ISSUE SIX CHANGE

THE BIG BANKS HAVE LARGE FINGERS IN YOUR FINANCIAL WALLET – HOW BIG ARE THEY AND IS IT GOOD FOR YOU?

THINKING OUTSIDE THE SQUARE

FIVE THEMES TO HELP YOU CREATE A BETTER FUTURE

FEBRUARY 2011

www.balmain.com.au

THOUGHT PIECE

balmain
arrange . lend . manage

THINKING OUTSIDE THE SQUARE

FIVE THEMES TO HELP YOU CREATE A BETTER FUTURE

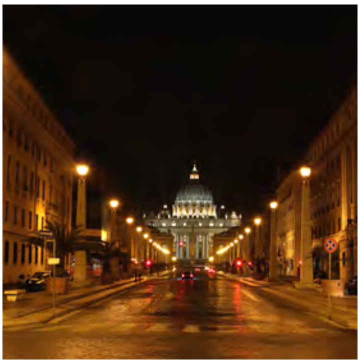
GLOBALISATION

NEW INVESTMENTS & INVESTMENT STRATEGIES

GLOBAL FINANCIAL CRISIS

SOVEREIGN RISK AND DEBT

CHANGE



WE BELIEVE THAT ALL ROADS LEAD TO INCOME!

At the end of the day, regardless of gender, age, relative financial security, employment or retirement, we all seek the same thing as the product of our investment strategy: income.

Put more simply the reason we invest is so that we can have sufficient income to live and hopefully live well at the time when we choose, or someone else chooses that we no longer will receive income from employment.

Balmain Funds over the period ahead will make available a series of "thought pieces" designed to provoke new thinking on why we invest the way we do, challenge investment orthodoxy, such as "modern portfolio theory", posit and in some cases guess at future risks and opportunities. The overall aim however is to help you create a better future for you and the ones you love.

We have identified five themes that we believe will impact your ability to achieve the income you want. These are:

1. The Global Financial Crisis
2. Sovereign Risk(s)
3. Change
4. Globalisation, and
5. New Investments and investment strategies

We will over time populate these themes with "thought pieces" that are designed to inform you, challenge and provoke your investment thinking and from that hopefully assist you in making better investment decisions.

ABOUT BALMAIN

Using our staff of 140 located in 8 offices in Australia and New Zealand we arrange and deliver financing solutions to Australian and New Zealand commercial property developers and investors. Balmain originates between $2b and $4b p.a in transactions ranging from senior debt to mezzanine and preferred equity.

Over the years Balmain has arranged commercial loans to over 140 lenders, banks, institutions, managed investment schemes and high net worth individuals / family offices. It currently manages over $8b of ongoing loan relationships with over 100 of these organisations.

Balmain is Australia's 5th largest commercial mortgage fund manager, who on behalf of over 8000 Australian investors, we manage over $800m in commercial mortgage loans.

Balmain in its own name and via AMAL (in which Balmain has a substantial shareholding) provides special servicing skills to loan portfolio owners covering both residential and commercial loans.

THE BIG BANKS HAVE LARGE FINGERS IN YOUR FINANCIAL WALLET – HOW BIG ARE THEY AND IS IT GOOD FOR YOU?

The current bank bashing over interest rate hikes reflects a deeper and (until now) little discussed public concern – that the banks control far too much of our financial affairs – from banking to investments to financial advice to insurance and everything in-between.

This control gives them many financial levers to pull in their effort to make a profit for their shareholders, and like a multi-headed hydra, any success in forcing banks to cut one set of fees will likely result in another fee popping up elsewhere.

But of greater concern is the potential systemic risk they may pose to our personal finances. Read on to get the picture on what this could mean...

Exactly what (and how much) do our banks own within the financial services industry?

In lending, the 'Big Four' banks (ANZ, CBA, NAB and Westpac) control more than 82 per cent of all loans in Australia. In life insurance, the four banks own 53 per cent of total premiums. Add AMP's market share and that percentage rises to 81 per cent.

Bank	Gross loans and advances $ billion
ANZ	250.4
CBA (including Bankwest)	411.4
NAB	277.6
Westpac (including St George)	366.9
Total 4 banks	1306.3
Total all banks in Australia	1576.1
Percentage share of market top 4 banks	82.88%

Source http://www.apra.gov.au/Statistics/upload/MBS-September-2010-2.pdf

In terms of investment funds under management, banks and their funds management subsidiaries have a 25.9 per cent market share. Add Macquarie Group, and AMP & AXA (which are likely to become one entity if/when AMP's bid for AXA is completed) and that share jumps to 39.1 per cent.

Rank	Investment Manager	Consolidated assets A$ billion	Market Share %
1	CBA/Colonial Group	105.1	9.9
2	NAB/MLC	79.5*	7.6
3	Macquarie Bank Group	79.2	7.5
4	State Street Global Advisors	78.9	7.5
5	Vanguard Investments	72.6	6.9
6	AMP Group	60.2	5.7
7	ING /ANZ	46.7	4.4
8	BT Financial Group (Westpac)	42.4	4.0
9	AXA Australia/Alliance Bernstein	34.2	3.2
10	PIMCO	27.9	2.6
	Sub-Total 'Big 4' Banks	**273.7**	**25.9**
	Total Industry	**1058.5**	

*Unconsolidated assets estimate as at Dec 2009, Austrade

Source Morningstar, Austrade

Administrating investment products for the general public (commonly referred to as platforms, master trusts or wraps) is dominated by bank-owned retail platforms such as BT Financial Group (Westpac), MLC (NAB), ING (ANZ) and Colonial (CBA). These four account for 57.3 per cent of retail funds under administration. Add in AMP & AXA and that market share rises to 76.3 per cent.

Platform Administrator	A$ billion	Market Share %
BT Financial Group (Westpac)	84.06	22.4
NAB/MLC	61.17	16.3
AMP Group	44.43	11.8
ING/ANZ	35.90	9.6
CBA/Colonial Group	33.80	9.0
AXA Group	26.97	7.2
Sub-total Big 4 plus AMP & AXA	286.33	76.3
Total industry	**375.50**	

Source Morningstar, Austrade

Even the financial planning industry is increasingly controlled by the banks. Of the 14,273 financial advisors working for the top 50 dealer groups, 28.8 per cent are employed by the 'Big 4' banks. Add AMP & AXA and that number climbs to nearly half.

Top 15 Dealer Groups	**Owned by**	**Number of financial planners**
Professional Investment Services	independent	1444
AMP Financial Planning	AMP	1360
Count Financial	independent	864
Millennium3 Financial Services	ANZ	810
Commonwealth Financial Planning	CBA	688
NAB Financial Planning	NAB	506
RBS Morgans (previously ABN Amro Morgans)	50% RBS	487
Charter Financial Planning	AXA	481
MLC/Garvan FP	NAB	470
Financial Wisdom	CBA	458
Securitor	Westpac	449
Westpac Financial Planning	Westpac	407
AXA Financial Planning	AXA	381
Genesys Wealth Advisors	AXA	335
ANZ Financial Planning	ANZ	327
Total Top 15		9467
Total Top 50 Dealer Groups		14,273
Total owned by 'Big 4 Banks'*		4115 (28.8% of top 50 Dealer Groups)
Total owned by Big 4 +AMP and AXA		6672 (46.7% of top 50 Dealer Groups

*Note, the Big 4 Banks also own a number of smaller Dealer Groups outside of the top 15 including Godfrey Pembroke (NAB), Apogee (NAB), Magnitude (Westpac)

Source Morningstar, Austrade, Basis Point Consulting

What does this mean for our financial wallets?

The entire financial food chain is dominated by banks and their subsidiaries. They create the investment products that we buy, sell it to us via their financial planning networks, and put our investment portfolios on their platforms, and then lend us the money to buy them and of course our home, perhaps an overdraft for our business and more. Across this food chain, they clearly make fees which add to the not inconsiderable profits the banks have made in recent years.

In addition to our banking/lending/deposits, they also most likely look after our insurance needs.

In reality, the banks' fingers are deeply embedded in our financial wallets….and this is where the problem lies. As financial consumers, we are increasingly at the mercy of a handful of financial service providers and it is not always obvious that they are bank owned. Take Westpac for instance. They have three banks (Westpac, Bank SA and St George), four fund managers, (Westpac, BTIM , Ascalon Capital and Advance,) five financial planning groups (planners 'tied to Westpac, Bank SA, St George) plus BT Financial Group and Magnitude, and two administrative platforms in BT and Asgard!

Unfortunately for us, and despite all the platitudes, their shareholders come first, not their customers. Yet it is the customer that drives profits. and maybe they deserve a better break than they are currently getting when it comes to fees and charges.

This concentration of power also creates systemic risk for us. In the unlikely event that they freeze up (remember the GFC anyone?), we potentially face a financial winter not just in banking, but across our investments and insurance. Will Australian banks freeze? Not likely – but the point is, if they go, they could have a major impact on our financial outcomes! It is at times like these that the old adage, 'all the eggs in one basket,' comes to mind! To see what impact a small computer glitch caused many ordinary Australian's, look no further than the recent issue that NAB's computer problems caused bank customers.

So how likely is 'Not likely?' In reality the likelihood is very, very low but – and this is an important point – the risk does exist. The collapse of Lehman Brothers in 2008 was also considered not likely, nor the fall of the USSR; the global financial crisis of 2008/09; or the Asian financial crisis of 1997/98. The point is, financial and economic systems happily go on and on… until they don't. Just like the sophisticated investment strategies and trading models offered by many fund managers…they work nicely in hindsight but are often demolished in subsequent years. It's the concept of the black swan event – an event no one could foresee (the European settlers could not believe their eyes when they saw black swans in Perth – as where they came from only white swans existed!)

So where are the potential Black Swans in banking?

Clearly if we knew them, then, they wouldn't be black swans! We are looking for 'unknown unknowns' to paraphrase Donald Rumsfeld, former US Defense Secretary during the 2nd Iraq War.

But let's have a go at it.

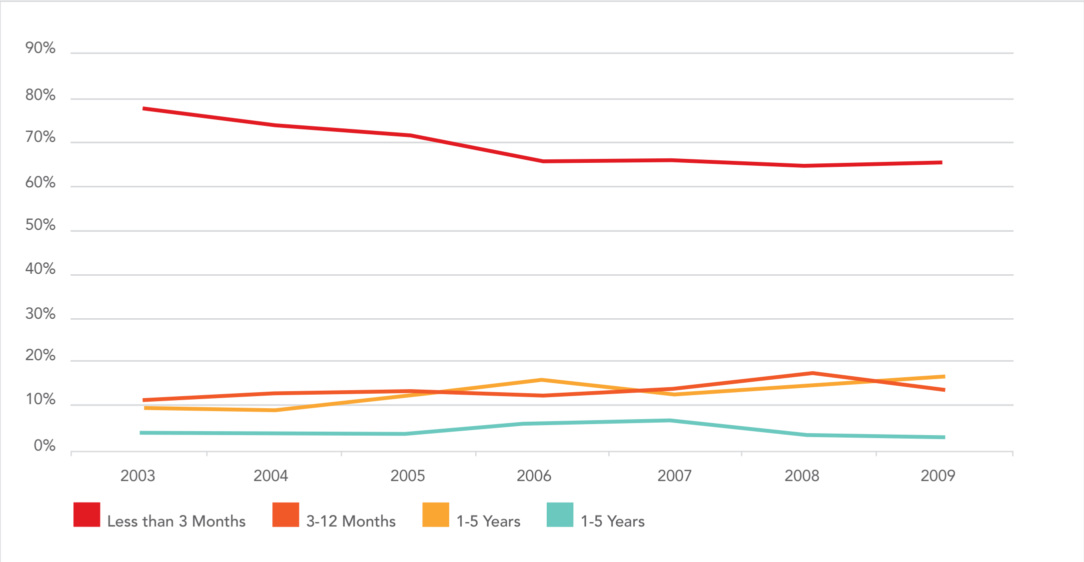
Banks are leveraged to the hilt (in an asset class that is increasingly becoming more volatile – property)

The futures markets, seen by many as the wild frontiers of finance, are typically leveraged at between 20 to 1 (5% deposit) to 10 to 1. (10% deposit) on the underlying futures contract. If the value of the contract goes against you, you are required to put up more of a deposit to maintain equilibrium.

But is this also true for banks. The banks are the largest lender to the Australian residential market. And whilst we accept that futures contracts on say, copper, or wheat or gold might be volatile, increasingly, so are house and apartment prices. To see this in practice, look no further than what has happened to the housing market in the USA and UK in the last three years!

CHART 1: AGGREGATED BANK FUNDING MATURITY ANALYSIS
From 2003 to 2009 for consolidated banking groups: Australia New Zealand Banking Group, Commonwealth Bank of Australia, National Australia Bank, Westpac Banking Corporation

Data Source: Annual Reports from respective banks dating back to 2003



Lending on borrowed funds

Bank loans are not lent out of their equity but out of their borrowings. Sure there's the Australian Prudential Regulatory Authority's (APRA) requirements for banks to have specific tier 1 capital and tier 2 capital, as well as the international Basel 1 and Basel 11 Accords etc but as we said, risk models work well until one day they don't! (It's not too hard to recall Long Term Capital Management, the giant US-based hedge fund that failed spectacularly in 1998 and had to be bailed out by the US Federal Reserve to prevent a wider banking collapse. LTCM's senior executives and board members included some of the most respected {at the time!} financial and risk modelling brains in the business.)

Interestingly, despite the banks' considerable exposure to residential lending, under the Basel 1 and 2 accords, they do not have to increase their tier capital weighting ….

Lend long, borrow short

Around 80% of bank borrowings are short-term – (65% matures in less than three months, 15% matures in three-twelve months time). Yet most of their lending, particularly in the home mortgage market, is long term.

It is true that this 'lend long/borrow short' has always been the case...which is why central banks and governments are nervous about the possibility of bank runs and do everything they can to prevent even the hint of a run. (eg LTCM crisis of 1998, Australian government deposit guarantees of 2008/2009, US Feb bailouts of AIG and the two Fanny's, Mae and Mac, etc.

Changing of the guard

(or the rise and fall of world empires......see Balmain's Thinking Outside the Square Issue 4)

The rise of China and decline of the US as economic superpowers could increase the risks of black swan events. This risk increases when this change is taking place between superpowers with vastly different; cultural, political, economic, societal and religious systems. The last superpower change, from the UK to the US, coincided with WWI, WWII and the Great Depression... and the differences between the UK and US?...well...they were like brothers and sisters!

The enormous debt pressures building in most of Europe, particularly the PIIGS (Portugal, Ireland, Italy, Greece, Spain) is also an economic tectonic plate grinding against China and the US. How the global institutions and non-related economies solve these issues without damaging fragile global financial systems is something that text books will write about in the years to come.

Big Demographic and Technology changes

The biggest demographic changes the world has seen since the Black Plague wiped out nearly a third of Europe, is upon us and this too will surely increase the risk of Black Swan events. (See Balmain's Thinking Outside the Square Issue 3 about China's changing demographics and the aging of the Boomer generation in Australia (and the West)).

In addition, technology now runs our lives, our markets and our financial systems. The 'Flash Crash' of May 6 2010, when the US stock market plunged 600 points within five minutes (to be down 1000 points or 9.2% for the day) only to recover most of the losses within twenty minutes, occurred because of the way the modern 'fragmented and fragile' markets are traded using technology driven systems. Pity then the poor investor who got wiped out when stop losses were triggered not for economic events but due to technology!

Conclusion and action

The four big banks (ANZ, CBA, NAB and Westpac) and to some extent AMP, control much of the Australian financial landscape. To be fair they have served their customers well over many years but, and this is a question that every investor needs to ask of themselves, have they become too big, and if they were to ever face a 'Black Swan' crisis, what could the impact be on you?

As well, their control means they have many levers to pull to ensure their revenue streams from banking to financial services and investments to insurance will continue to amass returns for their shareholders,—but do they have the same focus on their customers? Perhaps those borrowers whose mortgage costs were increased beyond the official rate increase lately have pause to consider this!

Their dominance of the financial landscape may also pose a systemic risk, particularly given their leverage, maturity mismatch and the potential for Black Swan events in an increasingly unpredictable world. There is a concern that the banks and their many tacked-on businesses in financial services, funds management and insurance, can become a financial Frankenstein.

So what can you do about this? First of all, understand how many fingers they have in your financial wallet. If you are comfortable with this, then do nothing, if not then clearly look at ways to diversify your risks away. Consider reducing your exposures to these institutions and their businesses across the financial landscape. Consider using non-bank deposit taking institutions, non-bank financial intermediaries and investment providers.

DISCLAIMER

balmain
arrange . lend . manage

SYDNEY
Tel: 02 9232 8888
Fax: 02 9232 8588

PARRAMATTA
Tel: 02 9860 5800
Fax: 02 9860 5899

CENTRAL COAST / HUNTER
Tel: 02 4363 9999
Fax: 02 4363 9900

MELBOURNE
Tel: 03 9617 5333
Fax: 03 9617 5366

BRISBANE
Tel: 07 3023 8700
Fax: 07 3023 8788

GOLD COAST
Tel: 07 5553 9700
Fax: 07 5553 9701

CANBERRA
Tel: 02 6161 1292
Fax: 02 6161 9129

NEW ZEALAND
Tel: +64 9 358 4208
Fax: +64 9 358 4298

Free: **1800 225 624** (AUS)
Free: **0508 225 624** (NZ)

www.balmain.com.au

BMT 4647 - 31 July 2011