

Policy Perspective



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Highlights

We believe many factors contributed to the financial crisis of 2008 and 2009, and excessive leverage made it much worse than prior credit downturns. While the proposed legislation does advance crucial actions taken during the aftermath of the crisis (the most important being effective limits on leverage), it falls short of a complete panacea and may include several new and unintended risks to the financial system.

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Financial Regulatory Reform: Will It Work?

Congress is issuing a sweeping overhaul of bank rules. We believe the legislation raises many questions, and in this document we seek to answer the most important two:

- Is the legislation likely to avoid another financial crisis over the longer-term?
- What is the market and economic impact of the legislation in the near-term?

In summary, we believe many factors contributed to the financial crisis of 2008 and 2009, and excessive leverage made it much worse than prior credit downturns. While the proposed legislation does advance crucial actions taken during the aftermath of the crisis (the most important being effective limits on leverage), it falls short of a complete panacea and may include several new and unintended risks to the financial system. In addition, some provisions could raise the cost and limit the availability of credit, negatively impacting the economy and markets. Finally, the bill fails to address Fannie Mae and Freddie Mac, the two companies most directly involved in funding the housing bubble.

Why We Need Reform

During the 10 years leading up to the financial crisis, legislative changes transformed the financial services industry. The Gramm-Leach-Bliley Act of 1999 effectively repealed the Glass-Steagall Act of 1933. This Great Depression era act had separated lending from investing, after combining both activities in the same financial services entity had led to abuses that threatened the safety of deposits. The 1933 act's repeal in 1999 allowed for consolidation between commercial banks, investment banks, and insurance companies, and blurred the distinctions between these lines of business and their regulatory oversight.

The result was an increased incentive for many banks to provide loans, bundle loans into complex housing-related investments, and then buy, hold, or trade these newly created securities. At the same time, relatively low interest rates set by the Federal Reserve (the Fed) and other Central Banks following the 2001 recession triggered a boom in housing activity. Consequently, the typical home price rose from about 3.5 times household income to 5.0 times income by mid-2006. Capital provided by the investment banks was abundant; mortgage rates were low; home prices were rising; and volume was the key driver of profits. Due to this combination of factors, lending was extended to less credit-worthy borrowers than traditional

mortgage lending would have approved. At the same time, innovations in structured finance broadened the appetite for mortgage debt in a yield-hungry marketplace.

Tight credit spreads encouraged investment banks to use high amounts of leverage through debt issuance to reach profit targets on investments. To illustrate the problem, consider a homeowner who is leveraged 5-to-1 by purchasing a home with a 20% down payment and an 80% mortgage. If the price of that home declined 10%, the mortgage would stay the same and the value of the homeowners' equity would be cut in half from 20% to 10%. This reduction in equity of 50% resulting from a 10% decline in price illustrates a 5-to-1 leverage of the homeowner.

Some investment banks were leveraged 40-to-1 on housing-related investments, and they continued to rely on quantitative tools that used historical inputs to measure risk on these investments. The historical data underrepresented the actual potential losses these new types of investments could bring to those inside and outside these institutions. Beyond banks, other financial entities—such as insurance companies and hedge funds—became highly leveraged by having underwritten a form of insurance that protected against default on the securities specifically comprised by bundled home loans.

Changes among financial institutions made investment banks more dependent upon borrowing from other banks to fund investments, whereas, in the past, funding had relied more upon bank deposits. This dependence on borrowing made many of the banks incredibly interdependent and securities highly intertwined. As prices began to slide, investment banks became unable to raise funds from other banks in the interbank market and were forced to sell their investments. Because the investment banks made up a large portion of the demand for these securities in recent years, there were few buyers to absorb the supply, which accelerated the decline in the value of the securities. The prices of housing-related securities entered freefall. As banks that had traded with or lent to Lehman Brothers began to assess their counterparty risk if Lehman failed, they increasingly pulled back capital and trading with Lehman Brothers, intensifying the capital crunch and accelerating Lehman's failing. The failure of Lehman Brothers caused interbank lending to suddenly seize up in September 2008. With banks unwilling and unable to lend to each other, the markets went into a tailspin and the previously undiagnosed recession intensified and became apparent.

The downward spiral of credit conditions exacerbated by years of unintended policy actions that fed the crisis of 2008–09 prompt the need for strong reforms to the financial services industry regulatory structure, environment, and provisions. Importantly, one of the steps to address the crisis was the conversion of investment banks into commercial banks, which, by their structure, have limits placed on their leverage.

Restated, our view is that while the proposed legislation does take important steps to advance crucial actions taken during the aftermath of the crisis in 2008 and 2009, it falls short of a complete panacea and may include several new and unintended risks to the financial system. In addition, some provisions could raise the cost and limit the availability of credit, negatively impacting the economy and markets.

Key Provisions

The key provisions of the 2,315-page bill include:

- Derivatives
- Too Big to Fail
- Consumer Financial Protection Bureau
- The “Volker” Rule
- Skin in the Game
- Credit Rating Agencies
- Bank Capital
- Hedge Funds
- Federal Oversight of Insurance Industry

Derivatives

At the heart of the legislation is the question of how to regulate and moderate the use of derivatives, called “financial weapons of mass destruction” by Warren Buffett.

Banks will be able to maintain only their derivatives and swaps trading operations that are used to hedge risk or to trade interest rate or foreign exchange swaps. However, the bill will seek to reduce taxpayers’ risk by forcing banks to set up a separately capitalized subsidiary, walled off from the bank’s access to lending from the Federal Reserve, to trade derivatives of non-investment grade securities, commodities and credit default swaps. Banks have two years to set up and segregate these operations. Setting up these subsidiaries may be costly for some of the big banks.

The legislation will push most derivatives through clearinghouses or exchanges, making it easier for the market and regulators to track the volume and exposures. This may enhance the security of the financial system; however, it may mean less customization for businesses seeking to hedge risk and may result in higher costs. For big banks, this greatly reduces a major source of profits.

Counterparty credit risk embedded in derivative contracts was a critical component of the financial crisis due to the insolvency of large financial institutions such as American International Group (AIG), Bear Stearns and Lehman Brothers. Due to the increased focus on counterparty risk in credit derivatives, the legislation creates a clearinghouse or exchange to act as the counterparty and guarantor to all parties. This may reduce the risk to the financial system that was evident during 2007–08, as the dominos started to fall and defensive actions were taken by institutions that may have exacerbated the crisis. The clearinghouse will have reserves and margin requirements to absorb and share any losses resulting from the insolvency of a member.

However, if the exposures are not well managed, the risks are even higher for the financial system than if no clearinghouse were created. The bigger the clearinghouse becomes as it absorbs counterparty risk, the more catastrophic its failure would be. With the pooling of counterparty risk, institutions may be more aggressive because the costs of failure would be spread across the whole industry. This may place more stress on the financial system in the long-term.

Too Big to Fail

The bill will establish the Financial Stability Oversight Council (the Council), led by the Treasury Department, as a super-regulator that will monitor financial institutions and respond to emerging systemic risks. During the build up to the financial crisis, the lack of coordination among agencies led to a patchwork of regulation that allowed financial services firms to choose among their regulators. The Council would be able to designate a “non-bank subject” to be overseen by the regulation of the Federal Reserve.

The Fed will establish new capital, leverage and liquidity requirements for those firms deemed systemically important—too big to fail—based on recommendations from the Council. The Council also will have authority to breakup firms if their structure poses a “grave threat” to financial stability. Those firms that are too big to fail would be required to maintain plans approved by the Fed and Federal Deposit Insurance Company (FDIC) for rapid and orderly resolution of the firm, including payments to creditors and counterparties should it become insolvent. The FDIC would take possession of any institution whose failing is deemed to be systemically important. If taxpayers’ funds were required and unable to be recovered in the resolution of the institution, the entire financial industry would be assessed a fee to cover the taxpayers’ cost.

One risk to the financial system is that the Fed will no longer be allowed to rescue failing firms. The bill restricts the Fed’s authority to provide support to an institution under “unusual and exigent circumstances.” Instead the Fed can only provide liquidity to the entire financial system and then only by accepting collateral of high quality and getting Treasury approval. While the bailouts are something no one wants to repeat, if a crisis develops, fast action will be needed to avert a collapse. Creating hurdles to rapid and effective intervention may increase the cost and magnify the scope of an emerging crisis.

Consumer Financial Protection Bureau

A bureau dedicated to consumer financial protection will be created within the Federal Reserve, led by a director appointed by the President and confirmed by the Senate, to police financial products and services along with their providers.

The idea for a new agency grew out of criticism from consumer groups that banks created home loan structures that were too complex and that they were too quick to impose penalties on troubled credit card borrowers. The bureau could require credit-card lenders to reduce interest rates and fees. Mortgage lenders may be subject to tougher disclosure rules. An unintended consequence may mean less credit is extended to relatively less creditworthy borrowers, possibly weighing on consumer spending and economic growth.

The possible risk presented by this bureau is that it would raise costs and limit choice by restricting loan customization and product innovation. Another possible risk is that by elevating consumer advocacy (through lower fees and rates) over the solvency (or the ability to generate profits) of the financial service and product providers, risk would be increased to the financial system. However, the bureau's rules could be overridden by the new Financial Stability Oversight Council at the Fed if the Council decided that the rules threatened the stability of the financial system.

The "Volcker Rule"

The Obama administration's proposal to ban banks from proprietary trading, nicknamed the Volcker Rule due to the support provided by former Federal Reserve Chairman Paul Volcker, is a major component of the legislation, although it was not a major contributor to the financial crisis. Rather than let regulators define the limits and definition of proprietary trading, the legislators wrote clear guidelines into the bill.

The ban on proprietary trading, in which a company makes investments with its own money, may reduce profits. Some big banks generate a material portion of their earnings from so-called "principal investments," which include many types of investments including stakes in other companies and real estate.

Banks will be allowed to invest in private equity and hedge funds, though they will be limited to providing no more than 3% of the fund's capital, and they cannot invest more than 3% of their Tier 1 capital. (Tier 1 capital is the bank's core capital, and is a term used to describe the capital adequacy of a bank, which includes equity capital and disclosed reserves.)

Skin in the Game

The legislation will force lenders, with the exception of some mortgage providers, to hold at least a 5% stake in debt that they package into securities. The rule will affect lending categories that include credit cards, auto loans, some mortgages (such as negative amortization, interest-only payments and balloon payments) and other securitized debt. If lenders had been forced to maintain some exposure to the products they created, they may have been more discriminating when extending credit in the mid-2000s, when expanding leverage and easy credit fueled the creation of too many bad loans.

Aligning issuers' interests with those of the investors who buy their financial products is a good goal, but it is not a guarantee that bad loans will not be made. After all, many big banks aggressively invested in these financial products during the boom years without being required to do so.

A risk of the provision is that it may curtail lending and raise consumer borrowing costs as capital becomes tied up in the creation of financial products.

Credit Rating Agencies

Credit rating agencies, including Moody's Corp. and Standard & Poor's, may end up being assigned, rather than compete for asset-backed securities business. The legislation requires the SEC to conduct a two-year study on whether to create a board to decide who rates asset-backed securities.

The credit rating agencies benefitted from the demand for their rating services during the boom in housing and mortgage securitizations, where groups of mortgages were packaged into bonds. Concerns emerged that a conflict of interest existed when rating agencies competed for business from the banks that were seeking the highest ratings for the bonds. These rating agencies were incented to give high ratings to garner more rating business. After the housing market collapsed, institutional investors who lost money on the bonds alleged the rating agencies assigned the bonds their highest AAA rating without proper analysis. If fewer bonds received high ratings, less capital may have been allocated to asset-backed bonds, limiting the size and scope of the bubble and the ensuing crisis.

The legislation eases the standard for pursuing litigation against a rating agency. Rating agencies may be sued if investors demonstrate a company “knowingly or recklessly” failed to conduct a “reasonable” investigation before issuing a rating. The purpose is to give credit-rating companies an incentive to conduct adequate due diligence without subjecting them to lawsuits related to their judgment.

The credit rating agencies are attempting to bolster their credibility by toughening up on their rating standards. However, with their credibility impaired and potentially two years before action is taken that may rebuild confidence in the objectivity of their ratings process, uncertainty on the part of investors may raise borrowing costs and result in higher yields.

Bank Capital

The bill may force some banks to shore up capital. During the crisis, many banks were forced to try to raise capital while their share prices were plunging and the value of their assets evaporated, endangering the financial system. Big banks will get five years to replace outstanding trust preferred securities with common stock or other securities that count as capital.

Trust preferred securities did not provide the capital cushion against losses during the crisis they were intended to, since banks were loath to defer dividend payments fearing a flight of capital. This provision of the bill should help at the margin to ensure an adequate cushion against losses.

A risk of this provision is that banks unable to replace the trust preferred securities will have to shrink their balance sheets to stay within the minimum capital rules dictated by regulators. That could mean less capacity to lend encouraging banks to be even tighter when it comes to extending credit. This may further worsen the double-digit decline in bank loans over the past year. However, most banks have adequate capital even without counting trust preferred securities, and those that do not should have plenty of time to raise the capital.

Hedge Funds

Advisors using large hedge and private equity funds will be forced to register with the Securities and Exchange Commission (SEC), subjecting them to mandatory federal oversight for the first time. The rules are much less burdensome than the regulations being imposed on banks, since hedge funds did not contribute materially to the financial crisis nor were they bailed out by taxpayers.

Advisors using hedge and private equity funds will be required to report trade information to the SEC. The confidential data could be shared with the Financial Stability Oversight Council to highlight risks to the economic system. A fund that posed a systemic risk could be subjected to stricter controls. This greater transparency into the actions of non-bank financial entities should help to provide a more complete picture to a single super-regulator and empower it to take action to avert a potential crisis.

Complying with registration and compliance rules may be costly for hedge and private equity funds and their advisors, impacting fees, and performance. However, limits on proprietary trading, leverage and higher capital requirements for banks are likely to more clearly differentiate the performance of hedge and private equity funds from banks.

Federal Oversight of Insurance Industry

Insurers have been subject to regulation by states, but now in addition will have a national regulator. The legislation creates a new Federal Insurance Office within the Treasury. Their action was prompted by the collapse and subsequent bailout of the world's largest insurance company, AIG, in 2008. AIG had sold protection in the form of credit default swaps linked to subprime mortgages, but was unable to make good on that protection without a \$182 billion taxpayer-funded bailout.

With insurance companies doing business in a global market, it makes little sense to restrict insurance regulation to state borders. While a new layer of oversight may complicate compliance and increase costs, a national regulator may coordinate better with counterparts in other countries to help ensure a more stable global financial system.

What Is Missing?

One major provision missing from the legislation is related to Fannie Mae and Freddie Mac. Nowhere to be found are provisions dealing with the publically-traded, congressionally-created, government-sponsored enterprises. The bailout of Fannie Mae and Freddie Mac, the entities that lent the money for half of the home loans in the U.S. beginning in mid-2008 has not yet ended. Following an injection of capital late last year and again in May of 2010, and after suffering additional losses, Fannie Mae and Freddie Mac asked for another \$19 billion from taxpayers. This brings the total price tag for the Fannie and Freddie bailout to \$145 billion, easily the biggest cost in the rescue of the financial system.

This ongoing risk to the taxpayer is not addressed by the new legislation, even as Fannie and Freddie continue to make loans. In the first quarter of 2010, while under federal conservatorship, Fannie and Freddie backed over 96% of all home loans. The legislation is lacking without addressing the two companies most directly involved in the funding of the housing bubble.

In a Republican amendment that failed to make the final legislation, Fannie and Freddie would have to reduce the size of their mortgage portfolios and begin paying state and local sales taxes when the conservatorship would end, within two years. Democratic lawmakers and the Obama administration have resisted efforts to address Fannie and Freddie, warning that they play an important role in supporting the housing market and are integral in the ongoing mortgage modifications intended to keep troubled borrowers in their homes.

Next year when the Republicans may be in control of at least one chamber of congress, we may see an enhancement to the legislation similar to what was proposed in 2005 when the Senate Banking Committee was controlled by Republicans. The bill would have established a new regulator for Fannie and Freddie and given it authority to ensure that they maintained adequate capital, properly managed their interest rate risk, had adequate liquidity and reserves, and controlled their asset and investment portfolio growth. However, a party-line vote and the threat of a veto from President Obama may keep this from becoming part of a truly comprehensive reform package.

Summing It Up

Overall, the financial reform legislation takes several steps in an attempt to improve the stability and transparency of the financial markets. Some of these steps may help to prevent similar crises in the long-term. However, there may also be some negative implications in the short-term for the economy and in the long-term for the financial system.

Additionally, financial crises and recessions will likely happen again—it is the nature of the business cycle. They happen nearly every 10 years—recall the savings & loan and commercial real estate crisis of the late

A Credit Default Swap (CDS) is designed to transfer the credit exposure of fixed income products between parties. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the product. By doing this, the risk of default is transferred from the holder of the fixed income security to the seller of the swap.

1980s, the emerging market debt crisis of the late 1990s, and the subprime debt crisis of the late 2000s. All of these were costly to the financial sector and preceded a U.S. recession. But, as each of these crises had different triggers and involved different assets, it is unlikely that the causes of future occurrences will be the same as the events of the late 2000s. This legislation attempts to address the symptoms of the recent crisis. However, legislators may be focusing too much on reining in the big banks while failing to address broader reforms needed to ensure a more forward-looking approach to avert, or minimize, future financial crises.

IMPORTANT DISCLOSURES

Options are not suitable for all investors and certain options strategies may expose investors to significant potential losses, such as losing the entire amount paid for the option.

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