WHERE THE DOLLARS FALL AFTER DODD-FRANK:

Corporate Finance in the New Era

Remarks of

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It is a pleasure to be here today to share views on the new era in U.S. financial regulation with so distinguished an audience. The Dodd-Frank Act will be three months old tomorrow, and what a strapping infant it is. We've already seen the law's implications in the first of the proposals required to implement it – and a daunting bunch they already are proving to be. At the same time, sweeping regulations are being finalized by global regulators, rules that will redefine corporate finance in tandem with the U.S. law. In fact, U.S. financial firms – especially large banks – are in the unique and unenviable position of being required to meet the highest, not-so-common denominator of all of these requirements, since the U.S. law anticipates many rules only just now being tentatively placed on the drawing board in the European Union, Japan and other financial centers.

You may not like this – the largest U.S. banking organizations sure don't. And, we've heard differing views today on the wisdom of these standards. What I'd like to do this afternoon is step back from this important policy debate and focus instead on what the combination of these requirements means in the near-term for the Fortune 500 firms represented here today. Of course, what happens to you has significant macroeconomic impact, given the implications for credit availability, profitability and customer demand. While the wisdom of these standards is surely debatable, their strategic impact is undeniable.

The law is of course complex and the new rules are even more formidable. I'll briefly describe some of the key provisions in a moment, but first let me summarize my views on the outlook for corporate finance resulting from these financial-market policy initiatives:

- Cost of Credit: This goes up outside the bond market. In fact, it goes up so much when interest rates start to normalize that I think the corporate bond market will adapt and provide more direct capital-market access for smaller firms. Those corporate loans that do get made will have significantly shorter terms than before, with fewer off-balance sheet options like letters of credit to be found.

- Fun and Games: Credit default swaps will be harder to get and cost more. Structured corporate-finance vehicles – think collateralized loan obligations – will be squeezed very hard in the U.S., perhaps leading foreign banks to fill this void.

- Private Equity: PEs are in a tough spot going forward because banks will largely pull out of this sector. One might think this leaves the PEs with an open field, and to be sure it does. But, other provisions in law and rule will adversely affect the ability of big global banks to make PE investments, clipping their wings to a considerable extent. Importantly, venture capital will be far less affected, albeit not immune.

Before I turn back to these conclusions, let me describe the key policy drivers behind them. As I said, it's not just Dodd-Frank that counts; it's also emerging global regulatory initiatives.

Basel III Capital and Liquidity Rules

For the cost of credit, the key drivers are to be found in the Basel III rules, and especially in the way the U.S. plans not just to implement them, but also to go way past the global standards to still more stringent ones. As I said, the U.S. is not just participating in the global-rulemaking process, but also demanding still more from our own banks. Case in point: global regulators are considering a surcharge for systemic institutions, but the Dodd-Frank Act already mandates one. Same thing holds for liquidity, where a surcharge is also mandated. In fact, the law says that all U.S. systemic institutions – banks and nonbanks – must be held to higher standards than any other banking organizations. Where these dividing lines stop and start is among the most critical implementation questions in the U.S. from a bank competitiveness and profit point of view. However, it's clear from the start that our rules will be tough and, then, even more stringent for the biggest banking firms.

Given the starting point of Basel III, this is a daunting proposition. I won't belabor the details of these global rules, but let me highlight some key points:

- Capital: Key changes here will dramatically increase the importance of tangible common equity as a source of regulatory capital. The final rules essentially take the requirement from one to seven percent. I know the biggest U.S. banks have said they can meet this without breaking a sweat, but that's based on an array of assumptions that will sharply reduce credit availability for all but the lowest-risk borrowers. Maybe it will take time due to the lengthy phase-in for global banks, but Dodd-Frank requires far quicker hikes in U.S. capital rules.

- Liquidity: This part of Basel III doesn't get the attention it deserves because it's even more technically challenging than the capital standards. The liquidity rules seek to prevent the "rush to the exit" type of panic that characterized Bear Stearns, Lehman Brothers, and AIG. They try to ensure that banks match funding with likely claims on it, taking into account both on- and off-balance sheet risk. The liquidity rules are in fact so daunting that even global regulators have deferred action on one aspect of them. However, this isn't to say the rules won't bite now, with this of particular impact in the U.S. where Dodd-Frank yet again requires U.S. rules now and still tougher ones for systemic firms.

Let me translate these rules into corporate-finance terms:

- If banks have to hold more capital, their return on equity is adversely affected unless their cost of equity drops in tandem. Regulators hope this will happen, but this remains to be seen. In the near term, banks under capital pressure will raise the cost of credit to compensate for higher capital requirements or reduce credit to higher-risk borrowers to maximize leverage and capital efficiency to the greatest extent possible. Pricing might adjust a bit for new capital to offset its increases. Still, the risk-adjusted return on capital problem will remain severe, driving up borrowing costs for most corporations and their customers.

- Matching funding maturities to meet liquidity rules means that long-term loans must be funded with long-term liabilities. These are almost always more expensive, exacerbating the price hikes coming from the capital rules for longer-term obligations required for facilities, equipment and the like.

Dodd-Frank's Structured-Finance Hammer

However, while Basel III is big, it isn't the only major initiative sure to affect corporate finance. Dodd-Frank will do this as well, and not just due to its one-up-manship on the global capital and liquidity standards.

First, the law takes a very hard stand on asset securitization. Much of the attention focused on this has been on retail credit, most notably mortgages. But, if your firm makes loans to auto, appliance or other customers in hopes of selling them into the secondary market, take a careful look at Section 941 of the Act and other provisions thereafter. These dictate new risk-retention requirements that reverse the capital incentives associated with securitization. If you don't get an exception – possible under the law – you will have a way tough time selling the obligation. So, corporate-finance here will be dramatically and adversely affected.

But, these provisions won't just affect the loans you can make and then sell to investors – loans that by the way accounted for half of U.S. credit formation right before the 2008 crisis. The requirements also affect the loans your firm can get from big banks. One reason credit flowed so freely before the crisis was the ability of banks to offer corporate loans that were then converted into collateralized loan obligations – CLOs – and, from that into CLO-squared and all sorts of other, highly-engineered instruments. These structured-finance products are also covered by the new risk-retention rules, and provisions in the Act mandating all sorts of new disclosures will also do them no good.

Time doesn't permit a discussion of the changes in Dodd-Frank that affect credit default swaps (CDS) and similar credit-derivative products. Suffice it to say now that capital requirements – thanks to Basel III and Dodd-Frank – are tougher and new clearing requirements even more stringent. CDS have been fun ways for banks to reduce the cost of corporate credit by obtaining hedging from other banks or insurance companies, but

the capital benefits of doing so will drop going forward. With this, of course, comes another reason to hike the cost of corporate finance.

Will the Shadow Do it?

Of course, banks aren't the only source of corporate finance. PEs are big players, so let me quickly take a look at what Dodd-Frank does to them.

You will, I'm sure, have heard of the "Volcker Rule," included in the law following a knock-down, drag-out as banks sought first to defeat it and, then, to modify the final, tough legislation. Among other things, the Volcker Rule essentially bars banks from investing in the U.S. in private-equity firms. This will not bar merchant banking, but will dry up a major source of cheap capital for many of the largest PEs. If they can get it from foreign banks and house corporate-finance operations offshore, U.S. PEs may be able to carry on as before, but this is a more than open question. The Basel III rules will hike the cost of credit for PEs from all big banks, even as cheap funding from U. S. bank equity investments dries up.

Venture capital is unaffected by the Volcker Rule, so it may proceed forthwith, but these firms are still subject to the Basel III standards when loans or investments go out to them.

Is Any of This to the Good?

I've tried today to be as dispassionate as I can in assessing all of these developments. I haven't said whether I think it's good or bad that Basel III does what it does or that Dodd-Frank forces so much change. In part, I'm withholding judgment because the critical rules here are still largely in the drafting stage and details matter a lot – a whole lot – in this complex arena. I'm also reluctant to pass judgment now because I don't think we should wholly avert our gaze from the profound regulatory and market lapses that got us all into so much of a predicament. If the cure is over-harsh, the disease was damn-near deadly.

I will, though, offer one policy conclusion before we open up for questions. We may well be over-compensating in the U.S. for all of the admitted failures that befell financial institutions. Piling up capital rules atop liquidity rules atop systemic surcharges in tandem with an array of new activity and investment restrictions could put banks in this nation under severe profit pressure and expose the U. S. as a whole to competitiveness concerns as capital markets shift to other nations. That the fingers of the U. S. financial system need bracing is hard to contest; whether its arm needs to be cut off is another matter.

That banks sinned is without question. That they need now to be flogged in the U.S. is, at best, debatable. And, if flogging ensues –as I fear it will – I don't think banks are the only ones in a world of hurt. When a market over-leverages as much as ours did and, now over-corrects as much as I fear we are, it will be a long, long time before normalcy nears and recovery is assured.