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Survival of the Financial Fittest

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Given the excitement of the past few months, one can be forgiven for thinking of the U.S. banking system as a homogenous, giant mess. After all, almost no bank has escaped the ritual of dramatic loss announcements, outsized asset write downs and urgent capital raises. Moreover, bold action on the part of an individual institution, such as Merrill Lynch's decision last month to sell its collateralized debt obligation holdings at distressed price levels, is seen as a harbinger of what others will need to do.

These dynamics will sound familiar to those that have been through multiple large market dislocations. They have seen repeatedly how markets' initial reactions to unanticipated crises are largely undifferentiated. In a way, it is similar to how fire brigades respond to house blazes: the immediate task is to inundate the structure rather than be highly selective as to which room to target.

Having said this, we are now on the verge of entering the next stage in the financial sector crisis – one where the truly superior banks distance themselves from the weak ones; and where some of the weak banks fail while others merge or are acquired.

Today, most U.S. banks face an urgent business challenge that amplifies the pressure from the system wide deleveraging: they must disentangle profitable core activities from other business units that, along with slumping non-core assets, eat up capital, hurt earnings, drain management time and incur the wrath of analysts.

Merrill Lynch's recent announcements reveal the path that will be adopted increasingly by the industry: sell non-core businesses (such as Merrill's stake in Bloomberg), dispose of non-core assets in what will seem to many as distressed sales (selling the CDO portfolios to Lone Star), and raise highly dilutive capital to bolster core activities.

For most banks, the outcome is a slimmer operational model that commands lower expected returns on equity. Indeed, the question is not whether this will materialize over the next year. It will. The question is how quickly; and the answer is a function of housing prices. The debacle in housing is at the root of the dislocation that is forcing the banks' balance sheet implosion, sapping investors' risk appetite and helping to pull the rug from underneath other credit facilities (with the most recent example being car leases) – all of which drive the ongoing morphing of the credit crunch into widespread economic weakness.

Given the outlook for a further decline in house prices, there is simply not enough cash on the sidelines willing to absorb banks' asset sales and provide the necessary new capital. Valuations will have to go even lower. As this occurs and contaminates other

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segments of the U.S. economy, we are likely to witness a long-lasting change in the institutional configuration of the U.S. banking system, with a highly differentiated impact on bond and equity holders.

Some smaller and medium-sized banks will be unable to find partners to recapitalize them and enhance their balance sheets. They will fail; the Federal Deposit Insurance Corporation will step in to protect eligible deposits and equity and bond holders will take another hit. Other banks will fare better. Due to their valuable core businesses, they will find partners to finance them directly or through mergers and acquisitions. Bond holders will do better while equity holders will continue to face downside.

The third group of banks will gain medium-term strength. They will take advantage of the systemic dislocations to acquire cheap assets and business units, thereby expanding their profitable activities. In the process, both bond and equity holders will benefit.

This outlook provides a good framework for investors wishing to test the robustness of their investment strategies vis-à-vis financial institutions. It also suggests that regulators will face challenges at the level of specific institutions, as well as the system as a whole. And, after a lull that must have seemed like an eternity to some of them, investment bankers will have lots of M&A work. Let us hope this comes together in a relatively orderly fashion.

The writer, co-chief executive and co-chief investment officer of PIMCO, is author of 'When Markets Collide: Investment Strategies for the Age of Global Economic Change' (McGraw Hill)

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