So, What's New?
Initial Answers to Critical Industry Questions

Remarks by

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You all do pick interesting times for your meetings – no curse intended. Last year, I joined you in early October as we hoped financial markets would recover from the thrashing they took the prior August. We talked about the impact of market developments to that point on the banking system and, as you will remember, had a lively debate. Perhaps wishfully, there was a widespread view that the regulatory world would right itself and resume much as it was. Now, I think we can all agree – like it or not – that those hopes are dashed and the banking industry – whatever remains of it – will confront a vastly-different universe. Indeed, it's already a wholly different regulatory framework than the one known only months ago – look for proof at the deluge of desperate rules each of the regulators is rushing out even as imaginative resolution strategies are crafted to handle growing failures.

So, what's new? As we speak, Congress is wrestling with a massive rescue that is now stuck with the "bail-out" sobriquet. So much has gone before that bill, accompanies it and will befall us after it that I'll hold for a moment discussion of the legislation itself and its specific implications. Instead, what I'd like to do this afternoon is consider what else has happened – not a little list on its own.

For starters, let's consider the historic change in the role of the federal government in the financial industry – Treasury and the FDIC now hold shares in privately-owned companies and, perhaps, more warrants are in the offing. This is an awesome paradigm shift that presages a complete overhaul in financial regulation as we know it. In addition, there is a daunting array of statutory and regulatory changes to come in areas like capital requirements, the powers of bank holding companies now that everyone who's anyone is one, the future of OTC derivatives and "shadow" financial institutions, deposit insurance and – whew! – the regulatory structure that will govern all this.

Let me emphasize before I go any farther that this talk tells it as I think it is, not as I or, perhaps any of you, would like it to be. You all have powerful advocacy operations with which to seek to craft different outcomes than the ones I now foresee and, indeed, these efforts could well lead to very different results. However, several critical events are already upon us and these drive immediate strategic decisions – legal and reputational risk management, capital-raising, resource allocation and M&A top on the list. Thus, I will try to outline an objective assessment of the strategic reality now defining the industry, leaving for later how you all might like it to change.

Because of the limited time we have and the vast scope of market events, I'm going to offer conclusions, not go carefully through the analytics that underlie each of them. Let me offer one initial thought, though. If you read through a "blue-ribbon" industry report of mid-2005, you'll see a remarkable outline of everything that's gone wrong since and a nice set of recommendations on how to fix it. The 2005 report was, in fact, generated after regulatory pressure for industry action because several agencies – not all, to be sure – saw a lot of what's since happened coming. Three years ago, though, a serious effort at

voluntary action floundered. Now, regardless of who thinks which regulation or deregulation did what, the industry and its regulators have little, if any, credibility. There's nothing like a $700 billion rescue plan, hundreds of billions of Fed funds and a series of systemic-risk failures among the GSEs and large banks to concentrate the mind.

So, to some suggested answers to complicated questions raised in a highly-volatile market in the midst of a Presidential election.

Capital at Risk and Then Some

After the thrift debacle, my firm was asked by the post-mortem Congressional commission to advise it on what went wrong. We said then that a predicate cause of the debacle was "net worth certificates" – phony money Congress created to pretend S&Ls were capitalized when they weren't. Without capital, the sky's the limit in terms of what financial-services firms can do with other people's money. And, without capital, the depths of the Treasury's coffers have to be plumbed when implicit guarantees are called or systemic-risk fears are raised following spending sprees enabled by lax capital standards.

This now is all too expensively understood. As a result, when the smoke clears, "capital at risk" will be the new regulatory mantra. It will dictate supervisory policy governing all regulated financial institutions and the new capital regime will, we think, bear only passing resemblance to the Basel II one so recently minted. "Shadow" financial institutions won't, we think, come under this capital regime directly, but a host of new standards will govern counterparty risk exposures that will, in effect, create proxy capital requirements governing all transactions with hedge funds, private-equity firms and similar entities.

One further thought: capital at risk will also dictate a new future for capitalized lenders and providers of credit risk mitigation. These will need to be housed in regulated institutions – the days of unregulated CDS providing capital relief are gone. To be sure, some of the CDS market's recent problems stem from regulated monoline bond insurers. However, they got into trouble in new ventures regulators allowed to run wild outside directly-supervised, capitalized insurers. As a result, CDS are already being reined in – a major issue for banks in this business and a potentially big confrontation down the road between state insurance regulators – assuming any are left after a new federal charter is mandated – and the OCC's business-of-banking doctrine.

As all this plays out, though, monoline, regulated providers of credit risk mitigation are, I think, in a sound position from which to prosper going forward, as is another form of credit risk mitigation: prudent lending. The rush around loans to speculative commercial paper structures housed in off-balance sheet vehicles is also, we think, over.

Full Faith and Credit – and Then Some

Recent developments have put the lie to the view that institutional money is on its own. Once Treasury opened the Exchange Stabilization Fund (ESF) to money-market mutual funds (MMFs), the gig was up. Time doesn't allow a discussion of the credit ratings agencies – nor is my vocabulary in public sufficient. However, let's simply say that all too many MMFs and their customers thought a AAA rating was fool-proof. They also bet that Fannie and Freddie preferred stock was blessed by the government with the same implicit guarantee as GSE debt and, for that matter, that Lehman and other major players were too big to fail. Secure in the AAAs and other protections assumed to backstop all these holdings, MMFs went for the yield.

In short, they came up short. Whether from liquidity strains or solvency woes or – as I would suggest – a combination of both, the MMFs last week were in a dire predicament and, with them, went the national economy and the global financial system. As a result, Treasury pulled another idea from its back pocket and came up with the ESF back-stop. This is, in essence, MMF insurance that transcends the FDIC. The MMF protection is, for starters, a darn sight cheaper – one basis point going forward and free for now – and a good deal deeper – there's no maximum account limit. Also – and not incidentally – it comes without any accompanying prudential regulation – at least for now.

What does this mean for deposit insurance? Many of us have argued for years that another predicate cause of the thrift debacle was the sudden decision by Congress in 1980 to raise the federal deposit insurance threshold from $40,000 to $100,000. But, if money that can and should know better is bailed out, then small businesses, retirees and wealthier consumers are understandably demanding that they get similar aid and it looks like their demands will soon be met. This is welcome news for all of your banks – cheap core deposits are critical to the new future and one major reason Goldman Sachs and Morgan Stanley decided to join the ranks of bank holding companies.

Will the full faith and credit guarantee of the FDIC stamp or, for that matter, Treasury's protection for MMFs come free? Of course not. With it will, we think, come not only the new capital regime noted above, but also prudential standards and social-policy requirements that will dwarf those with which you now deal.

If the return to intermediation we discussed last year is good news – and I think it is not only for banks but also for the market as a whole – we'll need to weigh it against the new regulatory framework to come in the wake of full-scale federal guarantees behind core funding. Thinking through who's under this regulation and what is required under it will, I think, be critical to ensure that yet another set of regulatory gaps that permit free-wheeling arbitrage doesn't resurface in short order. All of your banks lost a huge amount of market-share in recent years to un- or under-regulated firms and, to hold your own, you did a lot of things you've lived to regret. It is a critical challenge going forward to think carefully through where the new safety net starts and stops and how the price for this expensive new fail-safe will be set, allocated and governed.

To Have and to Hold

Now, to the new bank holding company. With the acquisition of Merrill Lynch and the transformation of Goldman Sachs and Morgan Stanley, the bank holding company is clearly the charter de jour. The SEC has given up the ghost on the consolidated supervised entity and, in short order, Congress will do the same for the S&L holding company. However, the tried-and-true bank holding company will not go forward in anything like the framework we've all come to know. For one thing, the fact that the FDIC now holds warrants in one large bank has forever changed the interplay between banks and their regulators, as has Treasury's stake in Fannie and Freddie.

Will this change so challenge the Gramm-Leach-Bliley Act (GLBA) that Congress in short order reinstates Glass-Steagall? Some on the Hill hope so, but I doubt it. For one thing, doing so would mean disentangling almost every BHC of size, and Congress isn't good at taking back that which has been given. It could grandfather prior mixed firms of course – shades of the unitary thrift holding company – but that bargain in GLBA didn't work out well and we doubt it will be repeated.

Instead, we expect Congress to craft a wholly new BHC regulatory framework designed to protect the government's existing stakes in financial-services firms and prevent the need for any more. This is where, I think, a massive strategic risk lies for each of your banks. Put together the factors I've outlined above: new capital standards, unlimited federal deposit/MMF protection and new prudential and social-policy regulations. Add to it the mandatory infrastructure rules sure to come in the wake of the CDS collapse and you have a regulatory structure all too reminiscent of that which has governed utilities since the Great Depression.

Under this approach, large firms are essentially allowed quasi-monopoly status and an array of protections in return for rate, infrastructure and community-service regulation. Utilities can earn shareholders a "reasonable" rate of return, but not more than that and they can't branch off into new ventures without receiving prior approval and implementing protections for their core operations. Compensation regulation? Of course.

A key difference between utilities and banks is that there aren't shadow utilities, nor are there thousands of little ones. By virtue of utility regulation, anyone offering public-utility service does so in a supervisory structure that ensures a few big players with protected profits. Turning banking regulation into utility regulation cannot be done without reckoning with the substantive differences between the two sectors. Failing to do so would, in fact, destabilize markets still further because financial-services firms outside the new "utility" regulatory framework will be ferocious competitors backed by a widespread expectation of an implicit guarantee. However, the model will be deeply tempting to shell-shocked Members of Congress and a new President, inheriting as they will a financial system in the worst shape since Franklin Roosevelt stepped into the Oval Office in 1933.

In conclusion, I think it's now certain that bank regulation will be rewritten from the bottom up next year – the debate we had in 2007 is over. "Principals-based" alternatives to prior regulation aren't, I think, viable options in the current situation, nor are rear-guard actions defending deregulation. Thinking through who's in the new structure, what it is, how much it costs, how much protection is afforded to whom and who runs it are just the start of critical questions confronting the U.S. banking industry next year. Without credible industry answers, others will be offered and, then, adopted. In the meantime, of course, the regulatory framework continues to change in response to shock after shock, posing significant challenges and – I think – some exciting opportunities for those left standing.