

Global Financial Markets Undergoing Transformational Changes

Global Islamic Finance Forum 2010

25 October 2010

Brian P. Baker

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PIMCO Asia Limited*

Biographical Information

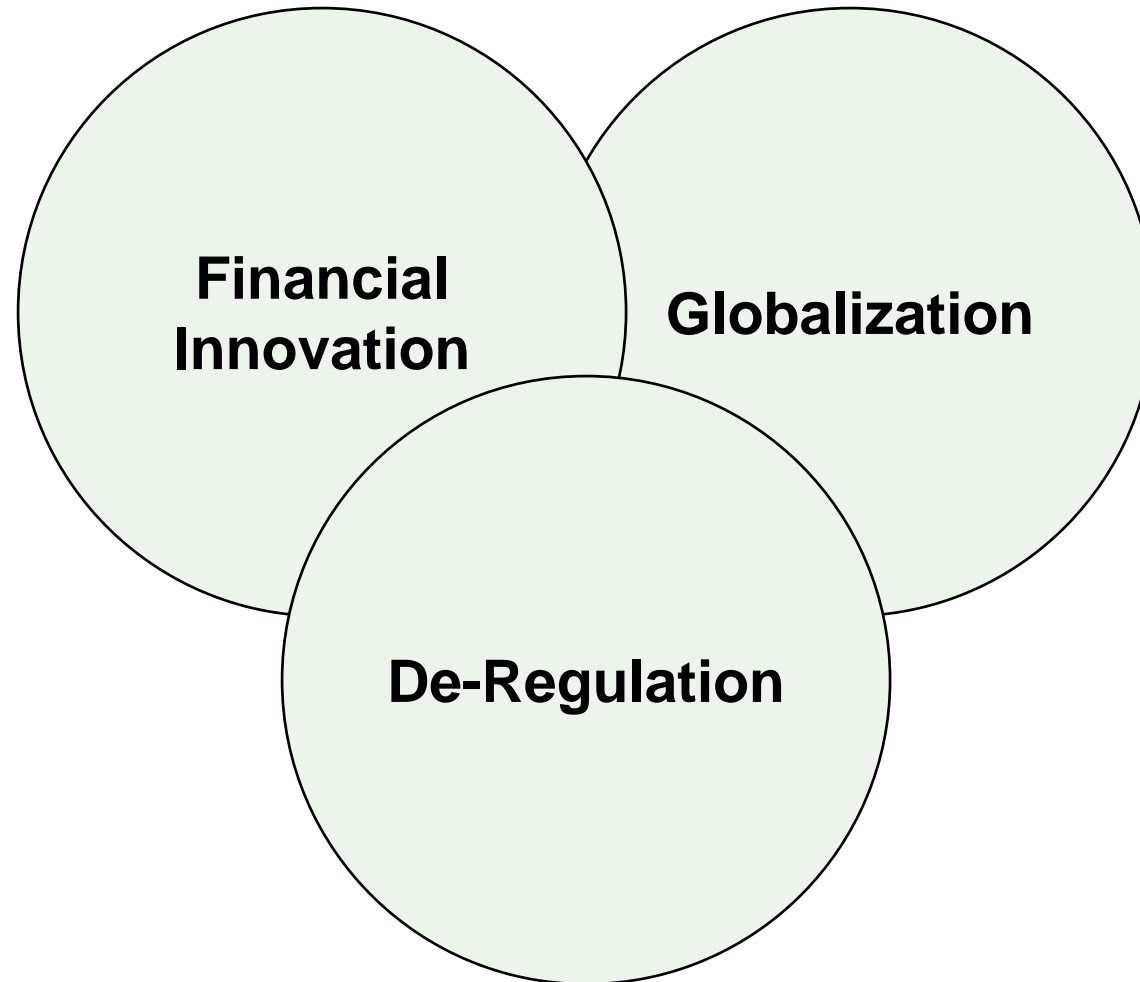
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Brian P. Baker

Mr. Baker is a managing director in the Hong Kong office and chief executive officer and director of PIMCO Asia Ltd. He oversees servicing of PIMCO's institutional clients as well as business development in the region. Mr. Baker is also co-head of PIMCO's official institution business, overseeing investment services to central banks, sovereign wealth funds and supranational organizations. Prior to joining PIMCO in 1997, he was a vice president at Bank of Montreal, managing North American institutional client relationships. He has 22 years of investment experience and holds an MBA from the University of Chicago Graduate School of Business. He holds an undergraduate degree from George Washington University.

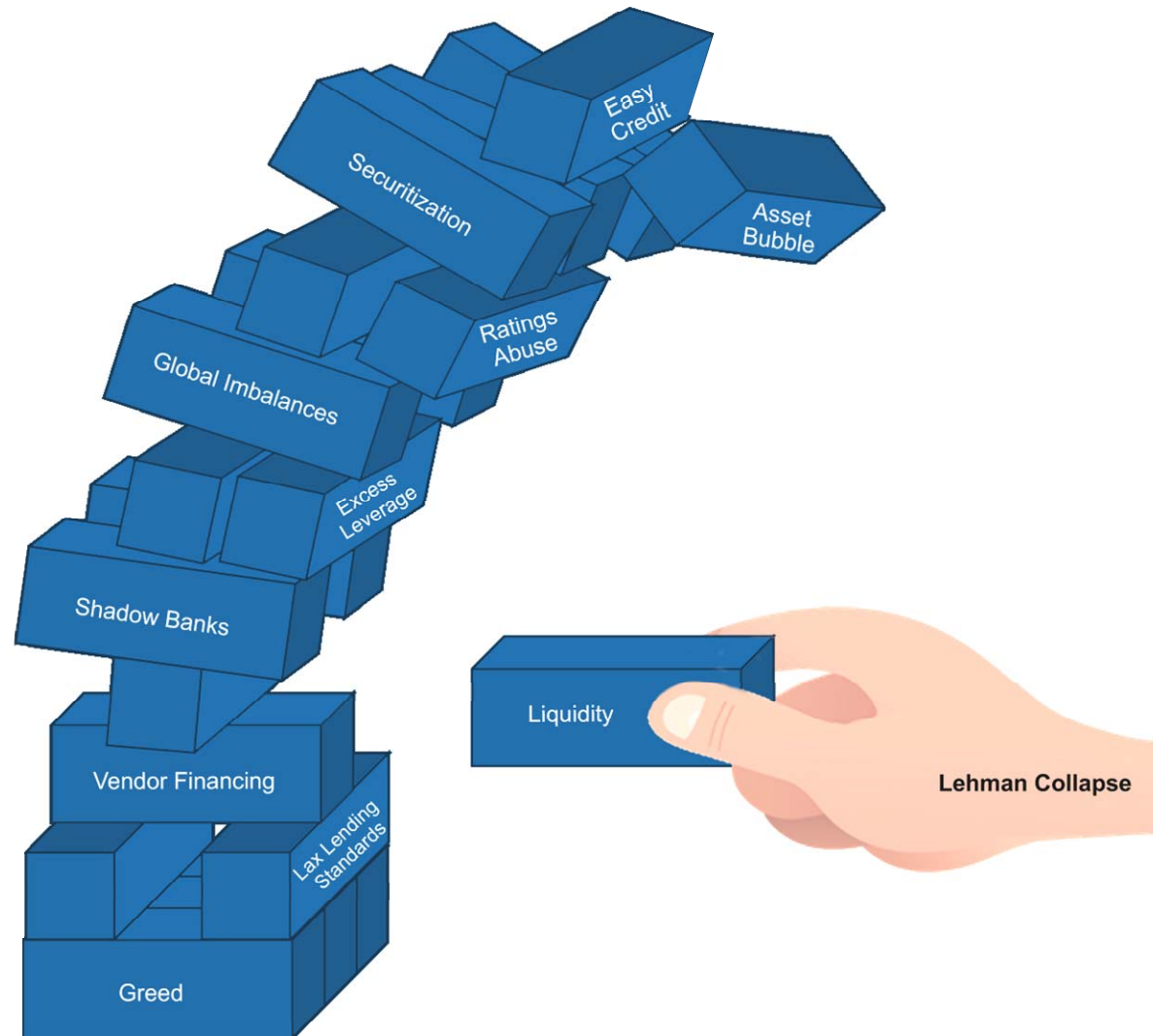
Where We Were: A Powerful Combination for Growth & Markets

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A Sudden Stop: A Crisis **Of** the Developed Markets Financial System

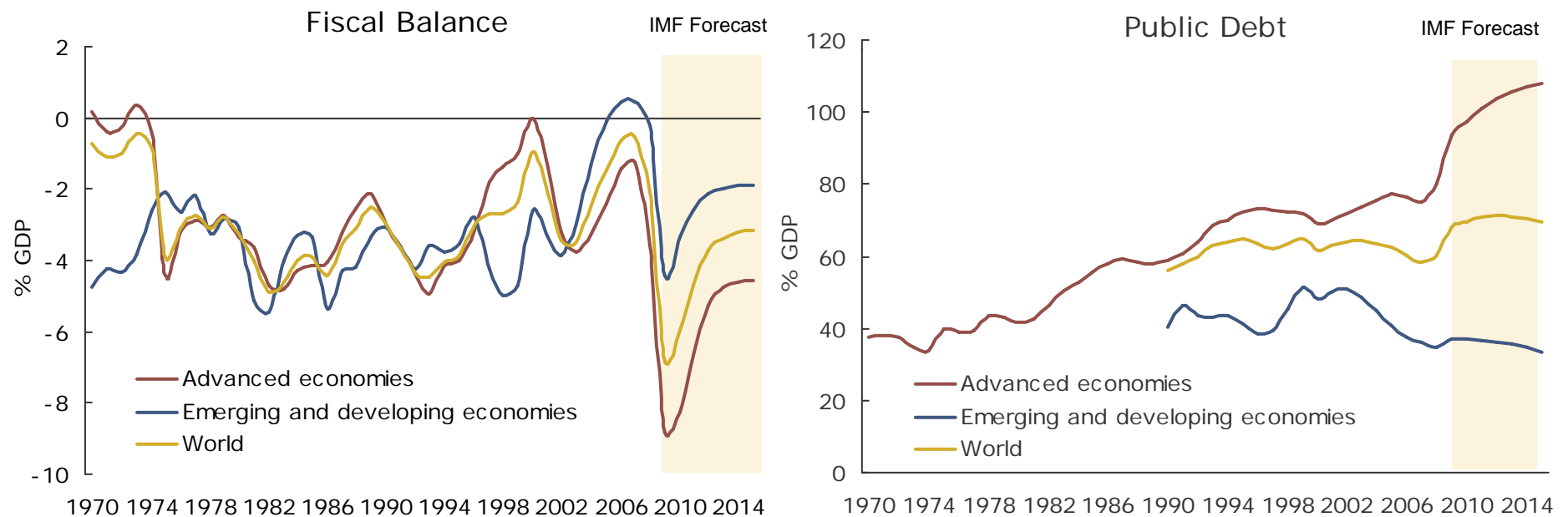
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Governments Have Provided Unprecedented Fiscal Stimulus

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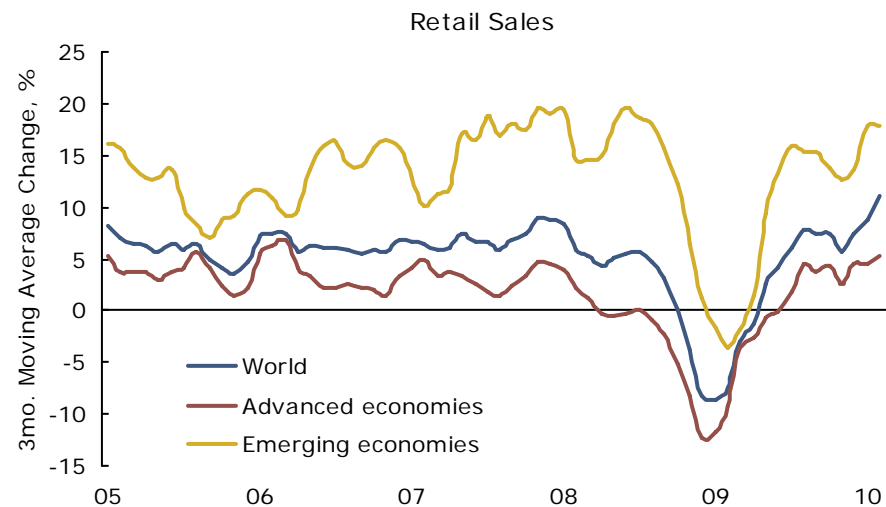
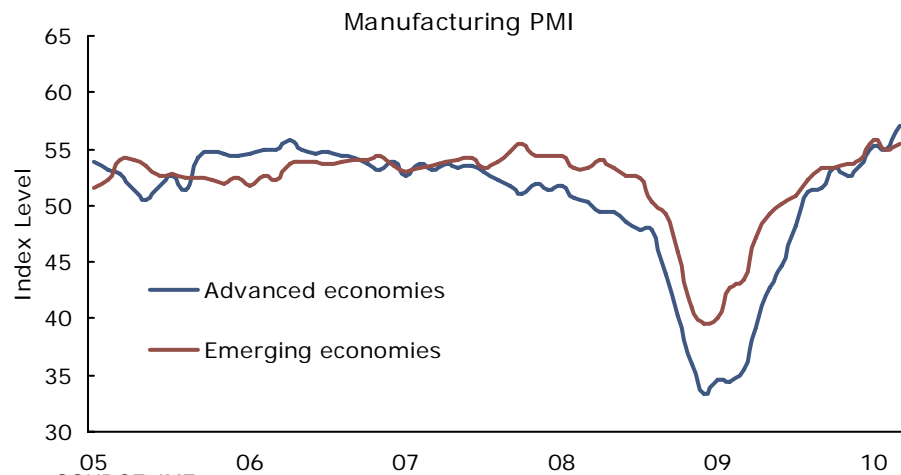
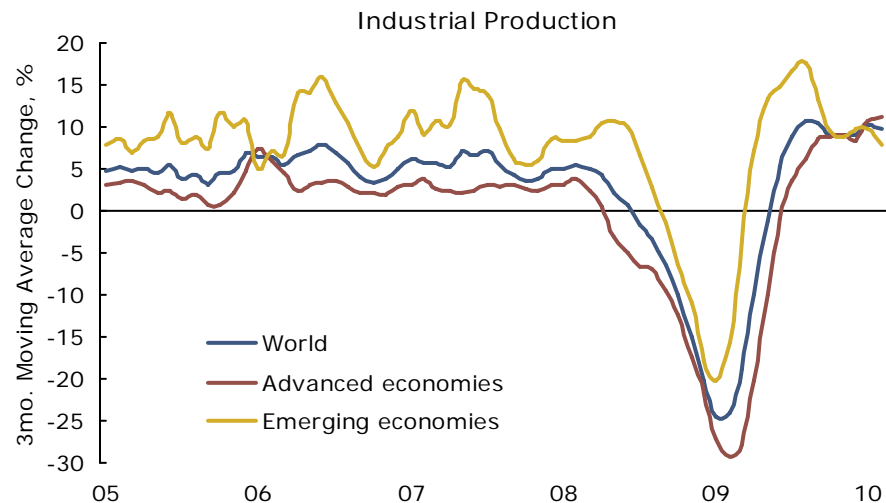
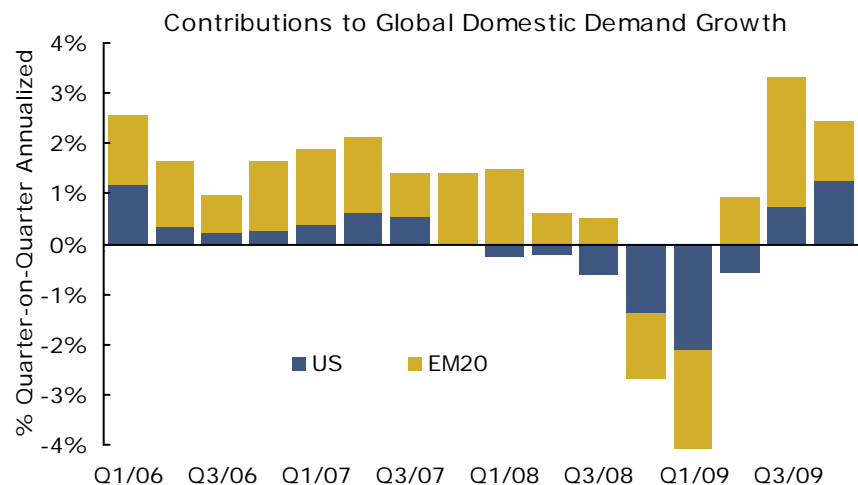
Global Fiscal Balances and Public Debt as % GDP



But the Recovery is Asymmetric...

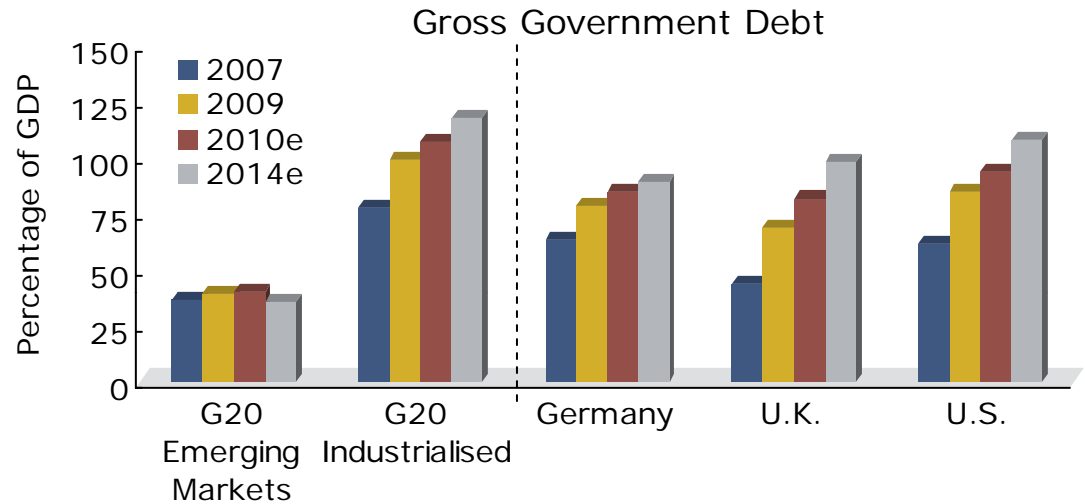
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As of May 15, 2010

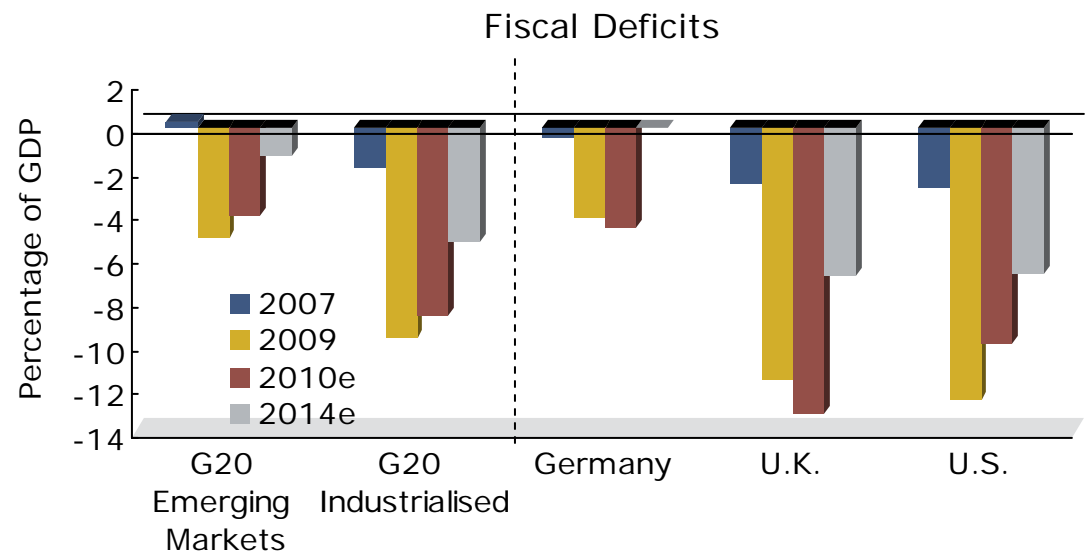


Initial Conditions Matter – Growth to Migrate

- Industrialised countries entered crisis with higher debt levels, which are expanding at an unprecedented pace ...



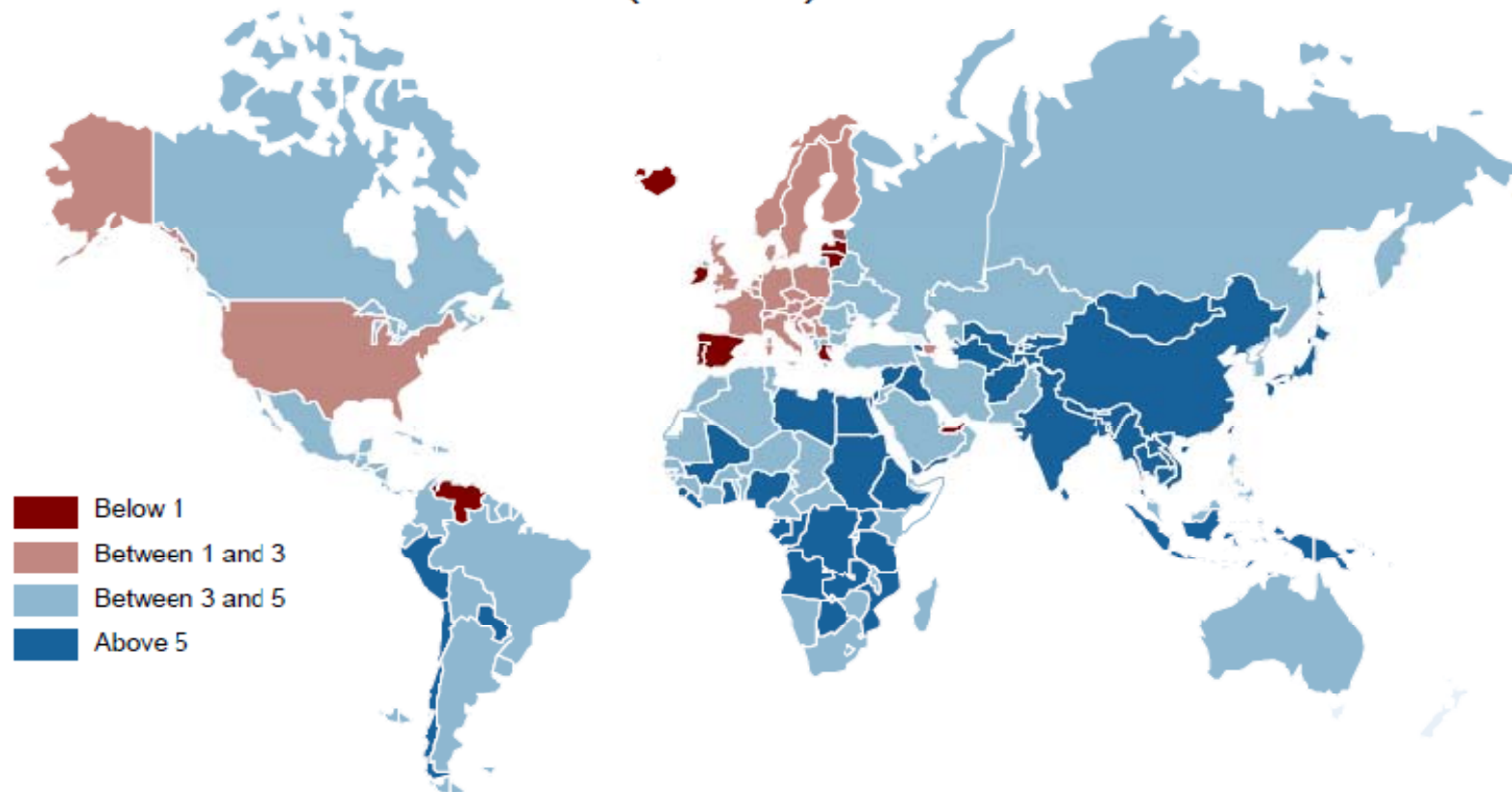
- ...while their capacity to finance their recovery through fiscal expansion is reduced



Emerging Market Dynamism Outpacing Industrial Countries

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Average Projected Real GDP Growth During 2010-2011
(Percent)

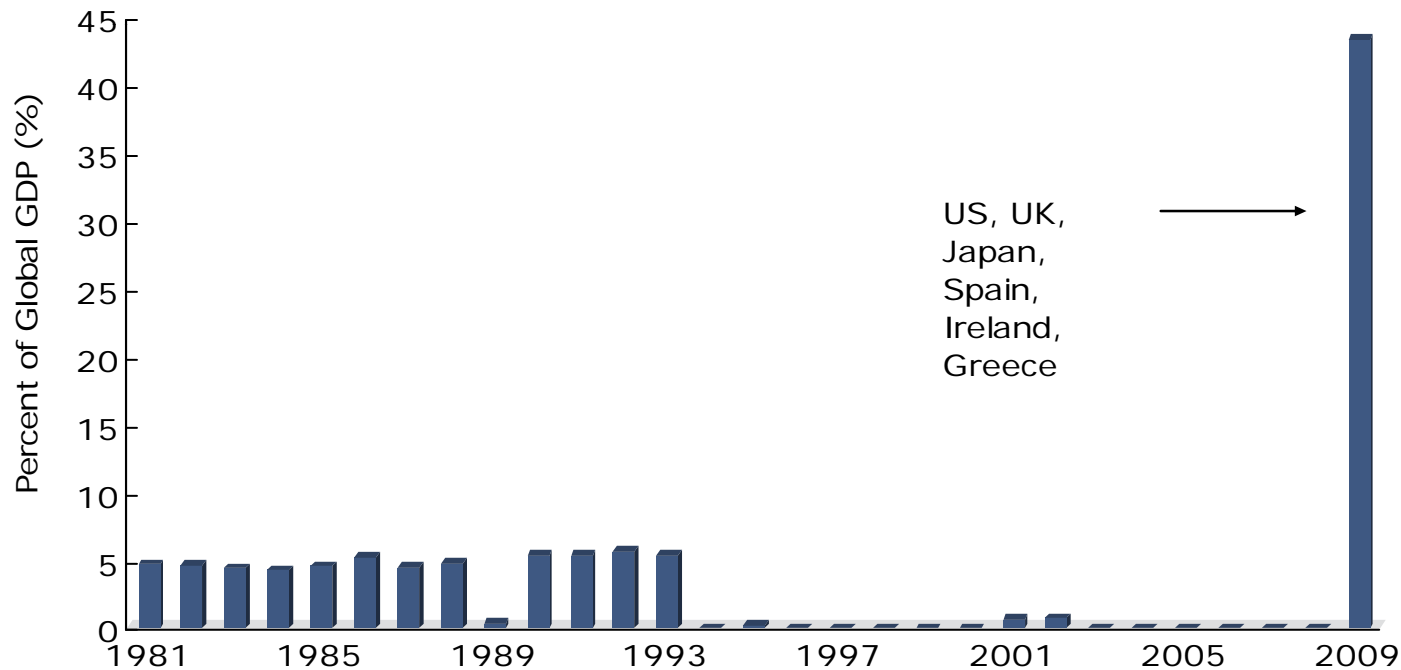


Global Growth Dependent on Heavily Indebted Nations

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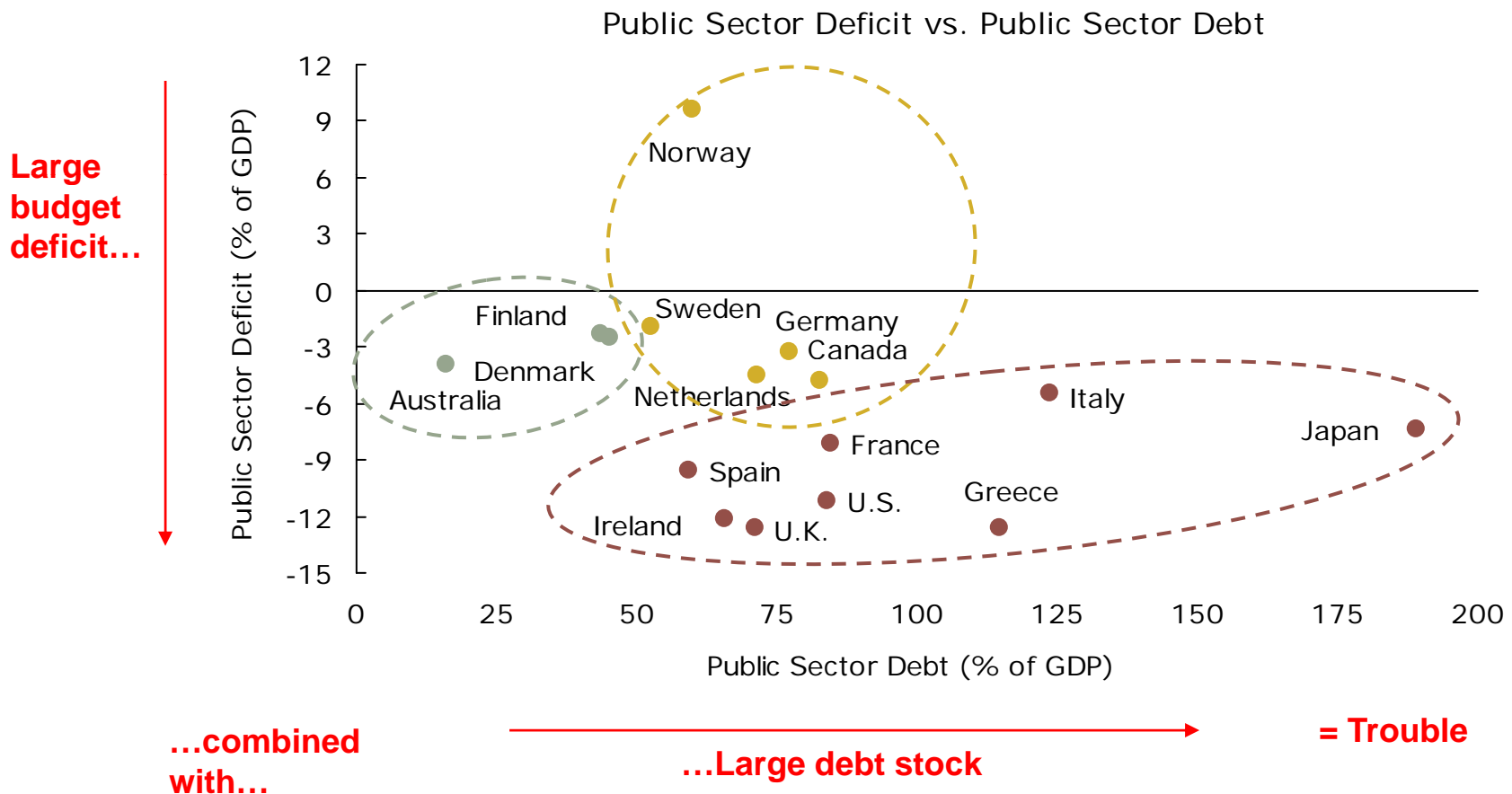
- Debt dynamics have deteriorated sharply in the developed world, making some traditional safe havens less secure

Percentage of Global GDP Consisting of Countries with Fiscal Deficit of 10% of GDP or More



Country Differentiation Grows in Importance

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Seismic Shifts in the Financial Services Landscape

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Pre - Crisis

Characterized by dominance and increasing importance of independent, multi-purpose investment banks (largely unregulated)

I-Banks

- Lehman Brothers
- Merrill Lynch
- Morgan Stanley
- Goldman Sachs
- Bear Stearns

Hybrids

- Citigroup
- RBS
- UBS

Commercial Banks

- Washington Mutual
- BofA
- Wachovia
- Wells Fargo
- JPMorgan
- Bradford & Bingley

Others

- Fannie
- Freddie
- AIG

The Shock/Fracture – September Crisis

- Fannie and Freddie nationalized
- Lehman Brothers bankruptcy
- Merrill Lynch sold to BoA
- AIG nationalized
- HBOS forced takeover by Lloyds
- Goldman and Morgan Stanley become banks
- Washington Mutual bankruptcy and assets sold to JPMorgan
- Bradford & Bingley nationalized
- Icelandic bank Giltner nationalized

Evolving Paradigm

Transition to a new “hybrid” paradigm, as investment banks trade off independence and lax regulation for funding and balance sheet certainty (moving to highly regulated)

~~I-Banks~~ Bank Holding Co.

- Morgan Stanley
- Goldman Sachs

Hybrids

- BofA / Merrill Lynch
- Barclays / Lehman
- Citigroup
- JPMorgan/ Bear Stearns/ Washington Mutual
- Wells Fargo/Wachovia

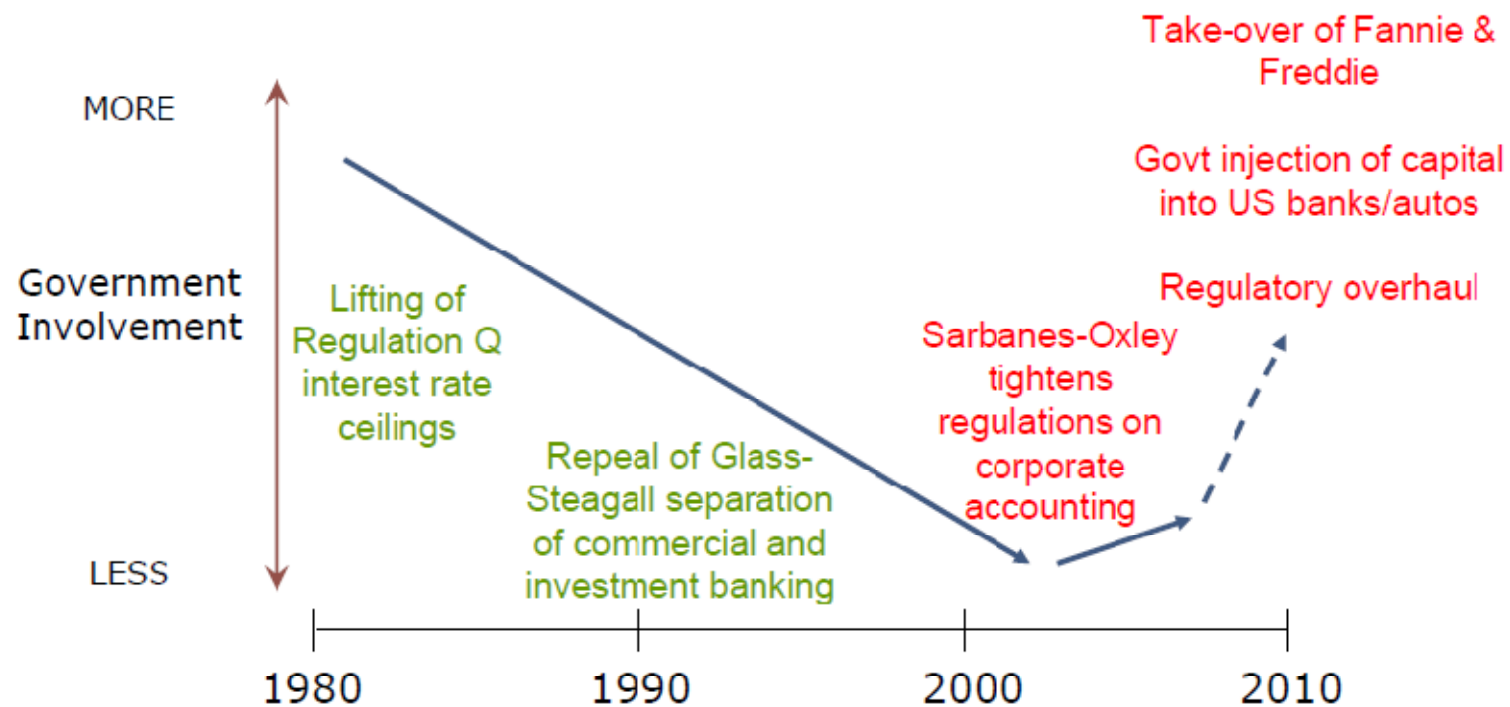
Government-ownership

- Fannie / Freddie
- AIG
- Northernrock
- Bradford & Bingley
- Lloyds
- Fortis
- ABN Amro

Early Stages of Re-Regulation and Government Intervention

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Evolving Government Regulation



Basel III – Watered Down for a Challenged Banking System

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- Initial December 2009 proposals heavily diluted
- Clarity should remove some of the regulatory overhang weighing heavily on bank securities since December, 2009
- Basel III-induced shock to the economy won't be as bad as feared
- Current environment and European banking crisis has induced regulators to take a more pragmatic approach

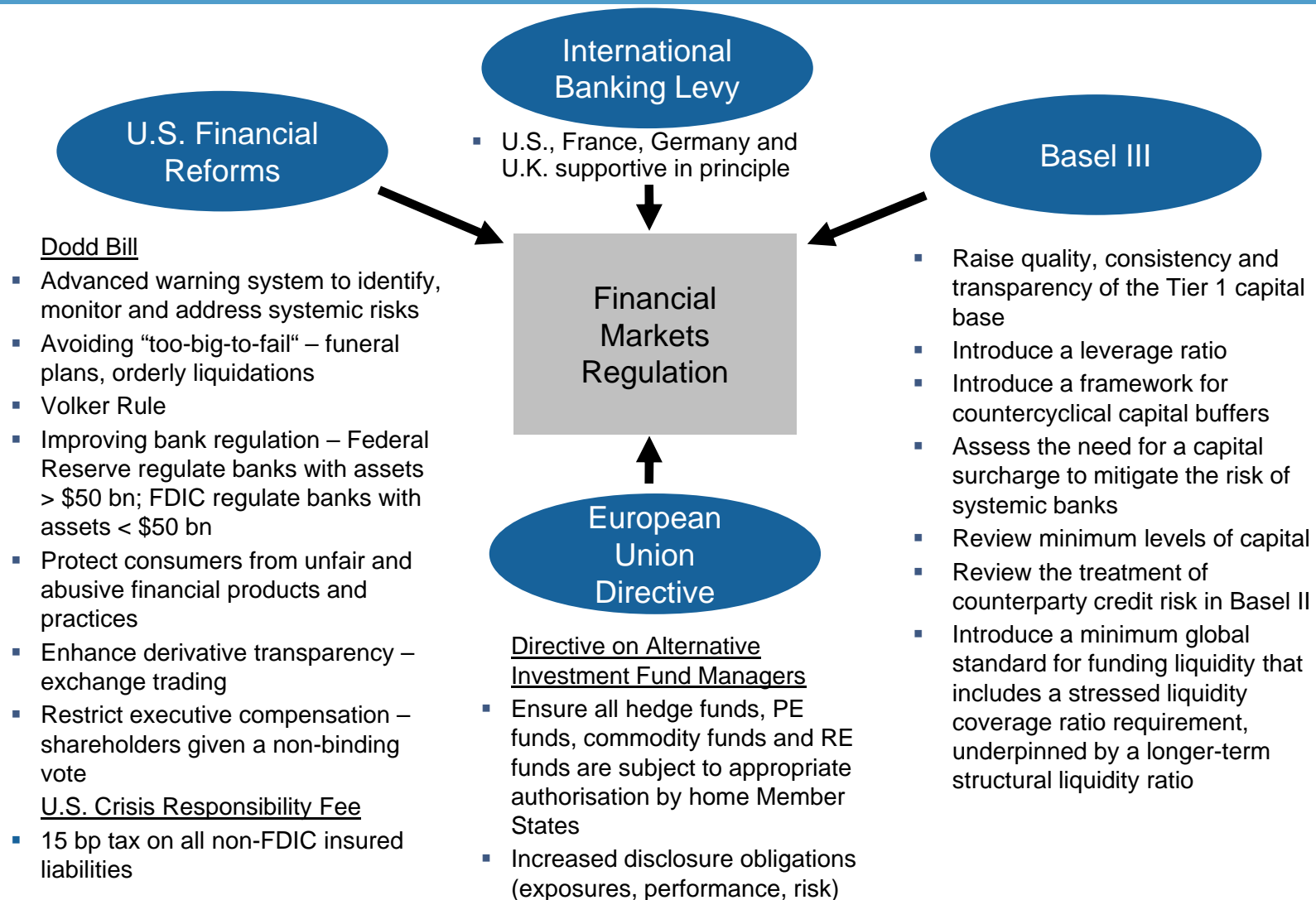
Basel III Roadmap - Extended

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Next Steps - Basel III Roadmap

August 2010	BCBS publication of QIS and economic impact assessment
September 2010	Status report "going concern" contingent capital
	LCR liquid asset standards for jurisdictions with insufficient level 1 assets
During 2010	Consultation paper "gone concern" contingent capital
December 2010	Full proposal "going concern" contingent capital
	Recalibrated NSFR proposals issued
	Agreement on bulk of Basel measures
1 January 2011	Start of leverage ratio monitoring
1 January 2012	Implementation of bulk of Basel measures
1 January 2013	Start of leverage ratio parallel run
1 January 2015	Bank level disclosure of leverage ratio
1 January 2017	End of leverage ratio parallel run
H1 2017	Final adjustments to leverage ratio
1 January 2018	Migration of leverage ratio to Pillar 1
	Introduction of NSFR standards


Summary of Current Regulatory Reform Proposals



The Unintended Consequences of Re-regulation

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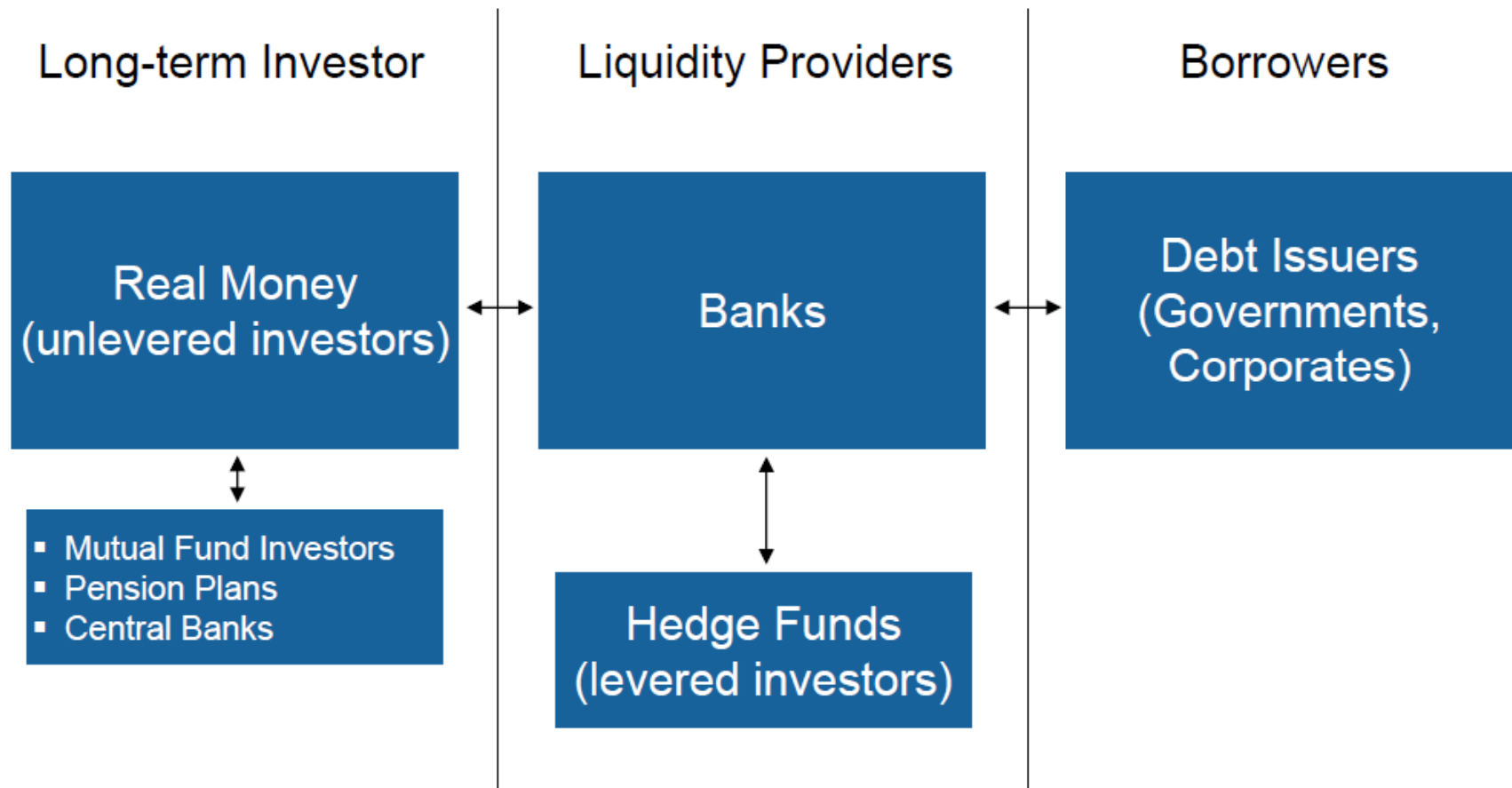
- **Increase not decrease systemic risk?**
 - Herd behaviour and tunnel vision
 - e.g. Basel Capital Accords (1992-2007) and Recourse Rule (2001) sowed seeds of 2007-09 financial crisis
- **Regulatory arbitrage?**
 - Lack of global co-ordination raises prospect of leakages to unregulated sectors
 - e.g. Regulation Q's (1930s) impact on Eurodollar market, money market industry
- **Excessive regulation and the implications for long-term growth?**
 - Delicate trade-off between higher growth and the adverse costs of instability
- **Challenges to central bank independence?**
 - Greater responsibilities imply increased political influence



Desired and actual outcomes may diverge considerably, increasing uncertainty about secular impact of regulatory reform

The ABC's of a Bond Market

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Requirements of a Well Functioning Bond Market

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- An effective bond market needs sufficient amounts of supply and demand
- Diverse set of borrowers and lenders
- Rather than build a broad but illiquid government yield curve, focus issuance on 3-4 points on the curve and make them fully developed/liquid
- Clearly defined and enforced rights and responsibilities of borrowers and lenders (strong rule of law)
- Motivate companies (through tax incentives, etc.) to borrow in capital markets versus bank loans
- Develop a securitized asset market so banks can free up balance sheet to lend to those that cannot access capital markets
- Key to a successful securitized market is consistency of collateral structures
- Electronic trading and clearing
- Developed derivatives markets so borrowers and lenders can hedge their risks

Key Events Leading to Development of the US Bond Market

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- Securities Exchange Act of 1934
- Employee Retirement Income Security Act (ERISA) – 1974
- Development of 401(k) Defined Contribution System
- Development of Mutual Fund Industry