Special Report
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Financial Services Focus
Freeman & Co. LLC

Indices at July 31, 2012

DJIA	13,009
NASDAQ	2,940
S&P 500	1,379
FTSE 100	5,635
10-yr US T-Bond	1.469%
USD per GBP	$1.57
USD per Euro	$1.23

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Global Financial Institutions Operate Under New Business Parameters

Over the past several years, factors driving the decision making processes of global financial services firms have changed dramatically. Pre-crisis, the main drivers were firm capabilities (franchise) and market opportunities. Post-crisis, the regulatory environment increasingly dominates the decision-making process, especially for bank holding companies. Ultimately, we expect firm capabilities to regain their prominence in the process over the next decade, but in the near-to-medium-term, regulators will continue to influence business decisions in banking as a consequence of the implementation of Basel III and the Dodd-Frank Act.

This special report will review where we are currently and the immediate implications to decision making, and will explore the potential longer-term effects of the changes wrought by the new regulatory environment.

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I. Background: What is Basel III?

The Basel Committee on Banking Supervision, which consists of members from 27 countries from Europe, Asia, Africa and the Americas, is deliberating on the final form of Basel III. The regulations will affect all large banking entities in the G20 countries and likely beyond those formally participating countries. Basel III will be phased in starting in 2013, with the goal of being fully implemented by 2019. The Committee, charged with improving the supervision of financial institutions, decided to implement new standards following the financial crisis to resolve perceived deficiencies in Basel II. It identified lax regulation and inadequate capital requirements as causal factors in the crisis. Basel's framework starts with the following formula as the foundation for strengthening financial institutions' ability to weather market downturns by curbing leverage, improving liquidity, and discouraging them from investing in risky assets.

$$\frac{\text{Eligible Capital} \downarrow}{\text{Risk Weighted Assets (RWA)} \uparrow} \quad \text{and} \quad \text{Equity Capital Ratio Requirement} \uparrow$$

In the capital ratios formula, requirements under Basel III will be significantly stricter in both the numerator and the denominator, causing banks to both increase core capital levels and shed risky assets in the near term, and subsequently raise capital in the future any time the balance sheet expands.

Basel III modifies the three pillars established in earlier Basel accords as follows:

1. **Pillar I: Capital** - *a comprehensive set of minimum financial ratios to increase capital buffers for potential losses related to risky assets.*
   - Higher Tier I capital requirements, plus additional common equity buffers and a variable countercyclical buffer based on market factors.
   - Higher capital requirements for securitizations and trading activities and a more conservative, non-risk based leverage ratio that includes off-balance sheet exposures.
   - Special requirements for Global Systemically Important Financial Institutions ("SIFI"s), as determined by the Committee (i.e. higher Tier I capital requirements).
2. **Pillar II: Risk Management and Supervision** - *requires firms to manage concentration risk, establishes valuation practices and encourages compensation plans that minimize principal/agent conflicts.*
3. **Pillar III: Market Discipline** - *requires enhanced disclosures on components of regulatory capital and the calculation of regulatory ratios.*

Additionally, Basel III addresses concerns over banks' liquidity. It introduces a liquidity coverage ratio ("LCR") to determine compliance with the requirement that banks have enough liquid assets to withstand 30-day stress tests. Another ratio it introduces is the net stable funding ratio ("NSFR"), calculated as long term funding sources divided by long term assets, which must be greater than 100%.

	Capital Requirements (as % of Risk Weighted Assets)						
	Common Equity			Tier 1 Capital		Total Capital	
	Minimum	Conservation Buffer	Required	Minimum	Required	Minimum	Required
Basel II	2.0%	0.0%	0.0%	4.0%	0.0%	8.0%	0.0%
Basel III	4.5%	2.5%	7.0%	6.0%	8.5%	8.0%	10.5%

Source: BIS

II. Implications: Paradigm Shift in Strategic Business Decision Making Processes

Basel III will usher in a paradigm shift in banks' strategic decision making process. Pre-crisis, the evaluation of strategic decisions (identifying which business lines a bank should consider entering, exiting, growing or diverting) were based on two main factors – a firm's franchise and capabilities in or around the particular business and the market opportunities in relation to the firm's client base.

Post-crisis (and importantly, post-Basel III implementation), that decision matrix is significantly altered. Questions regarding the effects on capital (Tier 1 capital, common equity, etc), risk weighted assets and liquidity are becoming significantly more important under the new regulatory guidelines.

Previous Decision Making Paradigm	New Paradigm = New Questions
• Do I have a strength in this product area? • Do I serve the target client base or need to expand client coverage? • Can I access the proper talent to grow/enter this business? • Does the market opportunity provide for a reasonable expected return on investment?	• Does entering/growing this business result in deductions/adjustments to my Tier 1 capital? • Does it cause an increase in my risk weighted assets? • How does it fit in my counterparty and general risk management framework?

Furthermore, a poor macroeconomic environment is providing additional headwinds to client businesses. This topic has been discussed ad nauseum recently, but we feel it is worth summarizing the impact of the economy on investment banks:

Investment Banking	Institutional Sales & Trading
• CEOs and corporate boards are stymied by macroeconomic, political and regulatory uncertainty resulting in a lack of conviction and catalysts for M&A activity	• Hedge funds and institutional long only funds have negative inflows in equities and are continuing to deal with flows out of risky assets • Securitization has fallen drastically from '07 highs
Retail Brokerage	**Lending**
• Slowdown in volumes and fee/commission compression has damaged revenues • "Risk-off" environment has remained as investors sit on the sidelines	• Macro deleveraging post-crisis has decreased demand while increasing credit standard has depressed loan volumes • Increased capital requirements and focus on counterparty controls

Basel III and other Regulatory Changes – Business Affected

Due to the increases in capital requirements, compounded by extensive changes in risk weighted asset ("RWA") calculations, we have seen, and will likely continue to see, a vast reduction in the balance sheets of banks and reduced capital and personnel commitments in several business areas. The following page contains a summary of Basel III's RWA guidelines.

Risk Weightings under Basel III

Item	Required Factor[1]	Item	Required Factor[1]
• Cash • Short-term unsecured, actively traded instruments • Securities with remaining maturity <1yr	0%	• Other loans to retail clients and small businesses having a maturity <1yr	85%
• Debt issued or guaranteed by sovereigns or central banks	5%	• All other assets	100%
• Unencumbered non-financial senior unsecured corporate bonds and covered bonds rated at least AA-, and debt that is issued by sovereigns, central banks, maturity ≥1yr	20%	• Off Balance Sheet Exposures: undrawn amount of committed credit and liquidity facilities	5%
• Unencumbered listed equity securities or non-financial senior unsecured corporate bonds (or covered bonds) rated from A+ to A-, maturity ≥1yr • Gold • Loans to non-financial corporate clients, sovereigns, central banks, and PSEs with a maturity <1yr	50%	• Securitizations / Resecuritizations ▪ AAA to AA- ▪ AA+ to A- ▪ BBB+ to BB- ▪ BB+ to BB- ▪ Below BB-	 20% /40% 50% /100% 100% /225% 350%/650% Deduction
• Unencumbered residential mortgages of any maturity and other unencumbered loans	65%		

(1) The market value of an asset is used in the RWAs calculation

III. Reduced Scale of Select Businesses

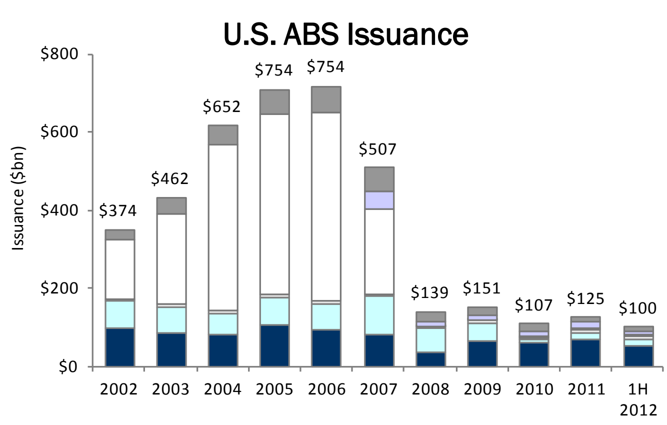
1. Securitization and Credit Correlation Businesses

- Goldman Sachs has formally announced that they have begun to reduce exposure to the securitization and credit correlation businesses – for example, Goldman Sachs had $173 billion in assets in credit correlation and mortgage securitization at the end of 2011. The firm plans to reduce that number by $88 billion in four years.[1] Similarly, Deutsche Bank plans to reduce RWAs to meet its capital goals instead of issuing equity. We feel that all the other global financial institutions will follow down the same path.

(1) Dow Jones, 5/31/12

- **Securitization**
  – "Skin in the game" rules under Dodd-Frank require issuing banks to retain a 5% interest in each tranche of a securitization.
  – On-balance sheet treatment of Structured Investment Vehicles ("SIVs") may trigger Systematically Important Financial Institution ("SIFI") designations and thus even higher capital requirements.
  – The ABS market has not recovered from the financial crisis and remains at 10 year lows.

- **Credit Correlation**
  – High RWA factors cause high capital charges for credit correlation assets, resulting in lower ROEs.
  – Enhanced supervisory review processes for risk management are intended to prevent banks from investing in higher yielding, riskier assets.
  – Volcker Rule limits proprietary trading to 3% of a bank's Tier I capital, although enforceability is limited by the difficulty in distinguishing between hedging, market making and proprietary trading.



Source: BIS, SIFMA

2. Other Businesses

- **Derivatives**
  - Dodd-Frank may add credit exposure from derivative transactions to banks' lending limits.
  - Basel III will require additional collateral for OTC derivatives that aren't transacted through a qualifying central clearinghouse.
- **Mortgage Servicing**
  - Banks are likely to monetize mortgage servicing rights ("MSRs") through sales to entities that do not fall under the purview of Basel III, as MSRs will be deducted from Tier 1 capital. These sales will have the additional benefit of enhancing liquidity.
- **Securities Lending and Repos**
  - Basel III increases capital requirements for counterparty credit risk for most of these products in order to encourage banks to seek longer-term financing.

IV. Shift Back to Customer-Focused Businesses is Necessary

Given the aforementioned shifts in business dynamics, we see a return to corporate advisory and problem solving re-taking a priority role at the successful global universal banks of the future.

The bank loan market is likely to contract following Basel III implementation, as all assets will require additional equity capital, and leveraged loans will be heavily risk weighted. Therefore, corporate issuers will need to resort to the capital markets more often for financing.

- **Equity Issuance:** Corporate issuers should re-equitize as the world's financial system is deleveraged – and may be forced to if bank loan markets contract. In addition, investment banks will generate additional underwriting fees from equity issuance. In light of Basel III, sizeable increases are needed in Tier 1 capital, due to inadequate levels of such capital in banks' current capital structure and increased risk weightings that are applied to assets.
- **Debt Issuance:** While the large global corporations will return to issuing equity, we think that traditional bank leverage will increasingly be replaced by debt capital markets issuance. In addition, investment banks will also benefit from a spike in long-term corporate debt issuance. Under Basel III, banks need to fund themselves with increased longer duration liabilities and will reduce exposure to shorter term funding such as asset-backed commercial paper ("ABCP").
- **Lending:** Consumer and corporate lending have both been cut back since the crisis. There is no doubt that there is a reduction in overall demand for credit as governments and consumers slog through the deleveraging process, but corporate credit demand remains robust and supply has been curtailed. Banks are raising lending rates to adjust to new profitability hurdles and directing new business toward less risky clients. As previously mentioned, capital markets activity will pick up and replace some of the reduced lending. There are also other alternative products and sources of funding that may become more prevalent:
  - Investment banks will continue to lend directly to corporate clients, but such loans will require collateral in the form of receivables and other assets. Because this lending will be collateralized, issuance levels will be lower than those of the bank loan market historically.
  - Investment banks may increasingly assume an intermediary role by facilitating lending between corporate clients and sources such as hedge funds, pension funds, insurers and smaller regional banks.

- **M&A:** Basel III is likely to spur higher levels of M&A activity within the financial services sector by creating a "sweet spot" for bank size. Large banks will seek to avoid the SIFI designation with its attendant requirement of higher levels of equity capital by divesting of subsidiaries and assets, while small banks will prefer more assets to enhance the scalability required to support a higher regulatory burden. M&A advisory should also pick up as general corporate clients scale to tap the public markets more efficiently.
- **Derivatives:** As derivatives are placed on exchanges following both Dodd-Frank and Basel III, investment banks' clearing business will have the opportunity to generate clearing fees. Additionally, the heightened transparency resulting from the use of central counterparties and requirements of cash or near cash collateral for certain derivatives transactions will mitigate counterparty risk and increase liquidity. In so doing, Basel III and Dodd-Frank may have the unintended effect of expanding the use of derivatives. Furthermore, the creation of Qualified Central Counterparties ("QCCPs") may have the unintended consequence of increasing systemic risk, as QCCPs would be "too big to fail."

V. Final Thoughts

The imposed requirements of Basel III and Dodd-Frank put all bank holding companies under new constraints in running many aspects of their businesses — several methods that banks have used in the past to boost leverage and returns are being regulated out — or the loopholes have been closed, depending on your viewpoint. For example, under Basel III, the list of items that are either going to be deducted from Tier 1 capital or weighted heavily as risky assets read like a laundry list of major revenue drivers for banks from 2003-2007: mortgage servicing rights, cash flow hedges, off-balance sheet vehicles, securitizations and repurchase agreements.

While much commentary has focused on how these regulations will lower ROE in the immediate term, we believe that long-term effects will be more muted. As the global financial system delevers, asset yields will necessarily increase, and, long-term, ROEs should normalize. Additionally, equity investors seek attractive risk-adjusted returns, and the regulations will decrease banks' earnings volatility. So, while ROEs will decrease in the short to medium term, bank stocks may be attractive to investors on a risk-adjusted basis after a period of adjustment.

For all these reasons, we ask several questions about the future of the competitive landscape:

- Are we likely to see firms that were once pure investment banks shed their bank holding company status to avoid regulation?
- Will we see the reversal of the commercial bank/investment banking combinations that took place following the weakening of the Section 20 Federal Reserve firewalls in the late 1980s/early 1990s and the ultimate repeal of Glass-Steagall in the late 1990s?
- Will middle market investment banks, with fewer burdens of regulation, experience growth that outpaces the growth at the global banks?
- As regulators attempt to close loopholes (for example, Basel's designations of certain firms as SIFIs based on asset size), will the industry find additional loopholes in which to operate? Or will all competitors realize that exemptions from regulation are fragile and fleeting?

We will close with a quote from former Citigroup Chairman & CEO Sandy Weill: "Creativity, ingenuity and the brain power of people is more important [in financial services firms] than a big balance sheet." *(CNBC Interview July 25, 2012.)* Whether this leads to a drastic separation of global banks from their broker-dealer operations still remains to be seen, but a legitimate debate will continue.

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