Equity Market Comment

29 January 2010

Summary

Is the Glass-Steagall half full, or half baked?

On January 21 President Barack Obama called for tough new rules that would limit the size and trading operations of commercial banks. These new proposals are currently being referred to as the "Volcker Rule", due to Paul Volcker's strong and vocal views during the regulatory reform debate. While we view this shift as positive for the sector and the broader economy in the medium to long run, in the short term as the issue is debated further, legislation is drafted, international debate ensues and the markets attempt to assess any systemic consequences and segregate winners from losers, we see additional risk and volatility for the sector. Add in a political dimension, in which many policy makers were on the wrong side of policy decisions leading up to and into the crisis, and we have the potential for even greater uncertainty.

The Obama administration has also talked about the need to recoup public monies used to bail out the sector. He has proposed a Financial Crisis Responsibility Fee to be levied on the major institutions that participated in TARP (Troubled Asset Relief Program). This fee should it be imposed could potentially cost between 2% to 5% for most institutions, clearly a negative.

Throughout the course of this debate Mr. Volcker has consistently recommended significantly tougher regulation and greater oversight of banks than key administration advisors. The move to limit activities of commercial banks is a significant departure from the administration's position. This in and of itself may be the source of confusion as we will touch on later.

This shift in policy has the potential to achieve positive outcomes for both the industry and regulators alike. However, there will clearly be winners and losers from this shift. There is equally a need for a broad international consensus on the topic as activities take place beyond the borders of the United States. This is where we see the shift as somewhat troubling. Prior regulatory policy recommendations have focused mainly on recalibrating risk measurement tools, factoring in liquidity requirements, getting tougher on risk weightings and lifting capital requirements. Proposed changes were previously being worked on by the Basel Committee in consultation with National Regulators, including the US Treasury and IMF, along with industry groups like the Institute of International Finance (IIF). None of these groups had concluded or recommended that there is any need to constrain the activities of large complex financial institutions. The Administration's shift in stance displays a significant break in policy continuum.

In our correspondence to investors on issues like the sub-prime crisis and Basel risk weighting models, we have frequently argued that "There is no model for common sense". The shift to impose clear restrictions and limits on activities in order to protect the most critical functions of the financial system, the payment and deposit taking functions, is only logical. The key remaining question is how policy makers will reconcile this shift in stance with decisions taken leading up to and during

Best Fund Group 2008 (Overall) UOB Asset Management Ltd Singapore The Edge-Lipper Singapore Fund Awards
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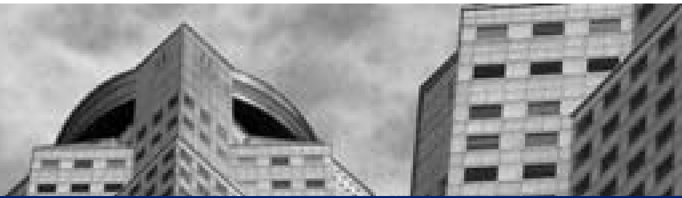
Best Mixed Assets Fund Group 2009 OSK-UOB Unit Trust Management Berhad Malaysia The Edge-Lipper Malaysia Fund Awards



the crisis. Free market reforms drove policy ahead of the downturn and marriages of convenience became a policy tool during the height of the crisis.

While the details of potential legislation are not known, we view the substantive shift in the debate as being a significant step in the right direction. We are concerned that it has taken so long to get to the stage of laying out some fairly basic principles that should have been at the core of the regulatory debate all along.

The "Volcker Rule" acknowledges two important facts. Firstly, that the global economy, or any economy for that matter, should not be put at risk by an institution that is too big to fail. Second and even more critical, that there is no way to have a complete handle on risk and no way to model it perfectly. By allowing innovations to take shape before gaining a full appreciation of the characteristics of the financial securities being held on bank balance sheets, regulators failed to provide the necessary sanity check to managements and boards that had become snow blind while skiing off-piste.

Several key questions still remain. How will administration officials and members of the legislative committees, who were previously involved in free market reforms fit into the policy team tasked with drafting reforms and re-regulation? Clearly this is an uncomfortable role. Several key members of the administration fall into this category, namely Chief Economic Advisor, Larry Summers, through his involvement in pushing the repeal of Glass-Steagall, and Treasury Secretary, Timothy Geithner, via his role in orchestrating marriages of convenience for the Broker-Dealers, and the bail out of AIG. The list goes on. Chris Dodd, Head of the Senate Banking Committee, was a significant architect of the repeal of Glass-Steagall as well. How can the creators of the greatest lapse in regulatory oversight since the 1920s be part of a solution? It is hard to see.

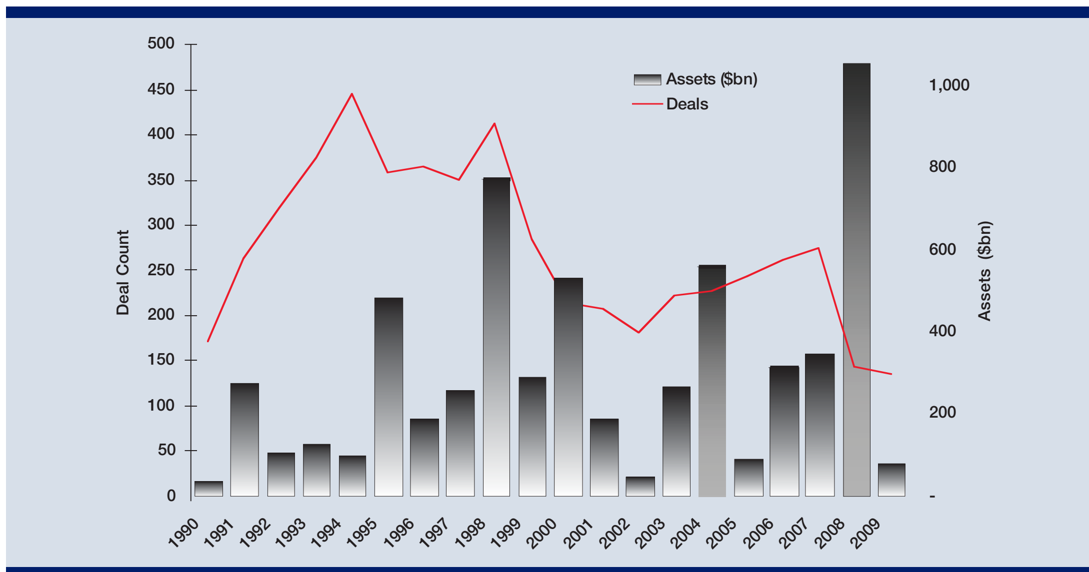
On a more up-beat note, the Chinese word for crisis 危机 is similar to the word for opportunity 机会, sharing a common character. The current crisis is no different. There will be opportunities out of crisis, winners and losers. Our focus is on investing in the winners that are well positioned to take the advantage to grow into the market share put into play by necessity and via reform.

"Too Big to Fail", and "Too Complex to Manage"

Several key changes took shape in the 1990s that set in motion rapid consolidation within the financial sector. The first was the relaxation of cross-State banking regulations that allowed institutions to expand across State lines, creating what were frequently referred to as the Super-regional banks.

The second and more explosive wave of consolidation started in 1998 ahead of the widely anticipated repeal of the Glass-Steagall legislation. This allowed for banks to expand into investment banking, securities underwriting and trading activities. The Travelers Group's merger with Citibank, was predicated based on this anticipated repeal, kicking off a spate of consolidation. Many of the largest institutions today evolved out of what were previously Super-regional banks.

US Bank M&A, 1990 - 2009 (%)

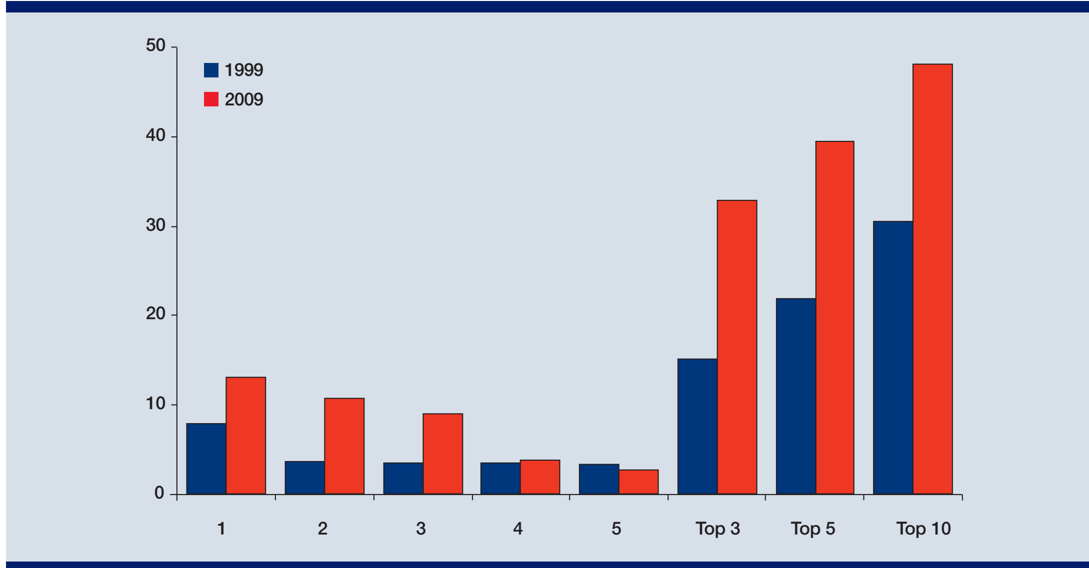


Source: SNL Financial, UOB Asset Management, January 2010

The peak in M&A in 2008 at >$1 trillion should be viewed in the context of the total FDIC insured banking system assets, which stand at slightly over $12 trillion, an astounding rate of consolidation and an equally astounding number of institutions that had become too big to fail.

The breakneck pace of M&A resulted in a significant consolidation of banking assets in the country. From 1999 to 2009 the top three banks in the US more than doubled their national market share from 15% to 32%. Today, the top three banks in California account for over half the deposit market in the state, with the largest standing at over 25%, clearly an issue for discussion among regulators in the context of systemic risk.

US Deposit Market Share (%)



Source: SNL Financial, UOB Asset Management, January 2010

The "Volcker Rule" – wisdom prevails, at last

President Obama's comments on banking regulation marked a significant shift in the administration's position on regulatory reform. While details are still to be worked out, we view this shift in stance as potentially positive for the sector and the broader economy as it squarely confronts the most pressing issues relating to safety and soundness, clearly a step in the right direction in terms of averting future crises. It does however, have the potential to place some headwinds in front of certain institutions, and potentially the broader economy.

The administration's position is encouraging as it recognised the fact that there are limits to the ability of institutions and regulators to keep pace with innovation and acknowledges the fact that there has been too much build up of risks concentrated among too few players. This was at the heart of former Federal Reserve Chairman's, Paul Volcker, arguments early in the reform debate. Unfortunately, no one chose to listen, including the President elect. The medicine was just too bitter to swallow.

Obama also recommended the inclusion of a "Financial Crisis Responsibility Fee" as part of any new legislation related to financial sector reforms. The administration has not named institutions that would be subjected to the tax but it is understood to be principally focused on the largest institutions, assets >$50 billion, mainly the firms that participated in TARP. The objective of the tax, which could run for up to 10 years, is to recover the estimated $117 billion in TARP losses incurred by the government. The problem here is that it is not clear if there will be any differentiation between institutions that truly needed public support from those that did so at the behest of policy makers so as to remove the stigma associated with taking capital and liquidity support.

A key issue of debate will focus around the fact that many banks have repaid in full and with interest and profit related to options the government's initial investments, so why penalise them for the

problems of others? Not least the majority of losses associated with government support measures are believed to relate to CIT Group, which failed as well as Fannie Mae, Freddie Mac and GMAC, which continue to survive on government support.

The Market's Reaction

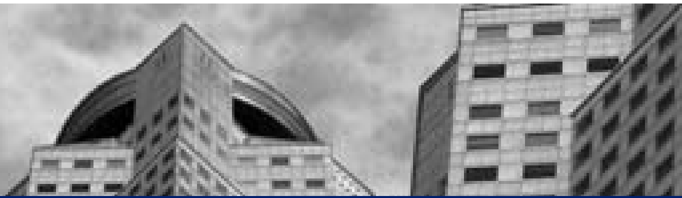
The Financial Sector reacted negatively to the news, with the KBW Bank Index losing 2.7% the following day, and Citigroup, the poster-boy of too big to fail, dropping 5.5%. The Broader Markets also fell, with the S&P 500 losing 2.2% and the FTSE dropping 1.6%.

Market concerns were multiple. Namely that Obama's plan could put additional pressure on the banks at a point when they have material credit challenges to deal with, further constraining credit to the broader economy. The plan appeared to be more a reactionary and populist response to the Democrats' loss in Massachusetts than a sincere effort to address the safety and soundness issue. The shift in stance brought greater uncertainty to the regulatory debate, as all major policy making groups had previously disregarded Volcker's recommendations. In the worlds of one contact late in 2009, "Nobody in the policy making community is listening to Volcker".

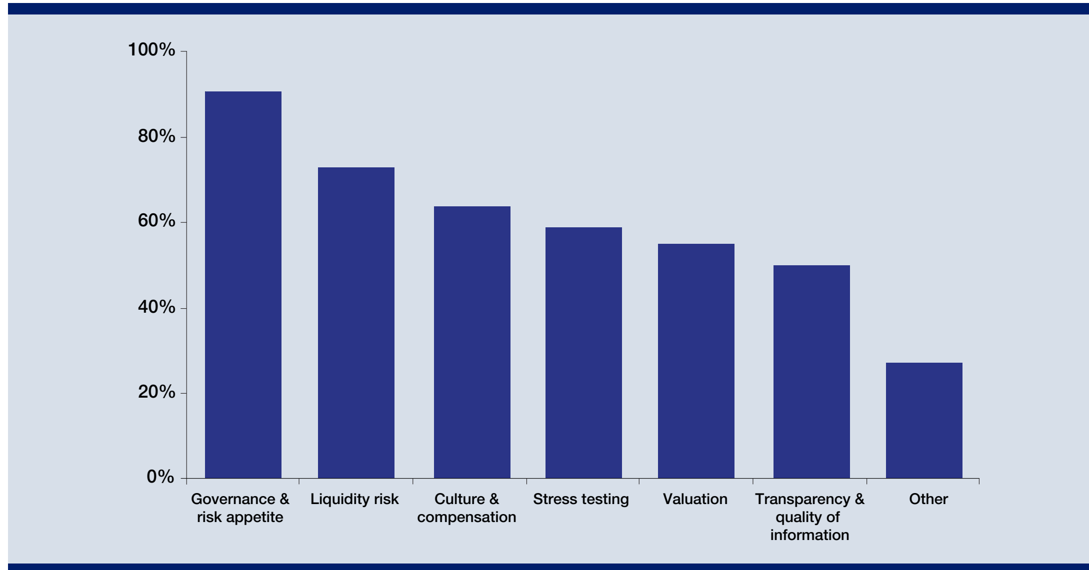
Global perspectives, the need for re-alignment

The two key recommendations that place limits on size and scope are a departure from international thinking on the issue. On the issue of size, while some competition authorities and regulators do impose market share caps to ensure sufficient choice among consumers and limit systemic risks, many do not. A shift in regulation placing greater emphasis on systemic risk and concentration, while desirable, may face significant resistance and be difficult to implement internationally. The separation of higher risk trading activities from traditional banking is also likely to face serious opposition from bankers and lobbyists. Although it would appear the tide on this issue has turned.

The Swiss regulator is clearly frustrated with the fact that Switzerland's largest bank need public support to prevent its collapse and has announced stricter leverage constraints. It is believed that it is also looking to reign in riskier trading activities as part of future reforms. Although similar in some respects to the UK's Financial Services Authority (FSA) comment on the need to sharply increase capital requirement associated with proprietary trading, they will likely move further than previous thinking on the issue, either disallowing or clearly ring-fencing certain higher risk activities.



Top Issues Across G10 Banks



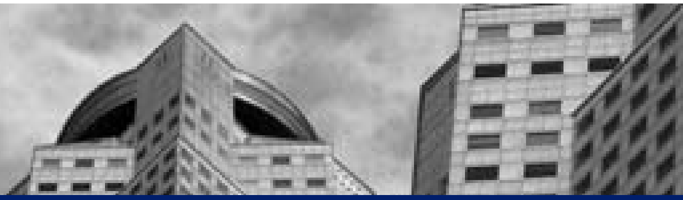
Source: Institute of International Finance, Reform in the Financial Services Industry, December 2009

Glass Steagall light?

The breakdown of risk management reflected multiple failures on multiple fronts. As the banker-creditor relationship shifted, both understanding of risk and sensitivity to it declined. Management teams, boards of directors, rating agencies and regulators were basing decisions on recent experiences. Most of these were benign as inflation was modest, interest rates had fallen to historically low levels and asset prices trended upward in steady fashion. A new world order, in which risk was permanently reduced, better diversified and in stronger hands ensued. In true Minsky fashion, animal spirits soared and the economy flourished. The evolution of new financing tools designed to better manage and re-distribute risk worked miracles. The problem was they worked too well, hiding risks and desensitising all participants.

We believe any move to restrict certain higher risk activities and limit size makes sense. Banks ultimately need to keep any potential capital calls or funding commitments in proportion with capital and liquidity levels. To do so certain activities including underwriting, trading and investments need to be kept proportionate. It may even be in the interest of regulators to disallow institutions from holding or trading certain higher risk securities or derivatives that carry leverage.

One potential solution without reverting to Glass-Steagall could be to shift these higher risk activities into a separate legal entity under a holding company structure. The key principles in doing so would be to insulate the core banking businesses and prevent them from transferring risks. The separately licensed and regulated entity would need to meet appropriate capital and liquidity requirements to survive on a standalone basis without recourse to the parent. Solomon Smith Barney used to operate as a separate legal entity in parallel with Citibank NA following the merger of Citibank and Travelers. It was only merged much later.



Another shift in thinking on the issue of systemic risk may involve a re-assessment of market share caps at multiple levels, national, regional and MSA (Metropolitan Statistical Areas). The challenge associated in resolving institutions deemed too big to fail is all too clear. A more desirable position for policy makers would be to have appropriate tools to ensure orderly resolution. These tools exist at the FDIC for handling traditional banks, but it needs to be extended to other financial institutions of significance.

Tougher questions need to be asked about the future role of the GSEs (Government-Sponsored Enterprises). It would seem they played a contributory role in facilitating the build up of risk. By channeling credit in a manner that is not always economic, they inadvertently contribute to market distortions, exacerbating the housing bubble, and facilitating in the build up of risk in the system. They remain the definition of too big to fail.

By expanding the scope of permitted financial activities without expanding the purview or powers of regulators, institutions were in a position of being able to exploit gaps in the regulatory. They did, and they took on more risk than they could handle. There is a pressing need to close the gap to prevent regulatory arbitrage in the future. This is perhaps the single greatest challenge, but also offers the greatest benefit in addressing the safety and soundness issue as it requires a deeper understanding of transmission/contagion issues. It would also clearly assign accountability to a single body with a clear mandate – preferably not to a committee.

While it may be popular to beat a banker, banking is not dead

Clearly regulatory changes are likely to go farther than previously envisaged. While many presage the demise of the sector as an investment opportunity, this couldn't be further from the truth.

The greatest risk to investing in a financial institution is that management and organisations have a tendency of doing foolish things to deliver short term performance and keep pace with "more sophisticated peers". This works great until they realise there were gaps in their assessment of risk, and then it doesn't.

Stricter regulation for the most critical group of institutions to the point where they become almost management proof will only help underpin their intrinsic value. Any effort to remove the low probability event of an investment going to zero should help to support the market's valuation of the business. Proper regulation should achieve this without discouraging calculated risk taking. While regulation can't prevent a bad bank from failing, it can and should prevent a single failure from becoming a systemic crisis.

Banks will over time re-price risk to the point that they achieve appropriate returns on capital. So during the transition phase to a new regulatory regime, there will undoubtedly be headwinds for the sector as certain opportunity sets move to less regulated pockets of the financial system. Revenue could grow at a more modest pace for a period as this transition takes place. Similarly, profitability could be held back through lower leverage. However, with the re-pricing of risk, profitability should be restored over time and should be of higher quality and lower volatility. This in and of itself is worth something to investors.

A strong, well regulated and dynamic financial system and capital market is at the heart of any vibrant economy. And politicians realise this. So no matter how popular it is to beat a banker, banking is not dead.

Opportunity in Crisis

The history of banking reminds us that as large banks emerge from M&A that there are always opportunities for mid and small size competitors to grow and compete head on with these enlarged institutions. This time is no different, only the opportunity may be greater.

There are a number of large institutions which through diseconomies of scale, balance sheet challenges, or regulatory shifts, will be on the losing side of market share change. This will create significant opportunities for a number of players, both organic and non-organic. Regulatory change will only accelerate the benefit. We see a number of institutions that are well positioned to take advantage of this opportunity.

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FINANCIAL SECTOR UPDATE

Contact Details

Address 80 Raffles Place UOB Plaza 2 Level 3 Singapore 048624
24-hour Hotline 1800 222 2228 (Local) • (65) 6222 2228 (International)
Fax (65) 6532 3868
Email uobam@uobgroup.com
Website uobam.com.sg

Regional Offices

Singapore

Institutional Investments
Dennis Siew
Senior Director

Retail Investments
Norman Wu
Senior Director

Regional Investments
Faizal M. Fazluddin
Senior Director

Alternative Investments
Chong Jiun Yeh
Executive Director

International Business (China)
Jasmine Lim
Senior Director

Brunei
Kamal Muhd
General Manager

Japan
Masashi Ohmatsu
Chief Executive Officer

Malaysia
Lim Suet Ling
Chief Executive Officer

Taiwan
Juang San Tay
General Manager

Thailand
Vana Bulbon
Chief Executive Officer

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