

OUR BET: THIS GOES THROUGH AND IT WILL NOT BE PRETTY FOR BANKS OR CONSUMERS

SUMMARY

This morning, the Obama administration announced a proposal which could potentially change the entire face of the financial industry by limiting leverage, banning proprietary trading within banks, and breaking up concentrated market shares. We note, this proposal comes just over a week after a big bank tax was proposed which would penalize leverage within the industry. While details are slight with respect to the White House's proposal for potentially game changing regulatory overhaul, it is clear to us that the market is not overreacting to what directionally could be a decidedly lower move for capital markets profits for the banks. Not only are banks expensive on the prospect of "normalized" earnings, but waiting for normalized earnings is like Waiting for Godot in our opinion, particularly in light of increased regulatory momentum. In addition, we believe the medium term impact of the proposal will be a reduction of liquidity in not only the corporate market but also in the consumer market. For the record, we believe the possibility of this proposal going the distance is high. This proposal is currently just a basic outline, but sentiment amongst the American voting block is against the large banks and therefore we believe political actions will respond in sympathy.

First, "Limit the scope" of proprietary trading activities. We are not sure what qualifies as proprietary trading and if this may include any long or short bias to a position, however it is clear that this will dramatically reduce trading profits as well as market liquidity. Pure execution trading models simply make less money. This is why JPM, GS, and others make more in their trading operations than others. Potentially, this could move more flow volume to exchanges and away from market makers. This clearly would be a positive for the likes of CME and others.

"Limit the scope" of private equity. What we interpret this to mean at a minimum is not only obvious private equity portfolios but also individual corporate stakes in companies like ICBC, CCB, Bank Itau, etc.

"Limit the size" or market share concentrations of the banks. This is more self explanatory to us. 2/3 of mortgage and credit card products are controlled by the top four banks. The reality of breaking this up will be an operational challenge as many of the smaller regional banks not only sold their mortgage and credit card businesses to the larger banks years ago but with them also their respective technology and systems. Given the operational challenges, we are reminded of the original opposition to this proposal a year ago

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which was the length of time this would take and the corresponding removal of liquidity from the system to execute the transition. Given the fact that the securitization market remains closed, funding these businesses will be deposit dependant and therefore difficult to scale. In sum, we expect even more consumer credit to come out of the market over the medium term if this proposal goes the distance.

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