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Financial Services

The Future of Banking

Six trends that will shape the industry

Contents

Introduction 3

1. The end of declining interest rates 7

2. Consumer deleveraging 11

3. Increasingly active regulation 15

4. Aging populations 19

5. The end of credit risk-free sovereign borrowers 23

6. Diverging growth rates between developed and emerging markets 25

Introduction

What is the long-term future of banking? This question was not at the front of bankers' minds during the crisis, when the imperative was survival. Now that the industry appears to be emerging from the acute credit and liquidity crisis, however, we need to address the future. How will customers' needs evolve? What macroeconomic and regulatory conditions will prevail? Which financial services business models will thrive?

By "long term" we mean the period after the peculiar crisis-related features of the financial environment have abated – when extraordinary losses have been absorbed and loss rates have returned to "normal", when banks have recapitalized and when exceptional government support (through monetary policy, extended debt guarantees and capital infusions) has been removed or moderated.

In most respects the worst of the crisis has already passed; the ECB and EU seem to have averted an immediate Euro crisis, and US and Eurozone banks appeared to be drawing down loss reserves in their 2Q 2010 earnings releases. Yet these reports also showed significant revenue and asset-growth headwinds, which mark the dawn of the post-crisis era. This report concerns the forces that will shape that era. Six will be most important:

1. The end of declining interest rates
2. Consumer deleveraging
3. Increasingly active regulation
4. Aging populations
5. The end of credit risk-free sovereign borrowers
6. Diverging growth rates between developed and emerging markets

Developments 2, 3 and 5 (deleveraging, regulation, and risky sovereigns) are, in part, consequences of the crisis. But, like the other developments, they are also consequences of decades-long trends with origins predating the crisis. Indeed, as we argue below in Section 1, the crisis was partly caused by the first of these trends, the inevitable end of the sustained period of declining interest rates that characterized the "Golden Era" of banking profits (i.e. the period beginning around 1993 with the end of the S&L crisis and ending in 2003 when interest rates bottomed out).

These trends will drive major changes in the industry over the medium term, including: **consolidation**, particularly in developed markets, to remove excess capacity; **innovation** of offerings and service models, to restore margins to acceptable levels; and **migration** of relative profitability from mass-market to affluent customers, and of growth from developed to emerging economies.

We will examine each of the six major trends in detail in the rest of this report. To preview, the headline implications for bankers are these:

1. **The Golden Era is over and it is not coming back.** At the end of previous recessions or banking crises, the industry reverted to above-GDP growth. That will not happen this time, at least in the developed economies. Stable or rising interest rates, relatively slow GDP growth, and increasing regulatory burdens mean that the near-ideal macro conditions for banking profits that characterized the Golden Era will not pertain in the post-crisis era. Asset growth will be slower. ROEs will be depressed by higher capital requirements, especially in Europe and in global capital markets businesses. And consumer protection regulation – particularly in the US – will require the re-invention of the mass-market profit model through a combination of re-pricing and innovation to compensate for disallowed fee income and less freedom to price for risk and cost-to-serve. In the very near term, bank earnings will be helped by curing credit and a boost to deposit profits as rates rise. However, once these one-time benefits are booked, the industry will have to face the prospect of slower profit growth.
2. **Penalties for weak performers will be harsh, with winners growing by consolidating losers.** Golden Era macro conditions drove profit growth for the whole sector, lifting mediocre competitors along with the best-run institutions. Without this industry-wide tailwind to propel growth and profitability, competition for market share and profit share will intensify, leading to an increased focus on "execution" (for both cost efficiency and revenue productivity) and on mergers and acquisitions (to reduce overall operating capacity in the market). **Average** return on equity is unlikely to return to the Golden Era levels, though the best performers will enjoy larger **relative** advantages than they did before the crisis, allowing them to capture a greater share of less robust profit pools. The prognosis for underperformers is grim: greater negative divergence from a lower average, leading to lower valuations (near book value) and, ultimately, to exit. Unlike in the Golden Era, the stakes of the post-crisis game are winner-take-all (or, at least, fewer winners take much more).

3. **Innovation will become more important for organic growth.** During the Golden Era, innovation was less important. Banks could simply do more of what they had been doing for the past ten years and ride the wave of growth. In the post-crisis era, banks will have to innovate to create new value for customers, and share in that value themselves. Population aging creates one such opportunity, probably the largest. This trend will shift consumer demand from accumulation products, such as traditional mortgages and savings, towards drawdown products, such as annuities and structured income vehicles, and generally create a demand for solutions to address the different needs of a customer base in a different stage of life. Interestingly, success in serving the aging segment will involve managing risks, such as longevity, that traditionally have been the province of life insurers. So the competitor set for growth opportunities could broaden.

4. **Growth tailwinds will continue in emerging markets, but only for those well positioned to take advantage of them.** The emerging markets story diverges from developed markets, as GDP growth will fuel robust demand for financial services. As economies grow from low levels of per capita GDP, financial services tend to consume an increasing share of the overall economy. Hence, we expect robust growth in both asset levels and banking revenues in several emerging economies – 10% or more in some cases. Along with profit growth, we expect to see financial services talent and expertise migrating south and east. Given the dramatically smaller starting point of these emerging markets, however, they lack the capacity to immediately absorb the developed world's "excess" financial services capital and labor. Players who do not already have a solid foothold in the emerging markets will be at a distinct disadvantage.

5. **Government will be a more intrusive regulator and a weaker guarantor.** The political and technocratic consensus is that lax regulation was a main cause of the past crisis. Whether one agrees with that consensus – or has faith that a new regime will avert the next crisis – the fact remains that banks are in for higher capital and liquidity requirements specifically and more intrusive regulation generally, especially in the area of consumer protection.

   Increased regulatory restrictions will constrain bankers' ability to adapt to the new macroeconomic and competitive environment, and undermine two of the most important sources of earnings growth and margin expansion upon which banks relied in the Golden Era: consumer fee income and leverage. In the US, new consumer protection and interchange regulation have disallowed the fee income that made many of banks' offerings to mass market consumers viable – especially checking accounts and credit cards.

These fee restrictions will diminish the offerings to higher-risk and less affluent consumers, and diminish the profitability of those offerings that banks do maintain.

In Europe, the larger effect will come from increased capital and liquidity requirements. Pre-crisis, European banks relied more than their US counterparts on low levels of equity to maintain ROEs. The already announced and likely future restrictions on leverage will mean that banks need either to find new sources of revenue to support the extra capital requirements or discontinue economically marginal risk-taking (lending or otherwise).

Even as regulators close off avenues to profit for banks, governments themselves have been weakened as borrowers, and therefore as guarantors of the banking system. The crisis has put enormous financial strains on governments, and heightened market attention paid to existing fiscal imbalances. To the extent that sovereigns lose credibility as financial guarantors for too-big-to-fail institutions, bank funding costs will rise, and the likelihood and severity of a future crisis will increase.

1. The end of declining interest rates

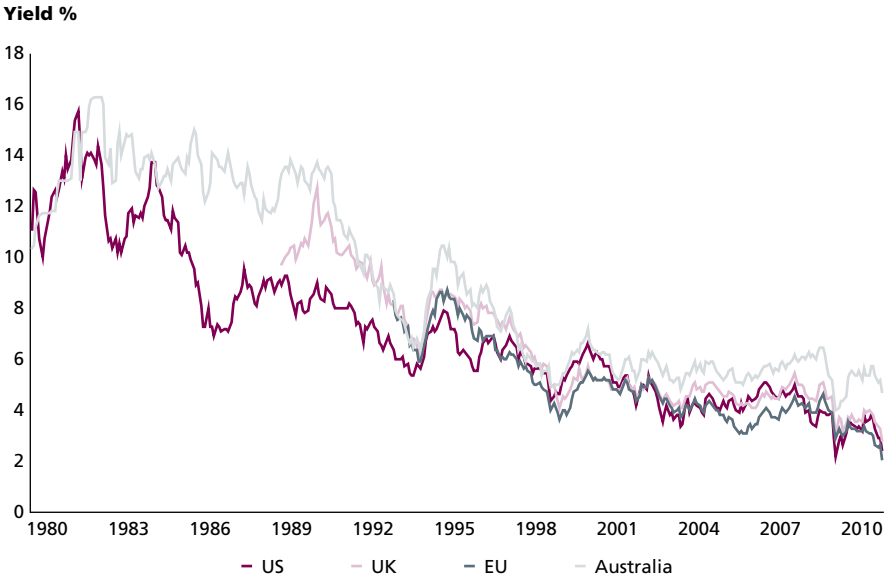
Banks generate earnings from their balance sheets in three main ways:

- Gathering inexpensive deposit liabilities
- Originating, servicing and holding or selling debt assets
- Taking interest rate risk through asset and liability maturity mismatches

The profitability of these activities depends, to a large extent, on a number of structural factors beyond banks' direct control: the regulatory regime, the level of competition, and the macroeconomic environment. Most importantly, the growth of debt assets and returns from maturity mismatches depend on the direction of interest rate changes and the slope of the yield curve, respectively. As interest rates decline, borrowers can service larger debts at any given level of income, which allows banks' lending volumes to increase faster than GDP. Moreover, given that most banks operate with a maturity mismatch of long term assets funded by short term liabilities, they profit from a steeply positive yield curve: that is, from long term interest rates being higher than short term rates.

The recent history of interest rates has been extremely congenial for banks. In September 1981 the 10-year US government bond yield was 15.8%. Over the next two decades it fell steadily until it reached 3.4% in 2003, allowing consumers and businesses to dramatically increase their debt at any given level of income. As shown in Exhibit 1, below, the major Western economies experienced a similar trend over this same period.

Exhibit 1: Ten-year government bond yields



Source: Datastream; Oliver Wyman analysis

At the same time, capital markets innovations, whereby loans are packaged into tradable securities, decoupled banks' and other lenders' ability to originate loans from the necessity of holding them and, therefore, of funding them. These new debt securities increased the lending capacity in the economy beyond the capital of banks, adding to the growth in credit caused by falling interest rates. They also increased the origination-related revenues banks could earn in relation to any given quantity of capital they held. Hence, not only did banks' revenues grow, but their returns on total equity (ROEs) were sustained in the high teens to 20% during the Golden Era.

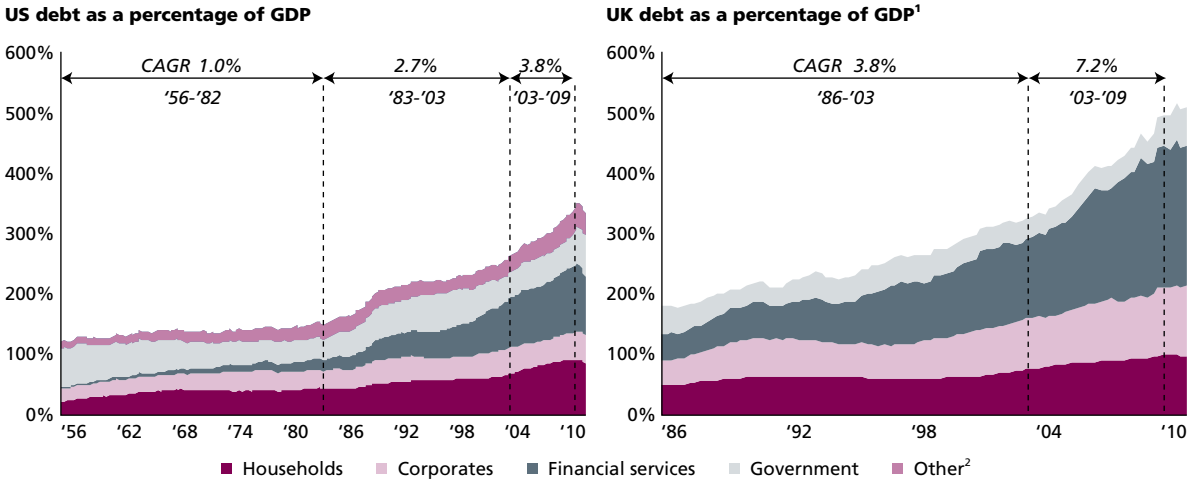
How the end of the era of falling rates contributed to the credit crisis

We date the Golden Era of bank profitability from 1993 to 2003, roughly from the end of the S&L crisis to the end of the falling rate cycle. The recent crisis did not begin to manifest itself until 2007. What happened in the interim?

From 2003, interest rates began to rise again, with the US Fed tightening short rates and US 10-year government bond yield rising from a low of 3.4% in 2003 and reaching 5.1% in May 2006. For the first time in 20 years, the tailwind of falling rates went out of the sails of credit growth. Bankers faced the choice of scaling back originations (and origination capacity) and foregoing the above-GDP growth they and their investors had come to expect, or lowering credit standards to maintain origination volumes.

With few exceptions, they chose growth. Credit outstandings continued to grow strongly from 2003 to the onset of the crisis, but this was a function of lower credit standards and of collateral appreciation (predominantly home price appreciation) which covered permissive credit decisions. When house price appreciation slowed and reversed, the crisis was born. Credit losses began to materialize, ultimately leading to a crisis of confidence in the institutions that held or guaranteed these loans or the securities based on them.

Exhibit 2: Growth in credit outstandings over time



US financial services debt (% of GDP)	
1983	34%
2003	96%
2009	120%

UK financial services debt (% of GDP)	
1988	47%
2003	140%
2009	251%

Source: US: Federal Reserve, Oliver Wyman; UK: UK Financial Statistics Publication

Exhibit 3: Bank returns on total equity

1 UK definitions: Corporate debt = debt securities and loan liabilities; Household debt = outstanding secured and unsecured credit; Financial debt = balance sheet liabilities (debt securities and loans, excludes deposits) of financial corporations (including banks, insurers, pension funds, asset managers)

2 "Other" includes non-corporate businesses, farms and foreign debt

Long-term economic predictions may be fraught with peril, but there is one safe bet: long-term interest rates will not drop by 12 percentage points over the next 20 years. Barring a Japan-style deflationary scenario, rates in the US and EU can only move up from today's extraordinarily and artificially low levels. It is hard to overstate the importance for the banking industry of this reversal of the long-term trend of falling rates. During the two-decade run of falling rates, above-GDP credit balance and profit growth was the norm. But those days are now gone. As rates rise from today's historic lows, debt service will become more burdensome each year. Tightening credit standards, less liquid securitization markets, and borrower deleveraging will also produce headwinds. Credit growth will have to be driven by the fundamentals of growth in GDP, productivity and collateral values. Even as funding markets heal and bankers put their post-crisis balance sheets in order, the great competition among banks will be to gain a bigger share of a stagnant to shrinking market of attractive lending assets. This will cause a further industry shakeout, reducing aggregate capacity.

Rising rates will hamper future credit growth. However, there is a worse scenario for banks, in which rates remain at stable at today's historically low levels. This is because today's near-zero rates have destroyed the earnings generated on the *liability* side of banks' balance sheets in the deposit-gathering business. The silver lining of the prospect of higher rates is that margins on deposits (and thus the balance sheet overall) will be restored. This is because banks will pass through most or all of any rate rise to borrowers, but much less to depositors (especially DDA or current account holders, who typically receive very little interest on balances). However, once rates stabilize at a new higher level, this source margin growth will run out, and banks will still be stuck with the challenge of wringing profit growth from stagnant to shrinking asset books.

2. Consumer deleveraging

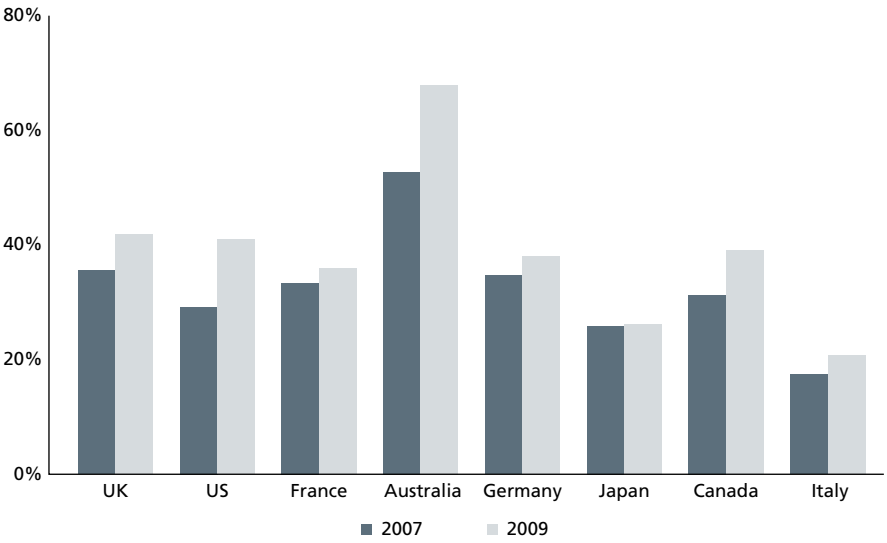
The end of the period of the declining interest rates means and the rapid credit expansion that characterized the Golden Era was sure to end. However, it has not merely ended, it has gone into reverse. Significant declines in credit balances are occurring, despite interest rates being held by central banks at historic lows.

Deleveraging[3] can occur in three ways

- The quantity of debt retired by consumers exceeds their new debt
- Consumers default on their debts
- Consumers' assets increase in value

Declines in asset values have exacerbated the problem with leverage. In the pre-crisis boom, appreciating assets allowed borrowers to add debt without increasing leverage. Post-crisis, the situation is reversed. Through the crisis and attendant recession the main assets of most consumers – namely, their houses and financial asset portfolios – have lost value. Similarly, assets against which businesses often borrow have also devalued, including most prominently commercial property. The exhibit below shows that leverage actually increased over the course of the crisis, even as credit growth ground to a halt.

Exhibit 4: Household debt to asset ratios



Source: OECD; EIU; IMF; Oliver Wyman analysis

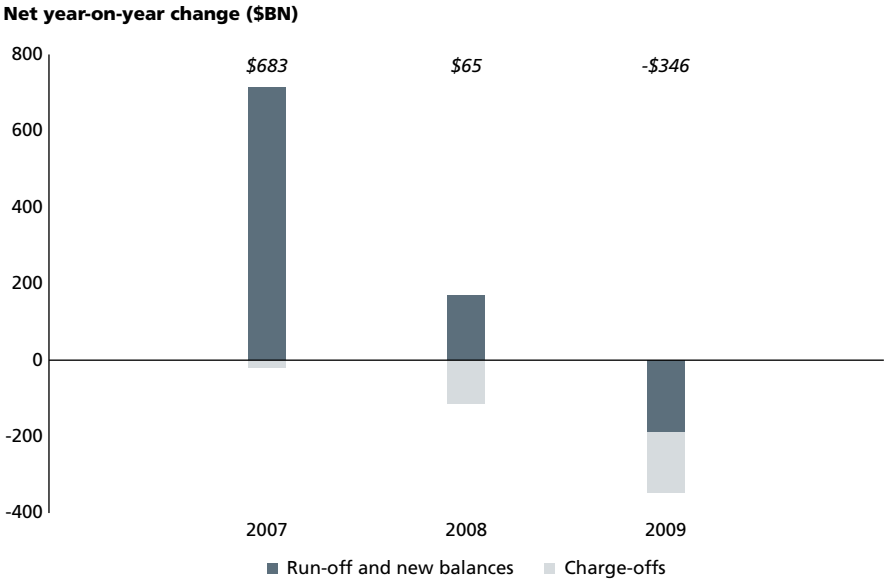
3 Here we use the term deleveraging to mean a lowering of the ratio of outstanding debt to asset values. Deleveraging is sometimes used in other instances as a decrease in the ratio of debt service payments to income, which is also commonly referred to as a decrease in the debt:income ratio.

This asset-value effect has significant implications for the prospects for credit growth in the near to medium term. In many markets, collateral values are off 30% to 40% from peak levels. Barring a significant recovery in values, collateralized loan outstandings will fall over the next several years as borrowers default on or pay down existing loans which are then replaced with much smaller loans, if they are replaced at all. Given that collateralized lending (e.g., residential and commercial mortgage lending) is such a large fraction of overall lending, the effect on the overall size of the loan market will be large.

As noted above, a fall in asset prices generally increases leverage. In extreme cases, however, such losses may also contribute to deleveraging. For example, when the value of collateral drops below the value of debt secured by that collateral and thereby precipitates default, the debt is wiped out entirely. Even if borrowers do not default, falling asset values reduce consumers' and businesses' borrowing capacity and hence both their demand for credit and banks' willingness to extend it to them. In other words, asset devaluations ultimately are likely to contribute to the first two of the above causes of household deleveraging.

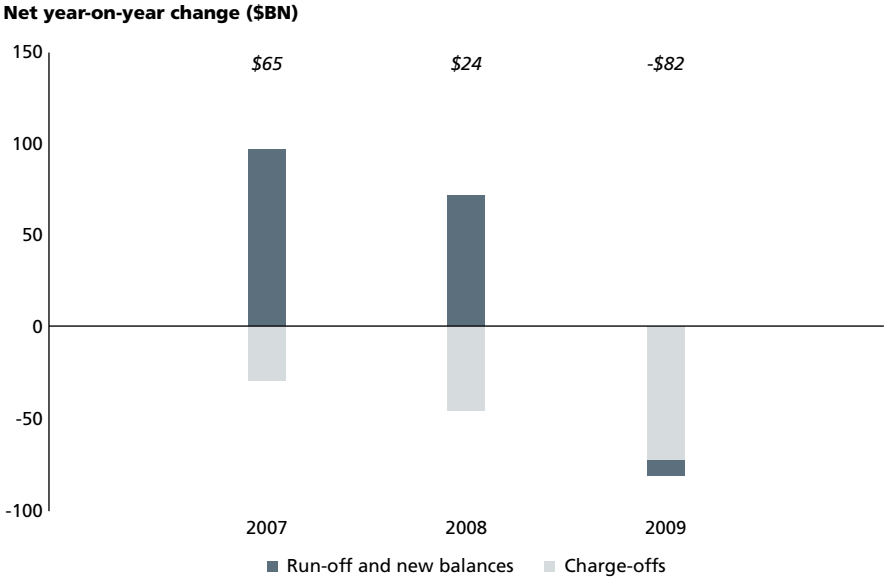
Both debt retirement and default are contributing to deleveraging. Defaults, which by definition are deleveraging, have accellerated. An even bigger shift has come in the difference between debt retirement and new borrowing. After decades of net growth, net new borrowing slowed dramatically in 2008 and was negative in 2009.

Exhibit 5: Net changes in US mortgage balances



Source: Experian – Oliver Wyman Market Intelligence Report; Oliver Wyman analysis

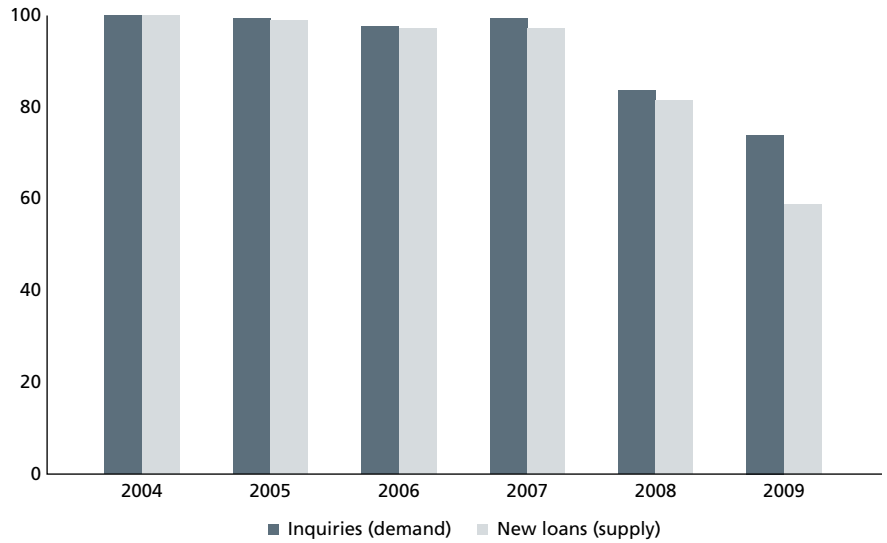
Exhibit 6: Net changes in US credit card balances



Source: Experian – Oliver Wyman Market Intelligence Report; Oliver Wyman analysis

The decline in new borrowing could be caused by a reduction in applications for new loans (demand) or a decline in the approval of such applications (supply). Exhibit 7 below suggests that, at least in the US, both forces are currently at work.

Exhibit 7: Supply and demand for consumer credit (US)



Source: Experian – Oliver Wyman Market Intelligence Report; Oliver Wyman analysis

Note: Data represent number of inquiries and loans.

In 2009, the decline in new lending was greater than the decline in the credit applied for. In other words, supply declined faster than demand.

This is not surprising. Given the losses incurred during the crisis, banks had to rebuild their equity capital. Moreover, new restrictions on pricing and other terms for consumer lending (e.g. the US CARD Act) have made lending to some consumers uneconomical.

New regulation is likely to extend the duration and deepen the degree of deleveraging. As explained in Section 3, new capital requirements for banks are likely to increase the cost of lending, while consumer protection laws (e.g. disallowing certain fees and risk-based pricing), combined with a political and media environment hostile to banks, will make it difficult for banks to pass extra cost onto borrowers. And, even in instances where banks are able to pass on their increased costs to borrowers, this increased price for borrowing will reduce demand and volumes.

3. Increasingly active regulation

Commentators disagree about whether the financial crisis was caused primarily by "market failure" or by "regulatory failure". The dispute is of less practical importance than it might at first appear to be, because the answer makes little difference to the likely future. All sides accept that regulations should change, and even proponents of the "regulatory failure" view have accepted that any future regime will involve tighter regulation.

Some new legislation has already been passed, such as the CARD Act and the Dodd-Frank Bill in the US, and some is yet to come. Additionally, regulatory agencies, such as the Fed in the USA and the FSA in the UK, have delegated powers to create secondary regulation which they are likely to use in the coming months and years. Whatever the detailed content and timetable of the (uncertain) legislative and rule-making agenda, however, we can already draw out the main threads of new regulation and examine their likely effects. Most G20 legislatures and regulators are pursuing similar measures and their effects are likely to be more or less the same wherever they are applied.

Three broad goals have been set out as the rationale for regulatory tightening. The first is to **eliminate the implicit and explicit guarantees** on the wholesale liabilities of banks and other "systemically important" or "Too Big to Fail" (TBTF) financial institutions. Implicit guarantees are widely acknowledge to have been a key contributor to the crisis, and explicit guarantees have been an almost universally applied emergency measure. Our view is that, for several reasons, a credible unwinding of TBTF liability guarantees is highly unlikely. The consequences will include greater consolidation, more intrusive safety and soundness regulation, and greater politicization of the industry (e.g. via politically mandated business practices or credit allocation).

The second stated goal is to **increase the safety and soundness** of the financial system, and especially to reduce "systemic risk", partly by reducing the chance that individual financial firms will fail and partly by reducing the systemic affects of any such failure. Regulatory initiatives included in this category include increased regulatory capital and liquidity requirements, restrictions on the business activities of deposit-taking institutions, the compulsory submission of "living wills", rules about the "currency", timing, and incentive effects of bank employee compensation, and attempts to shift derivatives trading away from "over the counter" contracts towards exchanges.

We anticipate mixed success on this front. Bankers will successfully lobby regulators to mitigate the effects of the most draconian curtailments on their risk taking, and they will also find creative workarounds to protect lucrative risk taking under the new rules. However, we do expect that, at the margin, banks (and bank-like institutions) will indeed face higher capital requirements and generally greater cost to risk. To the extent this is true, it will result in some combination of lower bank ROEs, reduced credit growth (and other risk taking), higher prices to end customers (consumers and institutions), and lower leverage in both financial and non-financial firms.

The third stated goal of new regulation is to **improve consumer protection**. Among other measures, legislators and regulators will continue to introduce usury laws that cap interest rates, limit banks' ability to make changes in terms to existing customers whose credit deteriorates, or otherwise limit risk-based pricing. They will also ban or limit products or certain features (e.g. point-of-sale debit card overdraft fees), increase licensing requirements for sellers of financial products, and increase government scrutiny of product suitability, pricing or required disclosures.

Industry observers disagree about the degree to which these measures will improve outcomes for consumers. However, they almost certainly will tend to raise the overall cost of offering consumers financial services and skew the profitability of consumer financial services customers away from the mass market (who tend pay more fees and be more risky) and toward more affluent consumers. We therefore expect greater competition for high-end consumers (i.e. those with low risk and high deposit or investment balances) and a decrease in offerings for the mass market, both in terms of products themselves (e.g. free checking) as well as access to high-cost channels, such a bank branches. These pressures will be a strong impetus for innovation in consumer banks' operating and profit models.

The table below provides an overview of the purpose and nature of the new financial services regulations that have been enacted or proposed.

Exhibit 8: Summary of regulatory actions

Reform area	Examples of initiatives
Eliminate the implicit and explicit guarantees	■ Alternative resolution regime to create non-bankruptcy non-bailout solutions for failing banks ■ Expansion of scope of regulatory authority to govern nonbanks ■ Contingent capital solutions for systematically important institutions ■ Creation of "living wills"
Increase the safety and soundness	■ Migration of derivatives to exchanges ■ Basel III capital and liquidity standards ■ Compensation reform ■ Rating agency reform
Improve consumer protection	■ Creation of US Bureau of Consumer Financial Protection ■ US CARD act limitations on re-pricing ■ Limits on interchange fee ■ Provision to impose a fiduciary duty on advisors to consumers/retail investors

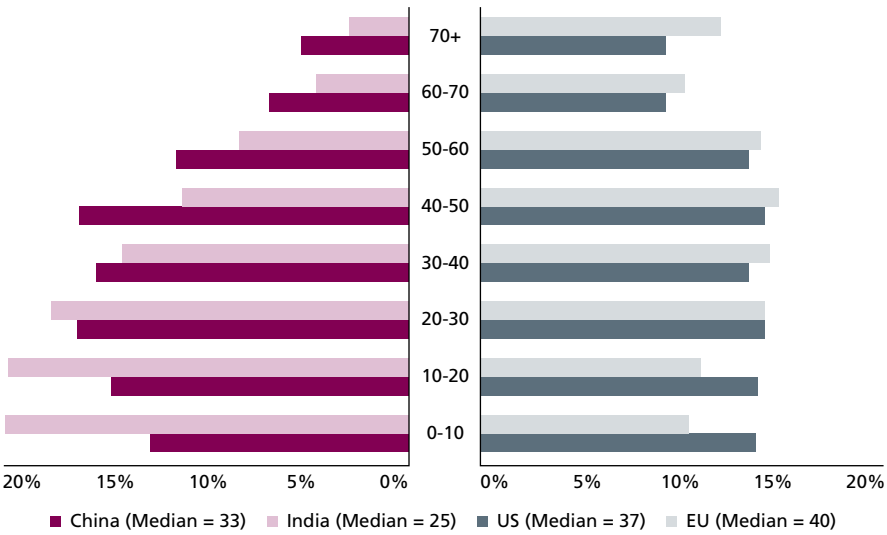
4. Aging populations

The arrival of the peak earnings years of the Baby Boom generation in advanced economies drove a dramatic increase in per capita GDP and in the consumption of financial services. The products that grew the fastest were those that addressed the needs for the peak-earning stage of life: mortgages to finance housing purchases and later savings, investments and other "accumulation" products.

The Boomers, however, had fewer children than their parents did. So, as they near retirement age, the overall age profile of the population continues to shift with them, out of the peak earnings years and into retirement. This shift in age profiles is typical of advanced economies, and contrasts with a much younger age profile in developing economies (see Exhibit 9 below).

Exhibit 9: Population profiles for major economies

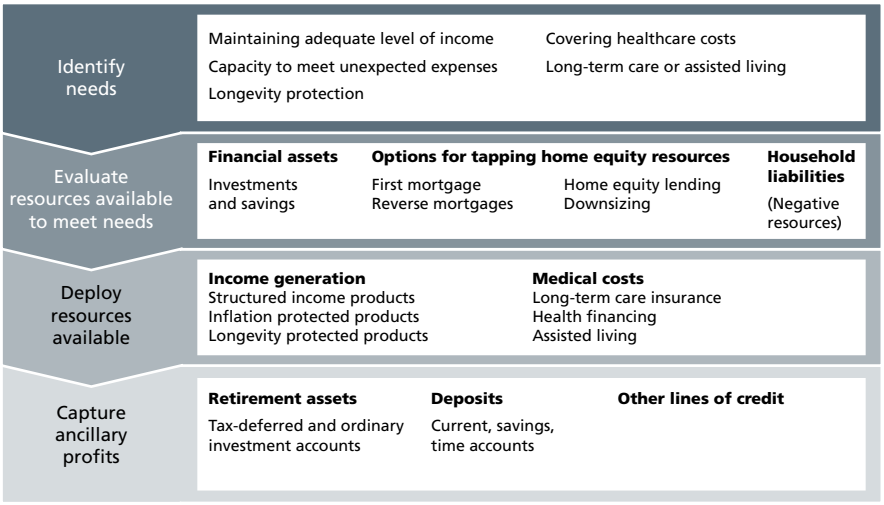
Population by age group (%) in 2010



As the population ages, the demand for financial products will change. Broadly speaking, older consumers are wealthier than younger ones. They have greater balances in savings and investment accounts and are much more likely to live in an un-mortgaged home. As they reach retirement, their demand for "accumulation" products, such as equity mutual funds and amortizing mortgages (designed to accumulate home equity), declines markedly from their peak accumulation years. At this stage of life, their needs shift to "draw-down" products, such as annuities and structured income contracts.

The impending retirement of the Boomers and the rapid shift in the aggregate population profile mean that banks and other providers of financial products and services are about to experience a sea change in consumer demand. This will require banks to expand and reorient their product and service offerings so that they are better adapted to the needs of an aging customer base. Exhibit 10 below gives an example of what such a "retooling" process might involve.

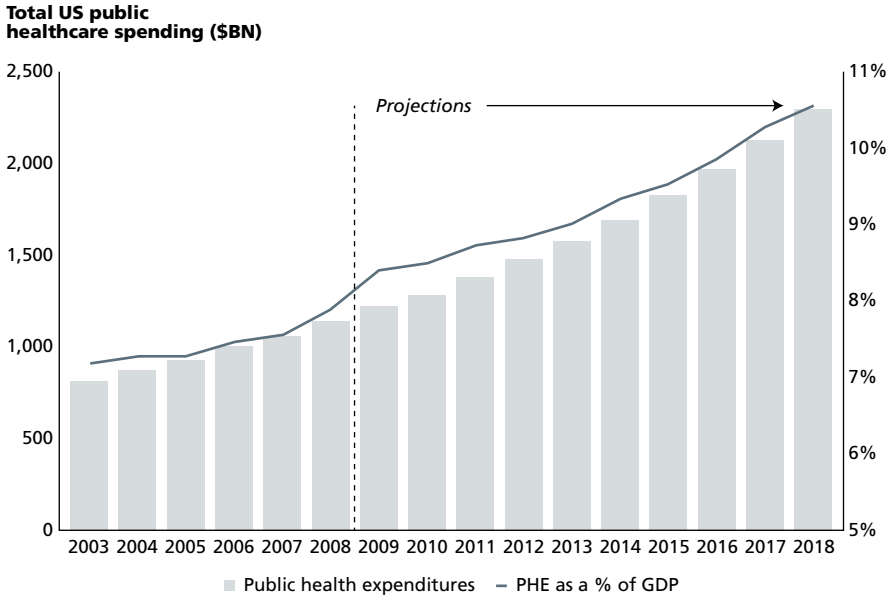
Exhibit 10: Meeting the needs of an aging population
Example: Banking solutions for seniors



The demographic trend towards increasing demand for financial services aimed at "seniors" will be amplified by unavoidable changes in social policies. Governments will continue to play a role in meeting the needs of the burgeoning numbers of seniors, but policies of universal (i.e. non-means tested) public pensions and tax-funded healthcare for retirees lasting 20 or more years will soon have to be modified, as they are no longer affordable.

Deficit spending by the US, UK and Eurozone governments during and prior to the financial crisis has left them with unprecedented and still-growing levels of peacetime debt. These explicit obligations, however, are dwarfed by governments' policy commitments, most notably to provide healthcare and pensions to their aging populations. For example, as shown in the Exhibit 11 below, (real) public spending on healthcare in the US is expected to double in the ten years up to 2018. In the US, unfunded obligations are estimated at between three and four times GDP. Other countries are even worse off.

Exhibit 11: Projected US public spending on health care



Source: National bureau of labor statistics; Centers for Medicare and Medicaid Services; UN; Oliver Wyman analysis

The current fiscal arrangements in advanced economies are unsustainable. Current levels of taxation are insufficient to fund the growing demands of the elderly from the (relatively) shrinking ranks of the economically active. Economic growth cannot sustain today's programs, as some hope, because the required growth rates are entirely unrealistic. Inflating away governmental obligations is unattractive for several obvious reasons. Nor would it work, as most of the obligations are structured to increase with the cost of living or of healthcare. Taxes will likely trend higher, but there is no reasonable level of taxation at which these obligations can be met.

Hence governments will be forced to restructure their obligations, by lowering cost-of-living adjustments, increasing retirement ages and means-testing previously universal programs. Individuals who are above the means-test cut off will, by definition, have both the means and the motivation to seek alternative, private-sector solutions to meet their needs in retirement.

Banks and other financial services competitors that can develop viable solutions for these consumers will create massive value for them – value in which banks' shareholders should be able to share. This trend offers perhaps the single best prospect in the developed markets for banks to tap into a burgeoning growth opportunity.

Life insurers begin with one advantage over banks. Their traditional business involves expertise in precisely the kinds of products and risks

(especially longevity risk) that are required to serve an aging customer base. To succeed in the emerging demographic environment, banks will need to acquire the skills characteristic of life insurers. And, after the reputational damage done by the crisis, they will need to work hard to restore consumers' trust.

5. The end of credit risk-free sovereign borrowers

During the late 1990s the US government was running fiscal surpluses. Many commentators, filled with the optimism of the simultaneous dotcom bubble, began speculating on the disappearance from the market of US government bonds and, hence, of long-term debt instruments yielding the risk-free rate.

The second part of their prediction may turn out to have been right – though for exactly the wrong reason. The markets are now awash with sovereign debt, and especially US government debt, but much of it is far from risk free. The explicit and implicit obligations of most Western governments have exploded over the last ten years, setting peacetime records both in absolute terms and as percentages of GDP. The credit-worthiness of sovereign borrowers is increasingly being called into question (see Exhibit 12).

Exhibit 12: Debt burdens of sovereign borrowers

	Gross debt (% of GDP)		S&P rating	
Country	**2000**	**2009**	**2000**	**Current**
Canada	81%	82%	AAA	AAA
France	57%	78%	AAA	AAA
Germany	60%	73%	AAA	AAA
Ireland	38%	64%	AA+	AA
Italy	109%	116%	AA	A+
Japan	142%	218%	AAA	AA
Portugal	51%	77%	AA	A-
UK	41%	68%	AAA	AAA
US	55%	83%	AAA	AAA

Source: IMF, Eurostat, S&P

The Greek government debt crisis of the spring of 2010 brought the problem to the world's attention. Had Greece not been bailed out by Germany and other Eurozone countries keen to defend the integrity of their currency, Greece would have defaulted. Of course, Greece is in an especially poor fiscal position; and the control over monetary policy that Euro countries lack make them especially vulnerable to fiscal crises (since they cannot inflate away their debt). But the fiscal burdens created by the Greek government's "generous" social policies are far from unique. The finances of most European governments are creaking under the same pressures, and several have already suffered credit downgrades. Further, as the CDS market demonstrates, no one believes that the recent Greek bailout solves the broader problem

permanently. There has been a spate of recent speculation on the sustainability of the Euro as a currency, and even the likelihood of a US debt crisis[4].

As these fiscal burdens grow, the assumption that the government debt of advanced economies is risk-free may come under pressure. The increasing market perception of real credit risk in sovereign debt has potentially profound implications for the banking system, especially where it intersects with implicit and explicit "too big to fail" (TBTF) guarantees. Sovereigns are the ultimate guarantors of TBTF institutions. As doubt about the credit-worthiness of sovereigns continues to grow, the confidence of banks' liability holders in the explicit and implicit liability guarantees will erode. If confidence in sovereign guarantees wanes significantly, there will be at least two serious implications for the banking industry.

First, banks whose TBTF guarantees are devalued will have to pay a greater risk premium on their debt capital or be forced to hold more equity capital. These costs will need to be passed on to borrowers, further slowing credit growth. In extreme scenarios, the industry could be forced to restructure toward simpler, more transparent and less risky institutions. This could be required by law or by punitive prices charged by nervous investors in bank liabilities or equity. In either case, it would imply a profound restructuring of the industry. Since a reduction in TBTF subsidies would represent the removal (or moderating) of a market distortion, it ought to move lending and other banking activity closer towards its socially optimal level. But even if the changes are desirable, they will tend to result in less and more expensive financing for both banks and their customers.

Second, as sovereigns are weakened as guarantors, the likelihood and severity of the next crisis will be increased. Governments provide the liquidity and solvency backstop for the banking system. At the height of the recent crisis, the only credible liquidity or credit guarantees came from sovereigns or central banks. If the ability of sovereign agencies to play this role became questionable, banks would become more vulnerable to runs, and the banking system less stable. Market pressures would require banks to hold larger reserves of liquid assets, further constraining their ability to extend credit.

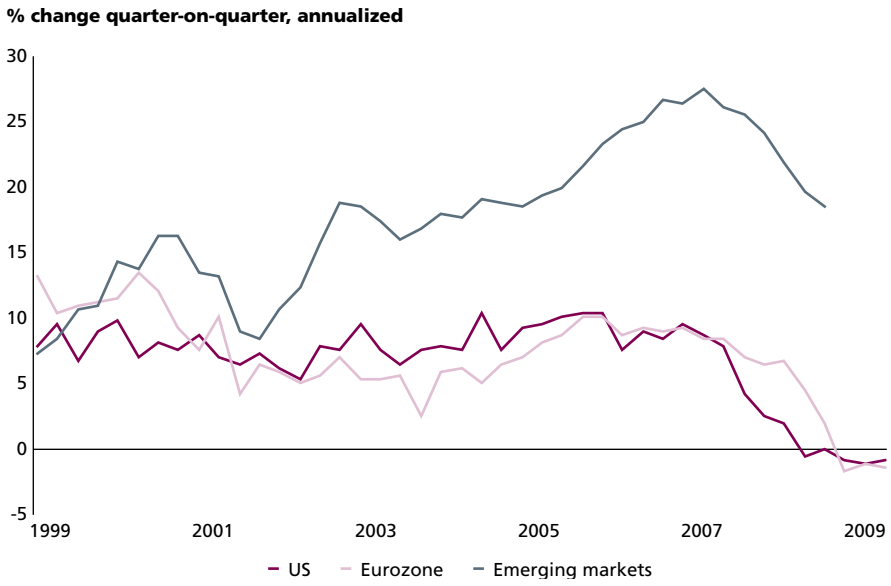
4 cf. Kling, Arnold, *Guessing the Trigger Point for a US Debt Crisis*, Mercatus Center, George Mason University, August 2010; Mares, Arnaud, *Ask Not Whether Governments Will Default, but How*, Morgan Stanley Research August 2010; Mayer, Thomas and Mobert, Jochen, Euro crisis: *Mission not yet accomplished*, Duetsche Bank Global Economic Perspectives, September 2010.

6. Diverging growth rates between developed and emerging markets

Post-crisis GDP growth in advanced economies is forecast to be "anemic", at around 2%. Such forecasts are notoriously unreliable. However, it is almost certain that rates of growth will be significantly higher in developing economies where they are generally expected to be between 6% and 12%.

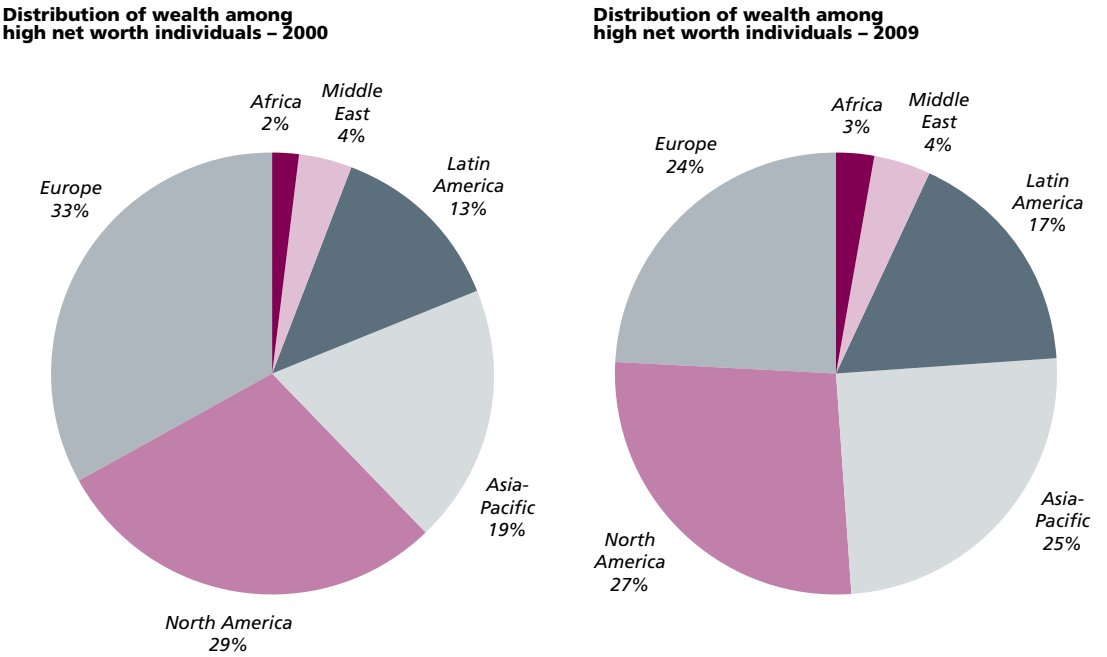
Even before the recent crisis, credit growth in developing economies was significantly outpacing growth in developed economies. Strikingly, a large proportion of the wealth held by high-net-worth individuals already resides in emerging markets, and the emerging markets rich have gained significant relative share in the past decade.

Exhibit 13: Private credit balance growth trends



Source: IMF; Oliver Wyman analysis

Exhibit 14: Distribution of wealth among high-net-worth individuals 2000 and 2009

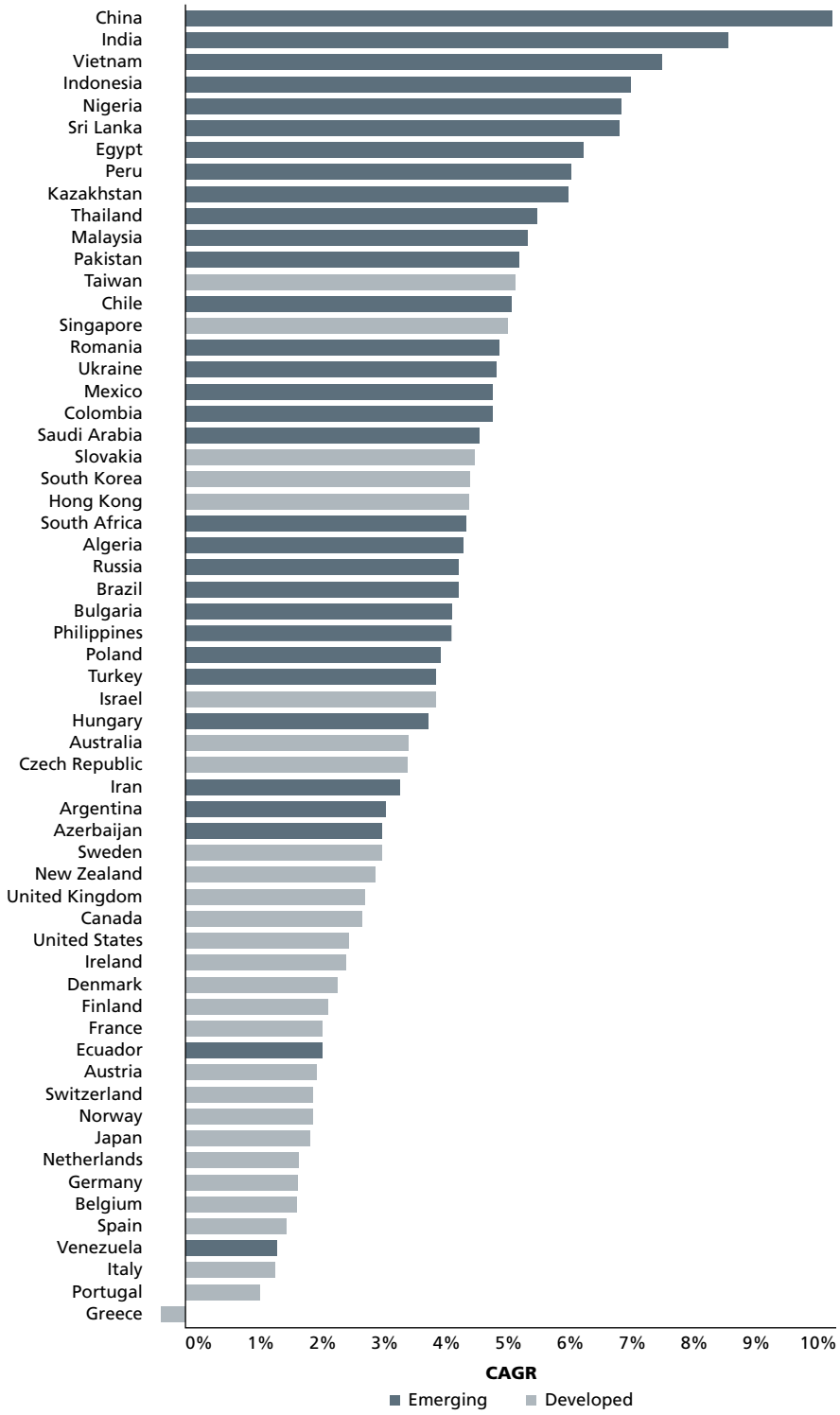


Source: World Wealth Report (Merrill Lynch)

Note: High net worth individuals are classified as having financial assets exceeding $1 MM

More important for the future, however, are the security and sustainability of the underlying drivers of emerging markets financial services demand. As discussed above, the primary drivers of banking's growth in developed economies during the Golden Era were falling rates and increasingly liquid secondary markets. These were not nearly as important in emerging economies, where interest rates were higher and secondary credit markets less liquid. Rather, emerging economies have shown, and will continue to show, higher rates of credit demand growth because of higher rates of growth in the underlying economy. The exhibits below demonstrate the differences in growth between developed and emerging markets, both for financial services lending and the economies overall.

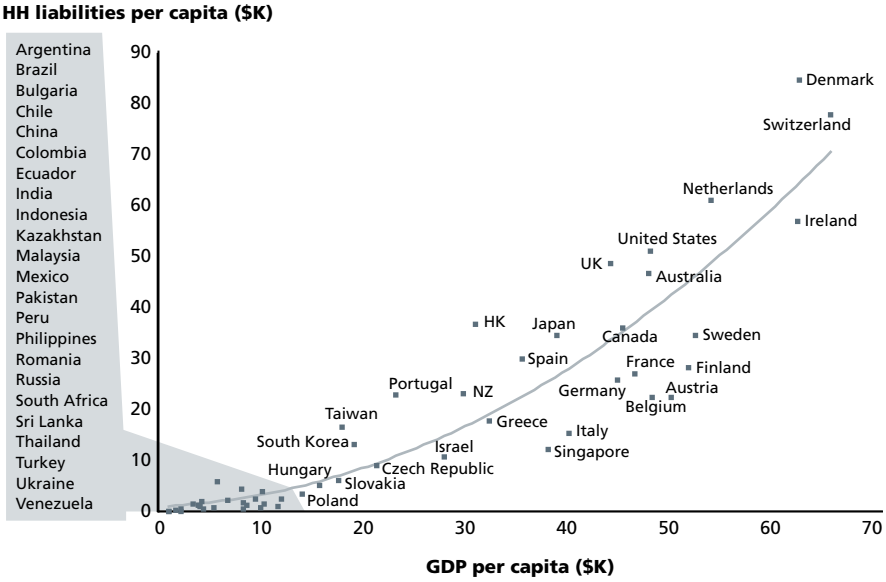
Exhibit 15: GDP growth projections 2010-2015



Source: IMF; Oliver Wyman analysis

GDP growth amplifies growth in financial services, because financial services is a luxury good: consumers' use of financial services rises non-linearly with increases in GDP. As the exhibit below illustrates, at low levels of income, financial services are hardly consumed. But as per capita income rises, the growth of consumption accelerates. This effect, combined with high GDP growth rates, auger strong growth prospects in these markets (barring a major disruptive event).

Exhibit 16: Household liabilities per capita vs. GDP per capita (2008)



Source: UN; EIU; Oliver Wyman analysis

The strategic implications of relative growth prospects seem obvious: banks should look to reallocate resources from developed to emerging markets. And for those institutions – either local incumbents or global players who have already established beachheads, this is likely to be the right move. However, there is a limit to this logic. The financial sectors and overall economies in emerging markets are too small to absorb a wholesale shift. Developed markets represent more than 70% of the world's total GDP[5]. The bottom line for large developed market institutions is that they will have to win at home to grow.

5 US, EU, Japan, Australia, Canada, Iceland, New Zealand, Norway, Singapore, and Switzerland

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