US Banks

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SECTOR REVIEW

Implications of the Bank Regulation Plan

The Administration proposed new rules regarding the size and activities of the large banks. Under the proposal, banks would be limited in their ability to both take bank deposits, as well as operating a trading operation. The proposal to limit size/activities of banks combined with the recently proposed "bank tax" highlight the immense political scrutiny of the industry.

- **Broader implications:** We remain concerned about the political climate and the potential reform that could ultimately change the business models of the largest firms. Ultimately, the business lines, including trading, are some of the more profitable operations of the larger banks/brokers (negatively impacting ROE's). However, for the large commercial banks, including BAC, Citi and JPM, we think that trading operations targeted in this proposal represent a manageable portion of total revenues (as low as 1-2%) and upwards of 10% for GS/MS. If the definition of proprietary trading is more liberal, we think the impact to revenues at the large commercial banks (BAC, C and JPM) could be about 10% of total revenues. We think the impact from curtailing private equity investments would also be manageable and potentially offset by monetization through spin-offs/sales. Although we note that in a strict interpretation of this proposal, JPM's ownership of Highbridge would have to be addressed. For the financial exchanges and potential impact on broader market volumes, we estimate that pure proprietary trading by banks represents a very small portion (we estimate 1-3%) of overall volumes/ profitability. The most granular data we have comes from CME Group--bank proprietary trading represents roughly 14% of volumes (8-9% of revs) which include pure proprietary trading, treasury management and customer facilitation/ hedging.

- **We reiterate our Outperform ratings on BAC and JPM within banks; CME, GS, MS and within capital markets universe.** The headline risk remains high, as more proposals as to the way in which to regulate/reform the industry will undoubtedly be forthcoming. However, we think the risk/reward on BAC and JPM among the banks; and GS and MS among the brokers remains attractive despite the proposed rules. We think that the current proposal will not pass in its current form. And while we are awaiting details regarding the definition of "proprietary trading," we think that non-client related trading represents a fairly low portion of total revenues at both BAC and JPM or in the range of 1-2% of total revenues.

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- **The proposal aims to limit the activities of federally insured depository institution.** Specifically, the administration proposed that banks or financial institutions that contain a bank will be prohibited from owning, investing or sponsoring a hedge fund or private equity fund or operating proprietary trading unrelated to serving customers and for its own profit. The spirit of the new proposal is reminiscent of the former Glass-Steagall Act which divided commercial banking from investment banking operations. While we understand the need for reform in light of the unprecedented market turmoil over the last two years, we think that this proposal is misdirected as neither proprietary trading nor private equity were root causes of the financial crisis. We think this proposal could have negative unintended consequences.

- **The proposal aims to limit the size of the largest firms.** The Administration would place broader limits on growth of market share of liabilities and supplement existing caps on the market share of deposits. The details are unclear, but banks have previously been restricted from acquiring an institution if the deal boosted national deposit market share above a 10% threshold. The proposal suggests implementing a cap, not only on deposit market share, but to wider forms of funding employed by large banks to limit size. This coincides with the Administration's "bank tax" proposal which would make wholesale funding incrementally more expensive. Restricting size or growth represents a reversal as regulators allowed/encouraged banks to get larger during the crisis, specifically in the case of JPM/WaMu, WFC/WB, BAC/CFC/MER.

Companies Mentioned *(Price as of 21 Jan 10)*
Bank of America Corp. (BAC, $15.47, OUTPERFORM [V], TP $21.00)
Citi (C, $3.27, NEUTRAL [V], TP $4.50)
CME Group Inc. (CME, $311.02, OUTPERFORM [V], TP $375.00)
Goldman Sachs Group, Inc. (GS, $160.87, OUTPERFORM [V], TP $235.00)
JPMorgan Chase & Co. (JPM, $40.54, OUTPERFORM [V], TP $54.00)
Morgan Stanley (MS, $29.34, OUTPERFORM [V], TP $37.00)
Wells Fargo & Company (WFC, $28.00, NEUTRAL [V], TP $28.00)

Disclosure Appendix

Important Global Disclosures

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**An analyst's coverage universe consists of all companies covered by the analyst within the relevant sector.*

***The broad market benchmark is based on the expected return of the local market index (e.g., the S&P 500 in the U.S.) over the next 12 months.*

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