capital before they emerged, and positioned Deutsche Bank to exploit weakened rivals weighed down by the strategic restrictions that go with taxpayer funds.

While Deutsche Bank is far less exposed than peers to the ailing US and UK consumer, it still faces a reeling German economy. The continuity of leadership could prove valuable heading into a potentially deep recession. What's more, with Ackermann staying on, Deutsche Bank can put off until after the crisis the plight of retaining key executives who lose out in a scrap for the CEO job.

As for Ackermann himself, he is probably keen to try to leave Deutsche Bank on a bigger upswing. Retiring with an overpriced Deutsche Postbank as his deal legacy wouldn't suit a man of his ambition.

But if Ackermann were to see through his new contract to its end, it would keep him at the helm until he was 65 and had been in the role for 11 years. That's pushing it. The average tenure of Jimmy Cayne, Dick Fuld and Stan O'Neal atop Bear Stearns, Lehman Brothers and Merrill Lynch far exceeded that of their counterparts at JPMorgan, Goldman Sachs and Morgan Stanley. It suggests a degree of staleness and complacency can set in for a chief executive who overstays his welcome, or is welcomed to overstay.

It's sensible for Deutsche Bank to keep Ackermann around a bit longer – but it should also aim to replace him before too long. Orderly succession should be a top priority of his new tenure.

**Context news:** Deutsche Bank's supervisory board unanimously decided on April 27 to request that Josef Ackermann extend his employment contract by three years, until the annual shareholders' meeting in 2013. Ackermann accepted.

*April 27 2009*

## **Wells Fargo**

### **Test of Wells**

*By Antony Currie*

Wells Fargo's bosses took a vocal stand against the US government's intervention in the banking sector. Chief John Stumpf insisted that capital injections under the Troubled Asset Relief Programme were "generating a return for the US taxpayer – at a significant cost to the company". Meanwhile the bank's chairman, Dick Kovacevich, labeled the US stress tests of bank earnings and balance sheets "absolutely asinine". But judging by Wells' second-quarter earnings, the stress test wasn't so wide of the mark.

Sure, the bank proved that government examiners underestimated its earnings power – at \$3.2bn, profits surged past consensus estimates. But that's not what shareholders focused on. They care much more about the unexpected spike in troublesome loans. Non-performing assets jumped by around 45% from the first quarter. The troublesome assets associated with the acquired Wachovia provided the bulk, rocketing 145%. But with a 24% increase, Wells' own balance sheet nasties were hardly pleasant reading.

The good news is that Wells' overall delinquency rate remains relatively low. But so does its reserve, which at 2.86% of loans is much less than competitors have set aside. What's more, the bank also has lower capital ratios than many of its peers. In fact, had Wells not raised \$8.6bn in common stock mandated by the stress test, its ratio of core common equity to total assets would stand at just 3.6%, higher than last

quarter but lower than the 4% target the government's test set for banks to exceed by the end of next year. As it is, Wells' ratio is 4.5%.

Of course, Wells may insist that its earnings ought to remain strong enough to have reached the target in time anyway. But the credit crisis has taught investors – and most bank bosses – that it's better to have the money in the bank than promise it's on the way.

**Context news:** Wells Fargo reported second-quarter net income of \$3.17bn, or 57 cents a share, beating consensus estimates of 38 cents a share.

- [Earnings release](#)

*July 22 2009*

## **Morgan Stanley**

### **Banker, broker, soldier, spy**

*By Rob Cox*

Can another stock peddler cut from McKinsey cloth lead Morgan Stanley? The last time a former management consultant from the brokerage world, Phil Purcell, ran the firm, the experience ended in tears for the Wall Street firm's employees and shareholders. Yet it's one of the key questions Morgan Stanley's board will need to answer as it considers candidates to succeed John Mack, who turns 65 in November.

That's because the pedigree also fits one of the internal frontrunners, James Gorman. He runs the firm's asset management as well as the brokerage arm, which is merging with Citigroup's Smith Barney. But to win the top job, the former Merrill Lynch and McKinsey man must do a better job than Purcell did in winning over the blue bloods of the bank's institutional business - Morgan Stanley's engine of profits.

The New York bank hasn't said anything publicly about succession. But whoever gets the job when it opens up sometime in the next 18 months faces a formidable challenge. Unlike arch-rival Goldman Sachs, which despite becoming a bank and having some retail deposits focuses almost exclusively on institutional clients, Morgan Stanley is of two minds. In addition to being a wholesale bank it has a relatively large retail operation, on which it has staked much of its future.

So Mack's replacement must find a way to balance both business priorities - and their very different cultures. That's why the guessing game as to who is best suited to succeed Mack, who is chairman and chief executive, has become a Wall Street parlour game.

There are other Morgan Stanley executives said to be in the frame to replace Mack, including Walid Chammah, who is co-president with Gorman and looks after the institutional business from London; Colm Kelleher, the chief financial officer; and Paul Taubman, the head of the investment bank. There are also whispers about potential external candidates, such as Bob Steel, who left Goldman to work at the Treasury before running Wachovia and then selling it to Wells Fargo.

Choosing among this crew won't be easy since none of them has experience running both sides of the business – except perhaps Steel, although his tenure at Wachovia was short and it's hard to see the Morgan Stanley rank and file welcome a Goldman man. The relative importance of the institutional arm to Morgan Stanley in theory argues for a banker rather than a broker to take the mantle. In 2009, the banking operation generated \$16.6bn of net revenues, twice the combined top line of the global wealth and asset management divisions.

But after its near-death experience in October and subsequent conversion, along with Goldman, to a bank holding company, the board must consider the firm's future as a less capital-intensive and more client-driven franchise when selecting its next leader.

What's more, following the deal to take control of Smith Barney – which is expected to be consummated this summer – brokerage will loom larger in Morgan Stanley's overall strategy. Indeed, it will be the largest in US, giving the firm a powerful distribution business that could potentially help it win more corporate clients – in the same way that Merrill's thundering herd helped it during its heyday.

This strategic shift might help Gorman's candidacy – especially given his track record of revamping the brokerage business and tackling the group's troubled asset management division. The problem is that, having lived through the Purcell years, the idea of naming a brokerage and McKinsey man might not sit well with the bankers and traders generating the bulk of Morgan Stanley profits.

There may be compromise solutions. If the concern is that Gorman is not a "culture carrier", then why not sandwich Gorman between executives who are? One way to do this would be to let Mack remain as chairman, and then name co-presidents from the institutional side of the business, say Taubman and Kelleher, to replace Gorman and Chammah – who in turn could take on the exalted role of vice chairman.

Alternatively, it might be better to find an outside executive whose resume spans the retail and institutional worlds. But breadth of experience doesn't always produce the goods. After all, Gorman's old boss at Merrill, Stan O'Neal, worked in nearly all of its businesses – and his tenure at the helm was a disaster. Maybe those McKinsey management chops will turn out to be worth a second try.

May 14 2009

## Between two stools

By Antony Currie

Morgan Stanley might look like it's the only investment bank that couldn't make money last quarter. But strip out all the one-off funnies and the Wall Street firm's \$159m reported loss actually turns into some tolerable core earnings.

Getting there involves adding a few items back to revenues. First, the \$2.3bn hit Morgan Stanley had to take as the credit spreads on its own debt improved – the result of a 2007 accounting change that forces firms to record gains as their liabilities slip in value and losses if they increase.

Next, fold back in the \$850m it paid to get out of the US government's Troubled Asset Relief Programme, and, just to be generous, the charge for swapping some preferreds held by Mitsubishi Financial into stock, Smith Barney merger costs and a one-off special assessment levied by the Federal Deposit Insurance Corporation.

All in, that boosts overall revenue to \$8.9bn, leaving Morgan Stanley with \$2.9bn in pre-tax earnings. Assuming the quarter's whopping 54% tax bill still applies, that leaves a profit of \$1.33bn. On an annualised basis, that makes for a return on equity of some 9%. That's far better than the paltry 0.3% first-quarter showing. But the results still stand out as sub-par compared to rivals.

Much of the problem comes in fixed income. Granted, \$2.5bn of revenue – after adding back charges on Morgan Stanley's own liabilities – looks pretty good for a firm that has disavowed prop trading. But with Citi and JPMorgan reporting twice as much and Goldman Sachs and Bank of America even more than that, Morgan Stanley looks rather shy – and insiders say it pulled its punches in both currencies and the rates business. Also, Morgan Stanley's asset management division is still losing money, largely because of principal investments.

That leaves the firm rather caught between two stools: its trading results are suffering because it isn't taking enough risk while investments are still suffering because it took too much.

The good news is that once properly up and running the brokerage joint venture with Smith Barney should post better results and boost returns. But until it is clear exactly what the firm's tolerance for risk is, Morgan Stanley's shareholders are likely to tread a cautious path.

**Context news:** Morgan Stanley reported a second-quarter loss of \$159m, or \$1.37 a share, missing the consensus estimate of a loss of 54 cents a share.

The firm recorded investment banking fee revenue of \$1.1bn, equity trading revenue of \$681m and fixed income trading revenue of \$973m. Overall, the investment bank recorded a pre-tax loss of \$307m, global wealth management a loss of \$71m and asset management a loss of \$239m.

The loss was driven by two factors. First, the firm took a \$2.3bn revenue hit as spreads on its own liabilities improved during the quarter. Under US accounting rules, financial firms must mark to market changes in the spreads of their own debt: as spreads widen – as they did as the credit crisis worsened – firms record a gain; as spreads narrow, they record a loss.

Second, Morgan Stanley paid a one-off \$850m preferred dividend related to paying back the \$10bn in capital it received from the US government's Troubled Asset Relief Programme.

Elsewhere, Morgan Stanley took a \$202m hit from the partial exchange of preferred stock issued to MUFG for common stock and a \$319m after-tax gain from selling its remaining stake in MSCI.

- [Earnings release](#)

July 22 2009

## THE STRATEGICALLY CHALLENGED

### Bank of America

#### Hold your horses

*By Antony Currie*

The US Treasury shouldn't let Bank of America out of the penalty box just yet. The Charlotte, North Carolina-based bank wants to repay \$20bn, or almost half of the capital it received from the Troubled Asset Relief Programme, according to press reports. The bank's fortunes have certainly picked up since the depths of the banking crisis – its stock has rocketed almost sevenfold. But it's hardly out of the woods.

For starters, it still trades at just 75% of book value, implying shareholders still see more pain ahead. And BofA's core business is hardly firing on all cylinders. Sure, the bank reported \$7.4bn of profit for the first half of the year. But that's illusory: BofA actually lost \$3.5bn – \$5.7bn if dividend payments are included – after stripping out tax benefits and one-off gains from selling chunks of businesses, including almost half its stake in China Construction Bank, and adjusting for accounting-driven gains and losses on its own liabilities.

What's more, some of the best-performing units in the first two quarters are unlikely to crank out such stonking revenues in the next two: mortgage refinancing, which accounted for as much as 80% of BofA's home-lending business, has died down and tighter fixed-income spreads make a repeat of its second-quarter trading bonanza unlikely. Even embattled boss Ken Lewis reckons the second half of the year is going to be tough.

Meanwhile, though the pace of loan losses may have decelerated in recent weeks, the bank will probably be adding to reserves well into 2010, even if the economy doesn't dip back into recession. Then there's still the lingering question of Lewis's role after the shenanigans surrounding the acquisition of Merrill Lynch exposed flaws in the bank's risk management in general and his leadership in particular. And none of the three individuals who now appear to be in the running to be his successor has any experience managing such a large institution.

Granted, BofA looks much better positioned than fellow struggler Citigroup. But with so many questions still hanging over its performance and leadership, paying back Tarp cash now would be a mistimed PR stunt.

**Context news:** Bank of America wants to pay back \$20bn of the \$45bn of capital provided by the US Treasury's Troubled Asset Relief Programme, according to the Wall Street Journal. The bank and the Treasury are also in talks to decide how much money BofA should pay for shelving plans to accept a government guarantee on

\$118bn of assets. The US is pushing for the bank to pay at least \$500m, according to the newspaper.

*September 1 2009*

## **Nomura**

### **Your career or your life**

*By Rob Cox*

How much is a lifetime employment guarantee worth to you? That's a calculation Nomura's Japanese workforce is having to ponder like never before. While the Japanese firm's domestic staff always had some option to choose the security of a job for life in exchange for a more Anglo-Saxon contract with generally bigger bucks, the pressure is growing to choose the latter.

Tokyo-based Nomura has told some 3,000 Japanese staff in its markets, investment bank and merchant banking divisions that if they opt for continuous employment they will no longer be considered for transfers to different businesses or geographies within the firm. The message, delivered as part of performance reviews over the past couple of weeks ahead of the April 1 start to Nomura's fiscal year, is effectively that staff seeking a job for life may do so at some sacrifice to their professional career.

That may sound harsh, if not downright heretical in Japan, but it is the direction Nomura needs to take. It is no longer just a local heavy with a few chunky operations in London and New York. Say what you will about the wisdom of Nomura's timing, but the purchase of Lehman Brothers' operations in Asia and Europe has vaulted it into the major leagues of global investment banking.

As a result of adding some 8,000 employees outside of Japan in one fell swoop, about 80% of Nomura's wholesale securities business – which is separate from its domestic stock brokerage operations – is now overseas. Prior to its purchase of Lehman's foreign businesses in October, just around a fifth was abroad. Barclays Capital picked up Lehman's North American operations.

With this overnight globalisation, Nomura is now undergoing something of a mini revolution. It is not merely holding more meetings in English. It is also making decisions in time zones on the other side of the globe. That explains its decision to relocate its global head of investment banking, Hiromi Yamaji, to London and put its global head of equities, Naoki Matsuba, in New York.

And there are other smaller, though significant, changes that Nomura is implementing. The firm will no longer pay bonuses twice a year, but once annually. It will also adopt a

common evaluation system around the world, which takes into account each business unit's performance in addition to the performance of the individual and overall company. While many of these measures were already in the works, the integration of the Lehman businesses accelerated their adoption.

Still, the most revolutionary change is the new treatment of continuous employment. At most Japanese corporations a job has traditionally been regarded as a commitment for life by both employer and employee. The security that accompanies that concept isn't free, of course. It reduces workforce mobility and allows companies to make demands on employees that western workers might find unreasonable or intrusive. It has also meant lower merit bonuses, which has kept pay in general lower in Japanese finance.

True, as the premier Japanese financial house Nomura has over the years had to grapple with Anglo-Saxon pay structures to keep its domestic talent from being poached by the likes of Goldman Sachs, UBS and, ironically, the formerly highly aggressive Lehman. That's why it has for years offered many employees in Japan a choice to forego the safety of lifetime employment for Wall Street-like contracts.

Nomura's purchase of the Lehman businesses has given urgency to the need for change. To compete, Nomura needs to ensure its cost base can be as flexible and variable as the new rivals it is battling with around the globe. And to ensure cohesion among its far-flung dojos it needs commonly shared goals, with the incentives that accompany them – thus a more unified compensation system.

Of course, Nomura being a Japanese corporation, nobody is being forced to switch. But in a consensual culture all it takes is one polite suggestion from a senior manager to move the masses. And with the prospects of bonuses some 40% higher for those who do, it's not hard to see how Wall Street's culture could come out on top.

**Context news:** Nomura has told some 3,000 Japanese employees in its markets, investment bank and merchant banking divisions that if they opt for continuous employment they will no longer be considered for transfers to different businesses or geographies within the firm, breakingviews has learned.

The message was delivered as part of performance reviews over the past couple of weeks ahead of the April 1 start to Nomura's fiscal year. The company declined to comment.

In addition, Nomura will only pay bonuses once a year, instead of twice. The firm is also adopting a common evaluation process around the globe, will factor in business unit performance in addition to individual and overall company performance when determining compensation.

*April 2 2009*

## General Electric

### GEC or CIT?

*By Rob Cox*

From the numbers, it sure is hard to spot the difference between General Electric's financial arm and CIT, the lender that appears to have called in the bankruptcy lawyers. Indeed, CIT's struggles to keep afloat give an excellent idea of what life would be like for a GE Capital bereft of a deep-pocketed corporate parent – and the extraordinary largesse of the United States government.

Both CIT – which has hired law firm Skadden to advise it on its financing options – and GE Capital cling to business models that no longer work: financing longer-term loans to customers largely with short-term funding in the capital markets.

Such financing is almost entirely unavailable these days. Lucky for GE Capital, it has a rich industrial parent, which has helpfully diverted a chunk of its dividend payments and capital to the financial business. Not so CIT, which was spun off from a rival industrial conglomerate, Tyco, a few years back.

And GE Capital has also availed itself mightily of the government's Temporary Liquidity Guarantee Programme. By the end of the first quarter, this allowed GE Capital to issue \$74bn in bonds backed guaranteed by Uncle Sam – making it the single biggest user of the scheme administered by the Federal Deposit Insurance Corporation.

Oddly, CIT's application to participate in the TLGP has been pending since January. Yet, CIT and GE Capital look like birds of a feather – arguably CIT looks like the prettier of the two ugly ducklings of finance. In the first quarter, CIT had shareholders' equity equal to 10% of its \$76bn of assets - higher than GE Capital's 9.6%.

Moreover, CIT was less dependent than its far larger rival on short-term funding. GE Capital, which had \$636bn of assets, qualified \$176bn, or 28%, of its liabilities as short term. CIT said \$17.1bn of its funds were due to be repaid within 12 months – equal to 22.5% of its total assets.

CIT may yet gain access to the TLGP and get through its short-term refinancing crunch. But the lender's travails should make a compelling case for GE to begin winding down, and getting out, of the financial business for the long-term good of its shareholders.

**Context news:** CIT, a US lender with a \$76bn of assets, hired law firm Skadden to advise it on its financing options, according to the Wall Street Journal. The company,

which may not be able to refinance a \$1bn liability coming due in August, could seek bankruptcy protection, the newspaper reported.

In December, CIT became a bank and received \$2.33bn in Tarp funds from the US government. According to Bloomberg, the lender to small businesses has not been able to access the corporate bond market for more than a year.

CIT said last week that its application for access to the Federal Deposit Insurance Corporation's Temporary Liquidity Guarantee Programme remains outstanding. "CIT continues to be in active dialogue with the government. There can be no assurance that CIT's application will be approved by the FDIC, nor as to the timing or terms of any such determination," the company said in a statement.

*July 13 2009*

### Black box or hole?

*By Robert Cyran and Rob Cox*

Does General Electric need to put aside more cash to handle bad loans at its finance arm? GE says it doesn't – it even insists it has higher loan loss reserves than the biggest US banks. But investors aren't fully convinced. And a look at just one small slice of GE Capital's \$650bn of assets suggests why they are right to be sceptical.

The company's reserves against losses in its \$38bn of leveraged loans are around 1.2% of its book. GE estimates these losses will probably peak next year at around 1.9% or slightly less. But this prediction, which would imply GE Capital just needs to set aside another \$266m or so, seems too low when judged against the market.

The average leveraged loan currently trades around 81 cents on the dollar, according to S&P Leveraged Commentary and Data. If marked to market, GE's debt portfolio might trade close to that level too, based on the distribution of credit ratings on those loans.

While some of the 19 cents on the dollar discount the market now attaches to the average leveraged loan may be a function of illiquidity, a large chunk is the market's way of suggesting defaults will be far greater, overall, than the 1.9% that GE is banking on.

Now, it's true that GE's portfolio may be of higher quality than the broader market. If the firm's boasts about its superior credit management skills are to be believed, it probably has fewer dud loans. The company also claims it is "willing to work longer and harder to recover full value" - even if rivals like Goldman Sachs or JPMorgan aren't widely known for letting borrowers off the hook easily.

So assume for the sake of argument that GE's leveraged loans have only lost half as much of their value as the average. That still would suggest potential losses of some \$3.6bn – or eight times its current reserves. That may not seem like a big deal. After accounting for reserves already taken, it would amount to just 5% of the finance arm's total shareholders' equity. But if investors apply similar arithmetic to the other \$600bn-odd of assets on GE's books the losses would clearly start to add up.

GE may prove naysayers – and the market – wrong by riding out the downturn and the credit cycle, and getting most of its borrowers to make good on their commitments. But with one small, but important, piece of the puzzle already looking wonky, shareholders can be forgiven their wariness for now.

**Context news:** GE Capital's investor meeting took place on July 28. The company predicts losses on leveraged loans should peak in 2010. Under the company's base case, 1.9% will be lost out of a \$38bn portfolio. Under GE's adverse case scenario, the figure is 2.8%. Unlike an investment bank, GE Capital is not required to mark its portfolio to market.

The S&P/LSTA leveraged loan 100 index currently trades at 81 cents on the dollar.

- [GE Capital presentation](#)

July 31 2009

## Lloyds

### Tricky one

By George Hay

First the detoxification, then the tidy-up. Having bought insurance on its bad assets from the UK government, Lloyds Banking Group is now looking to sell non-core assets inherited with its acquisition of HBOS earlier this year. But Lloyds' difficulty is that even the most successful disposal programme will struggle to address the UK bank's strategic priorities.

It is clear where Lloyds ought to be heading. The bank needs to end up looking like a bigger and more efficient version of what it used to be prior to the HBOS deal: a scale player in the UK retail and commercial banking markets, delivering modest growth but chunky dividends to shareholders. Indeed, the HBOS deal stands to deliver £1.8bn of likely synergies by 2011, according to Exane BNP research.

Getting there will mean exiting a lot of the fancier HBOS businesses Lloyds has adopted. The nuttiest of HBOS's follies - self-certified mortgages and equity stakes in doomed buyouts - have no place in such a group.

But sales of chunkier, less risky non-banking businesses - such as HBOS's Insight Investment or the Scottish Widows Investment Partnership - could create a modest capital boost if sold at a premium to book value. There are clearly buyers for such assets: Barclays' sale of BGI shows the asset management sector is open to consolidation and SWIP may attract interest.

Clerical Medical, the life business inherited from HBOS, could also be sold. Entrepreneur Clive Cowdery's acquisitive Resolution vehicle is on the prowl for a multi-billion-pound insurance deal. A sale to Cowdery looks a simpler course of action for Lloyds than trying to fold Clerical Medical into the Scottish Widows life arm. An attempt to bulk up Widows would bring together two conflicting cultures. Putting the customer systems on a single platform would be a logistical headache.

But getting good prices would be difficult right now. Insurance assets currently trade around 0.8 times embedded value, the industry measure for valuing existing policies. And even if deals could be agreed on good terms, the strategic benefits would be slight: Lloyds' capital base is already strong, with a core Tier 1 ratio of 9.3% if it presses ahead as planned with the government's asset insurance scheme.

Lloyds' problem is that even the most successful disposal programme will do little to address its strategic imperative - namely, getting back to its former loan-to-deposit ratio just below 150%. The HBOS deal lifted that measure to a frightening 178%. Only an aggressive sale of some of Lloyds' £703bn stack of loans could bring it back down quickly. But loan buyers would insist on big discounts to par, leaving Lloyds with a large hole that would erode its strong capital cushion.

There is no quick fix. In fantasy land, Lloyds would find a merger partner which would be deposit-rich, asset poor and hungry for a tie-up. But in reality Lloyds shareholders would be best served by their bank sitting on its hands for the next few years, letting its funding mix improve organically and selling assets when prices recover.

The question is whether Lloyds should be appearing to act more decisively to reshape itself for the sake of the politicians. The UK government may be willing to let Lloyds muddle through with an uncomfortable reliance on wholesale funding for the next few years. But an inert strategy may not satisfy the European Commission, which is likely to want to see shrinkage for shrinkage's sake.

Shareholders may think it is better for Lloyds to sit tight. But getting on with some high-profile disposals might at least keep Brussels from forcing Lloyds to go further than it would really like.

June 29 2009

## THOSE ON LIFE SUPPORT

### AIG

#### **Don't hold your breath**

*By Lauren Silva Laughlin*

Almost a year after it nearly collapsed, American International Group has only just found a chief executive who might stick around for a while. It has been a slow start to a marathon that began when Lehman Brothers went bust in September last year. The arrival of tough-talking Robert Benmosche has accompanied a rally in the company's languishing stock. But real progress is sluggish. A return to health looks a long way off - and any investment return to taxpayers is even more distant.

Lehman's collapse had unexpectedly dire and rapid repercussions, prompting politicians and officials to inject \$85bn of taxpayer money into AIG just days later. As time went on, AIG's financial position worsened as it began winding down its \$500bn portfolio of credit default swaps in awful market conditions. A series of further bailout moves followed.

In total, taxpayers committed about \$180bn to bail out AIG and buy some of its dodgiest assets. The hurriedly installed stopgap chief executive, Edward Liddy, proposed a plan to sell assets to pay back the government. But buyers for the big ones haven't bitten. So far, AIG has managed to sell only a few billion dollars worth of assets. There have been other challenges too. AIG was hit with a public relations disaster over bonuses it had agreed to pay members of its financial products unit, the source of its woes. Along the way, the dollar-a-year Liddy became fed up with taking flak from Congress and the media.

Finally, in early August new chief Benmosche, formerly the boss at MetLife, took the helm. He has helped boost AIG's stock by saying he will take a more patient approach to selling assets. The company's shares have tripled since he replaced Liddy - although they are still trading at less than 5% of their level six months before Lehman's collapse.

But Benmosche's tough talk - including criticisms of officials, a risky game given AIG's precarious position - can't on its own help US taxpayers get their money back. So far the government's investment has merely been reshuffled, reducing AIG's debt to taxpayers but increasing their exposure to equity in the company's business units. In June, the government agreed to swap \$25bn of its bailout loans to AIG for stakes in key insurance business units that AIG plans to spin off, but which are yet to prove their standalone value.

Even assuming the spin-offs conclude successfully, AIG will still owe the government \$20bn in debt. The US Treasury also made a \$40bn equity-like investment, while the Federal Reserve's original bailout has given it an effective 79.9% interest in AIG itself.

The odds that taxpayers will even get their money back, let alone a return, still look long. The two spin-offs need to be accorded enough value by investors that the government's stakes are together worth at least the \$25bn implicitly paid. The bad assets the US government took off AIG's hands for \$45bn-odd have to perform the unlikely feat of turning out to be worth that much. And AIG needs to get back on its feet so that the government's \$20bn in debt can be repaid or refinanced.

Then the government's remaining equity interest still has to be worth \$40bn for taxpayers to break even. Right now, AIG's publicly traded common shares are worth about \$5.5bn. If the government becomes the holder of a true 79.9% stake, the implicit market capitalisation would be around \$27bn - half what it needs to be, even though the stock has risen four-fold in the past two months. In other words, an awful lot has to go right.

There are some brighter spots. Benmosche, with his \$7m a year package, seems motivated to get AIG on track. He is already revving up the troops with colourful language, including criticism of New York Attorney General Andrew Cuomo. A certain amount of aggression may be warranted, but Benmosche has already had to back off some of his rhetoric. He will have earned the right to be more publicly belligerent if, in a few years, AIG is genuinely on track towards making taxpayers whole.

**Context news:** The US government injected \$85bn into American International Group on September 16 last year, two days after Lehman Brothers filed for bankruptcy. In October the Federal Reserve injected another \$37.8bn into the company.

On November 10, AIG announced a restructured bailout plan. The earlier \$85bn loan from the Federal Reserve was replaced with a new \$60bn facility. The US Treasury also purchased \$40bn in AIG preferred stock under its Troubled Asset Relief Programme. In addition, AIG and the New York Fed established a special facility under which approximately \$40bn of residential mortgage-backed securities were transferred to a new limited liability company.

AIG and the New York Fed also established a facility to terminate its credit default swap portfolio. The facility purchased collateralised debt obligations from the counterparties. The New York Fed committed up to \$30bn and AIG invested \$5bn.

On March 2 this year, AIG announced plans to separate American International Assurance Company and American Life Insurance Company into two separate vehicles that would be spun off. The government agreed to swap \$25bn of debt into stakes in these two vehicles.

Edward Liddy was elected chief executive on September 18 last year. He agreed to work for \$1 a year. On March 18 this year, Liddy sat in front of a congressional panel to answer questions about the \$165m in bonuses he paid out to AIG executives. Liddy and some employees received death threats as a result of the bonuses. On May 21, the company announced his plans to step down.

On August 3, AIG's board elected Robert Benmosche to take Liddy's place. He agreed to a \$3m salary plus bonus and stock options. In aggregate, the package is worth around \$7m. Shortly after, Benmosche told employees that New York Attorney General Andrew Cuomo had been "unbelievably wrong" to draw attention to AIG employees salaries and said that he didn't "deserve to be in government," according to a Bloomberg report. Later AIG said Benmosche regretted his comments and their tone.

As of June 30 this year, AIG had \$231bn in its super senior credit default swap portfolio, down from \$533bn.

*September 4 2009*

## **Freddie Mac and Fannie Mae**

### **Paper loss anniversary**

*By Robert Cyran*

Fannie Mae and Freddie Mac shouldn't be allowed to languish in Uncle Sam's arms. But as the anniversary of their seizure by the government approaches, the \$5.4 trillion mortgage giants remain the biggest black holes in the financial firmament. Lawmakers seem content to allow the two companies to slowly expand. That's a shame – forcing them to wind down their portfolios of mortgage-backed securities (MBS) would be a good first step toward eventually deflating them.

The Obama administration won't release its recommendations for the companies until February. This gives it time to wage battles in areas ranging from climate change to healthcare. These issues are already drawing heavily on the president's political capital.

That may leave little appetite to tackle the government sponsored enterprises (GSEs), especially given their popularity among some lawmakers and their increasingly dominant role in the mortgage market. The United States has already committed up to \$400bn to cover the firms' losses, providing enough of a cushion to tempt politicians to let the issue slide.

The problem arises from the companies' dual roles. They have a public policy mandate to boost lending to the housing market. And they are supposed to reward shareholders. The conflict between these two goals caused the companies to nearly collapse.

The GSE's principal business of guaranteeing mortgages caused economic distortions that helped fuel the housing boom. As private mortgage lenders pulled in their horns, the GSEs' share of the market grew from under 50% to around 80% by the end of last year, despite the fact that their aggregate portfolios have only increased by about 3% since their conservatorship.

Their success is the sticking point. Society benefits from the efficiency and lower costs derived from the standardization of mortgage pools, which allows them to be easily securitized. The GSEs scale this advantage up significantly. Fannie alone has \$2.8tr of guarantees on MBS.

On the other hand, the guarantees have unintended consequences. Since investors always reckoned the government stood behind the GSEs, mortgage rates fell below appropriate risk-adjusted market rates. This acted as a subsidy for home buyers at the expense of other taxpayers and contributed to the housing bubble.

Solving this problem without throwing the mortgage market into disarray will be difficult. Winding the GSEs down, or splitting them into smaller firms without government backing would get rid of the subsidy, but could reduce the benefits they brings to the MBS market. In any case, this would be a difficult sell politically due to the firms' dominant positions. Fannie guaranteed more than half the mortgages for new single-family homes in the second quarter.

Policymakers aren't helpless. They can initially target the GSE's portfolios of MBS. Fannie alone holds more than \$800bn worth. The figure has grown at an annualized rate of 6 percent in the year to date.

The MBS holdings are an arbitrage that benefited the GSEs' shareholders at the expense of taxpayers. Their quasi-governmental status means they could borrow more cheaply than others and plow the money into higher-yielding MBS. The resulting profits went to shareholders.

Moreover, the GSEs successfully lobbied to be able to hold low levels of capital against their investments, boosting returns. This also gave them little margin for error. Since the government now runs the show, there's little reason these holdings can't be wound down, although this would have to be done gradually.

True, the GSEs can act as mortgage buyers of last resort during crises, when the mortgage markets would otherwise seize. Yet Fannie didn't significantly shrink its

portfolio of MBS during the easy money years between 2002 and mid-2007. Also, their purchases – as distinct from their guarantees – during this period probably didn't have much of an effect on mortgage rates, since they represented a relatively small part of the overall market.

Moreover, when housing markets crashed, the direct mortgage portfolios left Fannie and Freddie saddled with avoidable losses. These are now taxpayer's problem. A quick way to avoid exacerbating this privatization of gains and socialization of losses would be to ban the GSEs from buying more MBS and force them to run off their portfolios. Then the government can turn to the more nettlesome issue of their guarantees.

**Context news:** Fannie Mae and Freddie Mac were placed into conservatorship by the US government on September 7 2008.

*August 31 2009*

### Citigroup

#### Keep the ditherer

*By Rob Cox and Dwight Cass*

What's the case against Vikram Pandit? The Citigroup chief executive didn't dig the hole the bank is struggling to emerge from. Yet calls to replace him - including from one of his bank's primary regulators - seem to grow stronger by the day. These are off the mark.

That's not to say Pandit is a management superhero. He has made many mistakes. But removing him risks further delaying Citi's recovery. Keeping Pandit in charge - while applying reasonable pressure to accelerate the bank's transformation - is in the interests of regulators, investors and taxpayers (who will soon be the bank's top shareholder).

To defend the man, it's worth considering the rap sheet against him. Chief among the former Morgan Stanley executive's flaws is an annoying tendency to dither.

He took too long to recognise Citi's all-things-to-all-people financial model was a problem. Even when he took over in December 2007 it was abundantly evident to investors that the behemoth Sandy Weill had created - and Pandit's predecessor Charles Prince defended - was too sprawling to manage effectively and not capable of producing the efficiencies its managers had promised but chronically failed to deliver.

Yet in fairness, Pandit changed his mind quickly when Citi's problems mounted late last year. Shortly after staring into the abyss, Citi agreed earlier this year to sell its

profitable brokerage, Smith Barney, and move a whopping \$850bn of assets into a holding company that will dispose of them, or run them down, over time.

That's allowed Pandit and the team he has put in place - a more functional one than the sniping executives jostling for power under hapless Prince - to focus on Citi's core. At its heart, the new Citi (which looks a lot like the one John Reed envisioned after Citi's last near-death experience at the beginning of the 1990s) is the only truly global provider of financial infrastructure to multinational businesses.

Pandit also failed to raise sufficient capital to offset coming losses when he could have. While he is in the process of swapping \$58bn of preferred shares held by the government and the public for common, this will cause significant dilution to shareholders who have seen nearly 90% of their investment wiped out during Pandit's tenure.

Finally, even when he looked to have engineered a super deal that would have reduced Citi's dependence on wholesale funding - the government-assisted takeover of Wachovia - he prevaricated in a way that ultimately lost him the prize. Pandit committed a grave error for an investment banker by failing to guard his quarry.

Citi initially emerged as the only buyer for Wachovia last September. But after agreeing only a term sheet, Pandit pushed too hard in structuring the transaction. While he was right to try to get the best deal he could, that left a flank open. Wells Fargo - having seen Citi's investors' positive response to the deal and the tax benefits that came with it - swept in with a better offer that Pandit could not match.

Oh, and Pandit blew his top over the matter. Indeed, it is the Wachovia episode that sparked Federal Deposit Insurance Corporation chief Sheila Bair's attempt to convince other regulators of the bank - including the Treasury and the Office of the Comptroller of the Currency - to replace Pandit.

But despite these many mistakes, it is worth remembering that Pandit isn't directly responsible for Citi's ills. Its unwieldy structure - which he has since streamlined - was a legacy of Weill's feverish deal-making. And most of the dodgy assets that led to \$64bn of write-offs in 2008 alone were accumulated under Prince's stewardship.

All of this makes a marked contrast to the situation at Citi's rival Bank of America. The Charlotte bank's chief executive Ken Lewis has been in charge since 2001 and is the person most responsible for its current straits. He led BofA's falling-knife acquisitions of mortgage bank Countrywide and Wall Street firm Merrill Lynch.

Moreover, Lewis's clash with Federal Reserve chair Ben Bernanke and former Treasury boss Hank Paulson over the Merrill acquisition - publicly dissected in painful detail by lawmakers last week - has eroded his tenuous standing with regulators and shareholders, who have already stripped him of his role as chairman.

To be clear, Pandit and his team also exacerbated tensions with regulators, not least by publicly calling FDIC Citi's "tertiary" regulator and dragging their heels on formulating the terms of the conversion of preference shares, due next month.

Regulators are right not to let Pandit dither again. And perhaps a little jawboning may prove helpful in that regard. But unlike Lewis, who not only led BofA into its troubles and has become a regulatory liability, Pandit deserves more time to complete Citi's transformation.

**Context news:** Bank of America's chief executive, Ken Lewis, testified in front of the House Committee on Oversight and Government Reform on June 11.

*June 18 2009*

### **Welcome, doormats**

*By Antony Currie*

The US is about to become the largest shareholder of Citigroup now that the beleaguered megabank's preferred-for-common stock exchange has been finalised. That means 148m taxpayers - 139m individual and 9m company filers - are soon to be the effective owners of almost 54 shares each. To help them get to grips with the complex beast that is Citigroup, Breakingviews.com has drafted a welcome note-cum primer that Citi chairman Dick Parsons might consider sending to the bank's new shareholders.

"Dear new shareholders,

It is my privilege as chairman to welcome you, all 148m of you, to the fast-growing ranks of Citigroup's shareholders. I know the 34% stake is actually held by the US Treasury. But we here at Citi know that it's the great American public that's stumping up the cash. And between you, me and the ATM machine, we probably wouldn't have made it without your help. So I thought the least I could do was to convey our thanks. Though we might not actually get around to mailing this as we've had to cut back on all kinds of expenses, including postage.

I also thought it might be a good idea to give you an introductory tour of our bank - a primer, if you will. Some of you may have tried getting to grips with the place after the government started pumping \$45bn of your hard-earned money into our preferred

stock last year. But it's a monster, and even our chief executives don't always understand what's going on, never mind us directors. Now that each of you has around \$150 invested in Citi, we owe it to you to try to explain.

First off, you just swapped your preferred shares for common stock. Right now it looks as if the exchange offer will wipe, let's see, about 11% off the \$25bn the government invested for you. And you're losing the 5% dividend you were getting. And shares are riskier investments than preferred stock. But hey, what's life without a little excitement? And one of the big lessons of this credit crisis is to take the long-term view, and shares have much more upside potential.

And look at what you're getting! Citigroup is now the first truly national bank in the US. Well, perhaps that's a bit of a stretch. But it will be if we manage to persuade you to add chequing and credit card accounts to your holdings as taxpayers. Naturally, we'd love to offer you low fees and interest rates as an incentive. But unfortunately we need the cash. Rest assured though, that the more of your money you give us, the less likely we are to go properly under and leave your shares worth nothing.

What's really neat about being a Citigroup shareholder, though, is that you own not one, but two institutions. First, there's Citicorp. This is a great firm. Our investment bank's in there. Our traders made a bundle last quarter, for example, double what Morgan Stanley's did. So they must be good! We've also got most of the retail bank in there as well as what we call transaction services. That one's a bit dull, to be honest, but, like selling shovels to prospectors in the gold rush, it's a great little earner.

Then there's Citi Holdings. True, that has some dross in there we don't want – like toxic securities. But there's good stuff in there, too, like Smith Barney - a great money spinner that doesn't need much capital. Sure, we had to hawk just over half of it to Morgan Stanley to raise some cash. But that means you also sort of get a vicarious stake in that firm, too. It's almost three for the price of one!

Despite being, collectively, our largest shareholder, you don't actually get a say in how we run the place. But don't worry, we have long since got rid of those renegades who lost us all that cash. Granted, you might not always agree with what we do – like whacking up interest rates on credit cards or paying successful traders like Phibro's Andrew Hall \$100m a year. But these practices can be good for your investment. And if it turns out they're not, well, you can always blame the government. But don't tell Barack Obama I said that – he's a friend of mine.

Naturally you are all invited to attend our shareholder meetings. But we'd be much obliged if you could help us cut costs by supplying your own coffee and bagels. That's only once a year, though. In the meantime, rest assured we're working like mad on your behalf. After all, Citi never sleeps!

Warmest regards,

Dick Parsons

Chairman, Citigroup"

**Context news:** On July 26 Citigroup announced that \$20.3bn of publicly held convertible and non-convertible preferred and trust preferred securities have been tendered to be exchanged into common stock. That represents 99% of the total liquidation value of securities Citi was offering to exchange. The holders will receive a total of 5.833bn shares in Citi.

On July 23 Citi announced that it had completed the exchange offer for \$12.5bn of privately held convertible preferred securities.

The US government is exchanging a total of \$25bn of the \$45bn of preferred stock it holds in Citi – half tied to the completion of the public exchange, the other half to the completion of the private exchange.

- [Citi press release](#)
- [Citi press release](#)

July 27 2009

## RBS

### There but for the grace of Gord

By George Hay

Almost everything about Royal Bank of Scotland has changed radically – but not its unpredictable nature. The compulsive deal-making of Sir Fred Goodwin, the hard-nosed, aggressive former chief executive, made the future size and shape of RBS hard to forecast. It is no different now under Stephen Hester – but the emphasis is on down-sizing, not acquisitions.

When he was appointed last October, Hester had two goals: to stabilise the bank and then to get rid of the dominant stake held by the UK. Whitehall first put in £20bn of

capital, acquiring a 70% stake. When that proved insufficient. RBS had to buy costly insurance on £325bn of its worst loans from the government, which will push the public stake even higher. Since then, the share price has risen from 10p to over 50p – still only a fraction of the 688p peak in 2007.

Hester has made his presence felt. He will complete the stabilisation process by maintaining RBS's core Tier 1 ratio at 8% – twice that favoured by Goodwin – while reducing the bank's loans and bolstering deposits. This will be achieved by substantially running down outsized portfolios such as commercial property and much of the dead wood left from Goodwin's disastrous purchase of large chunks of Dutch bank ABN Amro.

If all goes well, Hester will still have a bank with a market-leading position in UK business lending, a large wholesale and investment bank - albeit comprising around a third rather than 60% of the total balance sheet - a big-hitting insurance presence and large retail banks in both the UK and US.

But two factors blur the outlook. One is the European Commission, which will hit RBS where it hurts for getting its leg up from the UK taxpayer. The Commission wants to reduce RBS's 30% market share in small and medium-sized business lending – perhaps by splitting out a large chunk of the business and selling it to a competitor.

The other factor is RBS's biggest shareholder. The UK wants to make a profit from its investment, even if that means selling what are currently core businesses. If prices for financial assets start climbing, the sale of Direct Line insurance, the Citizens US retail bank and even RBS's investment bank cannot be ruled out, according to a person familiar with the situation.

Such a denudation would unravel Goodwin's creation. His highly successful integration of NatWest into RBS after a contested £21bn takeover kick-started the group's explosive growth. A decade on, the UK commercial bank's assets could be pretty much all that's left.

*September 10 2009*

## CIT

### Slightly better odds than Lotto

*By Robert Cyran*

CIT has paid a heavy price for a reprieve. A \$3bn loan facility, signed off on Monday evening, lets the desperate US small business lender avoid a quick trip to the

bankruptcy courts. But the rescuers have extracted tough terms from this desperate borrower. And survival is far from certain.

The new facility is backed by nearly all the firm's remaining unsecured assets, supposedly worth three times as much as the loan. It also comes with an interest rate 10 percentage points above Libor, according to news reports. That's not a bad deal for the lenders, a group that includes Centerbridge, Pimco and Oaktree Capital.

The lenders must also be hoping that by keeping CIT alive, they are increasing the value of existing loans. The new facility gives CIT enough cash to repay \$1bn of debt due in August via a tender offer. Moreover, the company will have a cash buffer against nervous customers drawing down their agreed lines of credit. And it will have more time to run down loans, putting less pressure on CIT's customers and thereby potentially increasing recoveries, even if the lender eventually has to close up shop.

There is also the slight chance that CIT might survive and repay all of its outstanding debt. This last is the best reason for CIT's board to agree to such punitive terms – actual bankruptcy financing might be cheaper.

The firm lives on in hope. While the new \$3bn probably isn't enough to prevent another cash-crunch next year, credit markets have been thawing. They just might warm enough for CIT to refinance its debt at manageable rates.

Then there is the government. Perhaps the Federal Reserve will allow the firm to transfer more assets to its small bank, which could then get funding at a reasonable cost from the central bank's discount window. Or maybe the Federal Deposit Insurance Corporation will change its mind and back CIT's debt, allowing it to borrow cheaply.

All of these seem unlikely – and they wouldn't address the problem of big operating losses. But CIT has kept the possibilities alive – at a high cost.

**Context news:** CIT, the troubled US small business lender, has secured a \$3bn loan facility from its creditors. The debt has a 2.5 year maturity. CIT did not disclose other terms of the debt, but according to news reports the loan is secured by more than \$10bn of assets and pays interest at 10 percentage points above Libor.

CIT also announced it will commence a tender offer for \$1bn of debt due August 17. The firm will offer \$800 for every \$1,000 of principal outstanding. It is contingent on holders of 90% of the amount outstanding tendering their debt.

- [CIT Announcement](#)

*July 21 2009*

## POSTSCRIPT

### Undersung

*By Jeffrey Goldfarb, Antony Currie and Rob Cox*

Investors should thank their lucky stars for people like Jed Rakoff. He's the US federal judge taking Bank of America and the Securities and Exchange Commission to task for the agreement they reached to settle allegations that BofA kept its shareholders in the dark about bonus payments agreed to be paid to Merrill Lynch employees.

Judge Jed's refusal to sign off on the settlement has caused controversy. That, in itself, is sad. The judge is simply questioning how the SEC decided that \$33m was an appropriate fine and why BofA neither admitted nor denied guilt. He has called the SEC's justification for letting BofA executives off the hook "at war with common sense" and told the court that it looks as if the bank "lied to its shareholders".

A year after the US and other governments around the globe were forced to intervene in the financial markets to save the banking system, probing questions like Rakoff's should be heartily encouraged. Without a thorough understanding of what transpired during the darkest moments of the capital markets, it will be difficult to prevent them from happening again.

Too often, agreed settlements like the one between BofA and the SEC are simply rubber-stamped by the courts. For his willingness to point out the flaws and hold both a corporation and its regulator to higher standards, Rakoff deserves a place in the pantheon of unsung, or at least undersung, heroes of the credit crisis.

Rakoff shares that honour with others, including regulators who spotted cracks in the financial system early on; whistle-blowing investors who tried to raise the alarm; and even some Wall Street executives for their swift actions as panic set in.

Some of these undersung individuals are relative unknowns, others are brand names on Wall Street. And some had their moment in the press. As the anniversary of Lehman's demise approaches, Breakingviews.com presents a shortlist of candidates for the Financial Crisis Undersung Hall of Fame:

**William White** - Toiling away on the river Rhine in northwest Switzerland, the head of the monetary and economic department at the Bank for International Settlements sounded a cautious note in January 2006 about the perils that lay ahead in the financial markets. In 18 prescient pages, White warned that the era's low inflation and steady growth could be jeopardised by "numerous financial and other imbalances". He then explained what should be done and why it probably wouldn't be. White has since retired from the BIS. But as governments mount regulatory reform, his suggestions for

macro-prudential supervision and a new international financial framework are more pertinent than ever.

**Harry Markopolos** – The options trader who several times warned the SEC that Bernie Madoff was running a huge Ponzi scheme received his 15 minutes of fame when the 19-page 2005 document outlining his concerns was made public. But the lesson of Markopolos should not be lost on investors and legislators hoping to create a more effective regime of watchdogs. The note an SEC staffer sent to Markopolos, with its curt "thanks", should be prominently posted in every regulator's cubicle.

**Jeff Kronthal** – Who's that? A former head of structured products at Merrill. Granted, he was no über-bear on subprime mortgages. But he had the cojones to tell his bosses that the firm was taking too much risk in the business, a move that cost him his job in mid-2006. But it saved his reputation. The Wall Street firm brought him back to try and sort out the mess a year-and-a-half later.

**Greg Fleming** - Perhaps the real unsung hero in the Merrill affair, if there really can be such a thing given its massive losses and the huge bonuses it paid despite the red ink. Merrill's former president was early to recognise that securing Merrill's future lay in accepting the embrace of a much larger institution rather than, say, selling a stake to Goldman Sachs – an option chief executive John Thain was seriously considering the weekend Lehman went under. Persuading Thain to adopt his view was critical to docking Merrill into safe harbour: without BofA's backing, Merrill would have been downgraded by the rating agencies and run out of cash within days – though BofA must surely regret the price it paid today.

**Tom Scholar** – This relatively unknown British civil servant didn't survive a stint as Gordon Brown's chief of staff at 10 Downing Street. But he sure lived up to his name for the prime minister at No. 11 – the Chancellor of the Exchequer's office. Scholar was one of the primary architects of the UK Treasury's life-support mechanism for banks – a scheme that became the blueprint for rescues elsewhere.

**Peter Wuffli** – The former head of UBS might seem a controversial candidate for praise after leading the ill-fated expansion of its investment bank from 2003. But even 18 months after he was ousted in an ugly boardroom coup – ironically, in part for being too risk averse – Wuffli did something few of his counterparts would only later do under duress. He surrendered the final SFr12m bonus to which he was entitled. His decision set the stage for pay reform across Wall Street that now includes clawing back bonuses for bets gone wrong.

No doubt there are others worthy of consideration. But let us not forget that crucial individual who has rarely received due thanks for staving off an even worse financial meltdown: the humble taxpayer.

*September 9 2009*



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