Four views of the US financial system

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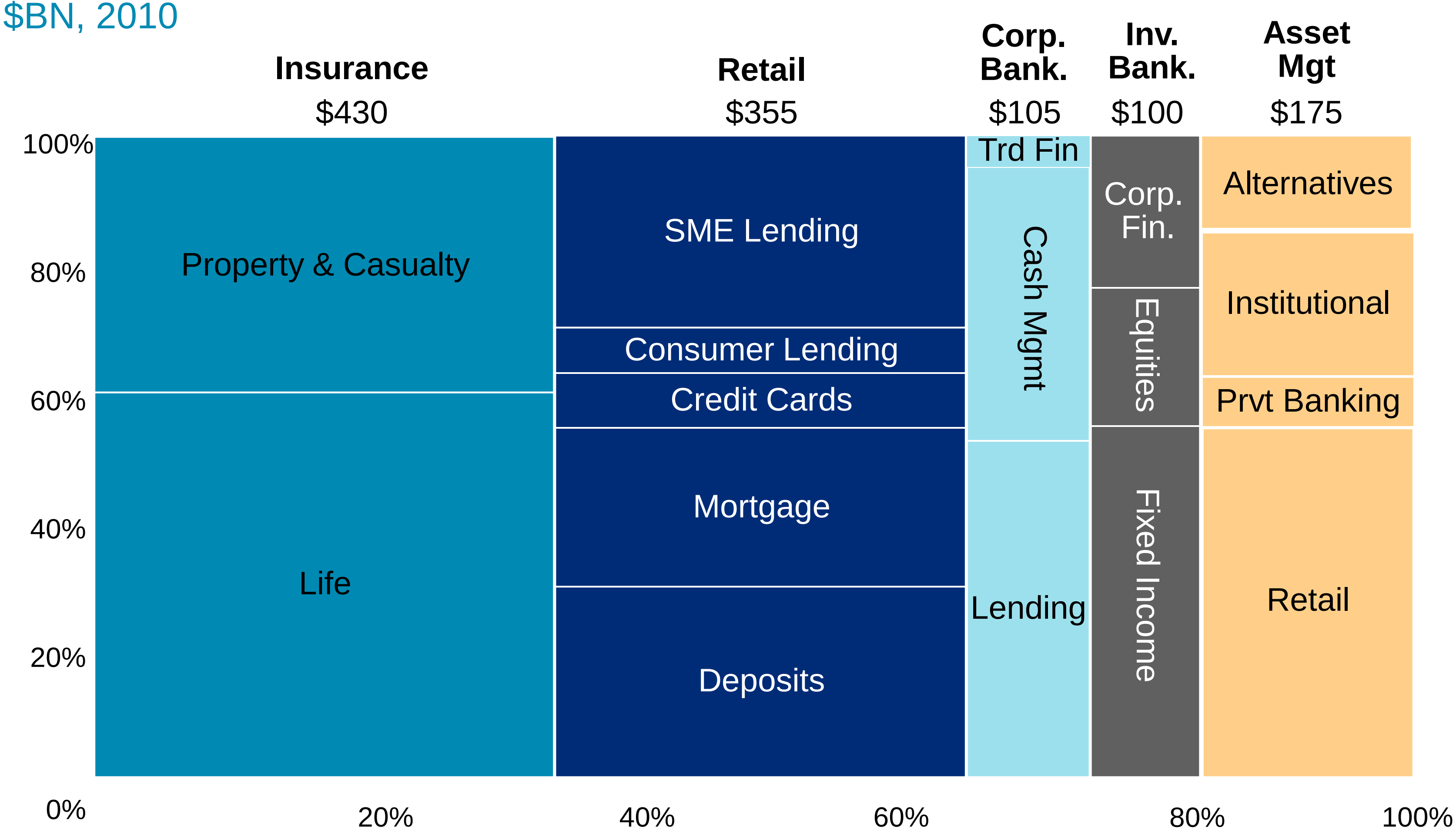
Summary
Four views of the US financial system

- **Business line view:** Financial system businesses generate > $1 TN in annual revenue across five major business lines
- **Structural asset-liability view:** Financial gearing of real economy has increased, while securitization further multiplied claims within the financial system
- **Comparative view:** US financial system is big, unbundled, less bank-centric, and complex
- **Evolutionary pressure view:** Financial system innovations and practices have been driven by the wish to reduce the amount of credit evaluation that must be done

US financial services – by business line

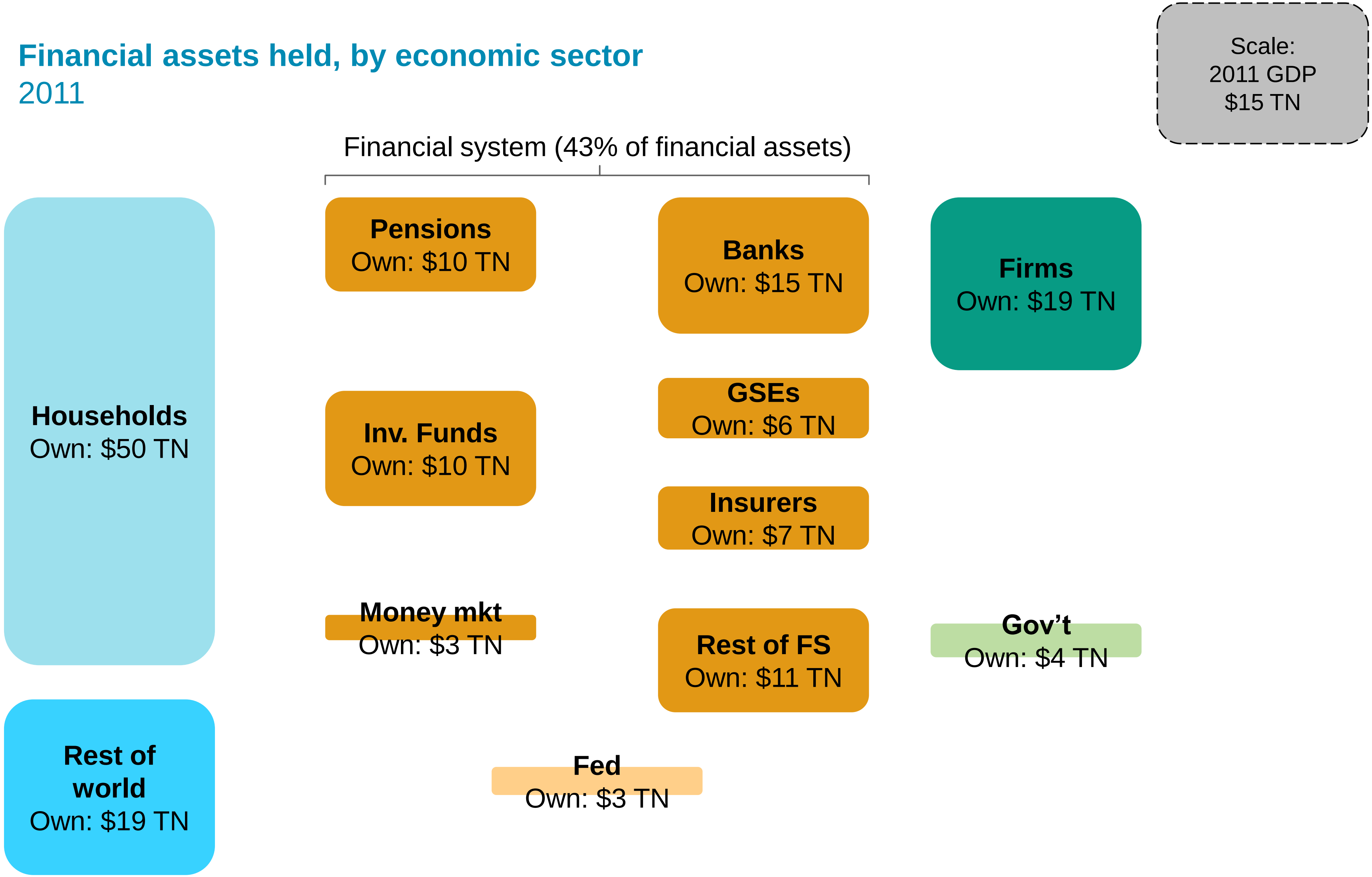
Revenues by financial services business, total = $1.2 TN
$BN, 2010



Source: Oliver Wyman analysis

Today, total financial claims are ~10 times GDP

Financial assets held, by economic sector
2011

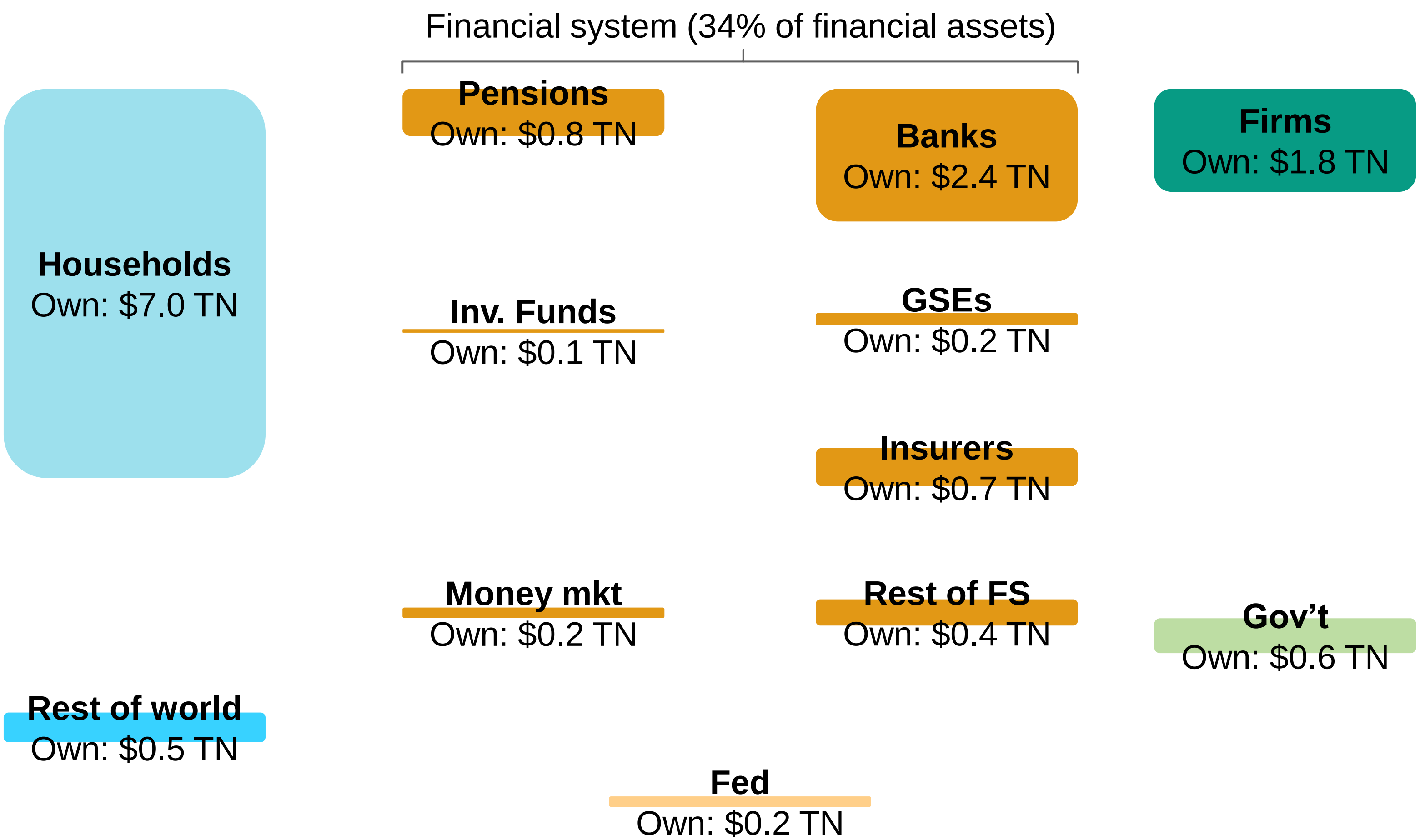


Source: Flow of Funds Accounts of the Unites States

Thirty years ago, financial claims were less than 5 times GDP

Scale:
1981 GDP
$3.1 TN

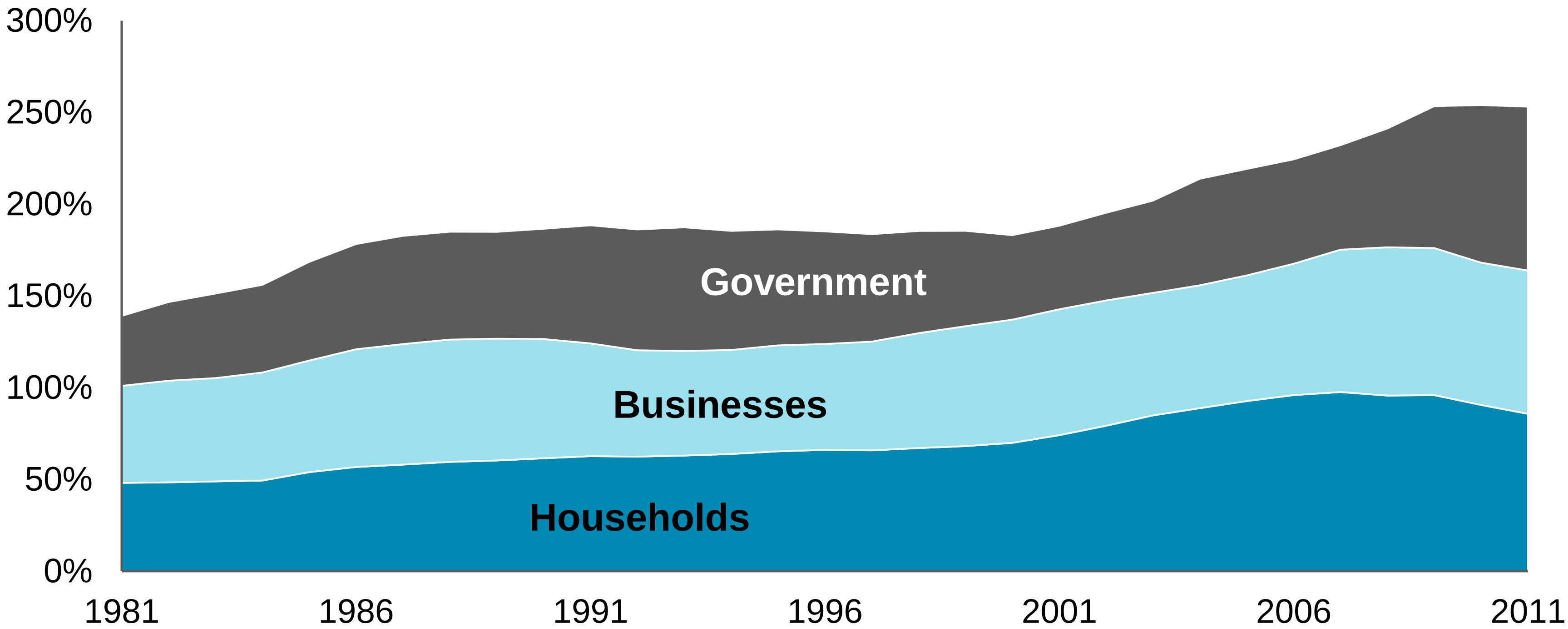
Financial assets held, by economic sector
1981



Source: Flow of Funds Accounts of the Unites States

Nonfinancial sectors have taken on more debt per unit of economic activity…

Credit owed by US nonfinancial sectors, as a percentage of GDP
1981-2011

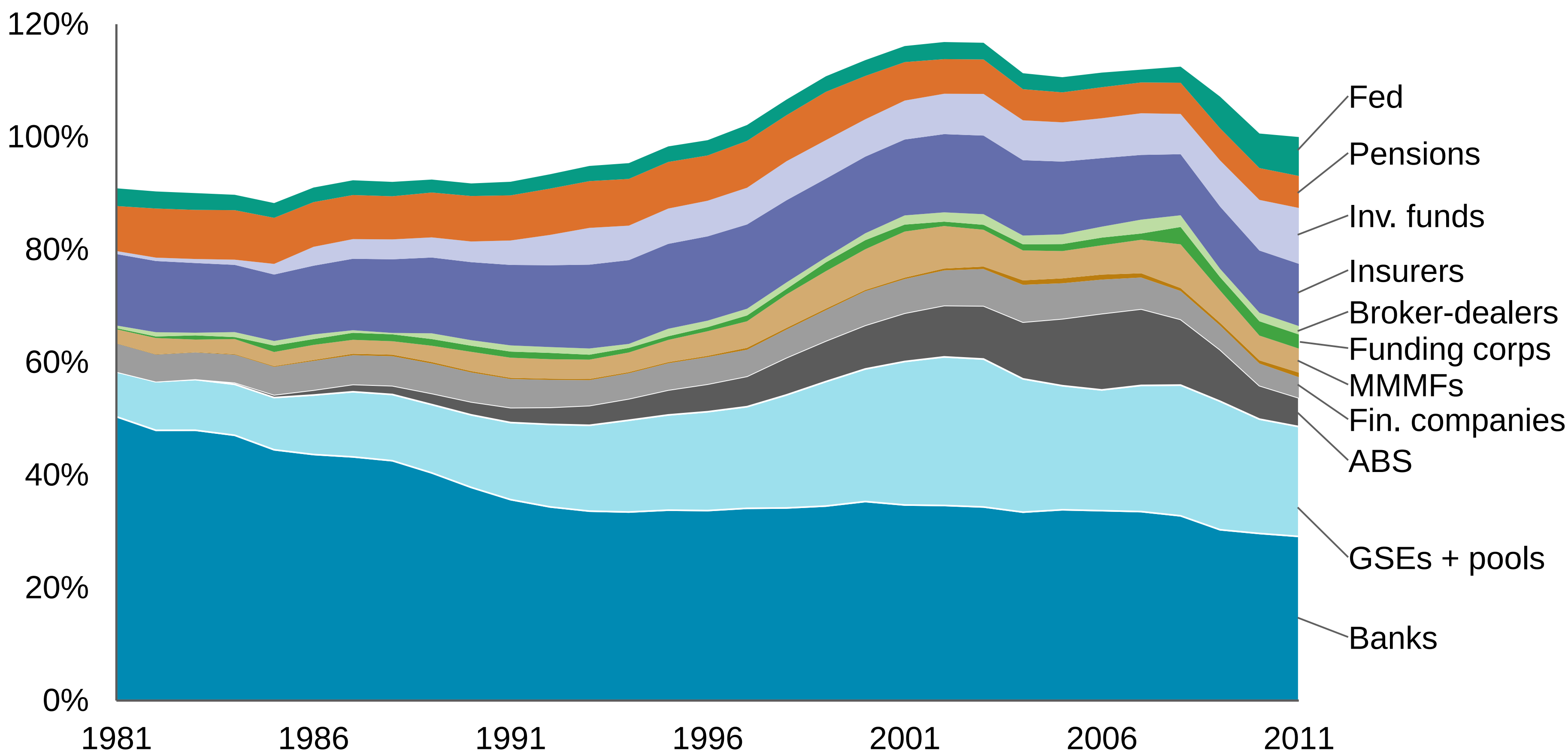


Source: Flow of Funds Accounts of the Unites States

…while daisy-chaining of credit via securitization increased the "credit multiplier" applied to claims on the real economy

Financial sector credit assets, as a percentage of credit owed by nonfinancial sectors

1981-2011



Source: Flow of Funds Accounts of the Unites States

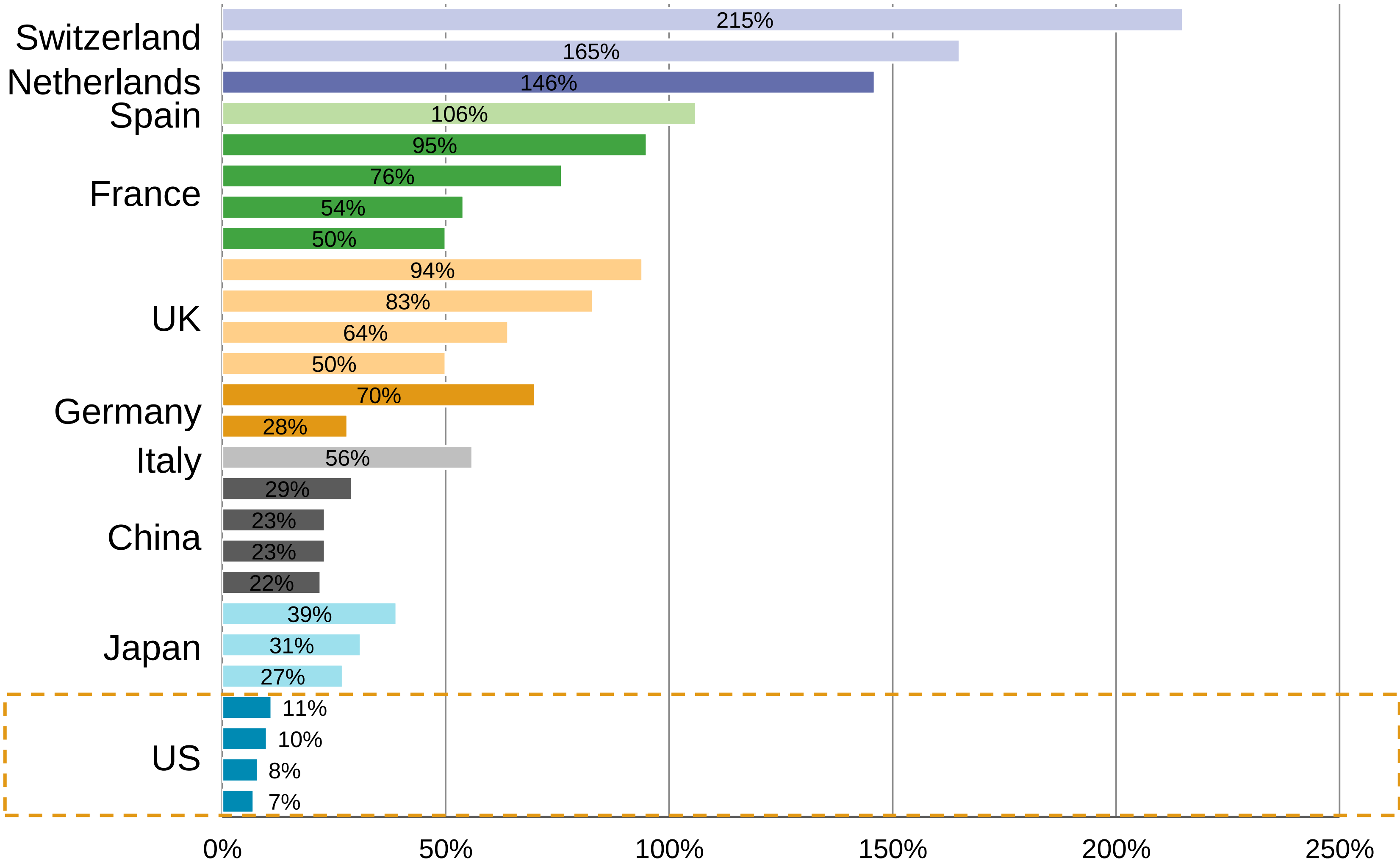
How the US financial system is different

- More credit intermediation via markets and nonbanks, less dominant role for banking system
- Lots of small banks
- GSEs
  - Subsidized mortgage asset funding
  - Hold mortgage credit risk, and significant amount of prepayment (convexity) interest rate risk
- Many different regulatory bodies, but increasingly same rules for major players
  - BHCs (including absorbed/converted dealers and finance companies) , nonbank SIFIs, foreign IHCs: similar prudential requirements
  - Orderly Liquidation Authority, the universal (in)solvent
- Big domestic economy

US – world's most credible bank guarantor

Assets as a percentage of home country GDP for world's largest banks

2011



Source: Bankers Almanac, Economic Intelligence Unit

Evolution of US financial system has been driven by the desire to reduce (or avoid) the burden of credit evaluation

Technology	Examples	Associated concerns
Collateral	• Repo • Sec lending • Prime brokerage	• Asset price and liquidity risk • Operational risk • Substitutes idiosyncratic credit relationships for more systematic market relationships
Credit rating	• Corporate, government, ABS ratings • Consumer credit scores (e.g. FICO)	• Model error • Moral hazard
Tranching / priority of claims	• Bank liability structure (equity, sub debt, senior debt, deposits) • Private label ABS • CDOs, CLOs	• Moral hazard • Model error • Principal-agent • Conflicts of interest
Credit guarantees	• Deposit insurance • Monoline bond insurance • Implicit guarantees (GSEs, investment banks, bank creditors)	• Moral hazard
Liquidity enhancement	• Agency MBS securitizations • ETFs • Money market mutual funds	• Asset liquidity risk

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