

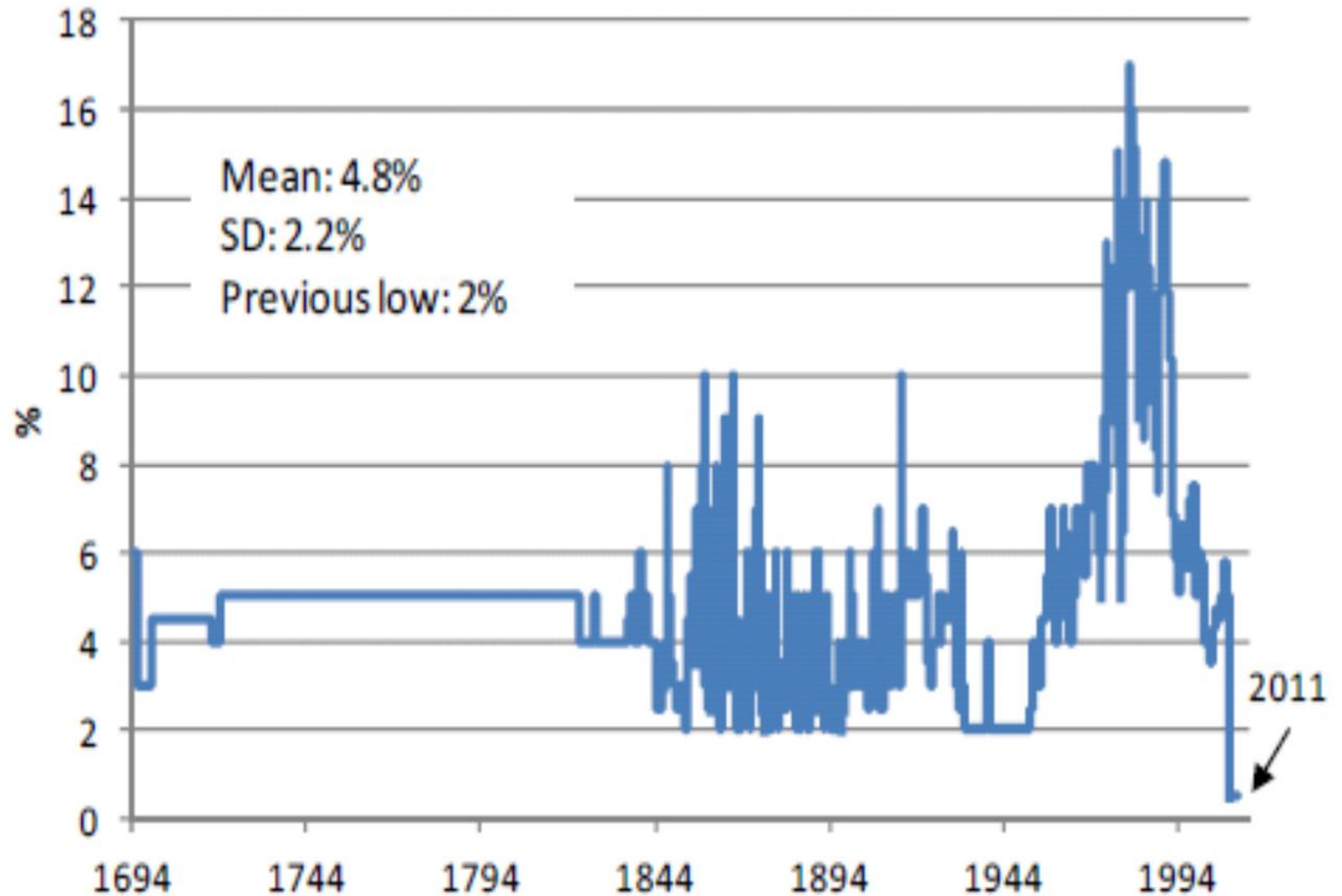
Risk-Based Bank Capital Requirements and their role in our downfall

James Ferguson – Head of Strategy

Phone: +44(0)20 7367 9065

Email: james.ferguson@westhousesecurities.com

Not normal: UK base rate @ 0.5% is currently at one quarter of the previous 315-year low of 2%, or 5σ below log normal

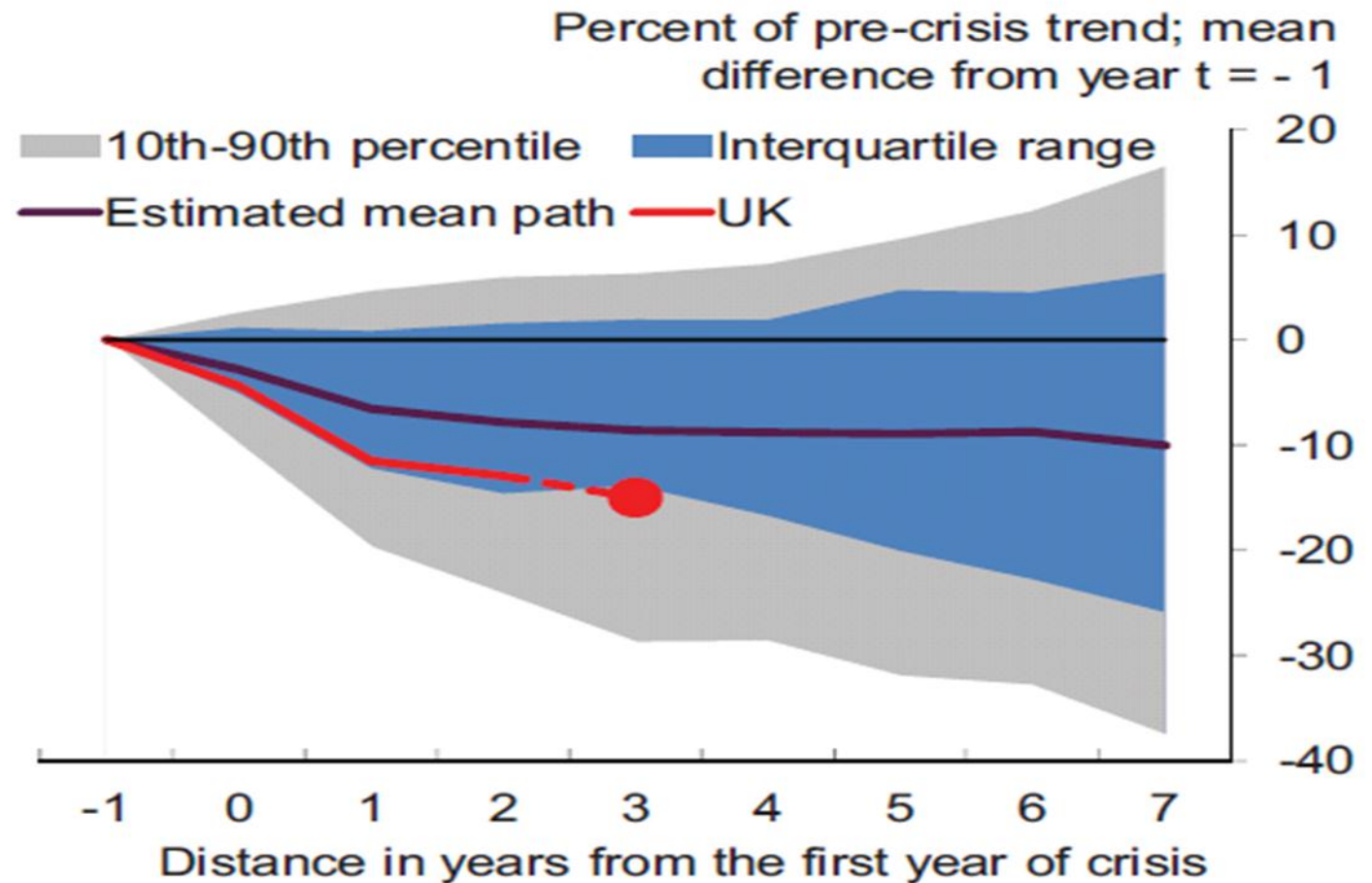


Source: Bank of England

UK GDP is already 15% below pre-crisis trend after the first 4 years.

Bank loan contraction forces the savings rate up, not down keeping consumption growth in the doldrums.

QED: fiscal austerity = slower growth



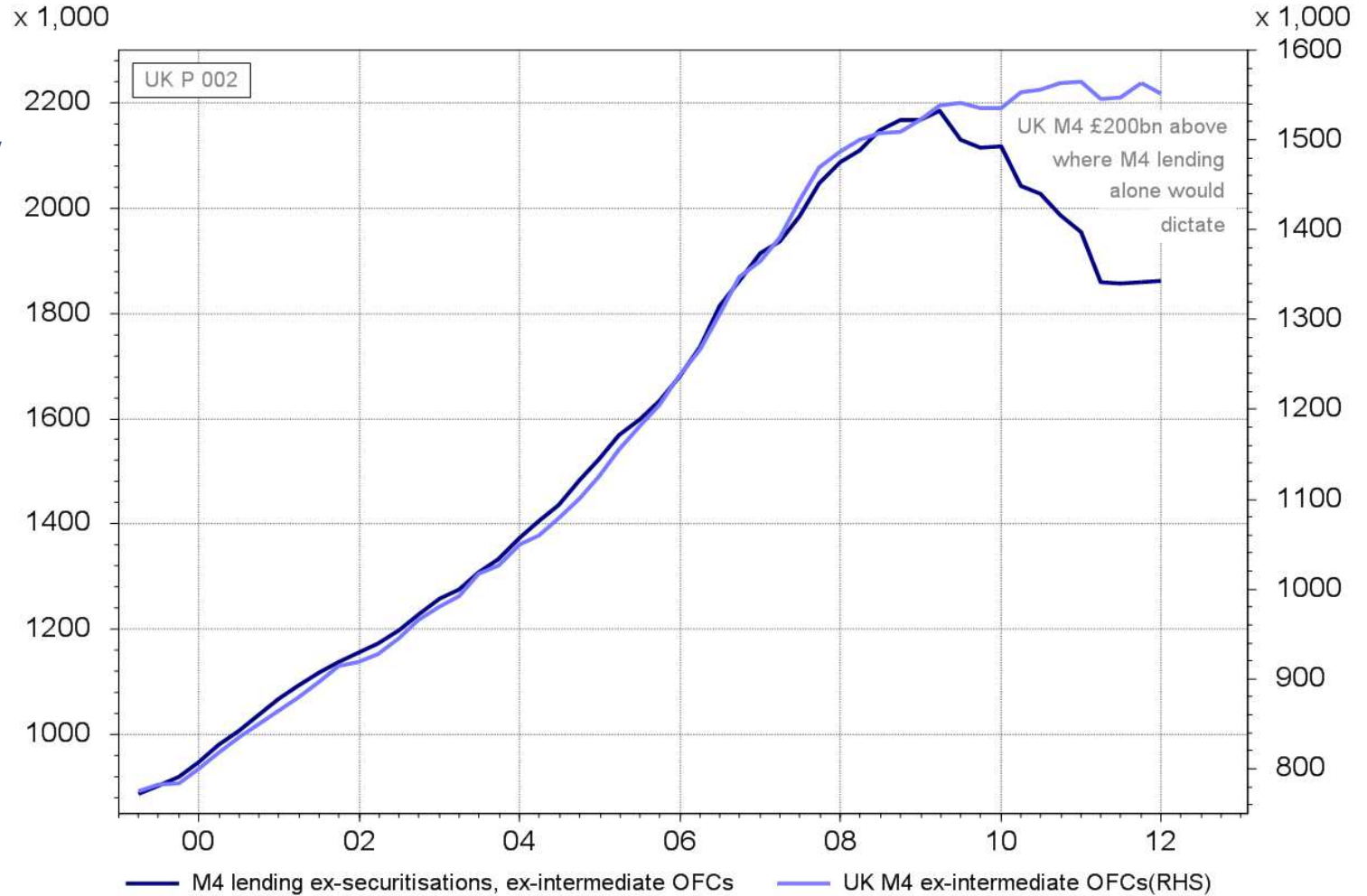
* UK observation for year 3 based on Q1-Q3 data for 2011

Source: Bank of England

The first £200bn of UK QE was required just to negate the shrinkage of bank lending up to the end of 2011

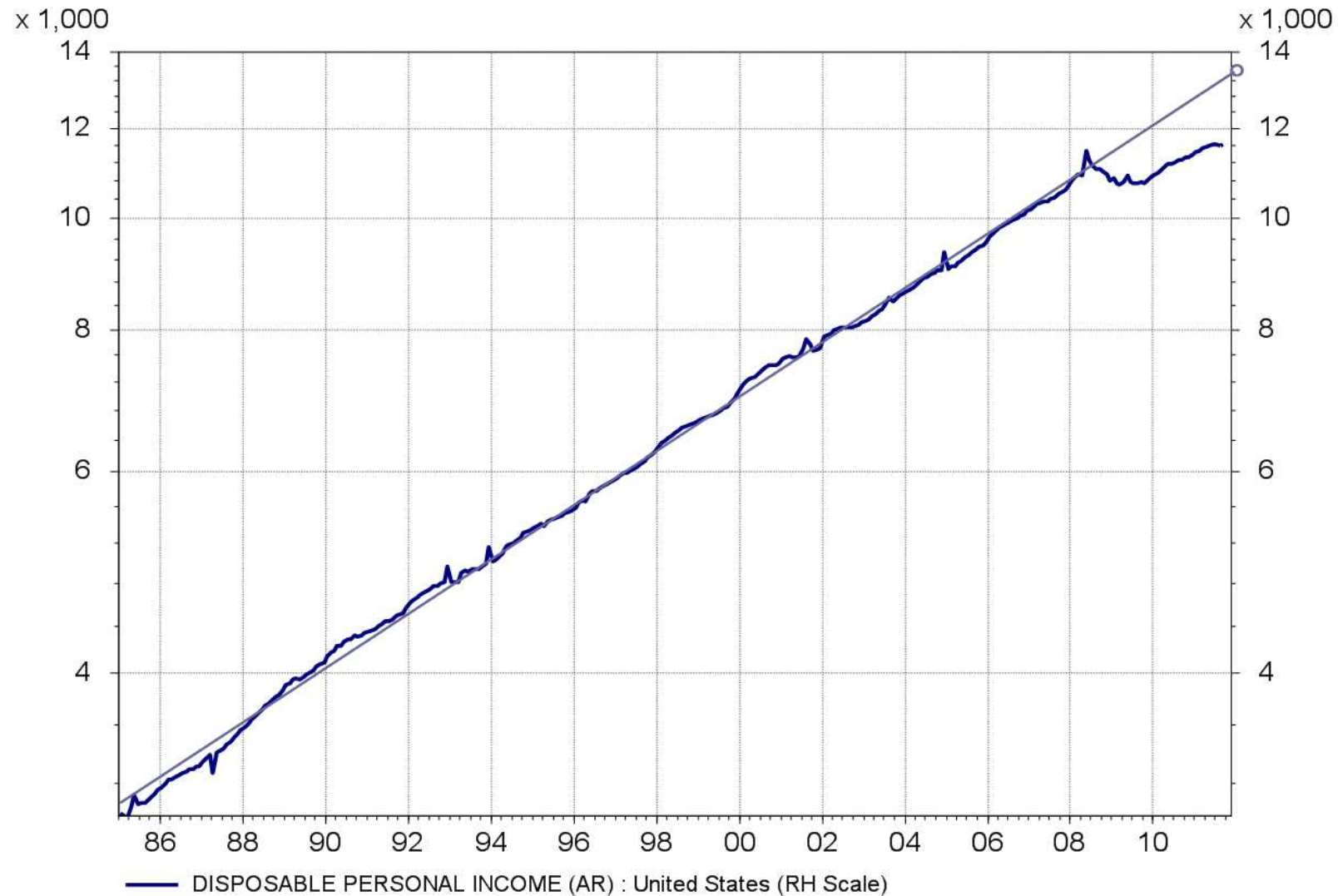
“We aim to buy mainly from non-bank private financial institutions, not from banks, as is sometimes erroneously claimed.”

Charlie Bean, 21st Feb 2012



Source: Thomson Reuters Datastream; Arbutnot

After more than 3 years and \$6trn of deficit and QE stimulus ($\approx 40\%$ of GDP) US nominal personal disposable income is already approx. \$2trn or 15% below trend



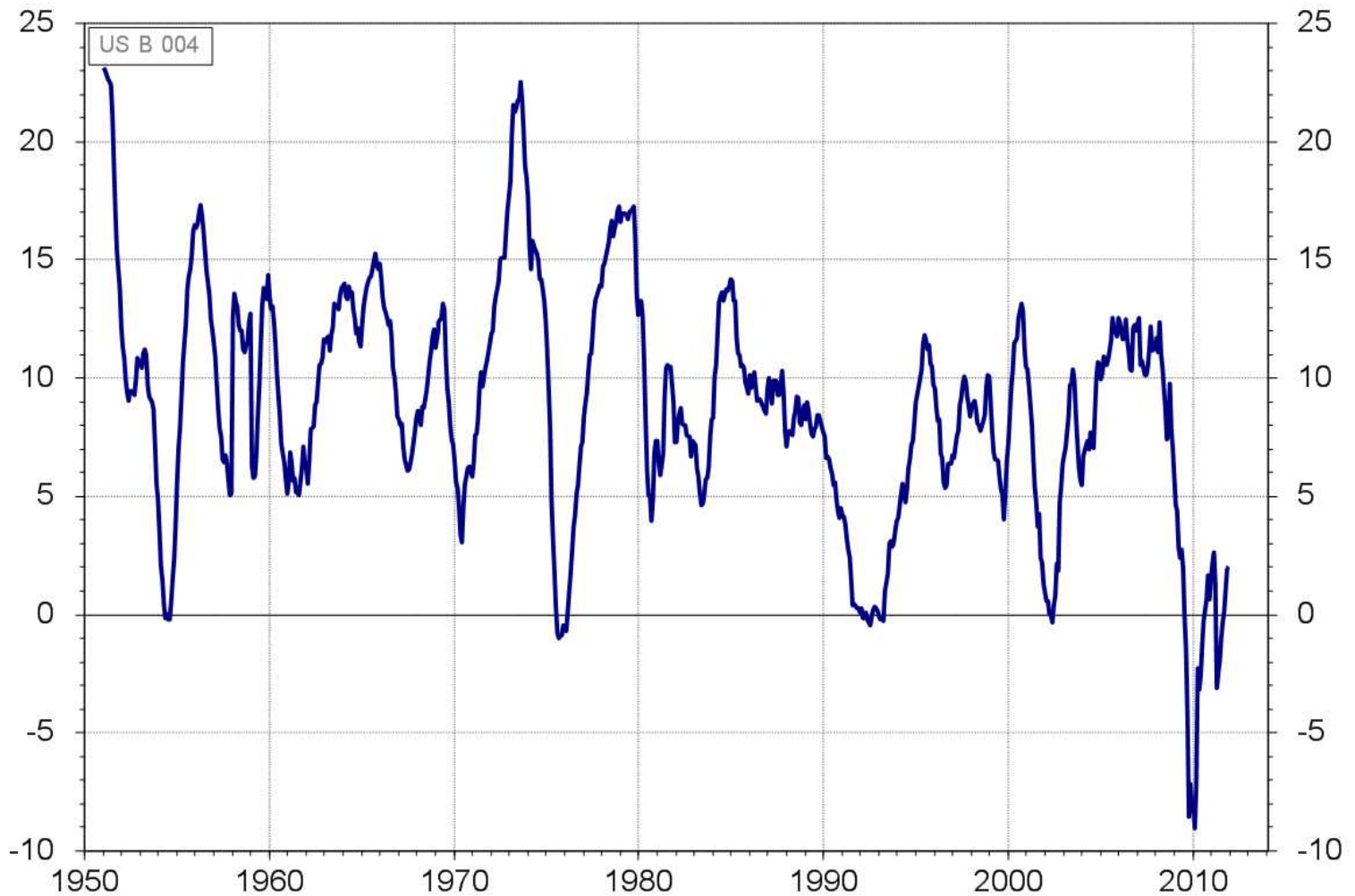
Source: Thomson Reuters Datastream

Bank lending *only* contracts after a financial crisis requiring bank B/S repair; in which cases it *always* does

During the recession — from December 2007 to June 2009 — household income fell 3.2 percent.

Between June 2009, when the recession officially ended, and June 2011, inflation-adjusted median household income fell another 6.7 percent, to \$49,909.

Source: Census Bureau data



— 1Y % change of COMMERCIAL BANK ASSETS - LOANS & LEASES IN BANK CREDIT : United States

Source: Thomson Reuters Datastream; Arbutnot

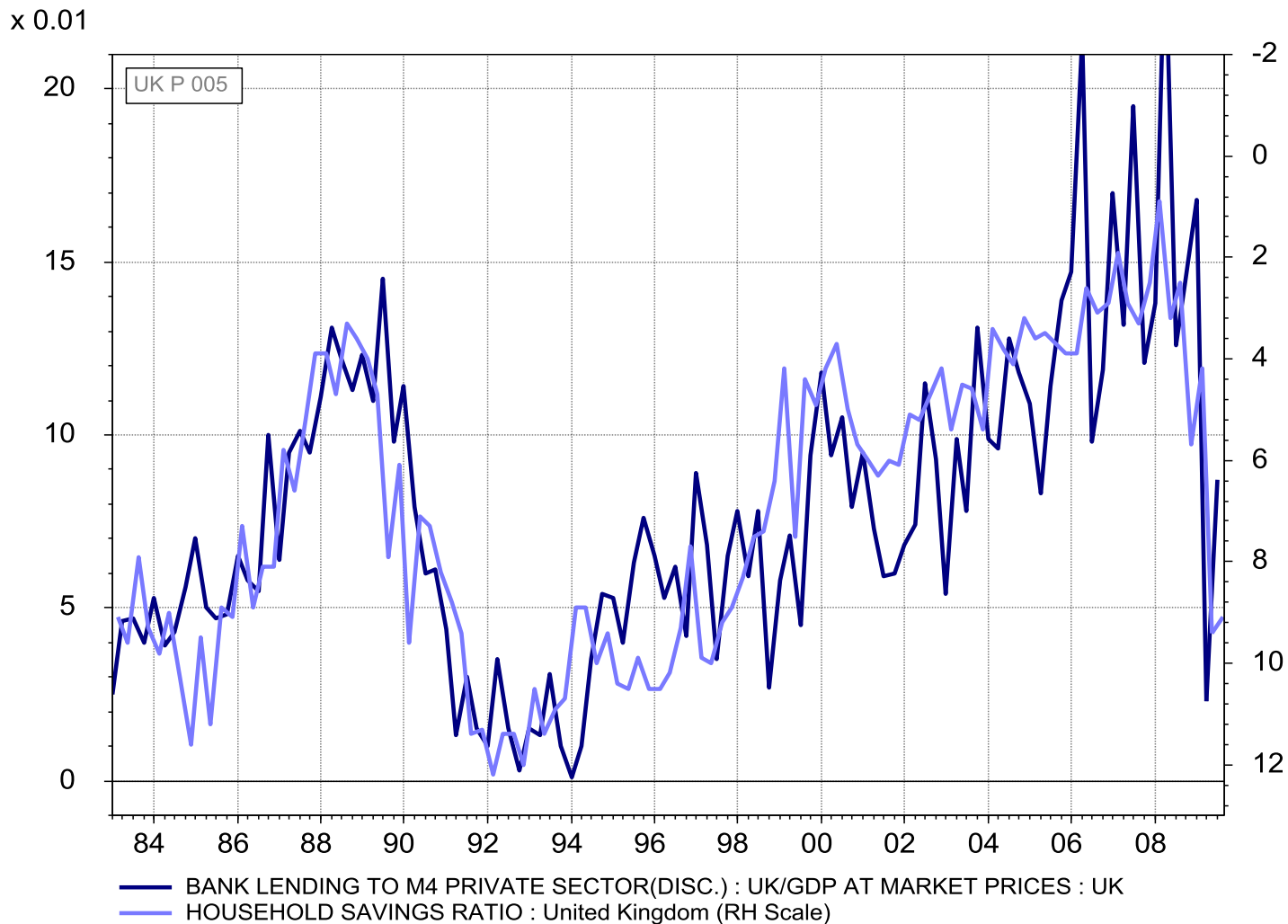
Saving = converse of borrowing. If bank lending contracts, the savings rate must rise; so GDP depends on govt. deficit spending

Caveat:

Public and private sectors can't both run a surplus.

As long as the banks are contracting private sector lending, the private sector will be running a surplus.

The external sector apart, if the public sector doesn't run a deficit, nominal incomes must therefore deflate.

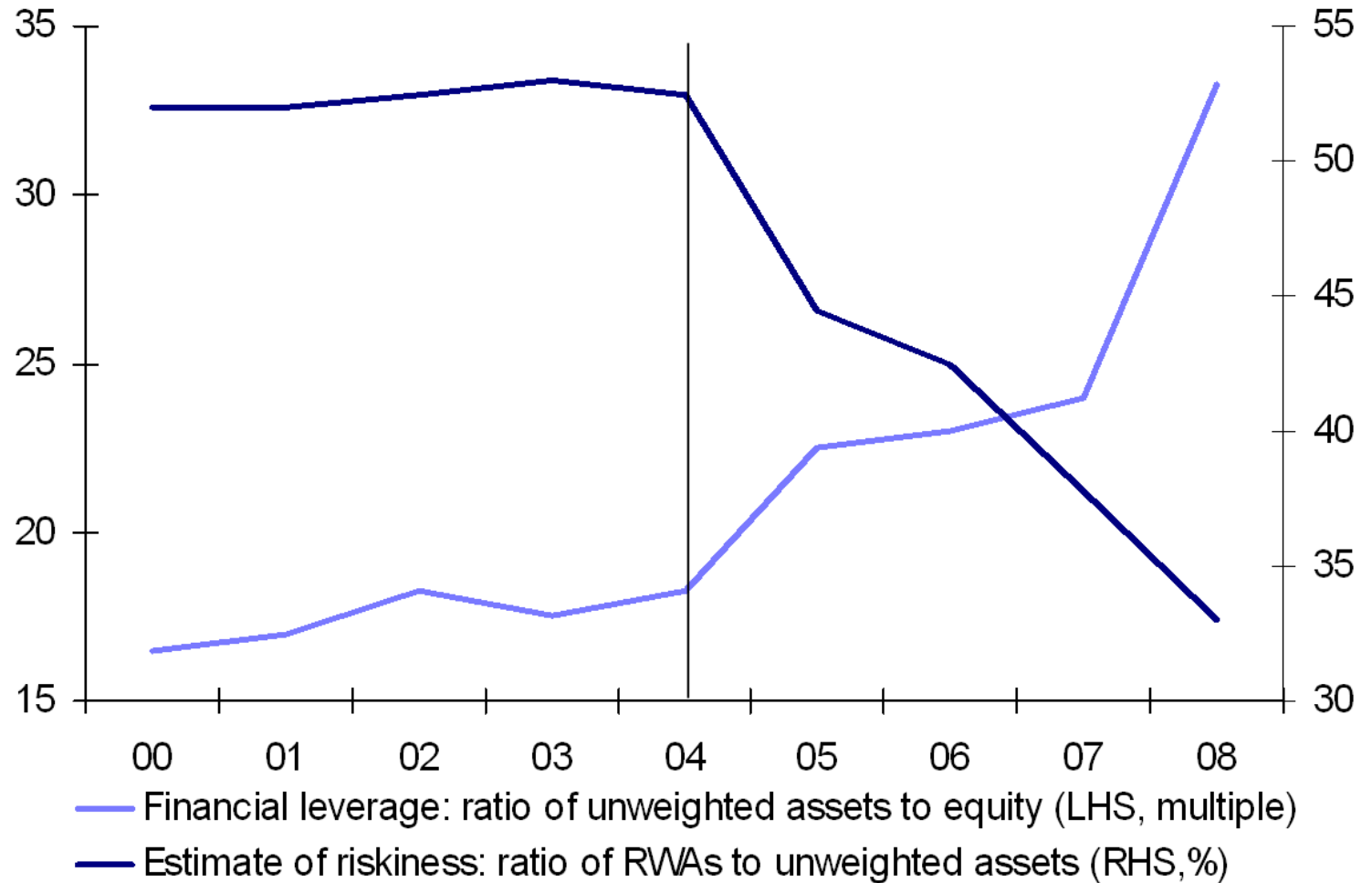


Source: Thomson Reuters Datastream; Arbutnot

From June 2004, Basel II allowed banks to risk-weight their own assets. RWA dropped from 53% of total assets to 33% in 4 years

“If you only look at the riskiness of the assets, you are ignoring the fact that you can be wrong about the riskiness of the assets.”

Lloyd Blankfein,
Chairman & CEO, Goldman
Sachs

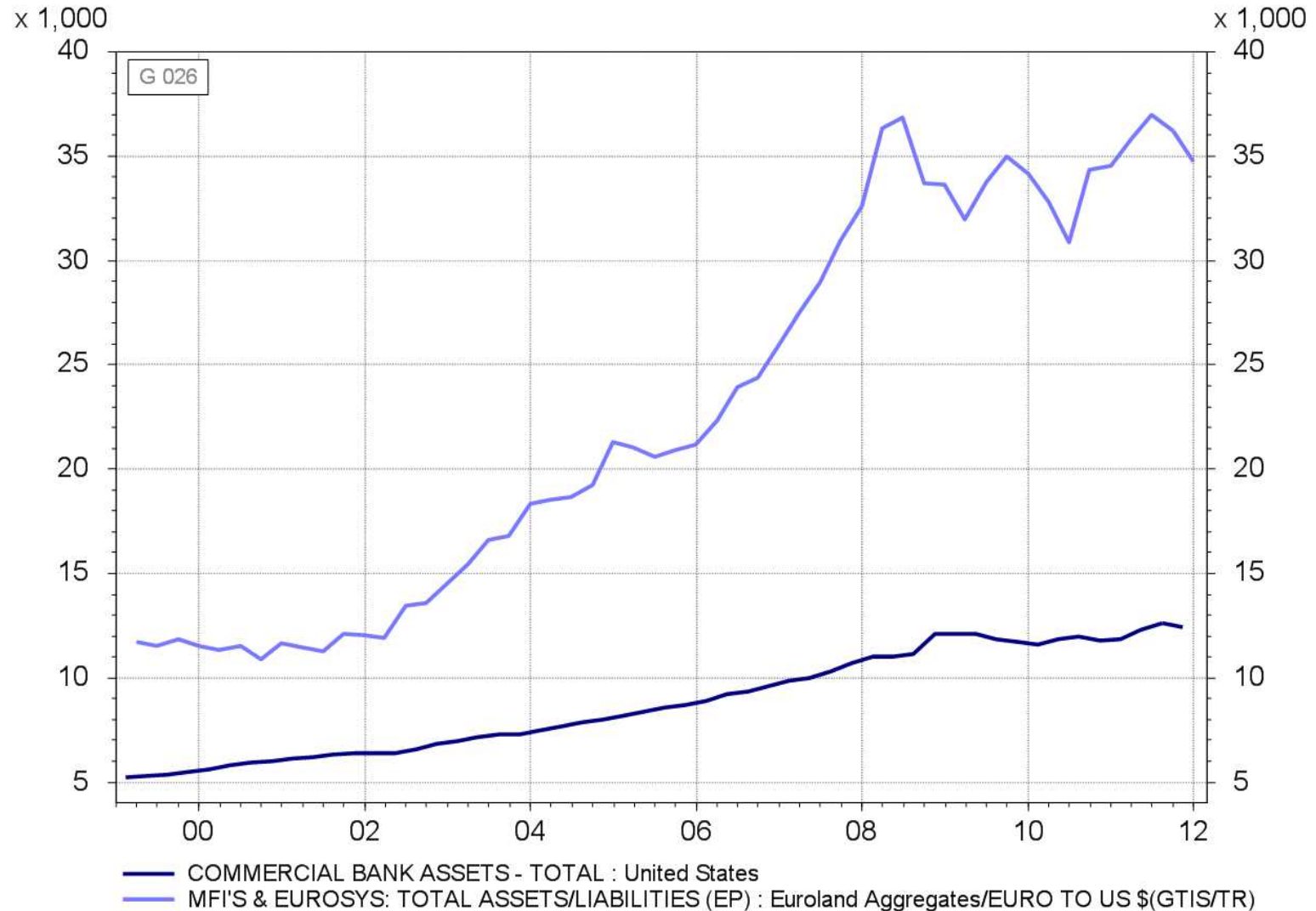


Source: Independent Commission on Banking

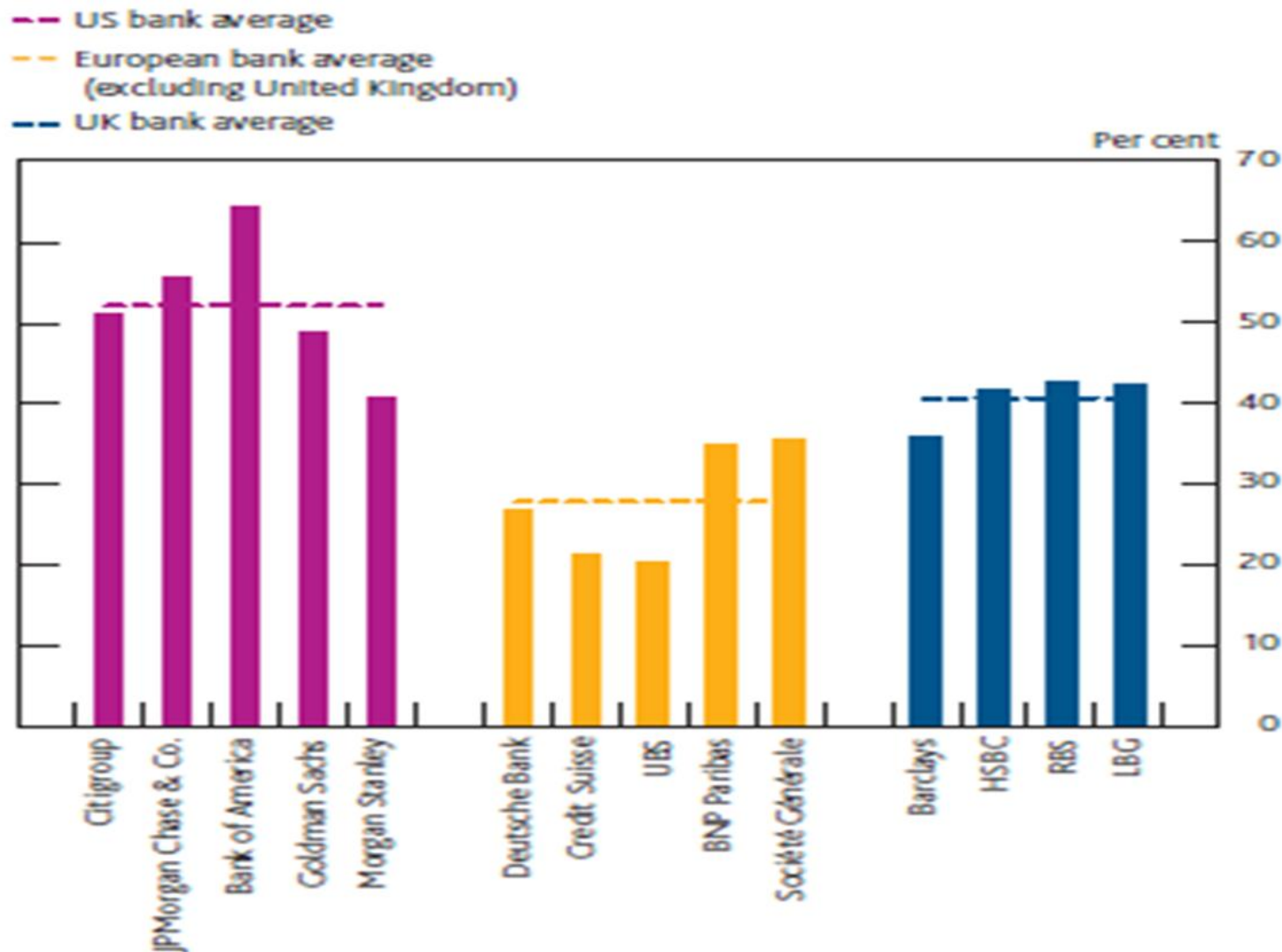
Basel II propelled Eurosystem bank assets (incl. derivatives) to 3X total US commercial bank assets (figs. in US\$trn)

“\$379bn in CDS represents derivatives written for financial institutions, principally in Europe, for the purpose of providing them with regulatory capital relief rather than risk mitigation.”

AIG 2007 Annual Report



Basel's distorted incentives: US banks' RWA/total assets = 53% (like UK banks pre June 2004) whilst many European banks' RWA/TA ratios are still < 30%



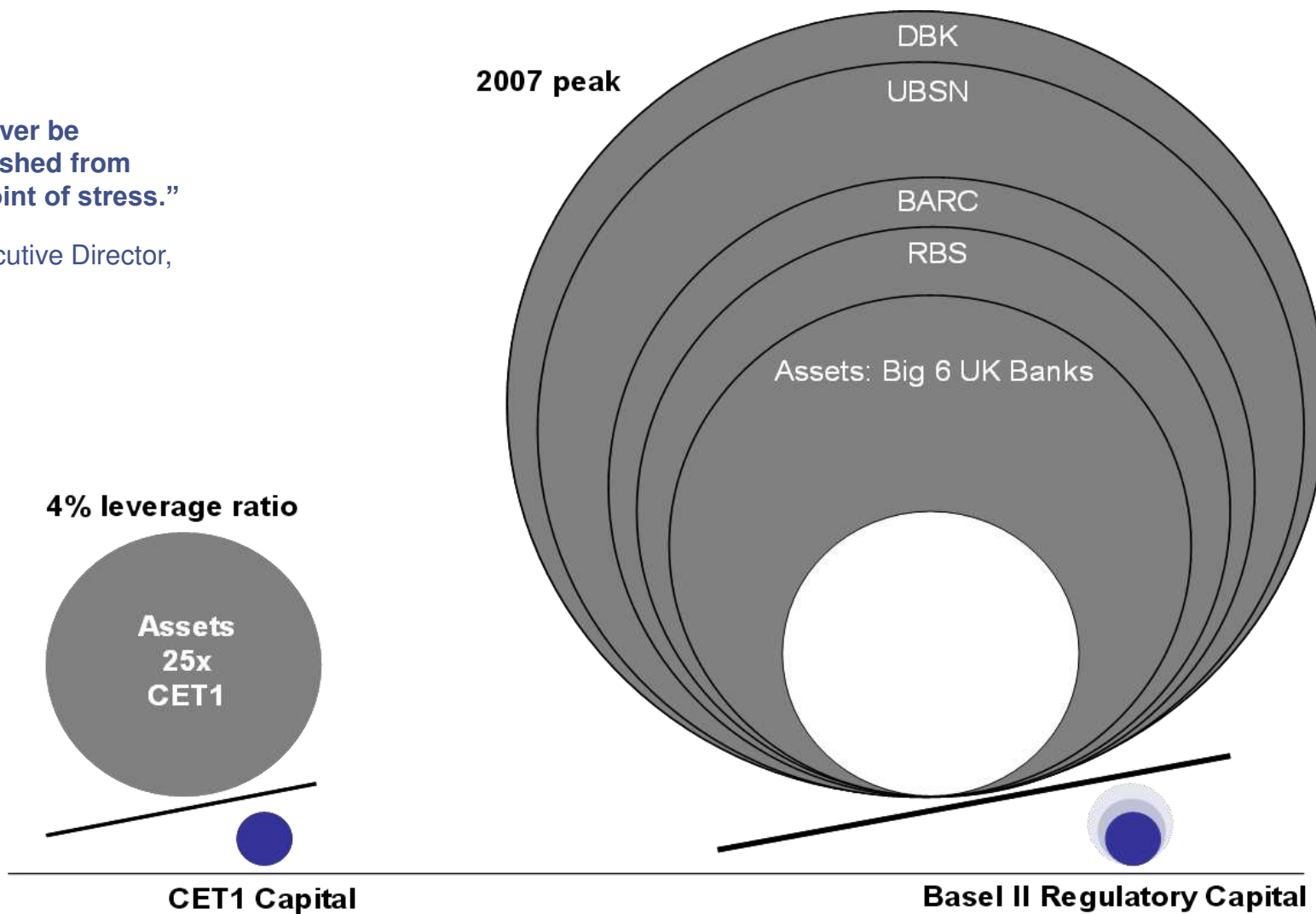
Source: Bank of England

The math: if European banks can't raise €114.5bn of capital, a 9% K/A ratio requires shedding €1.27trn of RWA, which = €3.8trn of actual assets

RWA-based capital requirements led to regulatory arbitrage, extreme leverage and dangerously thin capital buffers

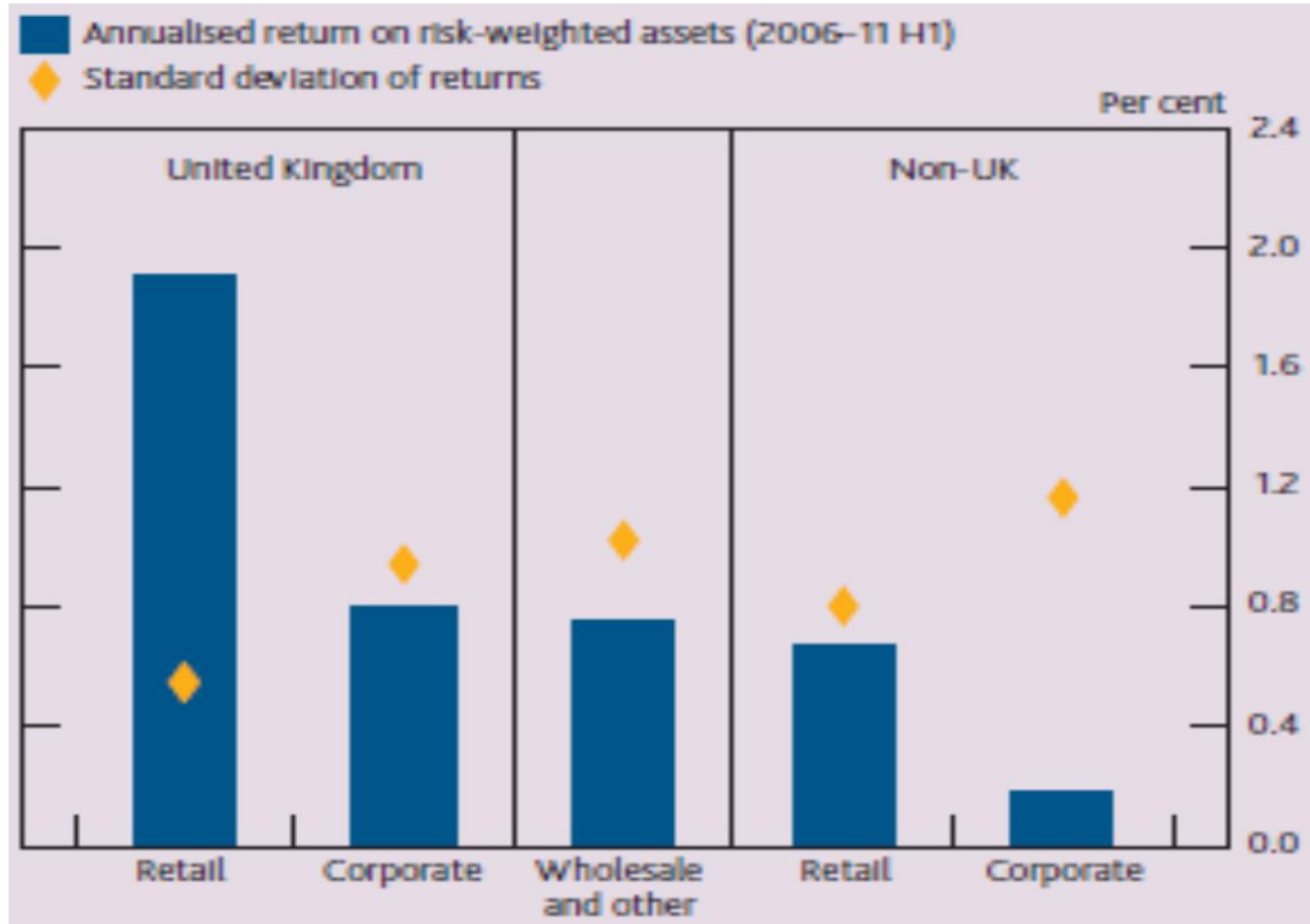
Liquidity risk can never be completely distinguished from solvency risk at a point of stress.”

Paul Fisher, BoE Executive Director, Markets, Sept 2010



Source: Companies' regulatory filings, Westhouse Securities

Contagion: non-core (foreign) assets are less profitable with higher variance, and so get shed faster; 3X faster in the case of UK banks to date



Source: Bank of England

US cumulative bank losses now = \$833bn vs. starting capital of \$560bn. But remaining est. losses of ≈ \$500bn are now approx. half current capital

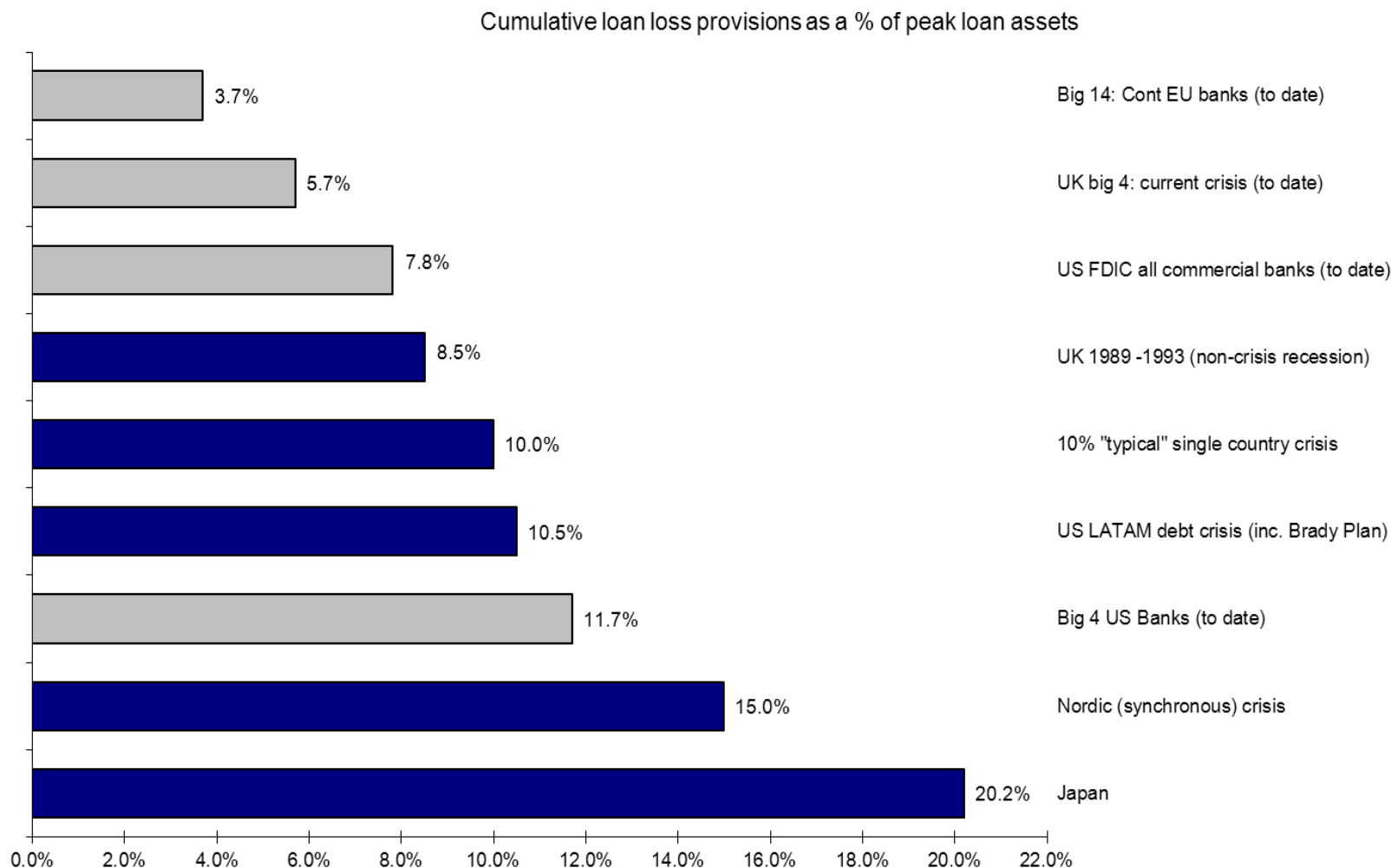
US Bank loan losses

Securities	\$bn	Assets Sept-08	Assets Sep-11	% Change	Stress test loss rate (%)	Stress test est. loss	IMF (e) loss rate (0410)	IMF loss forecast	FDIC charge-off rate to Q3 11	Gross bank losses to Q3 11
1-4 family residential		2,095.0	2,058.1	(1.8)	10.7	224.1	6.8	142.5	6.9	144.7
Secured by first liens		1325.5	1,391.2	5.0	8.5	112.7			4.7	62.6
Secured by junior liens		193.2	112.0	(42.0)	25	48.0			14.7	28.4
Home equity loans		576.3	555.0	(3.7)	11.0	63.4			9.3	53.8
Consumer Credit		1,345.9	1,192.3	(11.4)	16	215.1	16.2	218.0	15.3	206.5
Credit cards *		669.8	614.3	(8.3)	20.0	134.0			23.6	158.2
Other loans to individuals		676.1	578.0	(14.5)	12.0	81.1			8.7	58.8
Commercial Real Estate		1,846.3	1,570.8	(14.9)	12.0	221.6	7.8	144.0	5.7	105.9
Commercial real estate		935.4	947.7	1.3	9	84			3.1	29.0
Construction and loan development		552.1	234.9	(57.5)	18	100			12.4	68.5
Multifamily residential real estate		149.9	157.7	5.0	11	16			4.1	6.1
Foreign, Farm & Farm land		190.2	185.4	-7.0	30.0	19.0			3.6	2.3
Other real estate owned		18.7	45.1	141.2					0.0	0.0
Corporate (C&I) and SME's		1,707.5	1,501.0	(12.1)	8.0	136.6	5.5	94.1	4.9	84.1
Commercial and industrial loans		1,430.7	1,216.2	(15.0)					5.1	73.3
Other loans		276.8	284.8	2.9					3.9	10.8
Others		316.5	318.0	0.5	7.0	17.0			1.5	4.6
Bank loans and acceptances		135.6	146.6	8.1					0.0	0.5
Lease financing receivables		124.9	97.1	(22.2)					3.3	4.1
Loans to municipalities		54.1	75.9	40.3					0.0	0.0
Loan Loss Provisions		(139.8)	(185.0)	32.3						
Total loan assets		7,098.6	6,397.0	(9.9)	11.4	814.3	8.3	598.6	7.8	558.8
Trading Acc. & private securities		1,390.8	1,205.1	(13.4)	20.2	328.45	18.2	296.0	16.9	274.2
Govt. securities/risk-free assets		3,854.3	4,500.8	16.8	0.9	31.2		0.0	0.0	0.0
Total assets		12,343.7	12,102.9	(2.4)	9.5	1,174.0	7.2	894.6	6.7	833.0

* Addition of \$294bn per FAS 166/7 Adjustment Q1 2010

Source: FDIC, Arbutnot

US banks are more than 3X further advanced on loan loss realisation than continental European banks, which are paralysed by a shortage of capital

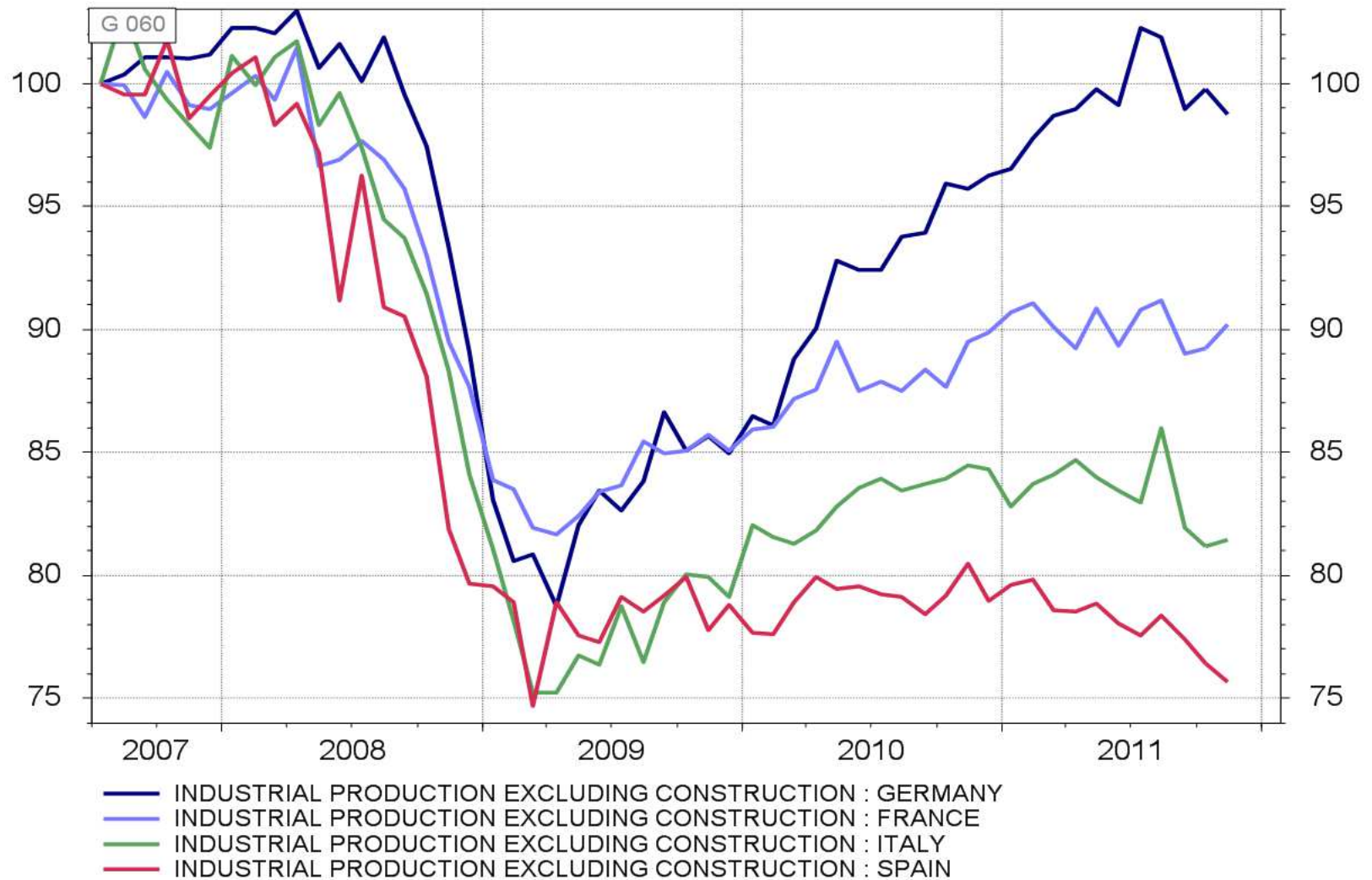


Source: Companies data, Arbuthnot

5 more years: Euro Area bank balance sheet repair has only now just begun – with negative implications for lending, money supply and GDP



4-Speed Europe: an un-restructured periphery, repaying debt under punitive rates, is condemned to extended depression – and QE will only make things worse



Source: Thomson Reuters Datastream; Arbuthnot

Endgame

“After a bad opening, there is hope for the middle game. After a bad middle game, there is hope for the endgame. But once you are in the endgame, the moment of truth has arrived.”

- Edmar J. Mednis (Chess Grandmaster)

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