GLOBAL FINANCIAL REGULATORY LANDSCAPE OCTOBER 2012 - TRANSCRIPT

1. Welcome to our presentation on the likely future shape and size of banks conditioned by the changes in regulation that are now emerging. The picture you see in front of us with a big arrow at the bottom and the yellow vertical line is in essence the story, so that before 2008 there were a set of economic factors and a regulatory environment which had consequences for the way that banks were evolving. We then had a watershed set of events in the financial crisis of 2008 which generated a new set of regulatory drivers and combined with the world's geography are now going to start moving banks in a different direction.

2. So looking at the details of the economics first. The main factors that were driving banks were around economies of scale, getting a system or a set of systems to process one payment cost roughly the same as a set of systems to process a million payments. And we saw large-scale specialised operation centres, with thousands of people handling calsl specific to credit cards or to claiming/recovering bad debts, so lots of centralisation and scale.

   Also we were getting much more of a global pattern evolving with economies of reach so that rich investors in the Middle East or in Russia or in Singapore were looking for investment opportunities which might be property loans in North America or a new pipeline in South America. This was leading to all sort of interesting innovation in the area of products from the investment banks, different types of investment vehicles and also regulatory facilitating standards such as single European payments area of the ISDA contract. So we had a kind of relatively positive in many respects, set of economic drivers looking to funnel wealth to where it was going to generate the most return, wherever that was on the planet. And in general most bank management wanted to compete in these economies of scale or in these economies of reach or in innovation, relatively unfettered by regulatory considerations.

3. Moving a couple of clicks forward into the regulatory environment leading up to 2008 it was in general one of government and regulators wanting to facilitate this globalisation, this increasing trade, this increasing investment. Regulation was by and large 'light touch' in the jargon phrase. There was quite a lot of harmonisation going on in the spirit of trying to create level playing field. An example was regulatory capital which was mostly around ensuring that banks all had to have the same amount of capital under BASEL. The European Commission again was trying to create a single European market for competing in financial services. They did have quite a big consumer protection dimension but things like the Mortgage Code, the distance selling directive, the payments service directive were a mixture of trying to create a competitive relatively open market whilst at the same time protecting consumers.

   Also at that time no one was really too bothered about systemic risk, the amount of indebtedness that one country might have.

4. And so again with a couple of clicks of the mouse we can see some of the consequences of the combination of the economic drivers with the regulatory environment. So within a particular country there were getting to be fewer banks and they were getting bigger. So in North America banks like Bank of America and JP Morgan Chase were becoming bigger by acquisition and merger. Likewise many of the if you like, predominantly retail commercial banks were starting to extend into investment banking, so Barclays or UBS or Royal Bank of Scotland or Citigroup. And to a certain extent but not completely there was an element of globalisation. There were no truly global banks, no one had a retail operation in every country in all geographies but some banks like Citi and HSBC were getting increasingly large retail or commercial operations in some countries and putting a layer across the top of global investment banking type activities or wealth management across most of the countries. You had a kind of a table model where you have an investment bank that was pretty global acting in pretty every capital city in the world and then in some chosen countries they would have retail, commercial, more branch traditional based model.

   If we then click again what we see, whilst there is not if you like a fully implemented target there is a direction of travel which was that banks were increasingly becoming universal in the sense that they were providing both retail, commercial and investment banking services, covering the tiers of the customer segments that they were increasingly in any particular geography reducing in number, that they were aspiring even if they hadn't got there to becoming more global, more multinational, and that whether they were within a country like Wachovia Bank or whether they were, you know, a global bank like Deutsche, they were getting much bigger in terms of their volume of assets, customers and so on.

5. Which leads us onto the events of 2008 where, as is well known, a large number of banks found themselves incapable of surviving without assistance. They either did not have enough liquidity or they did not have enough capital or both. And as an industry we discovered that many of these very big banks were too big to fail in the sense that the things they did were so important in some way that the Governments were forced to pour money in to keep them going In some countries, such as in Ireland or in Iceland, they were also too big to save, and actually the process of trying to bail out the banks effectively brought the government to its knees and required external assistance; in Ireland's case via the IMF and European Commission; in Iceland's case by joining the European Union. So banks that had got big had become either too big to fail or even worse too big to save.

   The system as a whole was perceived correctly to be unmanageable, that somehow we'd got ourselves into a position where the managers, the regulators were not on top of this and that taxpayers had been running risks which they didn't know about. And suddenly they were being forced to pour money into these banks to keep them going to do things that they wanted like the payment systems, salaries, small businesses paying each other, but they didn't know that there was an obligation on them to have to do that. So regulation and regulators failed and that there are things these banks do that are really important and that must be carried on under all circumstances. What we learnt was the kind of pre 2008 situation didn't provide that.

6. So, we've grouped if you like, the regulatory environment post 2008 into three areas. The one we're going to particularly highlight is related to systemic safety so, let's start there.

   System safety; all sorts of organisations have suddenly woken up to trying to make it a safer world for their citizens by reducing the capability of banks to cause bankruptcy. And it's kind of two main lines of thinking. One is to do with capital adequacy which is the ensuring that banks have set aside enough money to cover their own losses. And so we have global level regulation in the form or the Financial Stability Board and their recommendations. Also BASEL the subcommittee of the G20 banks coming up with capital adequacy recommendations at the European level. We've got capital adequacy, capital requirements directive and in the UK we've also got the ICB (Independent Commission on Banking) sometimes called the Vickers Report which also talked about capital adequacy.

The second idea is structural simplification of various types, so that within the UK perhaps the most striking one is also this Independent Commission on Banking Report which talks about having ring-fenced and non ring-fenced banks. And the most recent thinking in this area at the European level with Liikenan report, which again has the idea of separating out certain activities, trading activities from retail banking. Unfortunately not in the same way as the Independent commission on banking so that will be an interesting conundrum to resolve.

But we've also got at the FSB level, going back outside the box, the FSB level talks about environments where banks can be recovered or resolved, recovered by their own management or resolved by regulators in such a way that critical economic functions can be carried out as the taxpayers aren't being impacted too heavily. In the UK this is part of a thing called Recovery and Resolution Planning and at the European level this is something that's called the Recovery and Resolution Directive, which is in the process of being turned into European law. In the US Dodd Frank also covers similar both capital and structural simplification ideas. This body of activity in terms of regulatory drive is the main response to 2008 and it will have a major impact on the style and size and shapes of banks.

But there are some other bits of regulatory activity which are connected, so Consumer Protection still figures and a whole body of work that was developed pre 2008 like the Mortgage Code, and so on, carries on. Indeed will probably get beefed up in the light of all the bad practice incidents to do in the UK with Payment Protection Insurance or unpaid fees or, you know, interest rate derivatives being sold inappropriately to small businesses and so on.

But there is a part of the consumer protection world to do with insured bank deposits that very much figures in terms of overlap with how you protect banks and taxpayers. So in the UK we have a thing called the Financial Services Compensation Scheme. At the European level that's an example of something called the Deposit Guarantee Schemes, and in the US the Federal Deposit Insurance corporation. These schemes are important because they will probably end up having to fund some of the banks that fail in order that the taxpayers don't, so they're quite intimately connected to the mechanics of how Resolution and Recovery Planning would work.

The third bucket of regulatory activity is related to increased competition, there is a desire either to force banks that were the beneficiaries of bank bail outs to compensate other banks through the industry who have not had to turn to governments for support by making divestments. In the UK the divestment of branches by RBS and Lloyds being prime examples, but all over Europe banks have been getting, selectively, assistance from governments and therefore should be involved in, to some extent, some kind of divestment or compensatory activity to ensure that competition has not been distorted. This again is quite closely connected to, the structural simplification ideas.

7. Coming back out and looking at the big picture again, whilst there are a number of regulatory aspects such as Consumer Protection and such as the Anti Money Laundering, Financial Crime and Tax Evasion issues that are important, the nucleus that will drive bank strategy is around systemic risk and structural simplification falling out from 2008. However, this is being carried out in a geographic context and the governments are moderately nationalistic in this. At the end of the day we're talking about governments not wanting to use taxpayers' money, they want bond holders and depositors to suffer first. But if a government had got to bail out a bank with taxpayers' money they want, and their taxpayers and their voters will want, them to spend it on things that are vital to their economy not the whole global bank. So it's implausible to imagine that taxpayers in the UK are going to spend a lot of money trying to save the Korean arm of a bank. And similarly in the US it's improbable that US regulators are going to be keen to see US assets and US taxpayers' money helping resolve a bank that's failing in France or Germany for some

reason. So there's going to be a real tension about national interest and regulation versus global banks.

Also, as we've seen, we've got a lot of different flags on the previous slide at European level, UK level, US level, global level, and different governments are moving at different paces, and some are more or less accepting of international standards. And it's certainly the case the EC and the Americans rarely have the same view on a particular aspect.

8. So where does this lead? Well, if you like coming from the top down from that regulatory drive, the national regional fragmentation of bank prudential, systemic regulation, is putting pressure on banks to divide themselves up, to separate out retail and trading, vital to the economy, not so vital to the economy, and also by geography, US, versus EC, UK to EC, Asia to the EC and so on. So there's pressure to divide up the banks, which leads to in many respects, more smaller specialist banks. Meanwhile, the economics haven't changed that we want to compete globally, that we want to have economies of scale, and that we want to innovate, which pushed you towards fewer, bigger universal banks. So we now have a very interesting creative tension about how to structure the banking industry and for what it's worth, I think the tide has turned, that we are now going to end up for the next 20 or 30 years moving more towards the top of this screen rather than the bottom, more smaller specialised banks.

9. So clicking through to look at the big picture again, there you have it. Before 2008 we had a perfect storm of economic drivers and regulatory environment which were inexorably leading to bigger and bigger, more global banks. The watershed showed that these were not manageable by the systems and by the governments, so we've now moved to a new regulatory environment where the nucleus of which is saying, let's put a bit of a brake on this. That combined with the geographic factors and the incentives of governments is pushing towards fewer, smaller more specialist banks whilst economic drivers are pushing in the opposite direction. An interesting creative tension, my forecast is more small specialist banks.