

# BBS investment update

## THE GLOBAL FINANCIAL CRISIS

The financial market turmoil over recent weeks has huge implications for us all. The failure of leading financial institutions, as well as ongoing concerns about the balance sheets of other retail and investment banks, have led to many commentators declaring that we have now entered a global recession.

It may be the case that last week's news, including the US and UK Government rescue plans, and the cut in global interest rates, will enable markets to draw a temporary line in the sand and restore investors' confidence. The weekend meeting of G7 finance ministers and EU leaders has reinforced the commitment of Governments to provide stability.

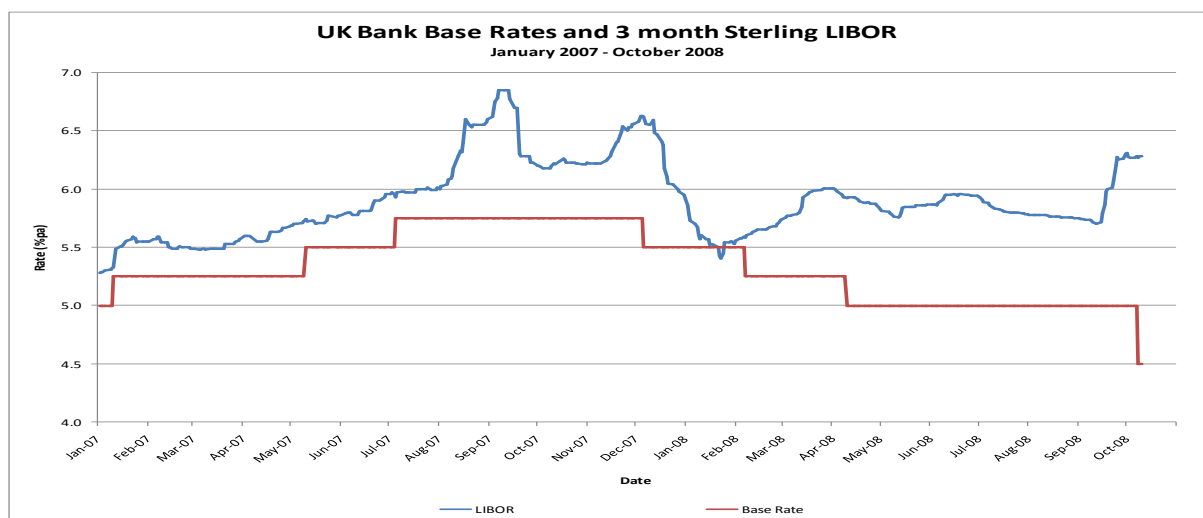
Markets continued to fall last week on fears of a global recession and of more bad news from the financial sector. Investors appear unconvinced about how much Governments and regulatory authorities can actually achieve. Whatever action is taken, it seems inevitable that some of the costs of the financial crisis will need to be funded by increases in UK Government borrowing and general taxation.

### What has caused the problems?

The first signs of the problems in the US sub-prime mortgage market appeared in the early part of 2007. These are mortgage loans to borrowers with poor credit histories who were unable to obtain mortgages from the better lenders.

In the short term, these sub-prime mortgages appeared profitable with banks financing their lending arrangements by issuing mortgage backed bonds. Increases in US interest rates from 1% to over 5% between 2004 and 2006 caused many sub-prime borrowers to fall into arrears and start to default. As mortgage borrowers started to default, the value of the mortgage bonds fell dramatically. The mortgage bonds had been sold on to many other US and non-US financial institutions so that very few banks were not exposed.

In the UK, concerns about the ability of some banks to meet their obligations led to a sharp increase in the London Inter Bank Offer Rate (LIBOR). LIBOR is the rate at which banks lend to each other and, in normal market conditions, would be broadly in line with the Bank Base Rate. The sharp increase from August 2007 onwards has been an indication that banks have lost trust in the ability of other banks to repay loans.



## BBS investment update (continued)

The general lack of confidence, reflected in the increase in LIBOR, means that banks are unable to raise funds to meet their capital requirements and that there is no liquidity within markets. This feeds through into the mortgage rates offered by the high street banks and business lending. One indication of an increased confidence in the financial markets will be the stabilisation of LIBOR and whether the current UK Government intervention in the banking system has given banks the capital base that they require to resume normal lending activities.

### What has been the impact on the financial sector?

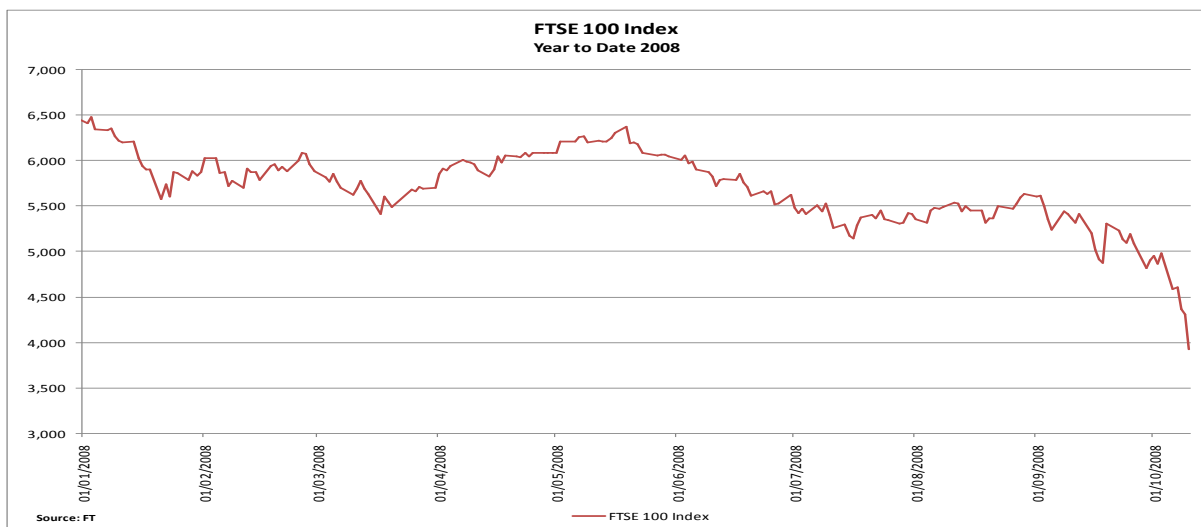
The problems with the lending decisions taken by some banks, and the exposure of other banks to mortgage bonds, has led to a domino effect both in the UK and abroad.

- Following the earlier nationalisation of Northern Rock, the Bradford & Bingley has also been nationalized. Lloyds TSB has announced its intention to buy Halifax Bank of Scotland (HBOS).
- While the UK Government has not yet guaranteed that all retail deposits in UK banks are secure, it appears unlikely that they will allow any UK financial institutions to fail in the current economic crisis.
- In the US, the giant investment bank Lehman Brothers filed for bankruptcy protection. Merrill Lynch was acquired by Bank of America. Washington Mutual was sold to JP Morgan and Citigroup bought the banking operations of Wachovia, the sixth largest US lender. The insurance giant AIG was rescued by the Federal Reserve.
- The European bank Fortis was part nationalized by the Benelux Governments.
- In the past week, the Icelandic Government has taken control of three major Icelandic banks. This has led to concerns about the security of many UK savers, including local authorities and charities.

It seems highly unlikely that there will not be further failures over the coming months.

### The impact on global equity markets

The loss of investor confidence has caused a worldwide panic as investors have looked to sell shares.



## BBS investment update (continued)

At the close of business on Friday 10 October 2008, the FTSE100 index of leading UK shares was down almost 39% for the year to date. The falls in the UK equity market have been mirrored in every global stock market. While equity markets have been badly hit, corporate bond markets have also suffered as investors have sold bonds issued by companies, especially those in the financial sector.

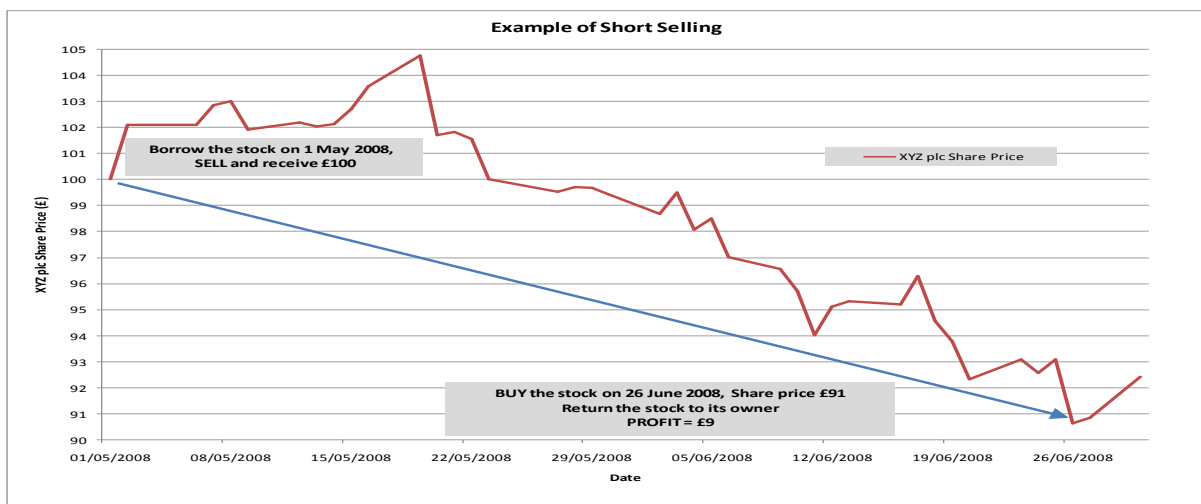
### What is Short Selling?

The equity market falls have, to some extent, been fuelled by some investors, such as hedge funds, using short selling strategies to take advantage of the run of bad news from the financial sector.

A typical investor buys a company's shares in the expectation that the share price will rise over time until the shares are sold. This is known as being "long" in a stock.

Short selling is a tool to enable an investor to profit when holding a negative view.

The investor borrows shares from another investor (such as an index-tracking manager), and then sells the shares at their current market price. If the shares do subsequently fall in value, the manager buys the shares back and returns them to the other investor. The profit on the transaction is the difference between the sale and purchase price, less a commission paid to the other investor.



In practice, short selling techniques can be used on all asset classes, not just equities.

On 18 September, the Financial Services Authority (FSA) announced a temporary ban on short selling of the shares of roughly 30 UK financial institutions.

The ban is expected to be lifted in January 2009. The US government has, perhaps prematurely, already lifted its ban on short selling.

### What short-term issues should Trustees consider?

As managers report their third quarter returns later in October, trustees should review the reports and ask managers to confirm their exposure to financial institutions, both within their equity and bond portfolios. If the trustees invest in a cash or money market fund as part of their overall investment strategy, the trustees should check what investments are actually held within these funds.

## BBS investment update (continued)

Other issues that trustees should consider include:

- Fund managers should be asked to confirm their stance on short-selling and what controls are in place to ensure that any stock lending is covered.
- Cash deposits have not yet been offered guaranteed protection by the UK Government so trustees may wish to check the levels of cash held and the perceived security, and consider whether action is required.
- Schemes investing in commercial property may want to check whether the managers have suspended the redemption of units.
- For schemes who have implemented Liability Driven Investment (LDI) strategies, trustees should check which counterparties are writing the swap contracts and the controls in place for ensuring that the collateral is being managed.
- The ongoing security and credit rating of financial institutions, such as insurance companies writing annuity business or for with-profits funds offered as part of an Additional Voluntary Contribution (AVC) offering, should be monitored.

### **What long-term issues should Trustees consider?**

Pension schemes remain long-term investors and are able to take a long-term view when setting their funding and investment objectives, subject to the continued long-term support of the sponsoring employer.

For many schemes, equity investment will be part of a long-term investment strategy, given that equities are expected to provide higher long-term returns, albeit with short-term volatility.

Given the current market turmoil, we would caution trustees and sponsoring employers about making changes to their investment strategy, or changes to their investment manager in the short-term. In the long-term, it appears likely that there will be some consolidation within the investment industry. This may include fund managers owned by investment banks (for example, will the merger of Lloyds TSB and HBOS mean that Scottish Widows and Insight are also merged in due course?)

Where equity market volatility is an issue for trustees, we would continue to encourage pension schemes to consider more diversified investment strategies. Pooled fund solutions offering access to alternative asset classes are now available to small and medium sized pension schemes, and some of these funds may also attempt to manage downside risk and protect capital in falling markets.

If you have any immediate concerns about your scheme's investment strategy, please speak to your usual BBS Consultant.

**BBS Consultants & Actuaries LLP**  
**13 October 2008**

*This note is provided for information purposes and does not constitute advice on a particular scheme's circumstances.*

