



## Wiser and Safer

The recent storm that has blown over the financial system is historic in many ways. Some experts have predicted the next Great Depression, others claim it is a healthy return to good banking principles and the best buying opportunity of the past decades. Whatever the view, we are living in momentous times, which will make history. Indeed, who could have thought that an institution like Lehman Brothers would simply disappear? That the U.S. would lose their investment banks? Or that global markets would plunge so deep, so fast? How have we come to this?

### A Historic Crisis

It is certainly the biggest financial crisis of this generation, and indeed since the 1930s. At its heart though are fairly common human behaviours. In the context of an exceptionally long cycle of economic prosperity and historically (some say artificially) low interest rates, excessive optimism, greed, speculation and euphoria followed.

Through a fiscal and regulatory system that acted like a subsidy, house ownership was strongly encouraged in the U.S. in particular. This led in some cases to the so-called subprime loans - low-quality mortgages, which were then re-packaged into financial derivatives and leveraged in investment products, such as mortgage-backed securities. Although the main culprit of the crisis was certainly the popularity of ever-more leveraged and complex financial instruments, the trigger was the collapse of the subprime market, and the eventual bursting of the real estate bubble, which caused panic.

A lack of financial regulation worldwide (and poor oversight of existing rules) allowed the spreading of the real estate crisis to the banking system and financial markets in the U.S., Europe, and globally. This brought about a credit crunch as deep distrust amongst banks froze the interbank market, leading to bankruptcies and severe financial distress. Confidence is essential in finance and an acute lack thereof over the past months has rapidly destroyed and discredited a large part of the global finance industry. Systemic risk, the last traumatic development of the crisis, comes from the liquidity dry-up of the credit crunch, which puts a halt on economic activity by notably reducing corporate financing, leading to recession.

In these exceptional circumstances, attempts at solutions have had to come from the lender of last resort: the government. Central banks have cut interest rates, bailed out financial companies, governments have adopted historic rescue packages, injected massive amounts of liquidity, backed mergers, and nationalised entire parts of their banking sector. The priority was to unblock the credit market to restore confidence.

### Banks in Trouble

The recent turbulence has put a lot of pressure on both banks and their clients. The industry now faces consolidation and a new competitive environment as the financial landscape is changing, with different participants and more restrictive regulatory requirements. Most banks can be expected to focus their strategies on regaining the confidence of the key stakeholders.

Not surprisingly, many clients are extremely worried. Like in 1929, the crisis has a strong human dimension with people losing their houses, their jobs and their savings. In the US and elsewhere, tax payers are wondering who is going to pay the bill. They fear it will most likely be themselves – and the next generation.

## Lessons Learned

In 1930, the US government took three years to react, leading to the Great Depression. In 2008, governments set up unprecedented rescue measures about a year after the crisis developed, back in August 2007. We have learned that decisive government action taken early is critical to restore confidence, minimising both the cost to the taxpayer and the damage to the economy. In this worldwide crisis, it was also clear that, in order to be effective, the response needed to be global and coordinated.

Many people now feel that there has been too much deregulation, speculation and careless optimism, for too long. There is a call for a new financial system where markets are not allowed to move as freely anymore, with increased regulations and reasonable profit expectations, away from the liberal paradigm we have known for the past 20 to 30 years. The extent of the change will likely depend on the severity of the crisis.

## The Future of Private Banking

Private banking is one of the most stable sector within the banking business. Yet, there too, volatile financial markets and the economic downturn have affected profitability and efficiency. The private banking sector has suffered from client wealth erosion, reluctance to invest, and anxiety over complex investment products. Mistrust has resurged and client loyalty has declined.

Nevertheless, private banking should be one of the main beneficiaries of the new financial system. Whether independent or part of a bigger financial group, it is indeed a stable and highly profitable business. Clients are wealthier and therefore financially stronger, the business itself is generally straightforward and transparent, it adopts less speculative strategies and lacks excessive complexity. But mainly, private banking is relevant because it is clearly focused on adding value through serving the client in a unique manner, with thorough risk management and an adequate risk/return ratio. It has and will continue to benefit from the importance of understanding the business and meeting clients' genuine needs.

As private bankers, at Lloyds TSB International Private Banking, we believe the wisest and safest policy is to respect a few basic investment rules, focusing on capital protection, real value preservation, absolute performance over time, and risk control. We have always scrupulously followed these sound principles and did not stray away from them when euphoria and the fancy of endless profits ruled. We believe in professional and honest investment guidance, applying the following principles:

- Timing the markets correctly and consistently is extremely difficult because they are ruled by investors, who are human beings. In the short term, people can act irrationally, especially when markets go down and fear takes over. The wisest and safest way to ensure results that meet our client's financial needs is thus to embrace a long-term investment view.
- The most relevant factor for financial success is strategic asset allocation, which is the combination of asset classes that best corresponds to the profile of the client, reflecting their needs, financial goals, income constraints and risk tolerance.
- For optimal asset allocation in terms of risk/return potential, diversification between asset classes (equity, bonds, hedge funds, etc) and within them (different sectors, countries, etc) is fundamental. The resulting low correlation between investments decreases volatility. But achieving true diversification is difficult, especially in today's globalised world, and can only be successfully done by professionals.
- Once the optimal long-term asset allocation has been determined, our commitment includes monitoring and rebalancing of the portfolio. This is one of the most difficult things to do as it means 'selling high and buying low'. It requires a disciplined and systematic approach. There again, experienced professionals are best equipped to do this fruitfully.

## The Value of Tradition

The crisis may not be completely over, there might still be hiccups and we can bet on a few months or more of recession. The financial system that will emerge post-crisis will be very different from the one we have known in the past 5 to 10 years, but it might not be all bad. Lean times also bring opportunities and drive people to find new and creative solutions. We may have a chance to experience a world where respect, accountability, honesty and transparency are the values that determine business success. In a context of heightened diligence and stricter rules, personal service will become paramount and tomorrow's winners will be those who put the interest of their clients first, basing their activities on truthful partnership and open communication. The emphasis needs to go back to basics: the special client-banker relationship. This is the essence of private banking, a sound concept at the core of business sustainability.

At Lloyds TSB International Private Banking, we stand by our clients in good and bad times, keeping them on course through turbulence and euphoria. We strongly believe that mutual success comes from a long-term relationship based on respect, transparency and trust. Our conservative approach has once again been recognised with confirmation, in October, of our Aaa investment rating (the highest one) by Moody's. This crisis may indeed be a healthy return to good banking principles by reminding everyone that sustainability comes from serving clients' needs. Today, we aspire to be a role model of excellence for the future wealth management industry by remaining faithful to the sound principles of traditional private banking, which have proven, time and again, to be the wisest and safest choice.

Isabelle Racine Shafa  
Investment Communications  
Lloyds TSB International Private Banking

