

# Regular research papers and articles providing sector specific insights and issues analysis – Financial Services

March edition 2009 – Financial Services

## Industry Intelligence Unit

Welcome to our first financial services sector IIU publication. Grant Thornton have expanded our research papers and articles to the financial services sector, reflecting the further diversification and expertise of Grant Thornton International. This compliments our strength in other sectors including: Retail, Property, Aged Care, Automotive and Hospitality.

In this edition we look at some of the key events we have witnessed recently that will impact in the short term. Specifically we look at:

- an overview of the financial sector, from both global and domestic perspectives
- the changing cost and availability of funds and its impact on business
- equity capital back in demand
- damage control for the wealth management industry.

The financial services sector has been experiencing unprecedented challenges for the last 20 months. Indeed, the Macquarie Dictionary recognised the addition of the definition of “Toxic Debt” in 2008 as its word of the year:

“Toxic Debt – debt which, although initially acquired as a legitimate business transaction, proves subsequently to be financially worthless, as the subprime loans which precipitated the GFC.”

Source: Macquarie Dictionary

The difficulties facing the sector over this period have grown exponentially. Initially quarantined within the US, the impact has now expanded globally. The consequences have been diverse and reaction to the predicament both severe and challenging for governments, central banks and corporates.

This year will continue to see the unravelling of the fallout from the global financial crisis (GFC). We have already seen that Australia is not immune and as a player in the global economy will continue to be affected by events overseas.



# Overview – a global perspective

The GFC started out confined to the fallout of sub prime lending by US-based financial institutions. It has since evolved, with ramifications massive and far-reaching. A small sample of US examples illustrate the dire nature of the situation:

## Lehman Bros.

- Filed for Bankruptcy protection on September 15, 2008, the largest bankruptcy in U.S. history.
- At this point Lehman Brothers Holdings disclosed it had bank debt of \$613b, \$155b in bond debt, and assets worth only \$639b.

## Bear Sterns

- In 2007 the company was badly impacted by the subprime mortgage crisis. This resulted in the need for the Federal Reserve to provide an emergency loan to try and avert a sudden collapse of the company.
- However, the company could not be saved and was subsequently sold to JPMorgan Chase for as low as ten dollars per share, a price far below the 52-week high of \$133.20 per share before the crisis, although not as low as the two dollars per share originally agreed upon by Bear Stearns and JP Morgan Chase.

## Merrill Lynch

- In November 2007, Merrill Lynch announced it would write-down \$8.4b in losses associated with the crisis. By July of 2008, the new CEO of Merrill Lynch announced \$4.9b fourth quarter losses for the company from defaults and bad investments in the ongoing mortgage crisis. In one year between July 2007 and July 2008, Merrill Lynch lost \$19.2b, or \$52m daily.
- Merrill Lynch was later sold to Bank of America at a price representing a discount of 61% from its September 2007 price.

One of the largest attempts to address this problem has been the US Troubled Asset Relief Program (TARP) scheme. This program has seen many changes since announcement and continues to evolve with the change of government. It has also been widely criticised for its lack of transparency and the haste with which it has been developed.

Some of the scheme's requirements have specifically addressed the concern that "fat cats" from Wall Street (popularly deemed responsible for the crisis) were still walking away with exorbitant remuneration:

- The TARP was reviewed on October 14, 2008;
- The Treasury announced their intention to buy senior preferred stock and warrants in the nine largest American banks. In order to qualify for this participating institutions had to meet certain criteria, including:
  - (1) ensuring that incentive compensation for senior executives does not encourage unnecessary and excessive risks that threaten the value of the financial institution
  - (2) required clawback of any bonus or incentive compensation paid to a senior executive based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate
  - (3) prohibition on the financial institution from making any golden parachute payment to a senior executive based on the Internal Revenue Code provision
  - (4) agreement not to deduct for tax purposes executive compensation in excess of \$500,000 for each senior executive
- The Treasury also bought preferred stock and warrants from hundreds of smaller banks, using the first \$250b dollars allotted to the program.

Government efforts are continuing and as recently as February 10, 2009 the newly confirmed US Secretary of the Treasury, Timothy Geithner, outlined his plans to use the \$300b remaining in the TARP funds for foreclosure mitigation and to fund private investors to buy toxic assets from banks.

What started as a financial disaster in the United States has become truly global. Banks and other financial institutions throughout the world purchased toxic financial instruments and the consequences widened.

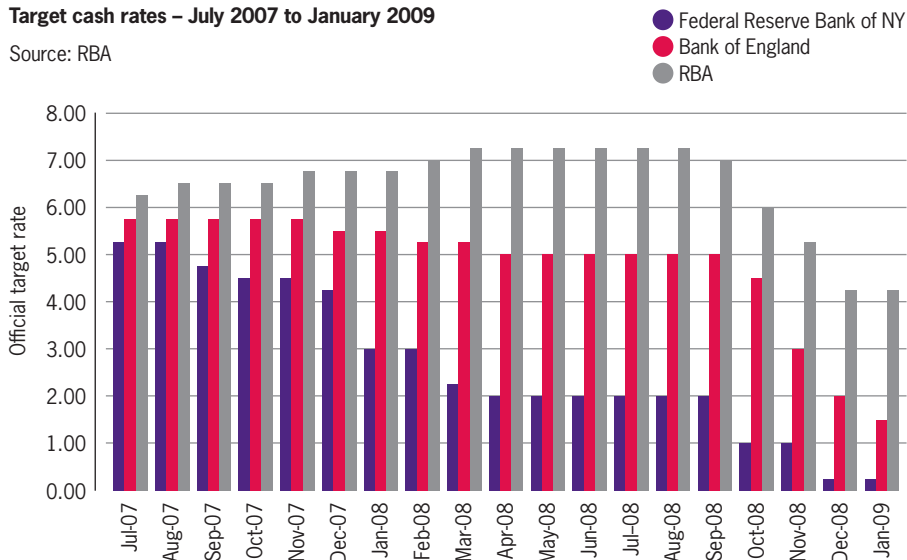
The United Kingdom, Germany, France and other European countries have poured trillions of taxpayer dollars into stopping losses in the world's financial system and attempting to restore liquidity to the market. The effects are no longer limited to financial institutions, but have spread to the real economy. The global contagion has seen actions such as:

- The British Government infusing £37b of new capital into Royal Bank of Scotland Group Plc, Lloyds TSB and HBOS Plc, to avert a UK “banking meltdown”
- Bank of England in March 2009 reduced interest rates to 0.5% and are printing around A\$160b of new money to pump into the financial system
- The European Central Bank reducing interest rates to 1.50%.

Whilst Governments have been pumping funds into the financial system the central banks have been taking drastic action which has seen the rapid cut in target cash rates as reflected below.

**Target cash rates – July 2007 to January 2009**

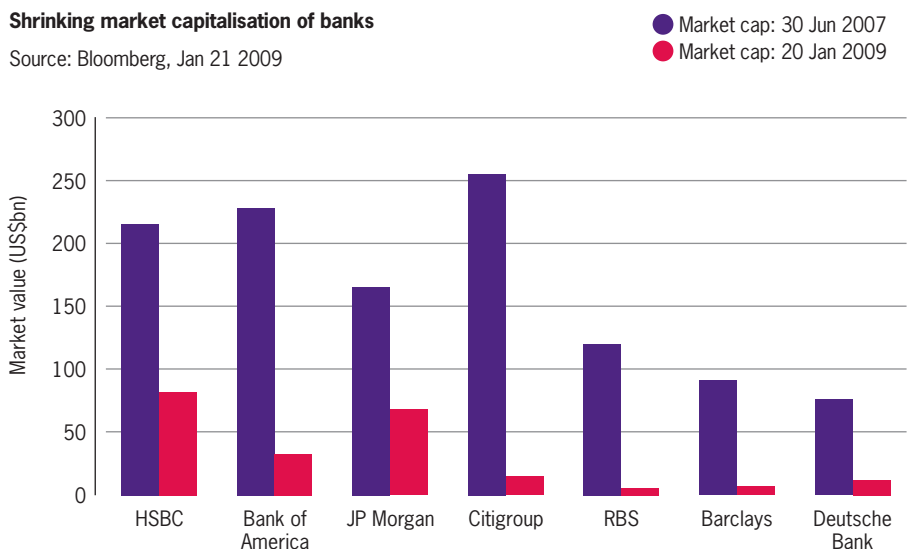
Source: RBA



The accumulation of the losses in the financial sector and subsequent action taken by governments and central banks has not stopped the position of the financial institutions around the globe from being punished. The market value of global banks has dropped by \$US5.5t (\$8.56t) since the start of the financial crisis, according to the US-based Boston Consulting Group. Until the losses and need for support stop, the market value of the financial institutions will continue to suffer. The severity of the falls in market capitalisation of a number of prominent banks is depicted in the graph below.

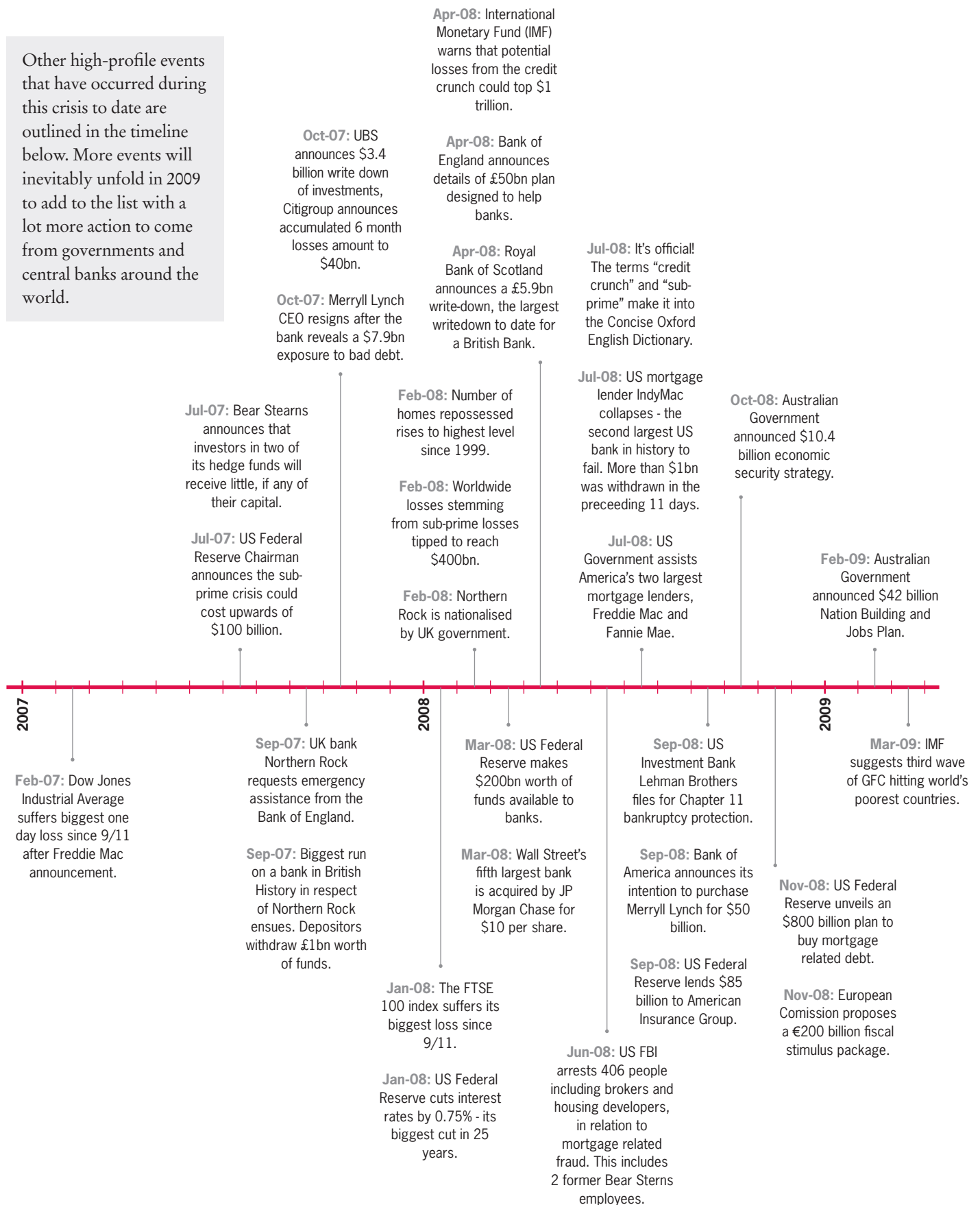
**Shrinking market capitalisation of banks**

Source: Bloomberg, Jan 21 2009



# Timeline: GFC

Other high-profile events that have occurred during this crisis to date are outlined in the timeline below. More events will inevitably unfold in 2009 to add to the list with a lot more action to come from governments and central banks around the world.



# Overview – an Australian perspective

Whilst Australia has enjoyed relatively strong economic prosperity over recent years the impact of the GFC is now being felt and seen in our market. The earlier graph highlighting the interest rate movements demonstrates Australia is quickly catching up to the rest of the world with pre-emptive action to mitigate the impact of the GFC. This is easily seen in the Australian cash rate movement between August 2008 and December 2008 below.

One area that has been having an impact in Australia for some time is the lack of liquidity in the debt capital markets, particularly for the Australian banks.

This position has a flow-on effect to corporates' ability to access bank funding, as well as the cost of such funding. A further implication is the reduced capacity to access funding from sources other than the major banks.

Wholesale markets remain more or less closed to non-bank corporate borrowers and with the foreign banks suffering so much in their own domestic environment there is continuing evidence they are retreating to their home markets, placing a massive call on the domestic banks' balance sheets to continue to fund businesses.

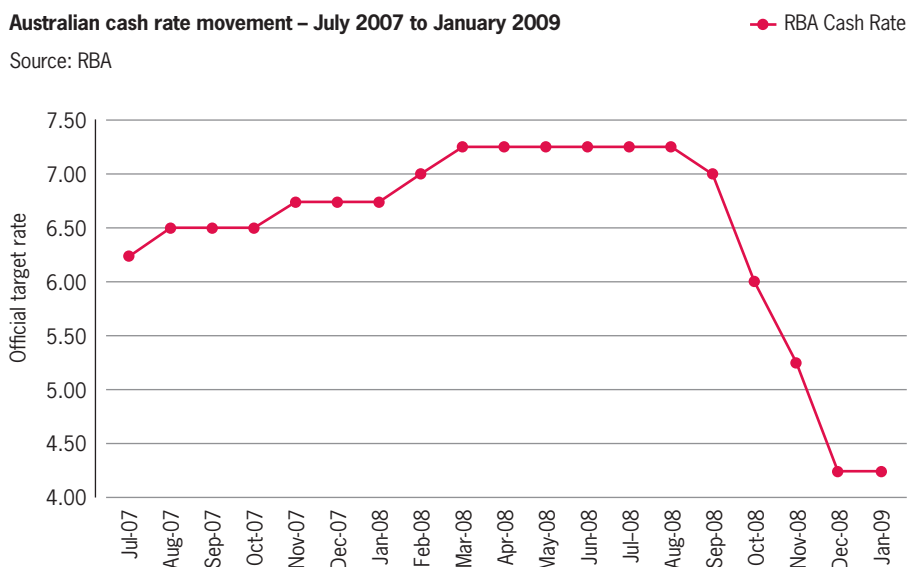
As discussed in a later section of this paper, this situation will lead to banks charging more for the scarcity of the funding availability.

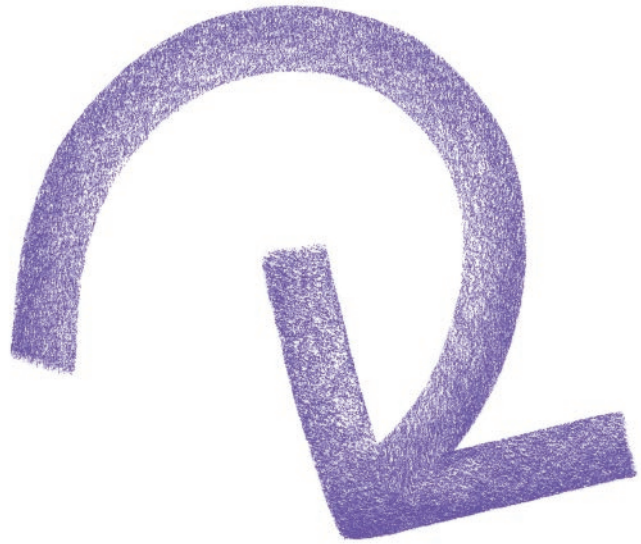
This situation has led many Australian companies to prepare for a flow-on effect, including reduced profit expectations. In turn there is a heightened focus on the level of costs carried by businesses. Inevitably this has resulted in large scale redundancies across many industries. One of the first and most severely impacted has been the financial services industry. Examples include:

- The US banking giant Citigroup shed around 2,500 staff in Australia, mostly based in Sydney and in Melbourne
- ANZ have target redundancies of between 500 and 1000 jobs
- Around 200 jobs lost at AMP
- Suncorp have reduced numbers by around 300 to 400
- Macquarie Group is estimated to have made 1,000 staff redundant to date
- Bank of Queensland is understood to have recently significantly reduced head office headcount
- Other layoffs have occurred at American Express and reportedly at Merrill Lynch.

**Australian cash rate movement – July 2007 to January 2009**

Source: RBA





This predicament is expected to continue at least in the near term. More recently we have seen the loss of jobs filter into other industries.

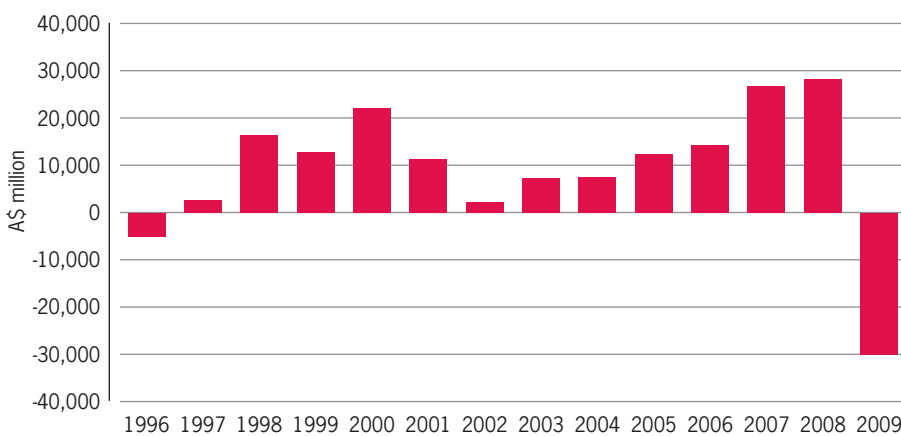
With all this negativity in the economy, the Reserve Bank has already taken substantial action. The Federal Government has also implemented its own measures to stave off the full impacts of the GFC and kick start the local economy. The cost of the Government stimulus packages will see Australia's budget in deficit for the first time in 12 years with an estimated deficit in 2009 in the order of \$30 billion, illustrated below.

Indications to date suggest the Australian economy has weathered the GFC quite well compared to many other countries. However there are concerns there is merely a delay in the problems hitting our economy, with the worst yet to come. The impact of the economic stimulus action by the Reserve Bank and the Federal Government will not be fully known for some time. We will monitor the success or otherwise of these initiatives in future publications of this IIU.

#### Australian economic performance since 1996

● Surplus / (deficit)

Source: RBA and ANZ March 2009 Economic Outlook



# The changing cost and availability of funds – its impact on business

As noted earlier, one of the causes of the GFC is the lack of liquidity in debt capital markets. The Australian economy has been caught up in this extreme illiquidity and risk-aversion.

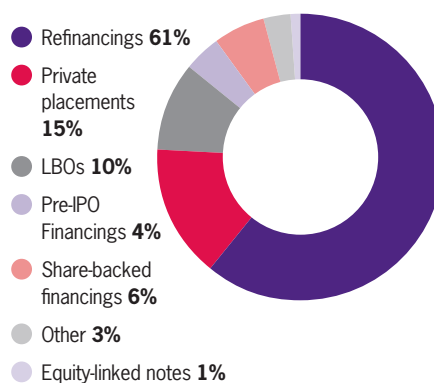
The situation has resulted in the Federal Government making available a government guarantee so banks can seek to raise funds in the market at a cost (and credit rating) acceptable to the market.

But the government guarantee is not perfect. It costs more for lesser-rated institutions (100 to 150 basis points versus the big banks' 70 basis points). So to mitigate the lack of funding availability, many smaller banks and other non-banks are competing aggressively for deposits, either because they can not access wholesale markets, or because deposits are cheaper to them than the government guarantee. This has also put a floor under the cost of retail funding.

What does all this mean for business, in particular, those entities with debts maturing in the short to medium term? A recent survey by Debtwire Asia gives an indication of the risk this scenario has on business. It identifies that 61% of likely distress in 2009 is anticipated to be caused by issues surrounding refinance of debt. Specifically this revolves around availability of debt from financial institutions and closer scrutiny of credit worthiness of borrowers.

## What type of situation will be the most likely source of distressed products in 2009?

Source: DebtWire: Asia Pacific Distressed Debt Outlook 2009



Another aspect impacting upon the availability of funding in the Australian context is the desire of offshore banks to provide funding into the Australian market. Given the overseas based financial institutions are experiencing substantial stresses in their own markets, it is natural that their appetite to fund into an offshore market will be reduced. It has been estimated a withdrawal from the Australian market by offshore banks could leave a \$75b hole in funding. This scenario again places further pressure upon the Australian based financial institutions to bridge the gap at a time when they are already experiencing difficulty funding their existing business requirements.

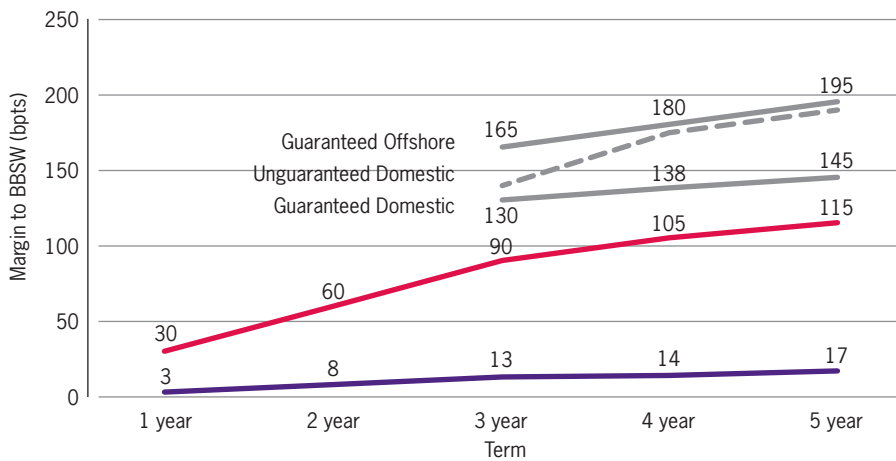
Lack of funding availability is one thing. However, for those able to obtain funding, the next issue is the cost of that funding given the supply versus demand equation. Unfortunately the reduction in target cash rate does not flow to the wholesale cost of funding and in turn the funding costs for business not tied to the cash rate reflect the movement in wholesale funding costs. As illustrated in the below example of the wholesale funding cost for the Commonwealth Bank of Australia, there has been a significant increase in the spread over BBSW in the period between July 2007, June 2008 and again in the period to 31 December 2008.

Based on the shortage of funding availability for banks and increased risk-aversion, the decision by banks to continue to fund business will be dependent upon how well they know the business and the benefit of the relationship to the bank. Clearly a potential borrower with limited relationship to the Bank and an unknown risk is not going to be treated with as much favour as a long term customer with a deep rooted relationship. With this in mind it is imperative for business to refocus the relationship with their financier at this time, ensuring to keep them well informed of how the business is travelling. Businesses cannot afford to be complacent about their ability to refinance.

**Long term funding costs**

Source: CBA: 2009 half year results analyst presentation by CEO and CFO.

— 1 June 2007  
 — 30 June 2008  
 — Current



# Equity capital back in demand

Due to the shortage of debt funding available, the market is turning to the alternative of equity capital.

A number of financial institutions have already been very active in seeking funding from this market:

- Commonwealth Bank completed a \$2b capital raising in December 2008 at a discount of 7% and has initiated a Share Purchase Plan (SPP)
- Westpac raised \$2.5b from a placement in December 2008 and a further \$442m via a SPP
- In November 2008 NAB raised \$3b and sought a further \$250m via a SPP
- Adelaide/Bendigo Bank raised \$175m by institutional placement and SPP in December 2008
- Bank of Queensland raised \$108m by institutional placement and SPP in January 2009.

Following on from the recent fund raisings by financial institutions a number of corporate entities have sought to boost their balance sheets and alleviate/reduce the need to refinance debt. Companies in this category include:

- Westfield raised \$2.9b to slash debt at 13% discount in February 2009
- Newcrest raised \$750m at a 12.9% discount in February 2009 and have initiated a SPP
- Wesfarmers raised \$2.9b in January 2009 and \$1.7b in a Retail Entitlement Offer in February 2009
- Qantas Airways raised \$500m from institutional investors in February 2009 at a discount of 17% and are currently seeking \$150m via a SPP.

As the volume of approaches to the equity market has increased, one notable trend is the level of discount being offered to encourage take up. Not all offers have been attractive with the likes of the Ten Network offering in February 2009 being unsuccessful.

As the flow of funds into the accounts of institutions continues (particularly as a result of monthly superannuation contributions, estimated to be in the order of \$350 – 400m per month), appetite will remain for equity investment at the right price. However should the volume of raisings continue at the current level, the demand for funds will quickly exceed supply.

In addition to approaching the market to raise additional equity, a number of other measures have been implemented to improve balance sheets, such as:

- re-commencement of dividend re-investment programs
- share purchase plans with existing shareholders
- dividend reduction or ceasing dividend payments.

The level of activity from existing listed companies seeking equity has inevitably impacted the number of new listings on the Australian Stock Exchange. The Australian share market reached a peak in mid-2007 and has been in freefall since. In the 12 months to July 2008, the average IPO halved in value, according to the Bloomberg IPO Index. As a result, the incentive for investors to hop on board new floats evaporated, and the

number of IPOs to hit the ASX during 2008 fell to 69.

In the second half of 2008 the market for new listings ground to a halt as junior resource companies, which had been the lifeblood of the sector, were hit by the collapse in commodity prices. Unless you are a blue chip company looking for fresh capital, the doors to broking houses and investment banks are now firmly shut. Most IPOs proposed since the second half of 2008 have been cancelled or delayed. Of the 20 attempted listings since July, only eight have made it to market. Success has been even rarer, with this small group posting an average loss of 28% since listing. Only two issuers are not under water.

As we continue in 2009 and the liquidity and availability of debt funding continues to be constrained the equity market will be the path chosen to try and alleviate these issues. It will be a difficult time to achieve equity funding in this market and will see severely discounted prices competing for a share of the funds. All the major banks have set the tone and gone to the market earlier to shore up their balance sheets and have not ruled out a return for further equity funding. Anyone else considering tapping this market should not delay as they may find themselves coming up short.

# Wealth management industry in damage control

Since the onset of the GFC, the wealth management industry has been struggling to deal with the consequences being felt, particularly for the people whose funds they manage.

In this period the equity market where much of the funds are invested has seen more than a 50% decline in a little over 12 months. This is best demonstrated in the graph below, which shows movements in the All Ords Index between June 2007 and February 2009.

The impact of the collapse in the value of equities has been exacerbated by the prevalence of aggressive wealth creation strategies adopted by many wealth management advisors. This scenario has seen portfolios with high gearing subject to many margin calls and requirements to provide additional security.

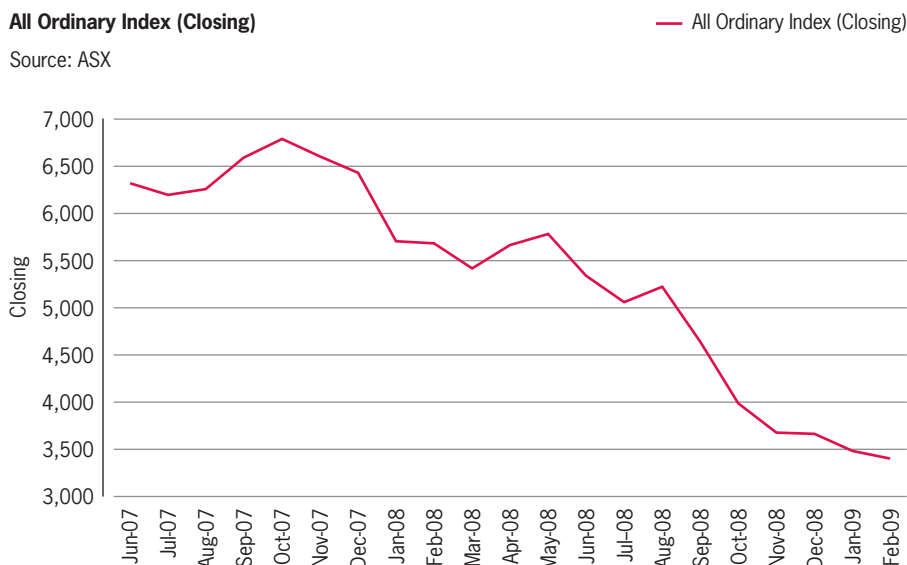
As revenues in the industry are linked to advice and performance there has been a severe decline in revenue, impacting the viability of many businesses in this industry, particularly those promoting aggressive strategies.

Two such prominent failures that have received extensive publicity are the Opes Prime and Storm Financial collapses.

- Opes Prime - Opes Prime's secured debt is believed to be over \$1b, with its major secured creditors including the ANZ (owed around \$650m), and Merrill Lynch;
- Storm Financial - one of the nation's biggest financial planning networks, was placed in voluntary administration impacting about 13,000 client portfolios most of whom had borrowed heavily using margin lending products and are now facing a situation where their portfolios have negative equity.

All Ordinary Index (Closing)

Source: ASX

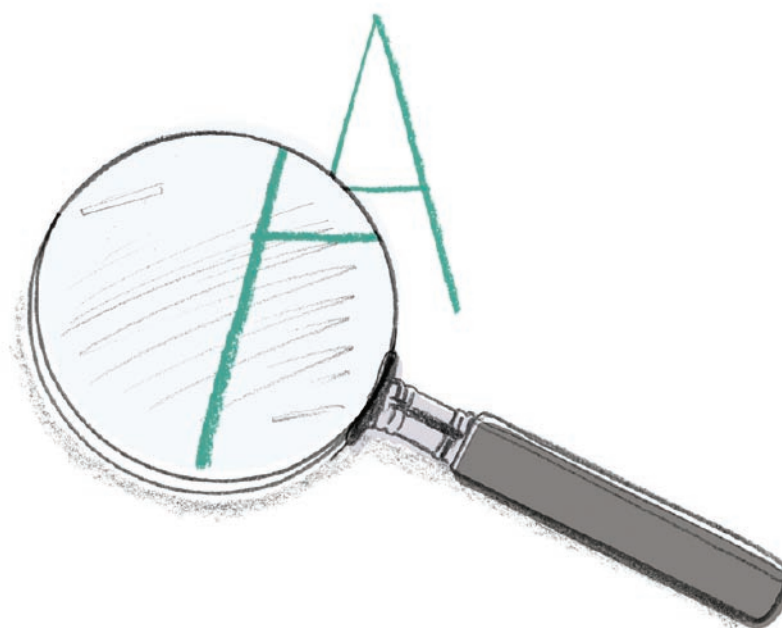


One of the biggest issues to flow from these collapses is the effect on the individual investor. This raises the question of whether regulators have done enough to protect investors and whether there should be a review of how the industry operates.

Given the substantial drop in the equities market and the expected continuation of the GFC, at least in the near term, it is going to take a lot longer for the value of portfolios to recover. This will have a continued impact on the wealth management industry for a long time to come and certainly the fallout from some of the high profile collapses will remain in the minds of investors and engender a more conservative approach in years to come. The immediate concern is that if the market does not recover, more collapses may occur.

# Grant Thornton – key takeouts

- 2009 is expected to be another difficult year with the GFC continuing to unfold
- We can expect to see further action from governments, central banks and corporates to address the difficulties of the GFC
- The entities that will survive the GFC will be those that are robust and proactive
- Liquidity in the debt capital markets will continue to be constrained and will be a prominent cause of distress for businesses. Early attention to refinancing or alternative financing will be key
- Equity will be in high demand with significant discounting required to successfully attract required amounts
- The reputation of the wealth management industry has been dealt a severe blow by recent collapses and the decline of the equity markets. Further regulatory review may be necessary for the industry as a result
- The market will present many attractive opportunities, however an increased level of due diligence will be necessary in the current environment to determine whether to pursue such opportunities.



# Industry Intelligence Unit

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They share a commitment to provide high quality services to all our clients and provide services which include assurance, taxation, reorganisation / reconstruction, corporate advisory, wealth investment management, risk management, and specialist business advice.

## What is the Industry Intelligence Unit?

The IIU is unique in its objective of providing stakeholders in the SME and business owner markets with information, understanding and analysis of the issues faced within specific industries and sub-industries. The IIU also seeks to provide pragmatic, commercial, practical measures and initiatives to improve stakeholder value.

## Industry focus

The IIU utilises the industry experience and expertise of Grant Thornton partners and staff across Australia. The IIU is predominantly focused on the following industries and their related sub industries:

- Property
- Retail
- Aged Care
- Automotive
- Hospitality
- Financial Services.

## SMEs and business owners

SMEs and owner managed businesses form the backbone of the Australian economy. They have unique characteristics and face challenges which larger public companies and multinationals rarely encounter.

Grant Thornton's experienced partners have developed an intimate understanding of the needs of SMEs and business owners in the above industries and others. This IIU seeks to apply examples of this experience in the sectors on which it reports.

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If you want to know more, please **contact us...**

### Adelaide

Dale Ryan  
T 08 8372 6666  
F 08 8372 6677  
E [info@gttsa.com.au](mailto:info@gttsa.com.au)

### Brisbane

Graham Killer  
Michael McCann  
T 07 3222 0200  
F 07 3222 0444  
E [info@gtqld.com.au](mailto:info@gtqld.com.au)

### Melbourne

Matthew Byrnes  
Matthew Donnelly  
Andrew Hewitt  
Greg Keith  
Nick Mellos  
T 03 8663 6000  
F 03 8663 6333  
E [info@grantthornton.com.au](mailto:info@grantthornton.com.au)

### Perth

John Carrello  
Tony Douglas-Brown  
T 08 9480 2000  
F 08 9322 7787  
E [info@gtwa.com.au](mailto:info@gtwa.com.au)

### Sydney

Paul Billingham  
Said Jahani  
Michael Owen  
Trevor Pogroske  
T 02 8297 2400  
F 02 9299 4533  
E [info@gtnew.com.au](mailto:info@gtnew.com.au)



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