

Are we leaving the eye of the financial hurricane?

Neil Dwane, CIO Europe at RCM, a company of Allianz Global Investors, comments on President Obama's latest proposals on financial institutions*:

"President Obama has been busy this week announcing two proposals which seek to address and possibly seek retribution for the costs and legacies of the financial crisis. The first was to formulate a method of taxing the balance sheets of the US banking industry, targeting the top 35 banks, which produces a revenue stream to "pay for" the uncovered losses, incurred by the US Government in stabilising the industry after the demise of Lehmans and AIG. Last night's proposals call for new restrictions on the size and scope of financial institutions*.

"Obama has clearly analysed that much of the difficulties caused over the last few years have originated in the trading and "casino" operations (and their related clients like private equity and hedge funds) and the ensuing connectivity and leverage and is thus narrowing the scope of "citizens banking" to just that; what the citizen or voter needs from the banking industry. This is of course a direction that many other banking competitors are now moving in many economies, like Tesco in the UK which will offer similar services with the confidence of a brand trusted by consumers. Thus in the longer term, banking will remain a very competitive, highly regulated industry with little further opportunity for leverage or raising returns to employees and shareholders with rising risk levels, and will instead drive a return to product quality and lowest-cost advantages. This will result in a better alignment of government and citizens' interests and leave the higher risk elements to bear the full brunt of capitalism. Pragmatically, this process will take some time, and it is in no-one's interests for there to be a forced sale of these financial assets by the banks who choose to remain "citizen banks".

"There will however be other consequences for the casino banks and the prop desks, private equity and hedge funds - in short, much higher capital requirements as they will not have an implicit Government support mechanism, ie the US Federal Reserve discount window, and less easy access to cheap credit which will significantly lower leverage ratios, as only the close business relationships of investment banks and their clients (private equity and hedge funds through prime broking) allowed access to such gearing levels. Thus the costs of capital will rise and possibly investors will discover that many of the "fantastic" returns of the prop traders and hedge funds were fuelled by the leverage only. In the future we are likely to experience lower returns and lower fees going forward.

"Obama's second proposal is also a very sensible one, as almost every OECD country has found its major institutions to have bigger balance sheets than the country itself, with the most egregious examples being Iceland, Ireland, the UK and Switzerland. This proposal will allow the industry to become more manageable from an economic perspective and also facilitate the extinction of the "too big to fail" conundrum which has coloured the behaviour of many financiers for the last two years. Interestingly, if one reviews the growth and reinvestment into their economy over the last 20 years or so in the USA, one discovers that the USA has found the financial sector squeezing out most other forms of investment in R&D, innovation and manufacturing such that its telecoms infrastructure, its roads and its education is now way off the pace of global competitiveness - thus an economic reprioritisation is urgently needed.

"Importantly, this capping of growth opportunities in the USA will drive many US banks to expand internationally; this will actually promote the growth of less developed economies which need to import stronger financial sectors, but it will, of course, limit the growth and returns from the existing US franchises. Crucially too, the changes which occurred after the last financial crisis in the 1930s took four years to implement, so investors, politicians, bankers and citizens will all need

to show some patience. What's more the process will not only globalise, as each country resolves its own national issues, but multiply as each adopts the good ideas of other governments.

"The politics and theatre around these proposals are undeniable, announced on the day of Goldman Sachs' results. It also shows the utter failure of the industry globally to appreciate the average citizen's (ie voter) opinion of them as organisations, and their internal level and structure of remuneration. But also a failure to appreciate people's views on the deeper economic impact at a local and national level, with high levels of unemployment to bear, and in the longer term, the consequences to their countries' abilities to honour pension and healthcare promises because of the ballooning public deficits and rising tax levels. In order to appease the citizen, the politician will always default to higher levels of inflation to ease national debts away over the longer term, rather than painfully cutting costs where the pain is already excruciating.

"Strategically speaking, the under-banked emerging markets will look more attractive to investors who wish to remain in this tarnished sector. In the developed economies, investors will see higher capital (equity) ratios, greater transparency and lower returns. Prop traders may move to the world of hedge funds and private equity where leverage may be lower or more expensive and returns fall, forcing lower fee structures and remuneration levels, thereby redressing the massive imbalance between the current banking remuneration level and its social utility.

"The prospects for the banking industry will remain buffeted by the tail of the hurricane as new rules are enacted and this process, both politically, and in a regulatory and economic capacity, will also serve to lessen the chances of a further V shaped recovery; with credit remaining hard to access, deleveraging continues and growth moves increasingly to the emerging markets. Many industries will no longer be squeezed out by the "über-banking monster" and its leverage anymore, and may flourish as markets return to the provision of capital to entrepreneurs away from the provision of bonuses to financiers.

- ENDS -

Notes to Editors:

* Source: White House press release, "President Obama Calls for New Restrictions on Size and Scope of Financial Institutions to Rein in Excesses and Protect Taxpayers:

1. Limit the Scope - The President and his economic team will work with Congress to ensure that no bank or financial institution that contains a bank will own, invest in or sponsor a hedge fund or a private equity fund, or proprietary trading operations unrelated to serving customers for its own profit.

2. Limit the Size - The President also announced a new proposal to limit the consolidation of our financial sector. The President's proposal will place broader limits on the excessive growth of the market share of liabilities at the largest financial firms, to supplement existing caps on the market share of deposits.

In the coming weeks, the President will continue to work closely with Chairman Dodd and others to craft a strong, comprehensive financial reform bill that puts in place common sense rules of the road and robust safeguards for the benefit of consumers, closes loopholes, and ends the mentality of "Too Big to Fail."

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Photographs

High-resolution photographs of our investment professionals are available to download here:

http://www.rcm.co.uk/press/04_fundmanagers.html

Awards

- RCM named winner of Active North American Equity at Pensions & Investment Provider awards 2009. RCM US Large Cap Select Growth is managed by Scott Migliori, Co-CIO for US Equities, RCM.
- RCM named No.1 leading fund management firm for SRI Research by Thomson Reuters Extel 2009.
- Global CIO of RCM, Andreas Utermann, named CIO of the Year by Funds Europe magazine 2008.
- Winner of European Investment Trust of the Year by Investment Week magazine, 2008, for the RCM-managed Charter European Trust.
- Allianz RCM Global EcoTrends Fund named winner Best Climate Change Investment fund 2008, by Holden & Partners/ Incisive Media.

About RCM (all data source: RCM as at 30/09/09)

RCM is a global asset manager operating from six international offices - San Francisco, London, Frankfurt, Hong Kong, Tokyo and Sydney – with assets under management of over \$130 billion worldwide. The firm provides a range of investment management solutions to institutions and individual clients. At RCM we believe that by generating and exploiting an information advantage, we will be able to deliver superior and consistent investment results for the benefit of our clients - a philosophy we call RCM informed. RCM is a company of Allianz Global Investors, a pre-eminent global asset management group committed to helping clients achieve sustainable success. As a company of Allianz Global Investors, RCM offers a distinctive investment philosophy and culture, while benefiting from the scale and substantial resources of our parent; including business support, industry best-practices and financial investment. This enhances our ability to attract and retain talent, and provide superior insight and investment performance.

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