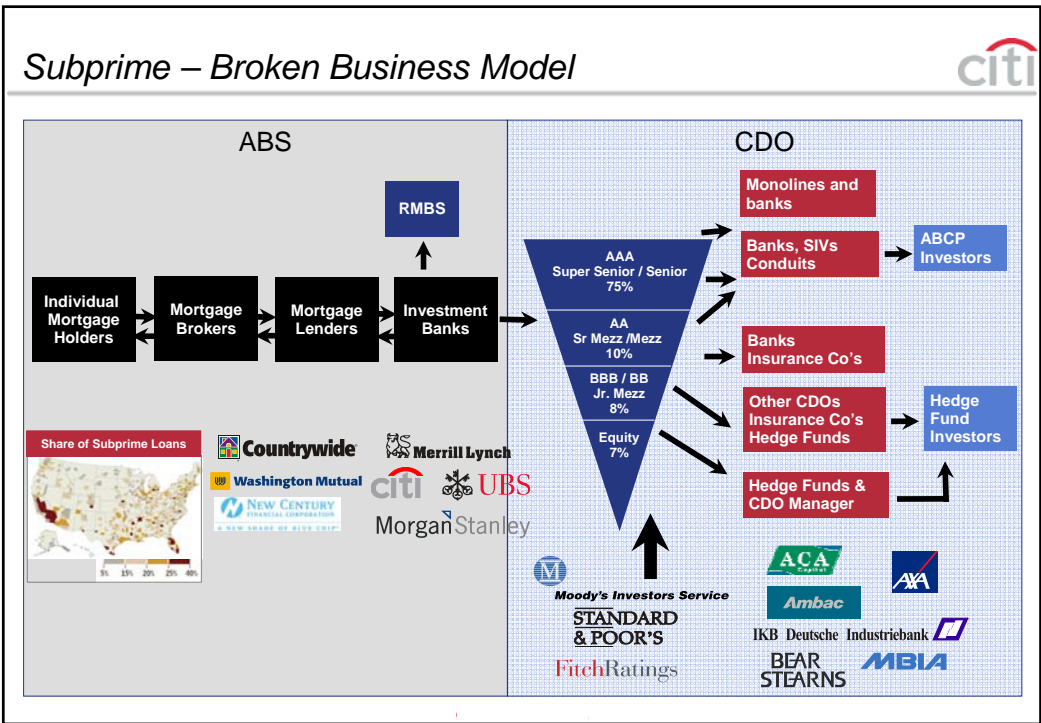





Brad Gans

22nd April 2008



What Went Wrong?



Two thirds of exceptional losses reported in past 9 months relate directly to US subprime exposure

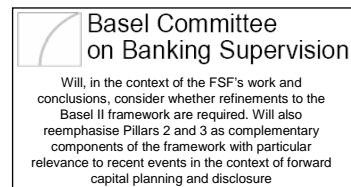
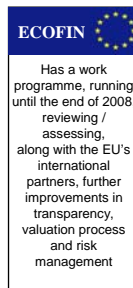
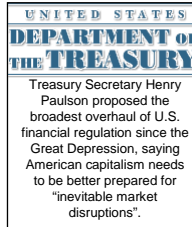
- ▶ Modelling: Assumed a pool of uncorrelated assets
- ▶ Modelling: Unrealistic HPA (late 07 structures assumed +7% HPA in perpetuity)
- ▶ Modelling: New subprime had little to do with legacy subprime data
- ▶ Originate to distribute model
 - End investors 4-6 levels removed
 - Incentive structures
- ▶ Traded by credit structurers, not mortgage specialists
- ▶ Business selection: Direct correlation between big originators and big losses

Source: Citi Fixed Income research

Policy Response



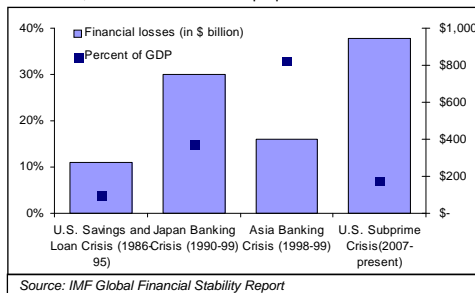
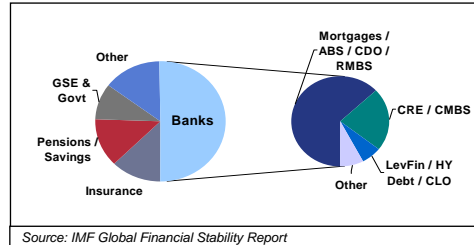
- ▶ Rating Agencies
- ▶ Originate to Distribute model
- ▶ Market Transparency
- ▶ Off Balance Sheet structures
 - Liquidity considerations
- ▶ Enhanced Financial Institution Risk Management
- ▶ Upgrade authorities' crisis risk management capabilities
- ▶ Mark to Market Accounting
- ▶ Basel II
 - Bear Stearns – Fed
 - Northern Rock - Triumvirate



Previous Crises and Current Outlook



- ▶ Within the wide range of headline estimates, the range of losses to be borne by the banking sector (including securities firms) is tighter – more recent estimates have been in the \$350-\$500bn range. Reported losses in this sector currently total approx. \$200bn
- ▶ IMF estimates that losses from the current crisis may total \$945bn, with around half borne by banks and securities firms
- ▶ This may be the largest crisis in nominal terms in recent history, however, it is more modest as a proportion of GDP



- ▶ Total capital raising in the financial sector (both completed and announced) totals just over \$100bn
- ▶ For comparison, the top 1000 banks in the world (source: The Banker's 2007 survey (based on 2006 results)) have Tier 1 capital totalling \$3.4trn
- ▶ Also from the Banker, profitability peaked in their 2007 survey with aggregate pre-tax profits of \$786bn, or 23.4% as a percentage of Tier 1 vs. 22.7% a year previously and 19.9% the year before that
- ▶ Assuming a depressed 15% return (equates to pre-tax income \$280bn lower than 2006) and an average 30% tax rate, net income among the top 1000 banks would be \$350bn
- ▶ Issue will remain the concentration of losses and the loss absorption capacity of sectors and individual firms rather than the aggregates