Reregulation and Its Long-Term Impact on the Financial Sector

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I. Introduction

In the two and a half years since the first G20 financial summit held in November 2008, following the failure of Lehman Brothers, a new framework for financial regulation, including Basel III, has come into focus. Financial institutions have passed the point of arguing what the regulations should look like and begun focusing on formulating business strategies that accommodate the new regulations.

Regulations are just one of the factors affecting the future of the financial sector, and there are multiple others that are important. These include structural changes in economies and fund flows as well as the trends in price levels, asset prices, interest rates, and exchange rates. When agreement was reached on Basel I in 1988, there was much talk about how bank lending in Japan would shrink as a result, but those concerns proved to be unfounded. This is because unrealized gains on the banks' shareholdings\(^1\) were growing during the economic bubble that was inflating at the time, resulting in substantial increases in their capital base, and bank lending actually wound up increasing by a fairly large amount.

The reregulation that is underway now, however, aims to substantially tighten regulations across a broad swath, and is likely to have an impact of unprecedented proportions, in our view. Apart from the strengthening of specific rules, in some countries a sea change is taking place in how the entire society views the role of the financial sector, and the hard-line stance on the financial sector being taken by politicians and bureaucrats reflects this. We expect this will also have a major long-term impact on the shape of the global financial sector.

This report will not dwell much on those other factors, i.e., structural changes to the economy, booms and busts, and others, but rather will focus on the impact the new regulatory environment that has taken shape since the global financial crisis could have on the financial sector.

We look first at the leading banking groups in the advanced economies, and consider how the various new regulations might impact their financial positions. Next, we will consider how this financial impact, namely the downward earnings pressure

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\(^1\) Under Basel I, up to 45% of unrealized gains on securities could be included in equity capital.
and increased need for equity financing, might affect the long-term stance taken by management on business lines, group structure, and global development. At the same time, we show how some regulations may directly force structural changes in business models, rather than indirectly through their balance sheet impacts.

We then consider how these changes in the leading banking groups of the developed world might impact other financial firms. We end with a hypothetical forecast of what the financial industry could look like in the future.

Be aware that in many cases the specifics of the financial regulations have yet to be finalized. Because this paper assumes that the regulations currently expected to be implemented and the strongest arguments now will prevail in their current form, any substantial revisions would likely lead to a different outcome.

II. Financial impact on the leading banks in the advanced economies

1. Downward pressure on earnings

1) Rules on equity capital ratios

The impact from the various modes of financial reregulation that is often considered first is the impact on banks’ balance sheets. This includes the strengthening of capital requirements under the Basel III rules announced in December 2010, which requires international banks to raise both the quantity and quality of their equity capital. The prevailing view is that this will put downward pressure on ROE².

The rules under Basel III are now scheduled to be phased in between 2013 and 2019, and also now allow for grandfathering in various areas, changes that to some degree eliminate the negative impacts that were initially of concern.

The Basel Committee published the results of a survey of the likely impact from Basel III as originally proposed in December 2009, and assuming the Basel III common equity Tier 1 requirement of 7% (a 4.5% minimum and 2.5% capital conservation buffer) were implemented at end-2009, the 94 major international banks that participated in the survey would have had an aggregate capital shortfall of €577 billion (approximately ¥77 trillion). In contrast, after-tax pre-dividend profits would have totaled €209 billion. Given that the final version of Basel III is not as strict as the initial proposal, these results suggest that overall the banks could easily meet the standards through the accumulation of retained earnings during the transition period.

In some countries and for some individual banks, however, there is likely to be a need to increase capital or shrink assets by retrenching operations. The impact could be fairly large in some countries, depending on the types of financial institutions that have to meet Basel III, as well as on whether any adjustments are made to the existing

² See for example "Banking is not working," Euromoney, April 2011.
domestic standards that apply to those financial institutions that do not have to meet Basel III\(^3\).

In the UK, for example, the government that took power in May 2010 set up the Independent Commission on Banking (ICB) to consider reforms to the UK's banking sector. In its interim report published in April 2011, the ICB recommended separating those divisions taking retail deposits from investment banking services and other divisions, spinning off the latter into group subsidiaries and requiring them to maintain a minimum core Tier 1 ratio 10\(^%\)\(^4\).

It is also important to be aware of the possibility that in the future, moves to require banks worldwide to maintain capital ratios above the requirements in Basel III may gain momentum. This view has been expressed not only by some academics but also by executives from the Bank of England, based on analyses showing that the ideal capital ratio requirement is at least double that required under Basel III\(^5\).

2) **Liquidity requirements**

In addition to strengthening capital requirements, the liquidity requirements planned under Basel III would partially limit an essential function of the financial sector, which is to profit by taking a position that matches funding demand with funding supply, and thereby reduce profitability.

There would be two types of liquidity requirements, the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR).

The LCR requires a sufficient level of liquidity to deal with short-term stress conditions, including an outflow of deposits or other pressure to repay liabilities.

The denominator is one month of net cash outflows under a stress scenario. This scenario assumes only a 5\(^%\) outflow from retail stable deposits (i.e., deposits that have deposit insurance and receive automatic crediting of salaries, and other deposits with a strong customer relationship) but a 100\(^%\) outflow of non-insured deposits from corporation that the bank does not have a strong relationship with based on providing it custody accounts and cash management services.

Banks are required to maintain more than enough liquidity to cover this stress outflow. All cash and 0\(^%\) risk-weighted government bonds (level 1 assets) are treated as liquid assets, while 85\(^%\) of 20\(^%\) risk-weighted government and public-sector assets and high-quality non-financial corporate bonds (level 2 assets) are counted as liquid assets\(^6\). Loans, shareholdings, and low-grade bonds are not considered liquid assets.

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\(^3\) For more on Basel III and its impact, see "Baazeru III no Shougeki" (The Basel III shock), Toyo Keizai Shimposha, 2011 (in Japanese).

\(^4\) Independent Commission on Banking, Interim Report, Consultation on Reform Options, April 2011.


\(^6\) High quality is defined as a rating of at least AA-, and additional quantitative standards are also planned.
Liquid and safe assets offer lower returns, of course, and an obligation to include these as a certain percentage of portfolios would lower the return on those portfolios. Because there is also an emphasis on obtaining funding from stable deposits, it will become more difficult than it used to be to borrow funds from another financial institution in order to take advantage of opportunities to invest a high rate of return, profiting from the spread.

In contrast, the net stable funding ratio is a metric aimed at eliminating mismatches between assets and liabilities, and the greater the holdings of assets with long maturities or of low quality, the greater is the requirement to obtain funding from equity capital, long-term debt, or retail deposits.

For example, non-financial corporate bonds rated AA or higher require stable funding at a 20% ratio. Regular loans with a maturity of at least one year and risk weighting of 100% require stable funding of 100%.

Banks are required to have stable funding resources in excess of the total required stable funding calculated based on asset quality and maturity.

The entire amount of Tier 1 and Tier 2 capital and liabilities with a maturity of at least a year can be counted as stable funding. Stable retail deposits and small business deposits, even if the maturity is less than a year, are treated as stable funding at a 90% factor. Only 50% of wholesale deposits from non-financial corporate customers with less than one year maturity are counted toward stable funding. Short-term loans from financial corporations are not counted as stable funding.

This will make it more difficult to borrow marketable funds from another financial corporation and then lend those funds out longer term as a way to profit from the long-short spread or from credit spreads.

The main business of the banks has been to collect relatively short-term and liquid deposits and invest them in loans or other relatively longer-term and less liquid assets, thereby earning a profit margin while serving the function of modulating funds supply-demand through both maturity transformation and liquidity transformation. It is precisely this gap between the cash flow needed by the seekers of funding and the cash flow needed by investors (providers of funds) that makes financial intermediation necessary, and why the financial service of filling this gap is a viable business. Liquidity requirements seek to control risk by limiting the ability of banks to fulfill this role, however, while also forcing a change in how they pursue profit.

A survey by the Basel Committee survey on quantitative impacts found that at end-2009, the leading international banks averaged a liquidity coverage ratio of 83% and net stable funding ratio of 93%, not a serious shortfall. This suggests that liquidity requirements are unlikely to have a serious impact. In addition, there will be a trial period, with plenty of time to meet the new requirements, currently slated to go into effect by 1 January 2015 for the liquidity coverage ratio and by 1 January 2018 for the net stable funding ratio.

These requirements will also have impacts that vary, depending on the country and on the bank. The impact is expected to be particularly large on European banks and on
banks in Asia ex-Japan, where government bond issuance is small and there are constraints on the liquid assets that can be held.

Although adjustments are supposed to be made for any unanticipated impacts on bank business models and funding structures, the move toward regulation originated in the perception that it was the traditional business model of the big banks that caused the liquidity crisis. Accordingly, it must be assumed that some impact on the banks' business is by design and therefore will not lead to a significant modification of the rules.

3) Leverage regulations

Although banks that depend largely on retail deposits for funding and invest a large share of their assets in government bonds and other safe, highly liquid assets are probably better positioned to comply with these liquidity regulations, the challenge for them is complying with leverage regulations. Leverage requirements do not take account of risk weights, but require a minimum level of capital relative to total assets, including those off the balance sheet. This requires shrinking assets, irrespective of type, and reducing liabilities. It also places importance on enhancing capital.

This makes it necessary to invest in assets with better returns, even if only slightly, using limited leverage, but because there are also liquidity rules to meet, there is a narrower set of choices, and less opportunity for profit.

Leverage requirements are scheduled to go into effect from 1 January 2018, "with a view to migrating to Pillar 1 treatment," and a Tier 1-based leverage ratio of 3% will be tested from 2013 to 2017. In addition, because financial institutions are required to start disclosing their leverage ratios and the components thereof from 1 January 2015, they may need to go fairly far in adapting their business to comply with leverage ratio rules early on.

4) SIFI regulations

Large banks designated as systemically important financial institutions (SIFIs) must meet stricter capital standards, and thus will probably be affected more.

The Financial Stability Board and Basel Committee are considering additional restrictions on global SIFIs, i.e. banks that are systemically important at a global level, and aim to finalize agreement on that at the G20 summit in France in November 2011. On top of additional capital ratio requirements (i.e., capital surcharges), systemically important banks may also be subject to large exposure limits and liquidity surcharges.

In the US, bank holding companies with total assets over $50 billion are automatically subject to additional requirements under the Dodd-Frank Act. Those nonbanks deemed capable of threatening financial stability in the US can be put under the supervision of the FRB at the behest of the Financial Stability Oversight Council, which would subject them to additional regulation.
The FRB would set these additional rules, including capital, leverage, and liquidity requirements, obligations to draw up a resolution plan and file reports on credit exposure, and concentration limits. The FRB can also require systemically important institutions to strengthen their contingent capital and information disclosures, and impose restrictions on their short-term debt.

In the UK, as noted earlier, some argue that capital ratio requirements should be set higher than they are in Basel III, and an interim report from the Independent Commission on Banking (ICB) proposed raising the core Tier 1 ratio for SIFIs to at least 10%, and suggested the consideration of contingent capital and bail-ins.

In Switzerland, even more draconian capital surcharges on SIFIs have been proposed. A panel established by the Swiss government announced a proposal in October 2010 to require the two major Swiss banking groups, UBS and Credit Suisse, to maintain a minimum capital ratio of 19%, and that is being debated in the Swiss legislature now.

Even banks not deemed to be systemically important are expected to increasingly start voluntarily complying with SIFI-level standards to improve their market valuations. Consequently, the impact from SIFI regulations could extend beyond the SIFIs.

5) Various services that will be restricted

In addition to the impact on earnings from reregulating soundness, there will be more direct negative impacts on bank earnings from tighter regulation of the various services that have been providing a source of earnings for the banks.

One example is market trading departments. The majority of bank losses during the financial crisis came from securitized products held in trading accounts, and even before Basel III came out it was agreed (Basel 2.5) to raise capital surcharges on trading accounts. The Basel Committee estimates that this rule change would increase the market risk-related capital requirement for major banks operating internationally by an average of three- to four-fold. In other words, for a given level of capital, the risk that could be taken in the trading account had to be reduced to one-third to one-fourth its previous level.

The US introduced the Volker rule, which in principle prohibits banking groups from engaging in proprietary trading activity, as well as from involvement in hedge funds.

In the area of OTC derivatives, Basel rules requiring stronger management of counterparty risk and the use of central counterparty clearinghouses (CCP) or a stock exchange to make trades, will also squeeze profitability, because banks will lose their dealer margins if trades are channeled through CCPs or exchanges. Trades will also require a margin deposit. Although OTC trading will remain possible for derivative

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7 A portion to handle additional risk and a stressed VaR were added to the internal ratings based approach.
contracts that are difficult to standardize, higher capital surcharges will be required than is the case for trades cleared through a CCP.

There is serious concern over the impact these rules may have on the major banks, for whom OTC derivatives are very profitable. The top 20 dealers generate annual revenues of about $40 billion from OTC derivatives excluding CDSs, and JPMorgan has stated that one-third of the profits in its investment banking division come from OTC derivatives.

In addition to that, in the US the Dodd-Frank Act effectively prohibits insured deposit-taking institutions from acting as derivative dealers (known as the "swap pushout" rule). As a result, major banking groups in which the bank itself is dealing in derivatives must spin that business off into a newly capitalized separate company.

In the securitization business, it was agreed at the London G20 financial summit held in April 2009 that the company doing the securitization should be obligated to continue holding a certain portion of the risk of the underlying assets, in part because the ease with which problem subprime loans were securitized and sold off to a wide range of investors was a major cause of the financial crisis. Legislators in the G20 countries are in the process of reflecting this in their laws. There has already been a substantial decline in securitization issuance as a result of the financial crisis, and future reregulation will probably slow the recovery of that business.

As noted earlier, in the UK there is already a proposal to require affiliated banking subsidiaries to maintain a minimum core Tier 1 ratio of 10% to cover their retail deposit-taking business, and to require the setting aside of separate capital to cover other businesses, including trading, derivatives, and securitization.

6) Bank taxes, stronger consumer protection regulation, and other costs of regulatory compliance

Another factor that is pressuring profits is the bank tax that either has already been implemented or is being planned in the UK, Germany, and France. Proposals to implement the "Tobin tax" have also been relentless. The Economic and Monetary Affairs Committee of the European Parliament has recommended imposing a financial transaction tax of about 0.01–0.05%, while in April 2011, 1000 economists worldwide, headed by Jeffrey Sachs, urged France, the G20 Chair, to adopt a financial transaction tax (a "Robin Hood tax")

There are also moves in both Europe and the US to strengthen consumer and investor protections. In the US, for example, the regulation of both home loans and consumer loans is being strengthened, based on lessons learned from the rapid spread of subprime loans. Credit card-related regulations are also being tightened. This will

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9 In February 2010, roughly 50 citizens' groups in the UK began a "Robin Hood Tax" campaign to encourage the country's three major political parties to assess an average tax of 0.05% on speculative currency transactions.
have a major impact, given the heavy reliance on profits from retail credit-related services of banks in the US.

Under the Dodd-Frank Act, for example, the FRB is given the authority to regulate the interchange transaction fees paid to the credit card companies and credit card issuing banks by merchants when accepting payment by debit card. It was seen as a problem that the banks, in anticipation of this fee income, were strongly motivated to give consumers more credit cards than they needed. The FRB has responded by proposing a substantial reduction in this fee, from an average of 1.14% of the transaction amount to a maximum of $0.12 per transaction. This would have a major impact on bank earnings and is expected to reduce bank profits by $12 billion annually. The banking industry is trying to get the regulation revised.

The Dodd-Frank Act requires changing the basis for calculating deposit insurance premiums from the amount of domestic deposits outstanding to the amount of total assets less tangible equity. Based on this, the FDIC has proposed regulations that would increase the insurance premiums paid for funding sources other than domestic deposits. Consequently, the deposit insurance premiums paid by the major banking groups that get a large amount of funding from sources other than domestic deposits are expected to increase.

Governments are also beefing up regulations and oversight in the area of financial product sales. The Dodd-Frank Act requires the SEC to undertake a study and issue a report on whether a fiduciary duty should be imposed on broker-dealers that provide personalized investment advisory services. It also gives the Investment Advisory Committee already established within the SEC legal authority, makes it a permanent organization, and calls for newly establishing an Office of the Investor Advocate.

In the UK, it was reported that the Financial Conduct Authority (FCA), which will be established to provide investor protection, will take over some of the functions of the soon-to-be disbanded FSA. It will be given the authority to prohibit or suspend for up to a year the sale of complex or high-risk retail products, and plans to disclose the names of companies it reviews at the start of a review.

Moves being considered to strengthen investor protection in Europe include information disclosure on packaged retail investment products (PRIPs), as well as debate over the quality of advice and fairness between products.

The banks will also incur costs from putting an organization in place to comply with the more robust regulations and oversight mentioned above. These increased reporting requirements make it inevitable that costs will also increase, including for system compliance.

2. Ability to raise capital will become more important

The higher capital ratios required under Basel III and SIFI rules will increase the need for banks to raise capital, primarily by issuing common shares. As we show
below, however, the new regulations will also have the effect of making bank capital securities less attractive to investors.

To begin with, investors will become cautious over investing in such securities because any increase in equity financing will itself raise concerns over dilution. In addition, high investment returns are unlikely because of the downward pressure on earnings caused by the regulations outlined above.

Furthermore, Basel III establishes a capital conservation buffer and a countercyclical buffer, and limit dividend payments and share buybacks if capital in excess of these buffers cannot be maintained, thereby placing constraints on returning profits to providers of capital. Unless there are sufficient returns, investors are likely to choose other types of shares without the uncertainty of common shares.

In addition, the guidelines announced by the Basel Committee in January 2011 require that for bank capital securities to be included in core Tier 1 or Tier 2 capital they must be subject to either a reduction in principal or conversion to common shares if regulators deem the bank a gone concern. If regulators take a conservative view to avoid a messy bankruptcy, there is a possibility that this trigger would be pulled fairly early. This would cause a major change in the nature of bank capital securities, which have traditionally been seen as less risky than common shares, and make investors hesitant to invest in them.

Some banks have started to use going concern contingent capital, a new way to procure capital, but if the likelihood of the contingency being triggered rises, common stock investors may feel suddenly compelled to sell their shares on fears of dilution. Thus the increased use of contingent capital may wind up making investing in bank stocks more uncertain.

As we note later, the debate over new rules for bankruptcy resolution have led to the suggestion that large banks be pushed into an orderly bankruptcy without spending taxpayer money and thereby eliminate their too-big-to-fail status, and this would make it more difficult to make investments that counted on a government bailout during a crisis.

Double-gearing regulations may lead to a substantial reduction in the amount that financial institutions invest in bank capital securities, which would shrink the size of the markets for preferred stock and subordinated debt issued by financial institutions.

Since the new regulations would increase banks' demand for capital while shrinking the supply of that capital, it would probably drive up banks' cost of capital, lower their earnings, and lead them to alter their asset portfolios and services. Apart from Basel regulations, there are other factors that have created a declining trend in the supply of risk money, including tighter solvency margin requirements for the insurance companies, changes in international accounting standards, and the maturation of pensions in advanced economies (Figure 1).

Another concern is continued deleveraging and a reluctance to lend that lower the demand for raising capital. This would put downward pressure on bank earnings via a
weakening of the economy. As noted later, it is possible that sectors other than banking will emerge to replace the banks as suppliers of funds.

It is not necessarily the case that all banks will find it difficult to raise capital all at once. The enhancement of capital at those banks that can successfully obtain equity financing may actually reduce the return demanded by investors and lead to a lower cost of capital. We think this would widen the gap between these banks and the banks that are unable to tap into capital markets.

3. Earnings and recent trends in capital procurement

The major banking groups in the developed economies saw a rapid recovery of earnings in 2009, helped by declining interest rates and the injection of public funds, but this recovery lost steam in 2010 as a result of the European debt crisis. In some sectors, such as securitization and mortgage loans, the earnings declines that began with the financial crisis have yet to end. Within this context, the trend toward reregulation will start having an impact when it gains momentum.
The banks rushed to beef up their capital as an emergency measure during the height of the financial crisis, but some still need to increase their capital further, even with the financial crisis having ended, as a result of Basel III and SIFIs rules.

More than a few banks in Europe are undercapitalized, having run squarely into the sovereign debt crisis before they were finished writing off subprime-related losses. Work is on schedule to announce the results of 2011 EU stress tests in July, but banks in Germany and Italy have been raising capital ahead of that announcement.

Downward pressure on earnings from reregulation and the need to raise more capital has caused some banks to cut their ROE forecasts. HSBC, for example, lowered its future ROE outlook to 12–15%, from its previous outlook of 15–19%. The CEO of UBS, which is headquartered in Switzerland, where some strict capital requirements have been proposed, commented that its ROE would be around 10%, lower than that of UK banks.\(^\text{10}\)

III. Impact on business lines, group structures, and global development

1. Regulations changing bank’s approach

These different regulations will put downward pressure on bank earnings and make it more difficult for them to raise capital, and will also probably bring changes to bank businesses and organizational structures as the banks try to overcome these negative impacts through trial and error.

This is in addition to the many new regulations that will more directly force those changes. The liquidity requirements noted earlier put very clear constraints on asset and liability structures in the financial intermediation sector. In addition, operational regulations (the Volker and swap pushout rules in the US and the ICB’s proposal in the UK), shadow banking regulations, and bankruptcy resolution rules will also create direct pressure for changes in the way banks operate and how they are organized.

Conceivable new directions in which the banking business could develop as a result of these direct and indirect impacts include their starting to place a greater emphasis on retail deposits, lending, and transaction businesses, and moves toward revising those businesses that have grown so much in recent years, including trading, securitization, and OTC derivatives.

If a greater emphasis on these traditional services does prove inevitable, it could make it more difficult for banks to generate profit, and push them to scale-up and develop their business globally, including in emerging markets.

A different approach to global development may be needed, however. This is because the debate over rules on bankruptcy resolution suggests that banks may need

\(^{10}\) "UBS prepares for a less glamorous future," Financial Times, March 2, 2011.
to establish their overseas operations in a way that makes it harder for risks to be propagated across borders.

In addition, each country has its own unique regulatory environment, and even the same rule can have a different impact, depending on the country. It is likely that this difference among countries in the way that regulatory environments form will have an impact on the vectors of global business development.

We look at these differences, one by one, below.

2. Traditional services are the fallback option

1) Where retail deposits are a priority

As already noted, those banks that are able to secure funding through stable retail deposits have an advantage in meeting liquidity requirements. Although funding by issuing bonds with at least one-year maturity also makes it easier to meet those requirements, if bail-ins are introduced the market for unsecured bonds will probably shrink. The issuance of secured bonds is limited by the extent to which collateral can be secured. The insurance companies, the largest investors in bank bonds in Europe, have pointed out that the Solvency II regime scheduled to go into effect in 2013 will make it more difficult for them to hold long-term corporate bonds11.

Liquidity requirements as well as the current debate over rules for resolving bank failures make deposits look more advantageous than other liabilities. The idea that banks should not be considered too big to fail is an important component of the new bankruptcy resolution rules being considered, and the possibility of making the holders of banks' senior debt take a haircut in the event of bankruptcy is also being considered.

Meanwhile, it appears that the financial crisis has reinforced the importance of taking care of bank deposits, with many countries strengthening their deposit insurance schemes. In the US, the new deposit insurance rules give more favorable treatment to domestic deposits than to other liabilities used for funding, based on the level of deposit insurance premiums.

There has been a proposal in the UK to separate retail deposit-taking from investment banking services and handle deposits at a group retail bank to make them safer, while at the same time making the claims of depositors senior to those of bank bondholders.

The latest financial crisis has also brought more clarity to the difference between deposits and other short-term financial products like money market funds, repos, and CP. Specifically, when money market funds that had invested in CP issued by Lehman Brothers dropped in value below their principal ("broke the buck") during the financial crisis, it sparked an exodus of cash from other money market funds, as well.

When funding with repos, a sharp drop in the price of securities serving as collateral or increase in counterparty risk creates problems with fixing collateral. There can be an increase in turmoil brought by the sudden suspension of tri-party repos in the US, depending on the risk management policies of the bank intermediating the repo.

For funding with ABCP issued by vehicles established by investment banks or banks, there were cases when investors completely refused to rollover the debt because it was largely backed by subprime loans. It has become more difficult to issue other types of CP, as well, because investors are now more wary in light of losses on CP issued by Lehman Brothers having led to money market funds breaking the buck.

Suppliers of short-term funding are increasingly eschewing investing in money market funds, repos, and CP, making it more difficult for banks to rely greatly on money market funding.

There are also moves afoot to reregulate these non-deposit short-term financial products. Some are arguing that the institutions that rely on CP, repos and other short-term funding and invest in assets of differing maturity, liquidity, and credit quality, known as shadow banks, may need to be regulated similar to the banks12.

And likewise money market funds are really no different than the shadow banks that perform maturity, liquidity, and credit transformation, since they promise investors roughly the same liquidity and safety level of demand deposits while investing those funds in CP and repos, etc.

Any strengthening of regulations on these short-term liabilities of shadow banks would probably further increase the relative attractiveness of bank deposits.

2) Falling back on the traditional credit business

As already noted, 85% of high grade non-financial corporate bonds are counted as liquid assets when computing the liquidity coverage ratio. In contrast, loans are not treated as liquid assets. When computing the net stable funding ratio, the required stable funding (RSF) factor is 20% for nonfinancial corporate bonds rated AA or higher and 50% for those bonds rated between A– and AA–, much more favorable than the 100% factor required for loans with maturity of one year of greater. This creates the possibility that investing in corporate bonds issued by blue-chip companies is preferable to providing loans to such companies from the perspective of complying with liquidity requirements.

As already noted, however, holding corporate bonds for trading purposes, i.e., in order to capture short-term price differences, is becoming more difficult than it used to be as a result of the rules in Basel 2.5 aimed at suppressing trading. On top of this, the US also has the Volker rule.

The banks are being incentivized to replace the trading businesses that had led to large losses by turning to the credit business, including investing in corporate bonds and providing regular loans. This combined with the advantages of retail deposits noted above suggests that the banks will probably start placing greater emphasis on traditional banking, namely taking small deposits from households and providing credit to businesses.

The "originate to distribute" business model in which loans were made and then securitized has already shrunk substantially, having been seen as one cause of the financial crisis, and we think the securitization market is unlikely to return to its previous size because of new rules being introduced that strengthen disclosures and require originators to retain a portion of the credit risk. Accordingly, we think a return to the traditional "originate and hold" lending model is inevitable.

In the US, there is currently a rush to dispose of and shrink nonperforming legacy assets, meaning that portion of home loans and consumer loans originated prior to the financial crisis. Loans to those sectors will also probably be affected by a strengthening of consumer protections. This will probably make traditional commercial loans relatively more important. In the future, depending on how the GSEs like Fannie Mae and Freddie Mac are reformed, there is a possibility that private-sector banks will take over the GSEs direct role in the mortgage business.

Another problem that occurred during the financial crisis was a drying up of liquidity in auction rate securities, which had become a common format for municipal bonds in the US. This led to turmoil throughout the US municipal bond market and resulted in the introduction of a program of federal guarantees, although now that the program has ended bank lending to local governments is growing.

As we outline below, the four major banks in the UK have made a number of commitments to the government in response to a groundswell of anti-bank rhetoric, and an increase in lending is one of the most important. These commitments include more than 6% growth in new lending to nonfinancial corporations from 2010 and a promise to reflect the results of lending to SMEs in executive compensation.

Thus the lending business is becoming increasingly important, while the businesses of trading, derivatives, and investments and loans to funds are being subject to increasingly tighter regulations. We expect this to result in a major overhaul of the new banking businesses that started growing in the 1990s, as well as in a higher priority being given to the traditional credit business.

3) Focus on transaction business

In addition to deposit-taking and lending, traditional banking businesses have included such transaction businesses as settlement, interbank transactions, trade financing, and custodial services. With the exception of prime brokerage services for hedge funds, these will continue to be seen as important services that banks should be

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Another advantage from providing these services is that deposits from those customers with which a bank has an ongoing relationship handling their financial transactions are classified as stable deposits when calculating liquidity requirements. In addition, the debate over new rules for bankruptcy resolution is heading in the direction of protecting most of these services as "essential services."

In contrast with businesses built on expanding the balance sheet and profiting from spreads via maturity, credit, and liquidity transformation, which will be increasingly constrained by capital, liquidity, and leverage requirements, those businesses that generate fees by mobilizing internal infrastructure to process transactions have the advantage of being highly capital efficient. 14

Although transaction services are a traditional bank business, this has become a very competitive sector offering IT-powered advanced services. With corporate clients increasingly extending their supply chains globally, the transaction business is becoming important from the standpoint of expanding the banking relationship and providing added value. 15

4) Securities industry also returning to traditional businesses

The banking groups in the US are engaged in the securities business through their brokerage subsidiaries, while the universal banks in Europe primarily do so inside the parent firm, but they are all in the process of revising their trading and securitization businesses, and will be putting a greater emphasis on their traditional roles of brokerage, market-making for clients, selling financial products, offering financial advice, and providing underwriting and M&A consultation.

Although they are traditional businesses, such sectors as the electronic execution of stock trades and clearing services use a high level of information technology. These are all similar to transaction businesses in the banking sector, and are likely to be similarly advantaged in the new regulatory environment.

As we note later, however, in the area of retail financial advice and investment banking services, we expect independent entities to emerge, increasing competitive pressures.

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14 Unless Basel III is modified, however, trade financing will be adversely affected because of the increased risk weights assigned to credit extended to financial institutions, the 100% leverage factor assigned to off-balance-sheet trade credit when computing leverage requirements, and its treatment as short-term debt under liquidity requirements. See "Impact of Basel III: Trade finance may become a casualty", Financial Times, October 19, 2010.

3. Efforts to scale up and develop globally

1) How to compensate for lower profit margins?

We have argued thus far that reregulation will make the traditional deposit/loan and transaction businesses more important for the banks, and that the securities industry would also be returning to its roots. The truth is, however, that it was precisely because these traditional businesses were not generating a sufficient ROE that the banks started getting into securitization, derivatives, trading, and fund-related services.

Given the new regulatory environment on the horizon, a robust recovery of these newly developed and important revenue sources is unlikely. Although it is conceivable that completely new high-margin businesses will be innovated, our assumption below is that this is unlikely over the near term. We also assume that because of the possibility that the banks will pursue higher risks in order to generate higher returns, such activity will be constrained through regulation and supervision.

Although these are just our assumptions, if true they would mean that the banks would have to focus on somehow raising profitability within the confines of the traditional deposit/lending and transaction businesses. We expect this would result in efforts to expand share in existing markets while also moving into new ones, including emerging markets.

Regarding the former, the financial crisis triggered consolidation in the banking industry as the relatively healthy banks rescued those in trouble by merging with them, and moving forward we think it likely that reregulation will create widening gaps between those banks that can easily meet the new requirements and those that cannot. This could become a new driving force behind further industry consolidation.

In the US, the process of financial deregulation resulted in continued declines in the number of banks, and the financial crisis imparted further momentum to consolidation of the banking sector, as JPMorgan acquired Bear Stearns, Bank of America acquired Merrill Lynch, and Wells Fargo acquired Wachovia. Nevertheless, the US already imposes market share restrictions for domestic deposits, and with new market share restrictions for domestic debt also slated to be implemented, there will be limits on how big banks can become.

In Europe, the banking sector's excessive size relative to the domestic economy has been identified as a problem in a number of countries, including the UK, and this will probably restrict efforts to achieve greater scale domestically in those countries. Although we still see room for the pursuit of scale via M&A within the EU overall, the emphasis in Europe is now on improving competitiveness, which is probably not an environment conducive to the pure pursuit of size. In Europe, banks that have received public funds have been required to radically shrink their asset base and spin off businesses in order to become more competitive.

Consequently, we think any in-country (in-region) acquisitions of business units by major banks in Europe and the US would be the exception, and we expect the focus to instead be on global development outside of the home country/region. In this case, the
preference would probably be to further accelerate moves into emerging markets, which have both higher profit margins and a greater potential for growth than do the advanced economies.

Global development will also be critical in the transaction business, given that it has a strong infrastructural element that makes it easier to benefit from economies of scale, the global development of the client companies themselves needs to be accommodated, and there should be strong growth of trade and capital transactions involving emerging markets.

2) The simple structure required by bankruptcy resolution rules

The direction of the debate over new rules for crisis management and bankruptcy resolution of financial firms will have a major impact on how banking groups look for new businesses and develop internationally.

To prevent the possibility that the catastrophic failure of a major financial firm will spread contagion across the entire financial system, as occurred with the Lehman bankruptcy, individual financial institutions need to start formulating plans for recovering from crisis, as well as liquidation plans in the event of bankruptcy, when conditions are still normal. It is also important that regulators have the authority to achieve an orderly liquidation without having to inject public funds.

Structures in which functions critical to the economy and the markets cannot be completely fulfilled without all of multiple affiliates, as well as structures in which oversees operations are excessively dependent on liquidity and credit enhancement from the home country-based parent company, are vulnerable to contagion from a localized crisis. Consequently, regulators may require a shift to a less risky structural organization in the process of formulating and improving these plans, also known as living wills.

Although coordination between countries and the implementation of systemic infrastructure in a way that will allow orderly bankruptcy on a global basis is also under consideration as a way for cross-border financial institutions to weather a crisis, some observers think building an effective framework for that would be difficult, owing to the many challenges involved, including in deciding who bears the losses in the event of failure17.

Consequently, a priority may be placed on policies aimed at preventing the cross-border propagation of crisis, such as by the host country authorities requiring foreign capitalized banks that want to do business there to be self-sufficient; i.e. requiring that they maintain adequate levels of capital and liquidity within the country, and/or that

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the headquarters in the home country have the mechanisms in place to provide adequate backup\(^\text{18}\).

This would likely give an advantage to those major banks with the ability to establish highly independent global operations, i.e., set up local subsidiaries rather than branches and accept deposits and raise capital in the local currency\(^\text{19}\). This suggests the possibility of a major transformation in the way that financial institutions pursue global development.

3) The future of second-tier banks

Because second-tier banks are not subject to SIFI requirements and market share restrictions, they have room to expand their share of the market through in-country and in-region mergers. In this case, there are likely to be examples of banks still suffering from the financial crisis and banks bearing a heavy cost from reregulation being acquired by other banks that do not suffer from those problems to any significant degree.

In the US, bank holding companies with total assets of at least $50 billion are designated systemically important and subject to additional regulations. As already noted, it is conceivable that even those banks of considerable size not subject to SIFI regulations may feel compelled to voluntarily meet the additional requirements in order to improve their market valuations. Many of these regulatory costs have a fixed component, including reporting obligations, and thus the burden on second-tier banks is expected to be relatively larger than that on the major banks.

In December 2010, Canada's Bank of Montréal acquired US-based Marshall & Ilsley, a bank that evidently was just big enough to be subject to SIFI rules, which would have greatly increased its regulatory costs. The financial crisis had only a minor impact in Canada, where the major banks have remained financially sound and plan to take advantage of the opportunity to strengthen their presence overseas.

We expect to see more examples of second-tier banks engaging not only in domestic/in-region mergers but also in cross-border mergers.

\(^{18}\) If the host country requires a confirmed framework for comprehensive support from the head office in the home country in the event of a crisis at the overseas operation, it is conceivable that supervisory officials in the home country will closely monitor those risks, and demand that the head office not expose itself to excessive risk overseas.

\(^{19}\) If the home country is forced to provide assurances to the host country that the home country banks operating in the host country are sound and have comprehensive capital and liquidity backup in the event of stress, it is conceivable that in some cases it will be preferable to set up as a branch. This would likely be the case when large banks from fairly large countries with advanced financial supervision/regulations and ample support capabilities are setting up operations in countries with smaller economies and relatively less developed financial systems.
4) A changing environment for important operational bases that have already been established

Judging from the new crisis management and bankruptcy resolution rules on the horizon, it will probably become more difficult for banks to follow their traditional pattern when developing overseas of centralizing critical functions at operations in certain countries and having operations in other regions rely heavily on those functions.

In addition, note that the dynamics that determine which location is the more important operation will be different than they used to be. That being said, regulations are not going to be strengthened at the same pace throughout the world, and some countries, notably the UK and US, will likely try to implement more draconian rules. This reflects the anti-bank bias that has taken root in these countries.

We think the headwinds faced by banks will be especially strong in the UK. Prior to the financial crisis, the UK took a fairly flexible approach to financial regulation and supervision, and London had come to be viewed as the world's premier international financial center. Because of the financial crisis, however, major banks were bailed out with public funds, Northern Rock and other second-tier banks became a source of turmoil, and the failure of Lehman Brothers' local subsidiary in London also caused some substantial disruptions.

The coalition government combining the Conservative and Liberal Democrat parties that took office in May 2010 pledged to take a hard line with the banking industry, as well as disband the FSA and give banking supervision authority to the Bank of England (BoE). BoE Governor Mervyn King and other top executives with the central bank started leveling harsh criticism at banking practices to date. For example, Andy Haldan, Executive Director for Financial Stability for the BoE, commented that stronger regulations would be worth it even if they drive some high-risk financial institutions out of the UK.\(^\text{20}\)

This view is echoed by the FSA, which is scheduled to be disbanded in 2012. Lord Turner, the FSA's Chairman at the height of the financial crisis, published his Turner Review arguing for radical changes to the financial regulatory and supervisory regime in March 2009, and that report has had a major influence over the subsequent debate on financial reregulation.

5) The realities of the anti-banking bias in the UK

The British Bankers' Association was tasked by the Ministry of Justice to report on whether the UK's regulations are stricter than elsewhere, and it delivered that report along with a cover letter to the Chancellor of the Exchequer George Osborne in

\(^{20}\) He said this in a BBC interview on December 18, 2009.
January 2011\textsuperscript{21}. That report identified the following items as having particularly adverse impacts.

- The UK applies minimal capital requirements to each bank in a group, as well as on a consolidated basis.
- Investments in subsidiaries are deducted from capital.
- For credit exposures to derivatives subsidiaries and other group companies, deductions from risk assets are limited to 25% unless the group holds 100% of the voting rights in, and has signed a capital support agreement with, the counterparty, and the counterparty is a UK company.
- The Basel III liquidity coverage ratio allows US agency bonds and covered bonds to be included in liquid assets (level 2 assets), but UK rules do not.

In addition, the UK introduced the bank tax mentioned previously before other countries and decided to raise the tax rate in both 2011 and 2012. In addition, the ICB proposed introducing a heavy capital surcharge on SIFIs in its interim report.

In addition to these specific regulations, the rampant anti-bank sentiment in the UK that is behind these regulations has heightened concerns in the UK's banking sector. In February 2011, the government and four major banks concluded Project Merlin, an initiative aimed at avoiding unnecessary conflict between the UK government and the banking sector, by announcing an agreement, which included a commitment by the banks to do the following.

- Write £190 billion of new loans to nonfinancial companies in 2011, versus £179 billion in 2010, of which £79 billion would go to SMEs, versus £66 billion in 2010.
- The performance evaluations of the CEO and other executives will reflect success in lending to SMEs.
- The results relative to targets of the above-noted new lending will be reported to the Bank of England quarterly.
- An additional £1.2 billion of support for regional economies and the "Big Society."\textsuperscript{22}
- The total size of the bonus pool paid to the four banks' UK-based employees in FY2010 will be less than that paid in FY2009.

This exacting of promises regarding actual numbers for compensation and lending volume could be viewed as excessive intervention beyond imagination based on the UK's stance on financial regulation thus far.

\textsuperscript{21} See Freshfields Bruckhaus Deringer, "UK Banking Regulation- Level Playing Field Issues."
\textsuperscript{22} The "Big Society" is a concept posed by Prime Minister Cameron to rely primarily on charitable organizations and social enterprises for social policies.
The ICB is scheduled to release its final report in September. The ICB was formed to implement the new government's anti-banking promises, and the interim report it released in April proposes spinning off retail banking to a group banking subsidiary with sufficient capital. The banking sector was relieved that the proposal was fairly moderate, since some had expected the proposal to be for the complete separation of wholesale and retail, but others criticized the proposals as not going far enough, and it will be interesting to see what the final report has to say.

There is of course concern, even among politicians, that the financial sector, a key component of the UK's economy, will become less competitive. Nevertheless, the ICB sees it as a problem that in the UK bank assets account for the highest percentage of GDP of the 19 major countries, and wants to see an industry structure that is not overly dependent on the financial sector. It will probably be difficult for the UK to achieve this objective and still maintain its position as the world's top international financial center.

6) The situation at other major financial centers

There are other countries besides the UK that are implementing their own fairly harsh bank policies.

As already noted, Switzerland is requiring its two big banks to meet a higher standard than Basel III. This can be attributed to the fact that the two banks combined have assets over four times Switzerland's GDP, and to concerns that excessive risk taking by the two banks could have a huge negative impact on the entire nation.

In the US, some fairly harsh regulations not seen in other countries have been implemented as a reaction against the government's bank bailouts, including the Volker and swap pushout rules and ceilings on debit card fees. Nevertheless, the political situation in the US is fairly contentious, pitting the Republicans and their dislike of government intervention against the Democrats now in control of the White House. The Republicans are currently asking for various changes in the legislation related to the Dodd-Frank Act that is now being drawn up. This is likely to result in some rules being made more realistic than as originally conceived.

The FRB approved the resumption of dividend payments by some large banks in early 2011. This provides further evidence that US financial regulators will take a realist position in dealing with the banks, in contrast with the UK, where there remains substantial regulatory uncertainty and where the banks have expressed dissatisfaction with the competitive disadvantage they have been placed in when raising capital. Even some Republican lawmakers in the US appear to have concluded that they lose votes by going easy on the banks, and opposition to tighter regulations is not necessarily that strong.

As of 2009, the UK, the Netherlands, Switzerland, and Sweden all had aggregate domestic banking assets in excess of 400% of their GDP.
Thus with banks in Europe and the US, where the financial crisis began, still facing headwinds, financial centers in the still developing world, particularly in Singapore and other Asian financial centers, are gaining a stronger presence. This is because, in addition to already offering high growth and ample business opportunities, their government policies aimed at national prosperity place a premium on developing the financial sector. As shown below, some financial institutions have been expanding their business in Asian and other emerging markets.

4. Recent moves to reshape businesses

1) Examples of changes to trading businesses

In anticipation of the Volker rule, a number of US banking groups began shrinking their proprietary trading desks and hedge fund-related services around the summer of 2010. With the employees from those businesses moving over to a hedge fund or going independent and starting their own fund, Goldman Sachs announced a clear plan for organizational changes.

Its Business Standards Committee proposed reorganizing its business from three divisions—Investment Banking, Trading and Principal Investments, and Asset Management and Securities Services—into four—Investment Banking, Institutional Client Services, Investing and Lending, and Investment Management. It eliminated the words "trading" and "principal investments" (proprietary trading) from its organizational chart, spun off that portion of trading for clients into Client Services, and put trading on its own account under the banner of "Investments and Lending" so as not evoke any images of short-term trading.

In 2010, the Institutional Client Services division generated the most net income at $21.8 billion, followed by the Investing and Lending segment at $7.5 billion, Investment Management at $5 billion, and Investment Banking at $4.8 billion.

The biggest contributor of profits within the Investing and Lending segment was the Special Situation Group, which was responsible for buying cheaply securities issued by firms with poor credit and then improving the business so as to profit from price appreciation. This is essentially a proprietary trading desk that specializes in distressed investments and trades like a hedge fund. Although this could be interpreted as a loan rather than short-term trading, it will be interesting to see whether the rules now being considered and later administrative rulings will approve such activity if the Volker rule is implemented.

24 For more about that committee and its proposal, see Yuta Seki, "Gourudoman Sakkusu ni okeru Gabanansu Kaikaku no Torikumi" (How Goldman Sachs is dealing with governance reform), Winter 2011 edition, Capital Market Quarterly (in Japanese).

2) Examples of a greater focus on retail banking

Among banks in continental Europe, the most impressive strategic turnaround has been by Deutsche Bank. Since before the financial crisis, Deutsche Bank has been using a high degree of leverage to actively engage in the trading and derivatives business, to the extent that it started being referred to as a hedge fund with a banking license. Another reason that Deutsche Bank focused on the wholesale side is that the second-tier and smaller banks owned a large share of Germany's retail banking business.

Deutsche Bank has been undergoing a major transformation in its approach since the financial crisis, however. Within the Corporate and Investment Banking group division, it has strengthened its Global Transaction Banking division, and its Corporate Banking and Securities division (which includes trading) has emphasized limiting risk, and has hedges on many of its positions. It has the top global share of the Forex trading business, and it is structured such that the portion of trading that fits the mold of traditional banking services contributes greatly to profits.

Of even more interest is that management has put together a plan to make its earnings less sensitive to wholesale profits by strengthening its more stable retail banking and asset management businesses and crafting a more balanced revenue structure. It has also announced that it will make retail banking another strong pillar alongside investment banking26.

Under this plan, it made acquisitions in 2010 of Sal. Oppenheim, one of Germany's top private banks, and of Postbank, the largest retail bank in Germany. It also acquired ABN Amro's commercial banking business in the Netherlands.

3) Changes in UK headquarters and operations

There have been persistent rumors that the leading UK banks may move their headquarters outside of the country, based on their dislike of the UK's relatively restrictive regulations.

HSBC was founded in Hong Kong in 1865, but moved its headquarters from Hong Kong to London at the behest of the Bank of England in 1992, when it acquired Midland Bank. The pending return of Hong Kong to China in 1997 may also have played a part in the decision to move.

Today, however, the Asian region accounts for 30% of HSBC's risk-weighted assets, and nearly 40% of its pretax profits.

HSBC reconsiders the best location for its headquarters every three years, and will do so in 2011, which has probably invited speculation that it may decide to move. In March 2011, both the Chairman and the CEO indicated plans to stay in London, and then retracted that plan, but they also noted that because of the bank tax and possibility of regulatory changes, they have been getting a growing number of

inquiries from investors and shareholders about the additional costs that would be incurred from keeping the headquarters in the UK.

There were also reports (denied by management) that Barclays Group considered moving its headquarters from London to New York,\textsuperscript{27} because capital requirements for SIFIs in the UK are expected to be demanding and the group may be required to spin off businesses depending on the direction of debate at the ICB, and also because Barclays Capital has heavy exposure to the US banking business, partly as a result of its acquisition of Lehman's US operation.

Standard Chartered Bank is headquartered in London, but primarily does business outside of the UK, in part because its predecessors were Standard Bank, which opened its first branch in South Africa in 1863, and Chartered Bank, which began business in 1858 with branches in Calcutta, Bombay, and then Shanghai. It currently earns 30\% of its profits from Hong Kong, and because of its business structure, there are always questions about what it will do with its headquarters.

If there is a change in the policy of UK regulators toward the financial industry in the direction of making the regulatory burden more onerous, we expect it would increase pressure from shareholders and may at some point force bank management into a decision that makes economic sense.

4) Focus on emerging markets in Asia and elsewhere

HSBC and Standard Chartered have always had their focus on Asia and other emerging markets, but with the regulatory environment becoming increasingly unfriendly in Europe and the US, the other major banks are also starting to focus more than before on Asia.

The Asia-Pacific ex-Japan has become an increasingly important area for the investment banking business, and in 2010 accounted for close to 20\% of all investment bank earnings, which have been declining in Europe and the US since 2008\textsuperscript{28}. UBS has led the way in generating investment bank earnings in Asia-Pacific ex-Japan, followed by JPMorgan, Credit Suisse, and Goldman Sachs, while the battle to win deals and hire talent is getting more and more competitive. At UBS, the co-head of investment banking in London moved to Hong Kong in 2010 to share responsibility for the Asia-Pacific business, and commented that UBS would expand personnel in China from the current 500 to 1200 over the next five years.

Asia is also attracting attention on the retail side, which has seen particularly strong growth in business with the wealthy. The Swiss banks, whose forte is wealth management, are moving aggressively into Asia. They are being further pushed to do so by the reregulation occurring in their home country, as well as the exodus of their private banking clients. The latter can be attributed to the banks having been forced to compromise in providing information in recent years, in response to criticism from the

\textsuperscript{27} "Will Barclays Turn its Back on Britain?," Wall Street Journal, March 30, 2011.
\textsuperscript{28} "Asia's foremost deal machine UBS risks running out of steam," Financial Times, March 23, 2011.
US and other countries that their commitment to banking secrecy, a Swiss tradition, has allowed rampant tax evasion.

UBS has been strengthening its Singapore-based wealth management business, and aims to increase its number of advisors from 900 currently to 1,200 over the medium term. At Credit Suisse, Asia-Pacific accounted for over 5% of group-wide earnings in 2010, and it plans to raise that percentage to about 25% over the next three to four years29.

Of the banks in continental Europe, a key pillar of Deutsche Bank’s management policy after the financial crisis, in addition to the previously mentioned strengthening of retail banking, is to strengthen its presence in Asia, and it plans to double both revenue and profits between 2008 and 2011.

Among the US banks, Goldman Sachs, which is still focused on the wholesale business albeit not under the trading moniker, has applied for a commercial banking license in India, and also acquired a mutual fund company there. It thus appears to be including the retail business in its expansion plans in order to benefit from Asia's high growth.

IV. The financial system's medium- to long-term outlook

1. The emergence of simple, traditional, yet large banks

To summarize our arguments thus far, we think it is possible that the downward pressure on profitability caused by reregulation may result in the emergence of large banks capable of pursuing business opportunities globally. The importance of being able to raise capital also suggests that large banks capable of accessing sources of funding globally will have an advantage. Such banks will also be able to achieve economies of scale in the global transaction business.

We think it only natural that country regulators will become more concerned over the risks of banks developing financial services in the country while relying too much on the resources of specific operations in other countries, and consequently expect global development to follow a multi-polar, distributed pattern based on developing independent operations, rather than a uni-polar, dependent pattern in which each function of the global network is centralized. Complex group structures with various interlocking dependent relationships between operations and corporate entities will need to be transformed into simple structures.

In addition, there will probably be less business development in countries like the UK and Switzerland that implement regulations that are more demanding than those in other countries. Overall, financial firms based in countries with a large real economy have an advantage in that they face no major constraints on their process of expanding and globalizing.

Our focus thus far has been primarily on banks in the advanced economies, but as we show below, these changes in the operating environment may lead to the emergence of players that are not banks and not from the developed world.

2. Independents and firms not affiliated with banks are attracting attention, but they also have weaknesses

Of interest in the securities industry is the emergence of independent entities in a number of different areas following the financial crisis. In the area of financial product sales, the large firms have been criticized for the losses they caused in the run up to the financial crisis from selling complex financial products to individuals and to unsavvy corporate customers. The conflict of interest created when these large firms sell their clients products that they have shorted in their own accounts has also become an issue. It is within this context that independent financial advisers have started attracting more attention.

The rise of independent firms in the investment banking business has also been in the spotlight, as both customers and employees have begun abandoning the large investment banks as a result of an increase in large losses, conflicts of interest, and the acquisition of investment banks by the major banks. Restrictions on compensation at the major firms also appears to be causing an exodus of talent.

In the US, it was newsworthy that boutique investment banks like Evercore, Greenhill, Lazard, and Perella Weinberg were involved in four of the five big deals concluded in Q1 2011. In Europe, as well, firms like Lazard, Rothschild, and Perella Weinberg that specialize in M&A advisory increased their share of M&A fees from 26% in 2008 to 37% in 2010.

The independent financial firms that are not affiliated with a bank (including those that are not independent investment banks; we discuss hedge funds below) have an advantage in that they are not subject to the Basel rules or other regulations that banking groups must comply with.

In the US, while the major independent investment banks were disappearing, the second-tier investment bank Jefferies doubled in size since the financial crisis. John Corzine, the former Goldman Sachs Chairman who in March 2010 was appointed Chairman and CEO of MF Global, a leading futures and options broker, announced plans to transform the company into an investment bank, and secured primary dealer status for the US market in February 2011.

The firms affiliated with the major banks can counter the rising independents and firms not bank-affiliated with their ability to provide globally and comprehensively

30 For example, see "Merrill Lynch loses more bankers to a 'Boutique'," Wall Street Journal, April 15, 2009.
32 "Boutique firms grab record share of European merger advice fees," Bloomberg, April 5, 2011.
coordinated services, although the level of resources actually dedicated to this sector varies with each firm. While there are some, like Citigroup, that have effectively pulled out of the securities business, there are others like the Bank of America, which aims to deepen its client relationships with clients by integrating the strengths of its commercial banking business with its acquisition Merrill Lynch's strengths in the brokerage business.

It is important to note that there are some areas where the independents and firms not affiliated with banks do not necessarily have an advantage over the bank-affiliated firms.

One of these areas is "tying" deals by the firms affiliated with major banks. Since repeal of the Glass-Steagall Act, the independent investment banks have complained about the affiliated securities firms' expansion of their investment banking businesses using the influence that the banks have over corporations via their loans to them. Now that the major independent investment banks have become part of banking groups they no longer represent a powerful opposing force, while the banks have been focusing on the deposit/lending business and at the same time are under pressure to raise that business' profitability. This creates the possibility of an increase in "tying deals."

In the US, banking groups have access to the FRB's discount window and are also covered by FDIC guarantees. Firms that are not affiliated with banks are not provided with this safety net, while at the same time there is a possibility that the regulation of shadow banks will be tightened. Furthermore, both the independents and other firms without bank affiliation would be subject to heavier regulation if they grow large enough to be designated as SIFIs.

In light of this, the independent and without-bank-affiliation financial firms that emerge may primarily be those that do not become large enough to be designated as SIFIs and that focus on businesses that do not have a large mismatch between assets and liabilities in terms of maturity, liquidity, and credit.

3. Funds are gaining a larger presence

Apart from a few very large funds that could be designated as systemically important and funds that pursue an extremely highly leveraged strategy, most hedge funds are exempt from Basel rules, the Volker rule, and restrictions on compensation,
and thus may increase their presence by engaging in the trading business and supplying risk money.

As already noted, the possibility of a relative decline in risk money supplied by the banks, insurance companies, and pension funds, combined with the banks becoming less able to obtain funding from outside the financial sector, could help these funds gain a larger presence.

If the supply of risk money from existing institutional investors shrinks, there is also a possibility that those investors will invest less in funds, but we think what is likely to happen first is that the desire for a better risk-return characteristics will cause them to increase the share of their portfolios in alternative investments.

Likewise, the funds will probably start putting more emphasis on their relationships with sovereign wealth funds and wealthy individuals, including those in emerging markets, rather than depend only on existing suppliers of risk money. Because the EU also regulates funds heavily, it is conceivable that the hedge funds will start looking at emerging markets in Asia and elsewhere as a base of operations.

We also think that the sovereign wealth funds may become increasingly important as the direct providers of risk money for various investment opportunities, rather than as purely a source of money for the funds.

4. Emerging market financial firms are becoming major players globally

It is also possible that leading financial groups from emerging markets, rather than financial firms in the advanced economies, will emerge as leading global financial institutions.

By 2009, there were already four banks from China ranked among the world's top 25 based on assets, while in the ranking based on pretax profits there were five banks from China and three banks from Brazil (Figure 2).

The number of banks from Asia (ex Japan) among the top 1000, which was only about 100 in 1990, is expected to reach 300 by 2020, which would be more than both Europe and the US. The number of banks from the BRICs countries, 33 in 1990, is expected to reach 190 by 2020, higher than the number from the US. Banks from China, India, and Russia are expected to account for most of this growth (Figure 3).

In addition to having higher economic growth rates, many emerging markets have placed a priority on developing their own financial centers and are trying to strategically strengthen their financial industries, a sharp contrast with the anti-bank bias and financial sector-unfriendly policies in the advanced economies of Europe and the US. This should further fuel the transformation of emerging market financial firms into stronger and more savvy market participants.

In fact, the history of the major financial groups in the advanced economies has been less of a story of a continued rise of the historically more advanced major financial groups and more a story of second-tier financial groups in ostensibly less
advanced and peripheral countries developing into new powerhouses via their effective acquisitions of the majors.

In the US, the mergers of Bank of America with NationsBank in 1998 and JPMorgan Chase with Bank One in 2004 were both examples of industry consolidation in which the brand of the money center bank's brand survived, but the supra-regional bank took management control.

Figure 2: The top 25 world banks (2009)

<table>
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<tr>
<th>Rank</th>
<th>Bank</th>
<th>Country</th>
<th>Assets (bn)</th>
<th>Pretax profits ($)</th>
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<td>BNP Paribas</td>
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<td>17</td>
<td>Societe Generale</td>
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<td>18</td>
<td>China Construction Bank Corporation</td>
<td>China</td>
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<td>Italy</td>
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<td>UBS</td>
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<td>Agricultural Bank of China</td>
<td>China</td>
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Source: The Banker, July 2010

Figure 3: Geographical distribution of the top 1000 world banks

Note: The asterisk (*) indicates estimates.
Source: The Banker, July 2010
In Europe, Hong Kong-based HSBC had already acquired Midland Bank, one of the UK's Big Four banks, by 1992. In addition, banks in Spain and Italy, which had already been consolidating and strengthening domestically as the European Union project moved forward, wound up either acquiring traditionally powerhouse banks in the UK and Germany or growing to rival them in power.

Examples include Italy's UniCredit, which acquired Germany's second largest bank, HypoVereinsbank (HVB) in 2005, and Spain's Santander, which acquired Abbey National, the UK's sixth largest bank, in 2004.

While Santander was growing via mergers with domestic banks, its aggressive pursuit of market share in Latin America has resulted in its business in that region growing to account for roughly half of its total profits. It has also moved into the UK market.

Even after the financial crisis, Santander acquired in the UK the mortgage lender Alliance & Leicester, a portion (the deposit and branch network) of the nationalized second-tier bank Bradford and Bingley, and in 2010, the RBS branches in England and Wales.

These examples in the US and Europe could be seen as evidence of a pattern in which previously powerful banks weakened by intense competition in mature and highly efficient markets are taken over by newcomers that accumulated their war chests in peripheral countries. Assuming the same dynamics at work, it is possible to see a future in which financial institutions from China, Brazil, and other emerging markets effectively wind up controlling the powerful financial groups of the developed world.

V. Conclusion

This paper has considered the mechanisms through which future reregulation could transform the financial system over the longer term. Figure 4 presents a summary of this.

It is frequently noted that reregulation of the financial sector will push bank earnings lower and lending rates higher, but these are the short-term, direct impacts. The banks facing downward pressure on their earnings will naturally seek to change their businesses so that they can increase their earnings within the bounds set by regulations, and thus bank earnings may not decline after all. If the banks' lending rates increase or bank services decline as a result of deleveraging or various direct regulatory impacts, customers will seek other sources of funding and other financial service providers. This may lead to the emergence of other financial business models, and may in turn moderate the negative impacts on economic activity from regulation.

For a detailed history covering the major financial institutions, see Yasuo Ota, "Guroubaru Kin'yuu Seibou Sanjuunen" (Thirty years of offense and defense in global finance), Nihon Keizai Shimbun-sha, 2010 (in Japanese).
Any offsetting of these regulatory impacts would be a result of the various economic agents changing their behavior, however, and would thus hasten the transformation of the banking sector and the overall financial system over the long run.

Consequently, even if the obvious costs of regulation are absorbed, the more important question for the longer term is whether regulation makes the financial system more stable and less susceptible to crisis, according to design, and whether it also makes it substantially less efficient.

This paper has been focused on forecasting what the future could look like, without trying to judge whether that future is an improvement over the current financial system. Making such a judgment would be difficult, because, as we have shown, reregulation will, through various channels, change the nature of the financial institutions being regulated, the behavior of users, and the positioning of those providers not subject to regulation.
One thing that can be said about the substance of the current drive toward reregulation is that because it is weighted toward soundness on a micro level, i.e., the soundness of individual financial institutions, it probably makes it harder to project the future. Pursuing the soundness of individual financial institutions can very easily lead to unintended consequences, such as having a procyclical effect on the system as a whole and encouraging the growth of nonregulated sectors.

The pursuit of regulations with a traditional weighting on micro soundness has been identified as a problem since the outset of the latest financial crisis, and it has been argued that a framework that encompasses the entire system and is oriented toward achieving macro soundness is needed, but there has not been adequate progress in making such changes\(^{39}\).

It is desirable to get away from this excessive reliance on policies oriented toward micro-level soundness with their uncertain effects, and to instead pursue financial system stability by implementing policies aimed at macro soundness and making more nimble use of regular monetary policy. It is also important to make this happen while avoiding the negative impacts of reduced financial system efficiency and distorted financial institution behavior and competitive conditions. If this can be achieved, it may be possible to realize a future for the financial sector that is different from that picture painted above.

\(^{39}\) One result has been the introduction of countercyclical buffers in Basel III. Most of the details are left to the discretion of each country, however.