Settling the Systemic Score:

Or, How to Plan for New Rules without Knowing What They Are

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It is a pleasure to join Director Norton and others on this panel to evaluate current and prospective rules governing financial institutions deemed systemically important (SIFIs). I suspect none of you is, though, pleased to be here with us. Being a SIFI is, in short, no fun. And, it's not just a status conferred upon the nation's behemoth financial institutions. Even bank holding companies (BHCs) with assets of just a bit above $50 billion are SIFIs, or at least Congress says so. We've already debated whether or not SIFI-hood confers too big to fail (TBTF) benefits or ignominy. This is a critical debate, as an end to TBTF is vital to restoring financial-market integrity. But all of these rules not only have vital policy implications, but also profound business impact. Thus, I will discuss what to do if you're a SIFI from both a strategic-planning and forward-looking advocacy perspective. In short, if you can't beat it, what's the best way to win at it.

As counsel, you play a particularly critical role managing and advising large banks and other financial institutions facing SIFI designation. In this sector, many of the most critical strategic risks come not from changing customer demand, emerging technology or macroeconomic circumstance, but rather from law and rule. Since the financial crisis, I've heard over and over again that policy issues are perhaps the most vital win-or-lose factors for the companies we advise.

I think this results from the fact that, in sharp contrast to most other external drivers, policy ones are among the few that can be altered by effective management. Many other strategic drivers are like the weather – you can't stop the rain, just put up an umbrella, clean the gutters and otherwise prepare for a soaking. But, with policy drivers, financial institutions need not hunker down to take a hit. Instead, even as you fear the worst, you can also step in early to capture first-mover advantage or, even better, change policies to make them better.

Critical Policy Challenges

Before I turn to what you can do to prepare your banks and bank clients for the strategic framework, let me first assess where it stands now and where it's likely soon to go. I won't opine on which rule may or may not make sense or how they all affect the TBTF policy debate – instead, I'll look forward to engaging more fully on these vital questions during our Q&A. Instead, I'll provide what I hope is an objective assessment of the bottom-line impact of the most critical strategic rules facing large banks doing business in the U.S.

Capital:

- Director Norton, Professor Amati, Chris Cole and Josh Rosner have all made clear how strongly they favor far higher capital charges based on tangible equity and a broad definition of assets. Maybe this will make big banks safer – we can talk about that – but I know it will have a significant and adverse effect on financial markets. Adding cost to low-risk assets hikes the rates needed to attract bank investors – in short, higher USG interest rates right at the time the Fed is trying to find the QE3 exit. If these rates don't rise, then your banks will have their net interest margins squeezed even harder, meaning a dramatic shift in asset composition to arbitrage the leverage rules to the greatest extent possible. A desired effect? No. Likely? For sure.

These arbitrage incentives are even more profound for the biggest banks because the sum total of all of their capital rules upsets any expectation of market-rate returns on equity unless or until predictions come true and investors learn to love far more highly capitalized banks. So far, market caps at banks with significantly higher capital ratios don't tell that tale.

So, like it or loathe it, higher leverage capital on low-risk assets distorts financial markets and, at least in the near term, investor expectations for bank debt and equity holdings. Hard to raise more debt or capital when, right when you need it, investors demand lots more return. Will this pressure break up big banks into economically-viable pieces in a gentle, gradual way? Maybe. Break up lots more along the way the hard way? Again, maybe. At the least, we need to know more before we do more.

Liquidity:

- The FRB will shortly propose the U.S. version of the Basel III liquidity coverage ratio (LCR) even as it puts far more pressure on big banks, especially foreign ones, to reduce their reliance on short-term funding (read money-market funds). The longer-term a bank's funding base, the more it costs, even if this comes from core deposits. Thus, net interest margin (NIM) gets squeezed still harder, especially when pending new rules force big banks to issue lots more long-term unsecured debt.

- What to do? First, of course, is minimize maturity mis-matches, with many banks already making great progress here. However, the supply of interbank credit will come under considerable strain, putting new demands on the largest banks that have essentially served as funding utilities for their colleagues. New core-deposit franchises will prove essential, especially for any bank able to provide contingency financing or other off-balance sheet assets under the new leverage rules. Are big banks big enough to do this from existing branch networks? Maybe, but these liquidity incentives will conflict with the leverage ones in unforeseen ways that might actually empower some big banks and, thus make them even more gigantic. Ring-fenced banking organizations (read your living will) will make your bank even more of a stand-alone silo from a funding perspective, a requirement that might make it safer even as resilience throughout the banking system is undermined.

Credit-Exposure Limits:

- These are technical, but very major new U.S. and global rules. If implemented as proposed, they will wreak havoc with securities financing and many other capital-market activities. To which my fellow panelists may say, "Great." But, the law of unintended consequences applies here as well. With a less liquid repo market comes still more expensive government securities, exacerbating the leverage risks I previously mentioned. With limits on single counterparties comes restrictions on bank ability to use the central counterparties posited as the cure to derivatives systemic risk.

Risk Retention:

- We'll be getting a new proposal here shortly and it's likely to make lots more sense than the last one. But, that isn't to say it will even then make any sense. Combined with tough new capital charges for structured securitizations, risk retention poses a punitive capital curse for banks seeking to improve their liquidity through securitizations or serve customers at less cost due to capital-market efficiency. In short, it gets harder to originate assets like mortgages, auto loans and corporate obligations – especially longer-term ones now covered by tough prudential rules on the bank's own balance sheet. Mortgages get particularly tricky for banks given the huge uncertainties in that sector pending GSE reform. Shadow-bank securitization, anyone?

<u>Sum-Total Impact</u>

These and many other standards on the strategic agenda are bank-centric – that is, only you come under them. Does this mean finance comes to a halt where regulators think it's unsafe or unsound without their new rules? Of course not. Formidable non-banking companies are exempt not just from most of the costs in the risk-retention rules, but also outright left out of single-counterparty credit limits, liquidity and capital standards.

Some have suggested that a flight to the shadows is fine since these non-banks aren't TBTF, but if anyone is, they are. All of the new resolution rules are also bank-centric, meaning that potentially-robust TBTF solutions like single-point-of-entry don't work for non-banks. The next time there's an AIG, Bear Stearns or Lehman Brothers, the FRB and FDIC will just have to make it up all over again. Maybe by then all big financial firms will have to be banks or, perhaps, FSOC SIFI designations will plunge into the shadows. But, unless or until this happens, higher-yielding activities penalized by bank rules (even when truly for good reasons) will flee regulated institutions, exacerbating not just competitiveness problems for your banks, but also precipitating a new round of still more dangerous systemic risk.

Stress Testing Made Strategic

Does this mean you should despair of finding a way to help your banks keep their noses above water? Tempting, but no you shouldn't and, indeed, no you can't. Devising a feasible, viable and – yes – profitable strategic plan through this policy minefield isn't optional. It's a critical responsibility of every senior officer – no bank has the luxury of waiting until all of these rules are final to find out who wins or loses because, if you do, your banks will be very much the loser for it.

You all know all too well about the stress-testing mandated since 2009 for the very biggest BHCs and the new standards now seeping down the industry as a result of Section 165 of Dodd-Frank. The idea there is, of course, to stress test capital adequacy under various scenarios to see if there's any left after the you-know-what hits the fan. I take the same approach – said differently – to strategic planning for policy developments.

What do I mean here? Just as in capital-distribution stress testing, one takes baseline, adverse and seriously-adverse scenarios, but here I apply them to key rules, regulations and other relevant policy actions.

The starting point is an understanding of the bank – not all rules matter to all banks, of course. Thus, one needs to know current business plans and – critically – potential new ventures, M&A and other options management wants to undertake. With a thorough landscape of standards that have strategic impact – leave aside rules that are just a compliance nuisance, force lots of new paperwork or otherwise make work without making a difference – one then forecasts likely outcomes and stress tests business planning against them to see if, under growing stress based on varying policy projections, plans can be achieved as is, accomplished if altered or need to be scrapped.

And, if one plan needs to be scrapped under, say, the seriously-adverse scenario, this forward-looking planning process looks for previously-unrealized alternatives. This is critical – we don't do our banks and clients much good if all we can do is point to big brick walls and provide them with no option other than to bump their heads into these obstacles. There's always, always a better way. What Is It?

Now, I know some of my colleagues on the panel are looking askance at me. This "better way" might sound like a sneakier way – that is, a search for loopholes, crevices and other evasive ways to skirt law and rule. But, there are three wholly-appropriate ways readily at hand to deal with government-policy obstacles to business planning:

- First, are the government obstacles reasonable? Is the activity too risky in light of board-set tolerances, too close to the legal edge or – no matter how modulated – unlikely to pass the sniff test once sophisticated models are tested, circumstances turn against optimistic projections or the press or – lots worse – Congress gets wind of it? If so, push back and change the plan or do your best to get it scrapped.

- If the plan is sound, but regulatory obstacles are daunting, can these be changed? Is there an alternative charter, different transaction structure or other strategic option at hand? All too often, we look in the rule-book, see what we think is a no and tell our clients to give it up. Innovative readings of the law – think the non-bank banks of the mid-1980s – have stood the test of time and made both their owners and the lawyers that thought them up very rich without posing prudential problems. The exception here is AIG, but that was a unique case created by a thrift charter shoved into high-risk CDS as its regulator happily looked the other way.

- And, if there isn't a better way under current law and rule? Or, do pending legislation and regulation seem to pose insuperable obstacles to strategic plans? First, stress-test the plan. As I said, many can be in fact accomplished if one stress tests the idea against even a worst-case regulatory projection, adjusts assumptions as needed and, then, assesses resulting return and other business goals.

- Secondly – and here's where law and rule aren't the weather – we can change public policy. The industry hasn't done a good job of this of late – sometimes, I think we just talk to each other and fail to recognize reasonable objections to industry objectives, including some high-profit business plans. But, the full panoply of rules

> being constructed in the wake of the financial crisis has many unintended consequences with risks all their own. Many rules are also so complex that they actually make their vaunted toughness impossible actually to achieve without collateral damage. If you make that case and make it well, policy-makers do listen and policy really does change.

Hard to believe, I know. But, I've seen it happen and know it can again if the case is right from a policy, prudential and – yes – profit perspective.