POST AUGUST 9:
The Strategic Impact of the New Regulatory Agenda

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It is a pleasure to be here with you again to review the major legislative, regulatory and policy events that will affect large banks in the coming months. I wouldn't know where to start except that Mike [Bleier] has put several items specifically on my to-do list. Before I get to these topics, though, let me start with a general observation: in the wake of the Fed's mid-August market interventions, the tide has completely turned.

In Washington, we're not talking any more about promoting U.S. financial-market competitiveness; instead, the talk has focused on controlling systemic risk. Treasury secretary Paulson and Chairman Frank – two leaders who of course don't always agree – have spoken in the past few weeks about how financial innovation out-stripped regulation, and the focus now is wholly on righting that balance and figuring out a way to get regulation, if not in front, at least marching in step with market developments. In this new climate, careful strategic evaluation of policy developments will be critical to M&A planning, new-business assessment and legal/reputational risk management. Senior regulators are still living day to day as markets roil and large banks come close to the edge. When all this dust settles – as hopefully soon it will – they will return to rewriting the rules, backed by a Congress and new Administration after the 2008 election. Call it the cliché you like – new paradigm, sea-change, tsunami, whatever – but it's heading our way.

In your material, you should have an environmental scan my firm pulled together last month. It's a redacted version of an assessment of a wide range of issues for one client, so the impact evaluations are necessarily cursory. However, I've asked that it be provided to you to show the depth of major issues on the table for all large banks and how far-reaching their implications will prove. I'll look forward to answering any questions you may have on issues noted on the scan, but let me now turn to just a few of them that may be of particular interest.

Return to Intermediation

The bulk of the innovations that have scared the dickens out of legislators and regulators are those that led to a thriving financial system outside traditional banks. All of this was, of course, based on complex securitization and risk-transfer structures often housed outside regulated institutions. These unregulated firms have, however, depended on regulated ones for all their capital, often in structures like the off-balance sheet conduits now collapsing in the asset-backed commercial paper market. Exacerbating these liquidity risks was the fact that long-term assets were short-term funded. As a result, when the music stopped, a whole lot of players didn't have a chair on which to sit.

When the music starts again, it will be a lot slower and most of those circling the chairs and holding them will again be regulated institutions. CDO and LBO structures, let alone all the complex trading positions related to indices based on them, will take a while to reconstruct themselves and re-emerge as formidable market factors. In the interim, large institutions with stable funding sources – core deposits, anyone? – will claw back a lot of lost market-share even as costs rise from tougher new capital and related regulatory requirements.

The One Exception: Mortgages

Most analysts are expecting the biggest gains for traditional banks to come first in the mortgage sector. Indeed, analysts were singing this happy song even as some very large companies earlier this week announced poor earnings due to mortgage woes. Pending regulatory and legislative changes could, though, throw the balance of power in the mortgage sector back to the GSEs and, for the first time in a long time, the FHA.

Of course, it's too early to say what Congress will finally do on the big bills now advancing to rewrite the rules governing Fannie Mae, Freddie Mac, the Home Loan Banks and the Federal Housing Administration. Let me, though, point to a few provisions that, if enacted, would take a major chunk out of the private market many hope will re-emerge when market conditions normalize:

- First, the House has passed an FHA reform bill that, among other things, would raise the government loan limit to (for now) $730,000, giving HUD authority to raise this another $100,000. That's right, the FHA would back mortgages of up to $830,000 when national median home prices are $230,000 or so. So far, this market has been the domain of the private jumbo-mortgage market, but that would change.

- Not to be outdone, the GSEs are likely also to get a higher loan limit if Congress acts on pending reform legislation. In an odd twist, the GSEs may not get as large a share of the jumbo market as the FHA – even though FHA is chartered to help first-time homeowners and others who can't get privately-insured loans. The talk about the GSEs' loan limit puts it around $625,000. Some say that would only be a temporary increase, but the temporary telephone tax was put in place for World War II and it is, I think, still on my phone bill.

- Atop this is talk from Treasury that the GSEs could also go beyond their current charter to rely on self-insurance for high-risk mortgages. This would put a heavy squeeze on private providers of credit enhancement, as well as alter the shape of emerging credit derivatives in the mortgage sector.

I think lenders and securitizers are looking at legislation that would put the federal government directly through the FHA and indirectly through the GSEs into every segment of the mortgage market from the highest-risk subprime loans to jumbo, prime-quality loans. If enacted, this would turn private lenders into the equivalent of mortgage brokers – perhaps taking over from a battered segment of the industry about to kiss itself good-bye. Bank distribution networks will take over from brokers and correspondent networks, but only to originate loans for subsequent sale not to their own investment houses, but rather to Ginnie Mae or the GSEs. There's still money to be had here, of course, but it's not the wide option-adjusted spreads for which many hope as they watch the mortgage-market's current travails.

New Costs of Doing Business

I mentioned a while ago that regulators are looking at a series of new capital standards and reserves to right some of the wrongs revealed by recent market shocks. Let me run down some of the changes on the horizon:

- Valuation reserves and new standards are in the works. The Basel Committee will soon issue a long-pending proposal for liquidity reserves, including in it a proposal for reserves to support mark-to-model assumptions. These ideas have been kicking around Basel for a while as the capital rules were finalized. Now, they're a top priority item on the international agenda, but U.S. regulators will move ahead with their own standards without waiting for global ones.

- Valuation enforcement is another hot button. The SEC is conducting a series of investigations about the degree to which valuations have been applied consistently within individual companies, and I think they'll do the same at banks, with or without the consent of the bank regulators. The SEC has a long-standing view that the banking agencies care too much about protecting their charges and not enough about investor protection. If they can grab hold of an action under the '33 or '34 Acts, they can and will impose sanctions at the bank level – see, for example, the settlement on September 19 between the SEC and HSBC's national bank as a case in point.

- Off-balance sheet? I don't think so. The Basel II rules on which I'll touch in a moment bring off-balance sheet obligations into the capital rules, sharply reducing the capital incentives that led many banks to put huge books into complex structures for which they stood as guarantor. Consolidation now would put too many banks out of business, so this won't happen. However, both capital and accounting rules will quickly change, with the capital provisions moving on their own track in the U.S. due to the Basel rules' problems.

Basel

Problems? What problems? In mid-July, the U.S. bank regulators hammered out a hard-fought compromise that advanced the rules – or so it seemed. In just a week or two, the premises on which the advanced options are based – internal models first among them – drew heavy, often deadly fire. Worse, the agencies' second compromise – advancing something like the standardized option for all but the biggest banks – is premised on ratings from the now tarnished NRSROs. The bank regulators knew that credit ratings were dubious, but viewed them as the least worst way to get an external handle on credit risk from which to set regulatory capital. Now, they know that ratings, especially on complex instruments, are wholly unreliable predictors of credit risk.

Importantly, even if the banking agencies wanted to carry on – and carry on they very much want to do – the SEC is launching a review of its own capital standards that puts the Basel framework in sharp relief. Last week, SEC Chairman Cox told Senate Banking that he is not only reviewing credit-ratings agency regulation, but also the way the SEC's net capital rule relies on external ratings. The SEC is also, by the way, looking at its own framework for trading-book risk, a rule that could add a whole new dimension to the competitive difference between large commercial and investment banks.

So, where does this leave the U.S. Basel rules? First, the agencies will, I think, issue the "final" advanced ones by the end of this month. They need, though, to clear OMB before going live, so the actual effective date won't be until early next year at the soonest. Banks will, though, see the shape of the final rules and can begin implementing them in earnest, conducting the requisite parallel runs and so forth. The big question – as yet unanswered – is whether the "final" advanced options will be let loose. The July agreement among the regulators I mentioned has a kicker: if one or another of the agencies doesn't like what it sees between years two and three of the Basel phase-in, it can pull the plug. The FDIC has said it's more than willing to do so and Congress will, I think, stand behind the FDIC should it do so.

Of course, risk-based capital under the new Basel rules could raise regulatory capital quite significantly – not drop it as the FDIC fears. This might bring Basel final, albeit at the cost of a credit crunch that validates fears that the Basel standards would prove, as economists say, pro-cyclical.

The second Basel rule for all but the biggest banks is far more of a work in progress. A proposal should be out for comment in the next month or so, but I would guess it'll hit a buzz-saw because of how entrenched a role the proposal will give to the aforementioned, unloved credit-ratings agencies. Finalizing this capital rule will take at least six months, if not more, and the advanced Basel rule could be put on hold until the other proposal is finalized if fears grow about competitive differences between the big and small banks – remember that high-risk positions take a big Basel II hit that could hammer big banks if smaller ones remain under Basel I as the mortgage and corporate debt mess works out.

Dancing Between the Raindrops

Atop all these changes are still bigger ones in the works. Early next year, the Treasury Department will release a blueprint to rewrite the U.S. financial regulatory structure. Nothing will happen on it next year, of course, and the prospects for this big reform package for now look no better than those for all the doomed ones that preceded it. However, even as the blueprint is laid on the table, the SEC, FRB and FDIC are moving ahead with initiatives that will drive charter decisions for non-traditional banks and, thus, affect your competitive landscape. In addition, the FRB is planning a new, hard look at the holding companies under its jurisdiction – you, of course – and non-bank, unregulated affiliates in the holding-company structure. I can't recommend the 2,000 or so page new holding-company exam manual the FRB put out this summer as light reading, but it's an essential guide to the role the Fed sees for itself even as most of you walk away from the state member charter.

Will the FDIC follow the FRB as a new, tough regulator at the consolidated level? I think so. Indeed, OTS is also flirting with this role – see, for example, the $120 million or so penalty it imposed recently on a thrift parent and the new UDAP standards it's thinking about placing not only on thrifts, but also on parent holding companies. A few weeks ago, I would have said these proposals stood on shaky ground, in part because of their datable statutory authority. Now, I think the agencies can and will do as they think best.

I'll stop where I started: In the wake of ongoing market turmoil, the benefit of the doubt has shifted to the financial regulators. If they want to do it, they will do it and no one in Congress or the Administration will quibble on grounds of undue burden, unfair competitive impact or unnecessary over-correction. This reminds me a lot of the early 1990s, when sins of the past were crushed to the point that market power moved outside insured depositories to all the non-banks that came to play so huge a role in the financial market. Those reforms rewrote the competitive landscape and the new ones will too.