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2009 Heads Global Banking into Critical Change – Australian Banks Rise to New Heights in World Rankings and Influence

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Since the launch of our December 2008 issue, there have been further critical developments that continue to not only impede global banking recovery, but absolutely reinforce our view that global banking and the financial system is undergoing a transformation the likes of which we have never experienced.

More bank losses and write downs by major banks, substantial fears of bank nationalization, new areas of financial stress in emerging markets, growing lack of confidence among investors in the banking sector and the lack of substantial impact by governments in UK, Europe and US despite massive bail outs to find the bottom of the problems for recovery, are some of the factors which account for this.

We now have a global banking environment in 2009 that is creating more uncertainty, complexity and vulnerability to an already fragile set of world financial markets and banking institutions.

At the same time, the world financial order and dynamics of banking continues to change with some profound consequences and new opportunities.

Major Australian banks appear to be benefiting both in terms of world market value rankings and their continued 'exclusive' membership of the 'shrinking' AA ratings club. This is bringing home some interesting results in terms of growing global power, providing further stability, influence and new opportunities that we began to canvass in our December edition.

Striking at the Foundation of UK's High Street Banks and their Power in Global Financial Markets – Will the UK be Forced into Substantial Nationalisation?

We now have real and unprecedented notions of substantial bank nationalisation in the UK which hits at the very heart and foundation of British banking, its solvency and power (loss of) in global financial markets.

The Bank of England's Governor was reported last month as saying that the adequacy of liquidity has turned into questions of solvency. These comments came after Royal Bank of Scotland announced an anticipated biggest loss in corporate history, sending its shares plummeting – the bank was on course to report a 2008 loss of up to £28 billion ($A61 billion). As a result, the UK government has lifted its shareholding from 58% to 70% in RBS.

RBS's problems stem primarily from its losses from the acquisition of ABN Amro, which had exposure to US sub prime mortgages and its own direct investments in that market. However, the bank claims that its retail and commercial banking operations remain profitable.

Lloyds TSB, already partly nationalised, announced that its HBOS banking operations made a pretax loss of 8.5 billion GBP ($A18.4 billion) in 2008. This has raised further concerns that more government assistance will be required and that as a consequence, Lloyds TSB will fall in majority public ownership. HBOS's corporate banking unit lost

7 billion GBP due to problems in funding properties and takeovers. It has been reported that 40% of HBOS's 117 billion GBP loan book was allocated to real estate. Shares fell heavily after the announcement.

The demise of HBOS and their difficulties is not only very sad for banking in Britain (and Scotland) its staff and shareholders, but also touches us in a special way. Participants to our global banking programs in 2005, 2006, 2007 and 2008 will perhaps recall the very open and friendly sessions that we had at the bank beginning in Edinburgh and then in London. We met some great people and very experienced senior bankers who provided excellent insights and analysis into a whole gamut of HBOS's operations. We very much hope that over time, HBOS will recover and prove to be a valuable asset of Lloyds TSB.

On the other hand, the avoidance of Barclays requiring government bail out assistance gives some hope that one of the icons of UK banking has been able to stand up independently to maintain its position. Barclays raised funds in the Middle East and have just announced a profit of 4.38 billion GBP, notwithstanding a writedown of 8.1 billion GBP; perhaps the financial accounting experts can tell us how such a result is possible given such a massive write-down.

The UK government has however been forced to respond with another plan following its first package. The basis of this scheme is for the government to insure banks against losses on bad or toxic debts which are estimated to be around 200 billion GBP. Shares may be taken in return for the insurance.

While there were high hopes that the first rescue package would be sufficient, this clearly has not turned out to be the case. The underlying problems are much deeper and problematic which clouds both recovery for the UK financial system, its impact on global financial markets and the future position and power of the City of London.

Banks in Europe Face More Losses and New Pressures

Banks in Germany, Europe's largest economy, continue to struggle.

Deutsche Bank has posted its first annual loss since World War II after a very bad fourth quarter but has made it clear that it wants to survive the financial downturn without state aid. Deutsche said it had made a net loss of 3.9 billion euros ($7.75 billion) in 2008, a figure that reached $9.5 billion in the fourth quarter alone. In 2007, Deutsche Bank had reported a record profit of 6.5 billion euros.

Other major German banks have benefited from a government rescue plan for the sector, but CEO Josef Ackermann indicated that it wanted the bank to pull out of the crisis on its own, adding that the operating conditions in the (fourth) quarter were completely unprecedented and exposed some weaknesses in their business model.

In another major development, the German government has had to rescue the merger between two of the country's other largest banks, Commerzbank and Dresdner Bank. A $A20 billion cash injection which for all intents and purposes, effects a partial nationalisation of the combined group. Commerzbank recently posted a fourth quarter loss of 809 million euros.

This will be highly relevant to all those bankers that participated in the B@nkfin September 2008 Global Banking Program where just 48 before we arrived in Frankfurt, the takeover by Commerzbank was announced. We were the very first outside group to have a formal investor presentation made regarding the takeover, which was then being enthusiastically canvassed and funded.

In a further blow to German banking, it now appears that Hypo Real Estate, having been in severe financial trouble for some time, looks likely to be fully nationalised due to its deepening market crisis.

Banks across Europe are facing a new set of financial pressures as Eastern Europe and their banks head for further economic and financial difficulty. Many banks in Europe have foreign currency loan exposues to banks in this very large and vulnerable emerging market.

And in the United States Some of the Most Critical Challenges Continue

There are a number of major problems that the US is grappling with:

- continuing uncertainty of major bank solvency and how much additional funding may be required;
- new fears of whether bank nationalisation will be inevitable for certain major banks;
- the effectiveness of TARP and transition to the new Obama Administration with a new plan for the rescue of the financial system, see below;
- whether a bad bank should be established to acquire toxic assets;
- failure of some banks to use bail out funds to boost lending and give some much needed oil to struggling credit markets;
- many banks simply short of capital and tightening lending as a result; and
- more losses/writedowns from a number of banks.

Bank of America posted its first quarterly loss in 17 years due to a major fourth quarter loss in Merrill Lynch's which it now owns. This had a major impact on Bank of America's share price, creating its lowest level since 1984.

Bank of America now lurches from being the US's leading bank a number of months ago, to the biggest bank that could face nationalisation.

Bank of America has been reported as receiving $US45 billion from TARP and the government is also sharing in possible losses on $US118 billion of troubled assets at the bank.

This development has brought an extra degree of extra fragility that the US financial system that it simply did not need or for the rebuilding of confidence in other global financial markets. It once again highlights that the biggest are still very vulnerable and we continue in an environment that is very unpredictable.

Confidence in investment markets was severely shaken by revelations that Bernard Madoff had got away with running a Ponzi scheme for 20 years creating losses estimated in the vicinity of US$50 billion. Not only high profile investors in the US lost money after being conned by Madoff, but also global banks such as HSBC, Royal Bank of Scotland, Bank Santander and BNP add to a heavy list of victims.

The fall of Wall Street and its responsibility for the financial crisis leading to world economic recession, continues like that of the Roman Empire in its decline. The last straw has just about been drawn with the revelation that some US banks have continued allocating substantial bonuses while receiving bail out money from US taxpayers and incurring losses e.g. Merrill Lynch has been reported to have paid its top four executives a combined $US121 million; the next four received a combined $US62 million; and the next six received a combined $US66 million. The top 149 executives received a total of $US858 million, and 696 received at least $US1 million each.

It once again highlights both the immorality and inappropriate culture that exists within certain banks, individuals and management in the US financial system. Coupled with many other acts of greed and excesses, pushing the safe boundaries of credit availability and sacrificing for short term profit, has called into question parts of US financial capitalism and how it operates.

Professor Robert Reich of public policy at Berkeley University and campaign advisor to President Obama recently said of the excesses and practices:

> *"This is not the kind of capitalism that we were taught in text books; this is probably the worst hybrid."*

President Obama looks ready to take further action as a result of this behaviour and the consequences will be fairly severe in terms of introducing both salary caps and other restrictions for those accepting government assistance.

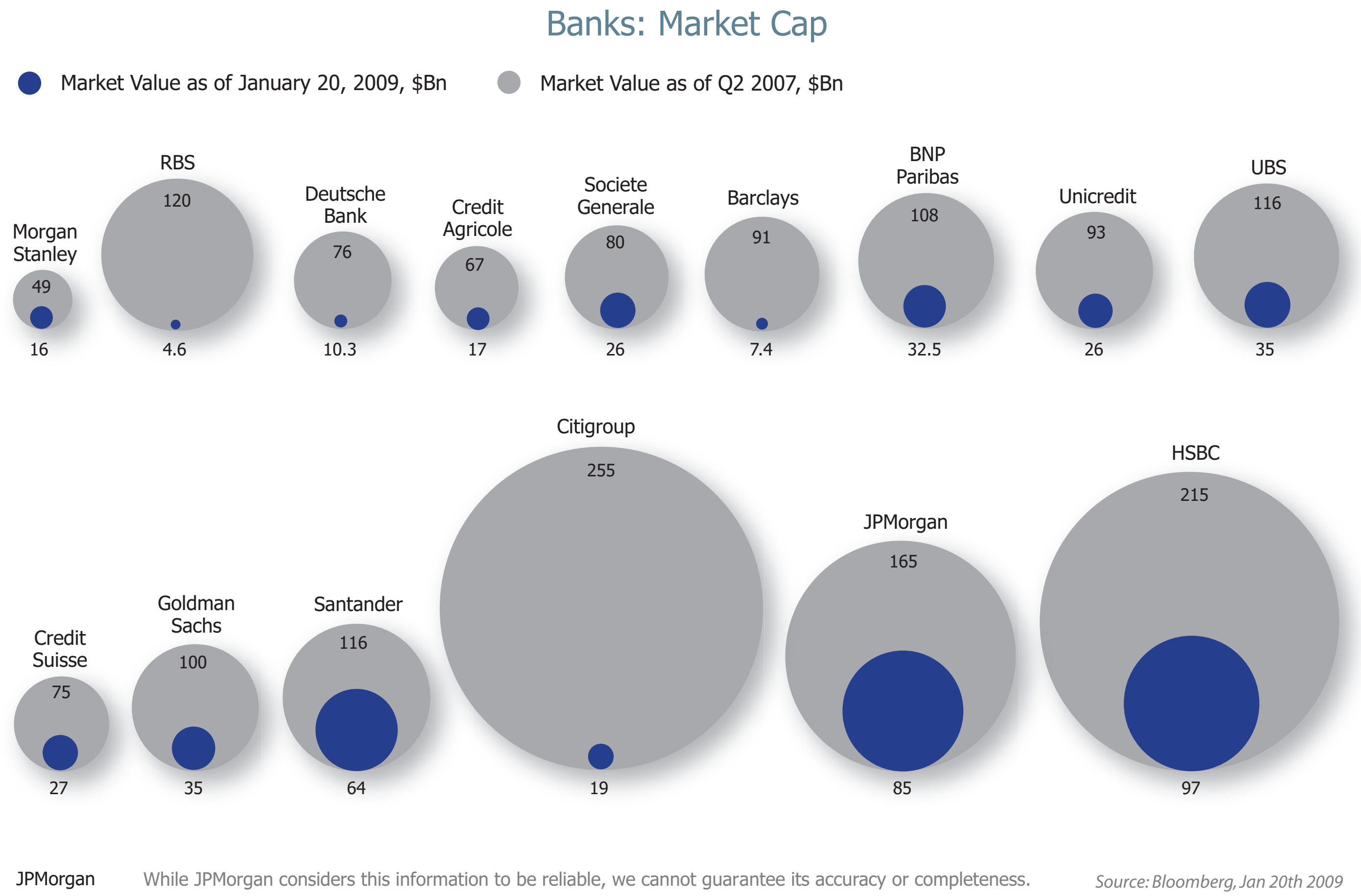
The more immediate result is that it sets up a most controversial precedent which may be influential and put pressure on other governments who are assisting their banks with bail outs and guarantee systems. Already some of the Australian financial press opinion are canvassing Prime Minister Rudd to consider following some of the Obama edict on the basis of deposit and wholesale debt guarantees.

The new US financial package, although lacking some detail and despite the criticism, looks like at least a positive move on from the Paulson era of unconditional hand outs and other support. The Financial Stability Plan will overhaul the Troubled Asset Relief Program, the name change in itself sounding more positive and provides in summary for;

- Capital assistance plan and stress tests where regulators will subject banks to new tests to determine whether they have enough capital. Banks that don't will be given additional taxpayer funds for convertible preferred securities.
- Public – private investment fund to provide financing for private investors to buy distressed securities.
- Consumer and business lending initiative to expand an earlier plan to spur new lending to consumers and businesses.

Changing Dynamics and World Order in Global Banking

This diagram prepared by JPMorgan highlights very simply how the order and power of global banks has been impacted by the global credit crisis.



Source: Bloomberg, Jan 20th 2009

It highlights how dramatic the impact has been on banks like Citigroup, Royal Bank of Scotland, Deutsche and Barclays in particular.

Based on recent market capitilisation figures for each of the major Australian banks, all now rank ahead of these banks and all are still in the shrinking group of banks (now 11) in the world that have a AA credit rating.

This is an incredible result for the major Australian banks many of whom have always pushed very hard on trying to dismantle the four pillars policy on the basis that you need size to compete in global markets. All of a sudden, there has been a leap frog into the top 20 banks in the world due to a faster decline in market value of major global banks compared to major

Australian banks. How long this will last is uncertain, but for the time being it provides a new era and presence of Australian banks in international banking markets.

This must give further confidence and will no doubt open up more opportunities for Australian banks in global banking financial markets, with other major international banks and substantially improving their competitive position.

Perhaps a very good example of this is the comparative ease at which, coupled with using government guarantees, banks are tapping offshore markets for much needed wholesale funding. This is positive for not only the banks themselves, but also for their customers, the Australian economy and also the financial markets where funds are raised.

The Japanese market is a very good example of this where Australian banks are helping to revive Japan's bond market as yield-hungry investors "yen" for issuance backed by government guarantees but also attracted by the relatively strong fiscal position of both countries. Japan's bond market, once an oasis for foreign borrowers looking to raise debt, ground to a halt following the collapse of U.S. investment bank Lehman Brothers last September.

However earlier this month, Westpac was reported to have sold 201.3 billion yen ($2.2 billion) in one of the largest ever Samurai bond offers. Samurai bonds are yen-bonds sold by foreign borrowers. At least one other major is also reported to be lining up for a similar bond offering and no doubt others will be examining their options.

At a time also when so many banks in other countries are simply in survival mode with real capital and loss problems, many major Australian banks can be looking over the horizon for asset, equity and other acquisition opportunities. In a comparative sense, major Australian banks may have no better time to be potentially looking at a range of new options, ideas, relationships and for business in international and emerging markets.

Australian Banks Need to Keep Understanding and Exploring Global Banking Developments, Issues and Opportunities

We opened in our December issue by stating that global banking is being redefined as a result of the financial crisis and will result in fundamental change to the international financial system. This whole process is now further accelerating given the developments that are occurring.

As we continue into 2009, these events raise the stakes for Australian banks in understanding how to deal with these unprecedented challenges and at the same time explore opportunities.

It is going to be imperative for all major banks to ensure that as much human capital understands all of this, how and where the changes, challenges and opportunities are taking place.

Japan Global Banking Program 15 to 19 June 2008 Tokyo

Given the growing importance of Asia to major Australian banks, we continue to focus our efforts and investment to develop highly relevant global banking programs in this region for major banks to develop both human capital skills/experiences and importantly business/ relationship opportunities. These are very important values and benefits that our previous global banking programs have delivered.

For the first time, we are organizing a major program with major banks, financial institutions and government in Japan latter in the year.

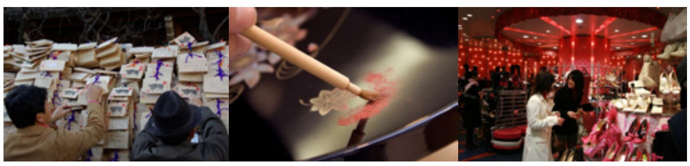
Notwithstanding Japan's severe economic downturn, it has some of world's biggest banks, prominent securities and investment companies, hungry investors and massive liquidity that are increasingly attracting major banks to take advantage of much needed funding as outlined above.

Some of the objectives of the program will be as follows:

- Perspectives on the banking and financial system in Japan having regard to the impact of the financial crisis and changes for future; banks, financial institutions, financial markets, structure, operations and culture;
- Lessons and experiences from the 1990s bank recession and beyond; impact on financial markets, living with zero or near zero interest rates and impact on banks, investors and financial markets;
- How major Japanese banks have developed and keep expanding their global banking business/opportunities, in Asia in particular, current and future opportunities/ strategy in view of the financial crisis;
- A full analysis and assessment of capital and investment markets in Japan, access, further opportunities, state of investor appetite, investor market, impact of financial crisis and how this is influencing the flow of debt, liquidity and investor preferences;
- Opportunities for Australian banks to further access investor and liquidity opportunities presented by Japanese banks and other financial institutions;
- Insights into other current issues, developments and opportunities across treasury and financial markets in Japan
- Understanding current issues and developments in business, corporate and structured finance, impact on balance sheets, how banks have had to readjust their credit for customers and current state of structured markets/products and perspectives for future;
- How Japanese banks are changing their approach to risk management in view of the financial crisis;
- Understanding the fundamentals of Japanese banking regulation and government policy; what impact has the financial crisis had on regulation/ prudential supervision, central bank policy and what is the current strategy and challenges in terms of financial stability environment to create stability in the financial system;
- Exploring how major Australian banks and Japanese banks can work more closely together to create further and better relationships and business opportunities given the very strong trade and political ties between Australia and Japan and also in view of the financial crisis;
- And much more.

This will be a unique opportunity for many senior bankers across business, corporate, institutional, treasury, financial markets risk and strategy to have an intense learning and business opportunity experience with many of Japan's leading banks and financial institutions; to understand and experience the problems, challenges and explore the opportunities that global banking is creating in one of the largest financial centres in Asia and to Australia from a trading and business point of view.

Further details will be issued shortly.



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