BALLENTINE PARTNERS

Investment Research

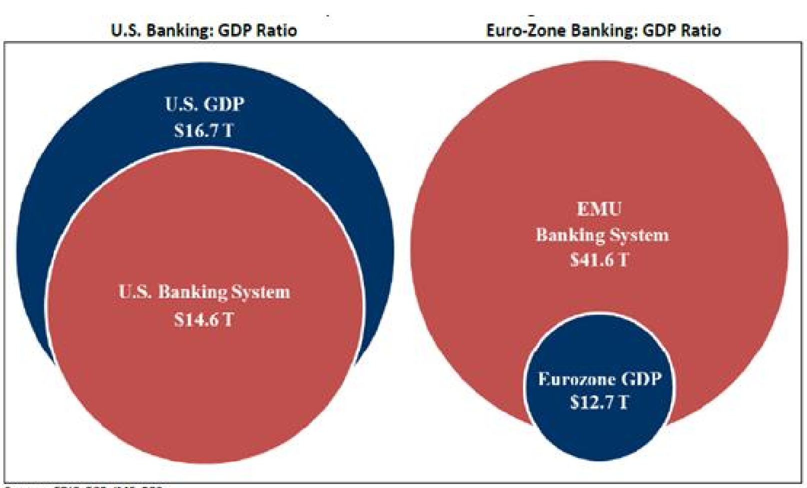
Investors Profit from a Shrinking Banking System

BALLENTINE PARTNERS | AUSTIN POIRIER, MSFP, CFA | FEBRUARY 2015

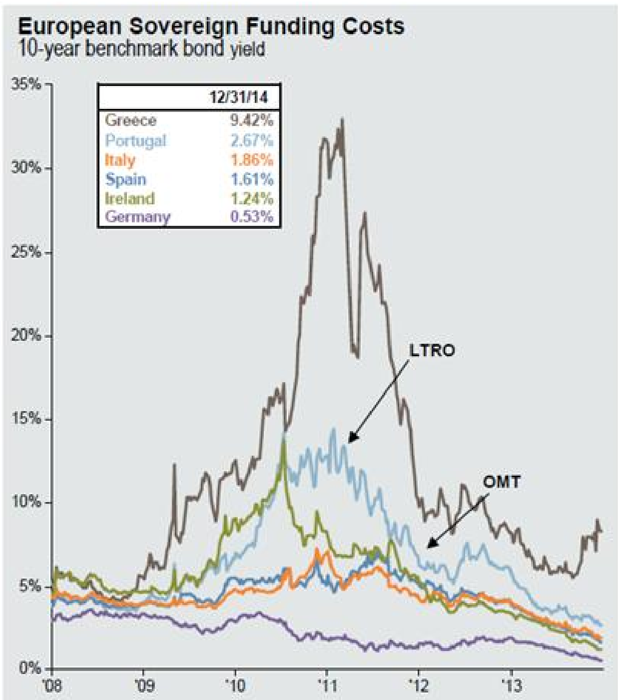
The 2008 US Credit Crisis and resulting European Banking and Sovereign Crisis exposed major weaknesses in banking regulations and oversight. The reaction from policymakers and market participants set about sweeping reforms that will permanently alter the system as we know it. Ballentine Partners has followed these events closely, recognizing that massive regulatory change will create significant investment opportunities for our clients in the years ahead.

Regulatory Changes

Deregulation of the US banking industry and the introduction of the Euro in the late 90's led to significant growth in both regions' banking systems through the mid-2000's. This came to an abrupt halt when declining housing prices in the US lead to massive losses across the financial system in 2007 and 2008 and the collapse of many of the nation's oldest and largest financial institutions. The US government was forced to recapitalize the banking system with hundreds of billions of taxpayer money in order to stem the crisis. The turmoil quickly spread to Europe, whose banking system was a larger percentage of GDP than the US's, causing it to morph into a sovereign crisis that posed existential risks to the European Union and its common currency.



Source: Marathon Asset Management



Source: JP Morgan

Regulators quickly went to work on new global banking standards and within a few years released the Basel III Accord, imposing stricter regulations on global banks. Governments also introduced their own supplementary regulations such as the US Dodd-Frank Wall Street Reform and Consumer Protection Act. These new regulations seek to make the following changes:

1. Increase the quantity and the quality of bank capital so taxpayer money is never again needed to bail out the banks.
2. Quantify and reduce the risk taking activities within banks.
3. Increase the transparency of banking activities.

These regulations are transformative and are fundamentally changing the banking system! The International Monetary Fund ("IMF") has estimated that European banks are under- capitalized by €1.5 trillion and will likely need to dispose of €3 trillion of assets in the coming years.

Figure 1: Capital Ratios: New Rules Stronger But More Complex[4]

[1]Source: International Monetary Fund, 'Economic Inclusion and Financial Integrity: an Address to the Conference on Inclusive Capitalism, by Christine Lagarde, Managing Director, International Monetary Fund, London, May 27, 2014. [2]Bank of England Capital Requirements Directive IV: [3]CBR, or the combined buffer requirements, is the additional equity buffers a bank must hold to safeguard total capital requirements. [4]CQS Research and Credit Suisse 'European Banks, Sector Still Offers Attractive Relative Value, 08 May 2014. [5]ECB as at 31 March 2014, CQS Research. http://www.ecb.europa.eu/stats/money/aggregates/bsheets/html/outstanding_amounts_index.en.html. [6]CQS Research and Credit Suisse 'European Banks, Sector Still Offers Attractive Relative Value, 8 May 2014.

Source: CQS

Transformation Creates Opportunity

These new regulations are forcing banks to exit profitable businesses and reduce their activity in others, creating a tremendous opportunity for private investors willing to fill the void. Ballentine Partners has been at the forefront of this shift, spending considerable time researching private funds and hedge funds pursuing the following strategies:

- Corporate Lending ($10tr opportunity size; Source: Blue Bay): Teams of bankers have left the banks to set up private lending funds originating loans to capital starved US and European companies.
- European Bank recapitalizations ($800b opportunity size; Source: EJF): Many legacy bank hybrid securities no longer qualify as Tier 1 capital, effectively forcing banks to redeem them on premiums to their current trading prices. We've identified a few experienced man- agers who we believe can perform the required credit analysis and determine the securities most likely to be redeemed.

- European bank asset sales (€2tr opportunity size; Source: King Street): Acquire assets from banks looking to rebuild their capital base. Banks often sell the assets at substantial discounts and include everything from performing and non-performing loan portfolios to commercial real estate to control positions in Greek shipping companies.

- Bank Regulatory Relief Trades: Structuring risk-transfer strategies with banks looking to retain their loan portfolios but offload the risk in order to minimize the amount of capital they must carry. Private investors accept losses from the portfolios in return for significant premium payments.

- Asset Securitizations: Purchasing pools of whole loans and securitizing them into asset backed securities and selling them to investors while earning a premium for the service.

- Bank Proprietary Trading Desks: Hedge funds have taken the place of traditional proprietary trading desks, providing liquidity to the markets and earning premiums to do so.

- Real Estate Recapitalizations: European banks fell far behind those in the US recognizing losses on loans coming out of the credit crisis. Many real estate loans are carried on bank balance sheets well above their true value. Increased regulatory pressure and scrutiny will force the hand of the banks to mark these loans down, and as the loans come due, the borrowers will need to sell assets or recapitalize and bring in new investors. Opportunity exists for investors who can bring capital to these forced sales and recapitalizations.

Looking ahead

These opportunities will likely last through the end of the decade so there is still time to invest. Basel III is slowly being phased in, European banks are still too large and undercapitalized, and private investors have yet to realize the true extent of the opportunities. It is our belief that these factors will lead to continued attractive risk-adjusted returns in the years ahead. Ballentine Partners continues to research and diligence managers exploiting these opportunities and will likely approve additional funds for client investment in 2015.

If you would like to discuss the funds that we have already approved for client investment, please give us a call.

About Austin Poirier, MSFP, CFA

In addition to his client responsibilities as a Senior Investment Advisor, Austin oversees investments in hedge funds and commodities, including public and private energy managers. Within these asset classes, Austin is responsible for formulating the firm's investment strategy, evaluating public and private investment opportunities and monitoring trends within the markets.

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