The Bulldozer in the Bulrushes: Sure and Certain Regulations that Redefine Banking Even as Congress Continues to Ponder

Karen Shaw Petrou
Managing Partner
Federal Financial Analytics, Inc.

Keynote Address

before the

University of North Carolina Banking Institute
Charlotte, North Carolina

March 25, 2010

Thank you very much for inviting me back to this distinguished conference. I will say to all the law students here that you are getting into the banking-law business at an opportune time – so much is changing that you'll start at a remarkably advantageous level in comparison to even the most senior bank counsel. None of us will have any experience with the battery of new laws that will redefine U.S. financial services on a scope not seen since the Great Depression. So, we'll be learning right along with you as you start in to an industry that is also redefining itself as never before.

Of course, Congress hasn't come anywhere near to finalizing the huge package of regulatory rewrites passed in December by the House of Representatives. With what used to be called parliamentary discourse reaching new lows every day, it's easy to bet against the ability of the Senate to finish work on the measure marked up just this Monday. And, even if the Senate pulls itself together and votes out a bill, it must then go to conference with the House and back again for passage in both the House and Senate. At this point, I think that will happen, but then I thought Kansas would be in the Sweet Sixteen.

Given the vagaries of the legislative process – a polite word for it these days – I want today to focus on what I know for sure right now: the regulatory landscape for bank and non-banking organizations is changing profoundly even as Congress continues to ponder. U.S. and global regulators have realized how woefully inadequate was much of what went before the crisis. Led by President Obama and other heads of state at the Group of Twenty summits, regulators on their own and in groups like the Basel Committee are dramatically redefining the rules of the game, doing so in ways that could well alter who's been winning and losing up to now.

A lot of these rules are complicated – at one point, global capital standards clocked in at over 800 pages. As a result, they are all too often consigned to low-level staffers and come into full effect long before those responsible for strategic decision-making hear the hoof beats. Counsel often are wholly left out of the assessment of these complex rules. For one thing, most have a lot of math in them, which puts lawyers off at the start. More fundamentally, though, the risk-management standards are not seen as policy decisions that drive board and senior-management action until far too late, at which point legal analysis is essentially moot.

Why are these rules important? Take the global regulatory-capital standards – they redefine how much equity a bank must hold. Then, remember that profitability is defined as return on equity or ROE. Hike the E and the R goes down. It's that simple. Require banks to hold higher-cost funding sources – a key issue in the liquidity-risk management arena and another critical profit

measure – net interest margin or NIM – goes skinny and, with it, shareholder hopes and dreams. Or, look at asset securitization – the secondary market is critical to the strategic structure of many banking organizations. Add to it a new FDIC proposal on a "safe harbor," and assets stay stuck on the balance sheet and a franchise is redefined. Some of this is for the good of the order, of course – many rules were way too lax. But all of it is vital to every bank – big and small. If the policy isn't going to change or shouldn't, at the least, you need to see it coming.

So, that's what I'd like to discuss today. I'll pick several of the most strategic pending regulatory initiatives, describe them and then outline their strategic impact. I think you'll quickly see why I think these rules – complex and arcane as they may seem – are vital to senior-management deliberations right now.

Regulatory Capital

Of all the pending rules, regulatory-capital standards are the most critical precisely because capital is a prime driver of profitability. Lots of other things determine return on equity, of course, but at the end of the day return still has to be measured against equity and, the higher equity has to be and the more expensive it is to raise, the less the return otherwise earned matters to the bottom line.

Time today doesn't permit a detailed discussion of Basel I – the initial risk-based rule put in place in 1988 that is still the rule of the land in the United States – Basel II – the current requirements finalized in 2007 everywhere else – or Basel III – the newest proposal from global regulators. The consultative period on the Basel III proposal ends on April 16, with the rules set for finalization by year-end, 2010. Reflecting this swift pace, U.S. agencies have already begun what's called a calibration exercise to make it easier for them quickly first to propose and then to issue the U.S. version of the global capital standards, executing President Obama's commitment last year at the G-20 that the U.S. would quickly come into compliance with the global standards.

As I said, time doesn't permit describing any of these initiatives – if I tried, you wouldn't get to eat lunch until well after the usual dinner hour. The most important aspect of the latest global capital proposal is that it would require a lot – and I mean a way lot – of new regulatory capital from every banking organization. Small U.S. banks may think they'll duck this new risk-based regime, but I don't think so. While the full panoply of the complex rules won't apply to them, the overall new framework will. As a result, U.S. banks big and small will need to hold a lot more capital in very short order. Off-balance sheet structures, securitization, and many other ways banks adroitly used in the past to meet the capital reaper won't work going forward. Also, the new rules will far better reflect real risk – they'll apply across the full business cycle, not allow

capital to drop dramatically in good times in ways that leaves banks as naked to the storm as they were under the old, Basel II standards.

Much in the rules is good, as my brief description may suggest. However, the total set of new standards is a pile-up. If every one of the Basel proposals was imposed – and in the mood regulators are in these days, that could happen – the sum total of regulatory-capital standards for all banks would at the least double if not triple or quadruple from current capital standards. That takes ROEs – of course already under a lot of pressure – and drives it down to single digits, if you're lucky.

Regulators know this and plan a transition period to ease the rules into effect. But, in many ways, that presents its own danger. The longer the transition, the greater the temptation for banks to feather their nests now and take continued advantage of all the risky options in the current rules. And, of course, the ability of different regulators to catch banks in the act is, at best, questionable. So, some banks may honestly try to comply with the new rules only to be blind-sided by less scrupulous competitors.

Another strategic concern: non-banks. In the European Union, many of them come under the Basel capital rules. So, if the rules are hideously painful, at least it's equitably shared across firms providing the same services. In the U.S., though, bank regulators have no power to impose regulatory capital on non-banks. In areas like asset management – where non-banks are big – this difference is a vital strategic consideration. Under the pending legislation, the FRB could impose bank-like capital rules on systemic non-banks, but how it does this and on whom the rules would fall is most unclear. Even if many non-banks are covered – which I doubt – the competitive landscape will still be dramatically altered, putting a lot of strain on banks and forcing many out of non-traditional business activities that have been huge profit drivers in recent years.

Liquidity Risk

Although I think regulators are going more than a bit berserk in Basel on capital, I know why they are issuing rules designed to cure the capital problems that led to so much leverage and, thus, so many systemic-risk calamities during the current crisis. But, capital wasn't the only problem: poor liquidity-risk management was also a major force that precipitated failures at banks and non-banks. Both Bear Stearns and Lehman Brothers are two clear examples of the latter – each firm failed because it didn't anticipate market worries that led counterparties to wake up in the morning and say no more money could go out the door to each of the strapped securities firms. When funding suddenly dried up, first Bear Stearns and, then, Lehman turned up its toes because they literally couldn't open for business the next day.

Citigroup is another liquidity-risk casualty because, along with all its other problems, it put a lot of risk off-balance sheet and then failed to fund it. When the market decided that Citi was at real, on-balance sheet risk, Citi couldn't fund its obligations and had to head straight to the Feds for even more of a rescue than it had first taken from the TARP.

Reflecting all of this, regulators are trying to right liquidity-risk management. The Basel Committee has also put out a new consultative paper in this area, again planning to finalize it by year-end. U.S. regulators haven't waited for the global rules, though. Unlike the capital standards, they finalized a new liquidity-risk framework earlier this month. It doesn't go as far as the pending international standards – which are amazingly stringent – but even the interim U.S. rules will make you gasp.

Again, time doesn't permit a detailed discussion of any of these liquidity-risk rules. If I added this to a detailed discussion of the Basel capital requirements, we'd be here not only until after dinner, but also well after your post-prandial cocktail. Key to understanding the liquidity-risk standards is that first, they again will apply to all U.S. banks – big and small. In fact, the new U.S. rules make this very, very clear by addressing concerns such as the degree to which banks rely on brokered deposits or Federal Home Loan Bank advances. If you do, you need to change your funding strategy. Even if you don't, banks need to revise their funding structures to ensure ample liquidity under even highly-stressed circumstances, with the rules likely forcing most banks to realign asset/liability composition in ways that will prove quite costly.

And, as I said, that's just for starters. The pending Basel rules are even stricter. Strategically, the new liquidity-risk regime will force all banking organizations to a far more traditional mix of funding sources and asset holdings. This will, as I said, put a lot of pressure on NIM, which is the predominate profit source at most traditional banking organizations. Non-traditional ones have made a lot of money from non-banking activities less directly affected by the liquidity rules, but the liquidity rules still matter in major business lines like securities lending and the cost won't come cheap.

Asset Securitization

Finally, I'll turn to the regulatory issues that cloud the outlook for asset securitization. If I try to explain all of them, we'll be here for breakfast. However, let me start by emphasizing how critical the secondary market has become to a wide array of loan classes. Securitization has been the primary form for residential mortgages for years, with Fannie Mae, Freddie Mac and Ginnie Mae of course playing prominent roles. Now, though, they are the entire market, with the U.S. Government (for that's where the GSEs now sadly are housed) controlling 95 percent of the entire U.S. market. Private-label mortgage

securitization is dead for all intents and purposes. But, mortgages aren't the only sector where securitization is critical. It's also a long-standing feature of auto, credit-card, student and commercial-mortgage lending, with Treasury recently concluding that the secondary market accounted for fifty percent of U.S. credit formation at its peak before the market crash began in 2007.

Because mortgage securitization is now wholly a government game, some of the pending regulations might not apply to it. However, the rules that darken the prospects for recovering asset-securitization markets in other sectors also cloud the prospects for residential mortgages. Thus, any and all banks active in each of these markets – mortgages included – needs carefully to consider whether it could continue securitization under the new rules and, if not, whether it could hold loans on portfolio under the new capital and liquidity standards I've already outlined. For many, the pile-on of the securitization rules could well prove a crushing blow that forces the bank back to a far smaller – albeit considerably more traditional – operation.

What are these new rules? The most immediate of them is one from the FDIC. In 2000, the securitization market began its rocket launch because the FDIC provided a wide-open safe harbor. It said that the FDIC would not seek to claim the assets underlying asset securitization from investors if a bank failed. At the time, this was principally a legal concern because bank failures had dropped to a negligible number. Now, of course, the safe harbor is critical. If the FDIC exercises a claim on assets in asset-backed securitizations (ABS), investors won't want the securities or will demand so high a price for them that securitization is stymied.

The FDIC has an advanced notice of proposed rulemaking (ANPR) out on this vital topic. It is now proposing not to afford a safe harbor to any assets that don't meet its standards, with these being a combination of consumer-protection and prudential ones designed to prevent ABS from firing up another systemic-risk crisis. For mortgages, the rules are even tougher, but, for all ABS, they are formidable.

We'll await the next step in the FDIC's rulemaking process, but it could trump pending legislation that would impose a risk-retention requirement on originators and/or securitizers. That bill would also put a huge speed-bump in front of securitization by requiring issuers and/or lenders to hold five percent or even more against assets sent to investors. This is tough indeed, but the FDIC could on its own moot this if it chooses to follow through on the even tougher approach in its ANPR.

That's why I think keeping a careful eye on the rules, as well as the legislation, is vital. Current law gives regulators a lot of scope that the pending bill often only increases.

Bringing It Back to the Lawyers

One common element in each of these proposals – and in many others also in the works – is the requirement now for boards of directors and senior management to know what they're doing to comply with them. This is a sea change in corporate governance at banks, where all too often, directors only leafed through their three-ring binders full of confusing, complex presentations. I've been a bank director – trust me, it's sadly all too true, especially for complex matters on which directors have little expertise.

I think this is wholly appropriate – if one doesn't know enough to dictate strategy and exercise fiduciary duty, one shouldn't be a bank director. Bank management should be able clearly to answer straightforward questions like "What's this credit-default swap for?" If they can't make clear that the transaction isn't a structured one designed to hide a client's truth or that of the bank itself, the board should ban it.

But, before the transaction gets to the board, it has to go through the general counsel and risk-management team. If you can't answer and ask these straightforward questions to your own satisfaction, then the board at the least needs to know that you haven't and won't bless the deal. If you think risk-management presentations are so abstruse that the board doesn't understand the risk tolerances being established, the reputational risk being run or any other critical factor, bank counsel also must intervene to ensure that the board can comply with applicable law and rule. This didn't use to hold the board responsible along with senior management – general counsels included. Now, though, it does.

I think much in the capital, liquidity and asset-securitization rules I've outlined today will change. This will help a lot and avert some of the worst consequences I've laid out. I also think a lot of work is under way to try better to balance these rules – and all the others we haven't had time to discuss. Or, at least I hope so, balancing all of these rules is among the most critical asks confronting regulators and the industry. Even if the rules are dramatically altered – and I expect only minor modulations as they are finalized – the net cost of all of these regulatory rewrites is huge. Add to it that of the pending legislation, and it could be crushing.

No policy-maker I know means to wipe the floor with any banking organization, even if they like from time to time to vilify one or other big bank. But, in the debris of the financial crisis, many have lost sight of the fact that banking is, at its root, risk intermediation. Take out the risk, and you lose the bank. Getting policy-makers to understand where each of your banks rightly takes risk – and ensuring your institutions appropriately control unduly risky behavior that could make you do wrong – is, I think, the most important strategic challenge

confronting each of your institutions despite the many others I know keep you all up nights.