

Following the collapse of Lehman Brothers last year, amongst the many stresses experienced by the banking sector, two periods stand out - a confidence crisis in all financials, and a rumour-fuelled threat of nationalisation of the US banking sector. These conditions have now passed: Nevertheless the cost to the financial system is yet to be compensated, but there are reasons to be optimistic.

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For Institutional Investors Only

insights

ING INVESTMENT MANAGEMENT

Lehman, one year later: A credit perspective

Crisis of Confidence

There was a massive confidence crisis in all financials post-Lehman bankruptcy, prior to the announcement of TARP¹ in October 2008. Bank spreads were extremely vulnerable to rumours as the public debate chose to focus almost exclusively on losses, rather than any offsetting earnings power these large institutions had to manage through the losses. Thus in the latter half of November 2008, investors took a "sell first, ask later" approach, driving banks wider by nearly 90 basis point spread (bps) in two weeks.

Liquidity fears dominated the market, and spreads only showed improvement after the Temporary Liquidity Guarantee Program and other Government assisted liquidity measures fully took hold in December 2008. The banking sector option adjusted spread (OAS) widened from 380 bps just prior to the Lehman bankruptcy to 618 bps on December 1, 2008.

Threat of Nationalisation

There was a market panic in Q4/08 which followed inaccurate rumours regarding nationalisation of the bank sector and a confused, and at times misleading, national debate on banking sector insolvency. The administration's announcements in February on stress testing the nation's largest banks (meant to increase public confidence in the banking system) were met with continued market angst and suspicion. Bank OAS widened from 524 bps on February 13, 2009 to 697 bps on March 13, 2009 (see Chart 1).

¹ The US\$700billion Troubled Asset Relief Program (TARP) approved by US Congress on 3 October 2008

Chart 1: Investment Grade: Banking - OAS



Source: Barclays Capital Live, INGIM Research

"Ten of the 19 large systemically important banks that received TARP money have fully repaid the government."

The threat of government action via nationalisation receded as a result of a successful conclusion to the stress tests. Thankfully, the test results were made public, contrary to earlier speculation. Since that time, banks spreads have improved as markets finally came to realise that the banking sector was not necessarily faced with imminent collapse and the government would not take over the banking system, wiping out shareholders and haircutting debt holders in the process.

Those who mistrusted the administration's clear statements in favour of a private sector banking system were proven incorrect. Those who suggested that the government would impose significant cuts for bank debt holders failed to see a fundamental contradiction in their argument — that administratively imposed (rather than market determined) cuts would only have served to heighten investor confusion, thus prolonging, rather than resolving, a credit crisis bred from lack of confidence.

TARP repayments a positive sign

Today, with more than US\$140 billion in bank equity raising deals completed, the soothsayers of impending banking system doom are no longer granted centre stage. We hear fewer legislators attempting to provide their own solutions, which often involved populist blame allocation, to solve the banking crisis. The Fed, Treasury, and FDIC, which clearly are better qualified to craft time sensitive crisis solutions than legislators, are doing their regulatory jobs and dealing with the still significant daily challenges of managing a stressed but recovering financial system.

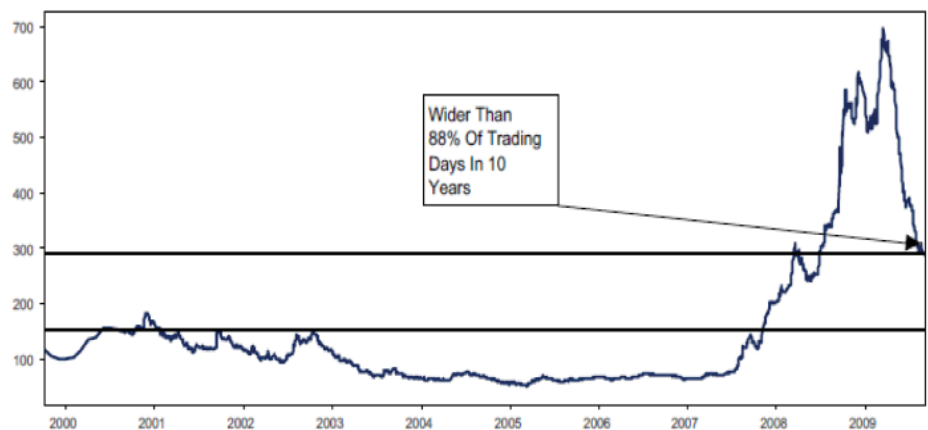
Ten of the 19 large systemically important banks that received TARP money have fully repaid the government while the majority of the other nine large institutions have started discussions on when and how best to repay.

Challenges remain in the banking sector

As of September 3, the Bank OAS was 290 bps, 90 bps tighter than pre-Lehman, 400 bps tighter than mid-March panic levels. The banking system appears to have recovered from two deep troughs in the last year. Currently, with the equity market's impressive vote of faith in banks, credit metrics have clearly improved. Yet at about a 290 OAS for the banking sector (wider than 88% of trading days in the last 10 years), spreads suggest that risk perception remains significant by historical standards. No surprise perhaps, since we continue to view this episode as the worst crisis since the great depression.

But what exactly are the challenges which lie ahead for the banks? We believe the major source of stress for the large banks going forward will be neither liquidity nor capitalisation. Investor angst will centre around the accuracy of loan loss estimates which underlie the stress tests (see Chart 2).

Chart 2: Investment Grade: Banking – OAS 10 Year



Source: Barclays Capital Live, INGIM Research

We believe loss rates should climb in the near future. The commercial down cycle should worsen, especially for commercial real estate. Stress test estimates for both C&I lending (2 year cumulative loss of 8%) and commercial real estate (cumulative loss of 12%) were very severe. In these two commercial lending categories, the worst of the losses still lie ahead of us; commercial real estate will continue to weigh on the banking sector, especially regional banks, through 2010 (see Chart 3).

Mixed signals on consumer lending suggest that the bottom of the consumer loss cycle may be on the horizon: witness the latest improved card delinquencies in Chart 4. Mortgage delinquency curves have started to bend, though clearly the inflection will be at a distressingly high rate. In this context, cumulative two year stress test loss estimates of 20% for cards, 11% for home equity and 8.5% for first lien mortgages are rightly conservative. In aggregate, if a gradual improvement in economic conditions can be sustained, these high loss estimates in the test, together with very conservative bank earnings power projections by the regulators, should prove to be a credible basis for banks to stay viable into 2010.

Bank spreads should improve

With two quarters of data, post stress test, a number of banks have outperformed on revenue compared with stress test estimates, lending credibility to the conservatism employed by regulators. What does this mean for bank spreads by the end of 2009?

We have a moderately positive view. Near term, banks have sufficient liquidity given increased depositor confidence and lacklustre balance sheet growth. Thus technicals should not cause too much spread widening even as banks continue to access the debt markets through the last quarter of 2009.

With consensus expectations of economic recovery in 2010, we expect spread performance improvement by the end of 2009 as markets look forward to better earnings performance and potentially growing bank balance sheets further out in 2010.

Near-term however, we expect weak results out of the non-capital markets focused banks, high loss rates across all banks and a generally supportive regulatory structure. We do not currently anticipate another market panic given the massive capital raising actions and increased market confidence.

Regulatory reform will guide bank behaviour

Regulatory reform will be a key issue affecting the US banking sector in the immediate future. Changes to systemic risk tolerance will likely cause the largest and most complex banks to either improve risk management and/or reduce risk appetite.

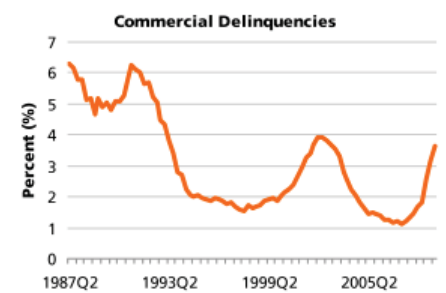
Increased capitalisation requirements will be driven by a "never again" attitude on the part of the central bankers who were forced to ride to the rescue of the global financial system in its darkest days of the last year. Confidence will likely increase while bank debt should become safer investments in the longer term since we expect equity capital buffers will be larger than in the recent past.

We do not believe the US banking system will quickly return to peak profits given our views on asset quality above. But the building blocks of a more secure environment for bank debt investors are present and we await proper execution.

We believe a strategy of holding subordinate paper of the stronger large banks and staying in the senior part of the capital structure for the better regionals will produce favourable carry while adequately catering to the risk of continued economic weakness and high bank losses in the near-term. We would avoid the smallest non-systemically important institutions unless they have raised capitalisation levels sufficiently.

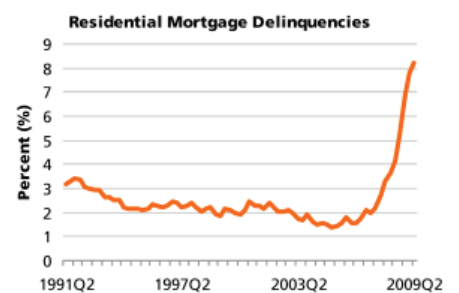
From a long-term perspective, given that bank spreads remain historically wide, coupled with our belief that regulatory action will build a more credit friendly environment in future, we believe bank paper should remain a core portfolio holding.

Chart 3: Commercial Loans - Look for more losses in 2010



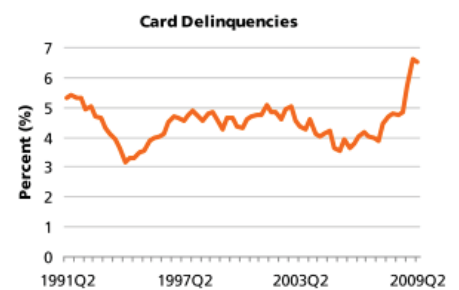
Source: Federal Reserve

Chart 4: Consumer credit card delinquencies are improving



Source: Federal Reserve

Chart 5: Residential mortgages may be near inflection



Source: Federal Reserve

ING Investment Management Limited
ABN 23 003 731 959
Level 21, 83 Clarence Street
Sydney NSW 2000 Australia

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