

Financial Services Reform: How Will Community Banks Fare?

B. Riley & Co.
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Background for Current Proposals

- March 2008: Paulson Report: Blueprint for a Modernized Financial Services Structure
- January 2009: Group of 30 (leading international economists and financiers) headed by Paul Volcker
- January 2009: GAO framework for evaluating reforms
- January 2009: Congressional Oversight Panel
- June 2009: Treasury White Paper
- June/July 2009: Various Legislative Proposals from Obama Administration

White Paper Objectives and Overview

- Five key objectives of reforms:
 - Promote robust supervision and regulation of financial firms
 - Establish comprehensive supervision and regulation of financial markets
 - Protect consumers and investors from financial abuse
 - Improve tools for managing financial crises
 - Enhance international regulatory standards and improve international cooperation

Summary of White Paper Proposals

White Paper Summary				
Supervision and Regulation of Financial Firms	Regulation of Financial Markets	Consumer and Investor Protection	Resolution Authority (a/k/a TBTF)	International Standards
<ul style="list-style-type: none"> • Identifying Tier 1 FHCs • Financial Services Oversight Council • Expanding BHC status • Stronger capital standards • National Bank Supervisor • Regulation of “non-banks” or “shadow banking system” • Office of National Insurance • Elimination of thrift charter • Assessment of the role of GSEs 	<ul style="list-style-type: none"> • Enhanced regulation of participants in the securitization market • Oversight and regulation of credit rating agencies • Regulation of OTC derivatives and OTC derivatives dealers • Harmonizing futures and securities regulation • Federal Reserve oversight of payment, clearing & settlement systems 	<ul style="list-style-type: none"> • Consumer Financial Protection Agency • Financial Consumer Coordinating Council • Transparency, fairness, accountability, access, and appropriateness of consumer and investor products • “Plain vanilla” products 	<ul style="list-style-type: none"> • Addressing Too Big To Fail problem • Resolution authority for Tier 1 FHCs • FDIC or SEC as conservator or receiver • Federal Reserve to obtain Treasury approval for SEC 13(3) lending 	<ul style="list-style-type: none"> • Support for G-20 initiatives • Foreign firms to be tested for FHC status

Summary of White Paper Changes

Changes in Regulators/Oversight		
New	Purpose	Composition/Structure
Financial Services Oversight Council	To identify emerging systemic risks and improve interagency cooperation	Chaired by Treasury; will include heads of principal federal financial regulators as members (8 members)
National Bank Supervisor	To supervise all federally chartered banks	Separate status in Treasury
Consumer Financial Protection Agency	<ul style="list-style-type: none"> • To protect consumers across the financial sector from deceptive practices • Focused on credit, savings, and payments markets • Authority to reform mortgage laws 	Independent entity
Office of National Insurance	To coordinate regulatory policy in the insurance sector	<ul style="list-style-type: none"> • Separate status in Treasury

Enhanced Powers for the Federal Reserve

- Under the proposals, the Federal Reserve and the FDIC maintain their “respective roles in the supervision and regulation of state-chartered banks”
 - In many important respects, the authority of the Federal Reserve would be enhanced as a result of the proposals

Federal Reserve
Summary of new/additional authority
<ul style="list-style-type: none">• Supervise all firms that could pose a threat to financial stability, even those that do not own banks (Tier 1 FHCs)
<ul style="list-style-type: none">• Oversee payment, clearing, and settlement systems
<ul style="list-style-type: none">• Enhance authority over market infrastructure
<ul style="list-style-type: none">• Will have a right to assess risk and set higher standards for a Tier 1 FHC to protect against excessive risk taking

I. Supervision and Regulation of Financial Firms

Identified Problems

- Regulation proved inadequate and inconsistent
- Dividing oversight responsibilities among many agencies resulted in fragmentation and regulatory “loopholes”
- Capital and liquidity requirements were too low
- Regulators did not require institutions to plan for stress scenarios where access to liquidity would be constrained
- Regulators did not take into account the full systemic impact of the failure of the largest financial institutions-those whose failure could threaten financial stability because of their size, leverage or linkages with other market participants. These so-called “Tier 1 FHCs” may include companies that are not bank holding companies (e.g., AIG or large hedge funds)

Financial Services Oversight Council

- A Financial Services Oversight Council (“FSOC”) to be Chaired by Treasury
- Purpose:
 - Fill supervisory gaps
 - Facilitate coordination of policy and resolution of disputes
 - Identify emerging risks
 - Advise the Federal Reserve on the identification of Tier 1 FHCs

Consolidated Supervision and Regulation

- Federal Reserve to exercise consolidated supervision and regulation over Tier 1 FHCs: Macro prudential focus
 - Will be subject to stricter capital, liquidity and risk management standards
 - Regulation of all subsidiaries of a Tier 1 FHC, regulated and unregulated, domestic or foreign
 - If Tier 1 FHCs have bank subsidiaries, the bank subsidiaries will continue to be regulated by their primary bank regulator

Resolution Authority

- Treasury would determine when an institution's failure would have a serious adverse effect on the financial system and the use of a special resolution regime would mitigate these effects
- Receiver/conservator would be the FDIC (or in limited cases, the SEC) with broad powers to operate the institution instead of immediately liquidating it

FSOC/Federal Reserve Debate

- Under the Administration's proposed legislation, the Federal Reserve is designated as the "systemic risk" regulator
- By contrast, the FSOC would serve more of an advisory role
- SEC Chair Schapiro agrees with this approach
- FDIC Chair Sheila Bair prefers that the FSOC have this power, and that its chair be appointed by the President, subject to Senate confirmation
- Many legislators and others think that the Fed failed in the current crisis and are reluctant to give it the power to serve as "systemic risk regulator"
- Others (like the CSBS) are concerned about concentrating so much power in one regulator and would prefer that the systemic risk regulator report to the FSOC

The “Too Big To Fail” Debate

- Critics express concern that designating institutions as Tier 1 FHCs (*i.e.*, too big to fail) creates a class of special institutions with an implicit government subsidy that places the remaining financial services companies at a competitive disadvantage.
- FDIC Sheila Bair has called for making “too big to fail” more stigmatizing and less favorable—and this view perhaps influences her desire not to have the Federal Reserve in charge of that determination
- ICBA wants Tier 1 FHCs to pay a fee to capitalize a special systemic-risk fund to cover special resolution authority expenses that might be entailed
- Some have called for preventing institutions to become too big to fail in the first instance. They are skeptical whether additional capital and other prudential requirements will hold them in check. Some have called for decreasing the 10% nationwide deposit cap

Effect on Community Banks of FSOC and Systemic Risk Regulator?

- ICBA supports strong systemic risk regulation under the Federal Reserve
- Which regulatory agency or council serves as systemic risk regulator ultimately should not affect community banks.
- It remains to be seen whether Tier 1 FHCs will have an advantage over other institutions by reason of an implicit government guaranty against failure—or whether the imposition of additional capital and other prudential requirements on Tier 1 FHCs (to account in part for this subsidy) may provide a competitive advantage for community banks.
- There may also be reluctance by the regulators to allow further growth and/or geographic expansion by the largest institutions unless and until their risk profile comes under control. This may provide room for community banks to provide offerings of a kind formerly dominated by the largest financial services providers—for example, SFR mortgages and consumer loans.

Consolidated Supervision and Regulation

- A National Bank Supervisor (“NBS”)—merger of OCC and OTS
- Federal Reserve to continue to supervise member banks
- FDIC to continue to supervise nonmember banks
- Federal thrift charter proposed to be eliminated. ICBA is strongly opposed
- **Interstate branching for all banks**
- Companies owning industrial loan companies, credit card banks and FDIC-insured trust companies would become bank holding companies. This provision is broadly supported by community bank organizations

Observations

- These reforms perpetuate the dual-banking system and the basis on which community banking is built
- The only area of objection for community banks appears to be the elimination of the federal thrift charter; but the issue here is whether there is a current need for specialized institutions with concentrations in residential mortgage loans that are especially vulnerable to the housing downturn we are now experiencing

Capital Reform: Findings

- Insufficient capital required at inception of financial crisis
- Some that failed were “well capitalized” immediately prior to failure (e.g., Downey)
- Need for capital against off-balance sheet vehicles that banks supported in crisis (e.g., asset-backed cp programs; advised MMFs; structured investment vehicles)
- Insufficient loss-absorption capacity in general

Capital Study (December 31, 2009)

- Changes to reduce procyclicality:
 - require banks to hold more capital during good times to keep above minimum desired levels during times of stress
- Contingent Capital
 - Debt that converts into common equity
 - tail insurance against macroeconomic risks
- Higher capital against higher risk exposures
 - Trading positions; equity investments; credit exposures to low-credit quality firms and persons; highly rated ABS and MBS, etc.
- More reliance on leverage ratios as supplement to risk-based capital

ALLL Changes

- During good times, ALLL tends to be low based on historical loss rates—could present false picture when downturn on its way
- Earlier loss recognition would have resulted in higher ALLL's earlier in the cycle
- FASB to be asked to review accounting standards to determine how banks should be required to employ more forward-looking loan loss provisioning—using broader range of information. ICBA supports this initiative
- Currently, examiners are requiring banks to change methodology and to use very short-term look-backs for provisioning—perhaps as short as last 4 quarters—rather than longer-term historical experience

Study to Re-assess Bank Supervision (due October 1, 2009)

- Many of the issues to be addressed involve the supervision of complex, large institutions
- However, some are relevant to smaller, simpler banking firms, including how the scope of supervision and regulation should differ for them
- The study will also address the funding of supervisory agencies, the effect of such funding on regulatory competition; and the degree to which regulated entities might wind up exercising some degree of control of the regulator (“regulatory capture”). This is an area for community banks to follow closely.

Executive Compensation: White Paper

- Federal regulators should issue standards and guidelines to better align executive compensation practices of financial firms with long-term shareholder value
- Compensation practices should not incentivize excessive risk-taking
- Non-binding shareholder proposals on executive compensation and additional independence requirements for compensation committees should be supported

Executive Compensation: H.R. 3269

- Approved last week of July by the Fin. Serv. Committee. Supported by the G30
- Federal regulators required to proscribe imprudent compensation practices as part of their prudential regulation of banks
- Financial firms would be required to disclose compensation structures that include incentive-based elements
- Banks with less than \$1 billion in assets would be exempt from the disclosure requirements and the related compensation structure oversight
- Compensation committee independence would not apply to nonpublic companies

Effect on Community Banks of Executive Compensation Legislation

- Independence requirement for compensation committee not applicable to nonpublic companies
- Institutions with less than \$1 billion in assets exempt from disclosure requirements and compensation oversight.
- On balance, this legislation is not likely to turn out to be a burden for community banks. Community banks are not where the compensation excesses were located.
- For public community banks with assets exceeding \$1 billion, their compensation committees will need to exercise appropriate oversight over compensation, but they are likely doing that already.

Regulation of Private Capital Pools

- Require investment advisers (IAs) of private equity, hedge and venture capital funds and other private pools of capital to register with the SEC as investment advisers under the Advisers Act, if the IAs meet a modest specified amount of assets under management
- Require registered IAs to provide the SEC with sufficient data to determine whether a particular fund may be a Tier 1 FHC
- Hedge funds and other private pools of capital advised by registered IAs will be subject to record-keeping obligations
- The SEC to conduct regular compliance examinations

Money Market Funds (“MMFs”)

- MMFs are direct competitors for bank deposits
- The run last fall on MMFs indirectly affected banks. Treasury guaranty program for MMFs triggered the guaranty of all demand deposit accounts to prevent disintermediation
- The White Paper proposes to strengthen the MMF regulatory framework in order to make MMFs less susceptible to downturns
- Potential actions to take:
 - Eliminate ability to use a stable NAV?
 - Requiring MMFs to have a reliable back-up source of liquidity?

Future of Fannie Mae and Freddie Mac

- Various options under consideration, including:
 - Returning them to their prior status as GSEs, with the paired interests of maximizing returns for private shareholders and pursuing public policy home ownership goals
 - Gradual wind-down of their operations and liquidation of their assets
 - Incorporating the GSEs' functions into a federal agency
 - A public utility model where the government regulates the GSEs' profit margin, sets guaranty fees and provides explicit backing for GSE commitments
 - Conversion to providing insurance for covered bonds
 - The dissolution of Fannie Mae and Freddie Mac into smaller companies

II. Regulation of Financial Markets

Reform of Financial Markets

- Securitization Related Reforms
- Credit Rating Agency Reforms
- OTC Derivatives Regulation
- Payment and Clearance Systems
- Harmonizing Broker-Dealer and IA Regulation

How Did We Get Here?

- 2007-2008: Securitization Fails
 - Widespread delinquencies beginning with “sub-prime” mortgages
 - Perceived lack of transparency in layered securitization vehicles leads to illiquidity in all securitization interests and beyond
 - Perceived lack of accountability because originators are disconnected from ownership and maintenance of the loans
 - Inability to act quickly to work out loan problems leads to downward spiral affecting communities across the U.S. and further decreasing home values

How Did We Get Here? (cont.)

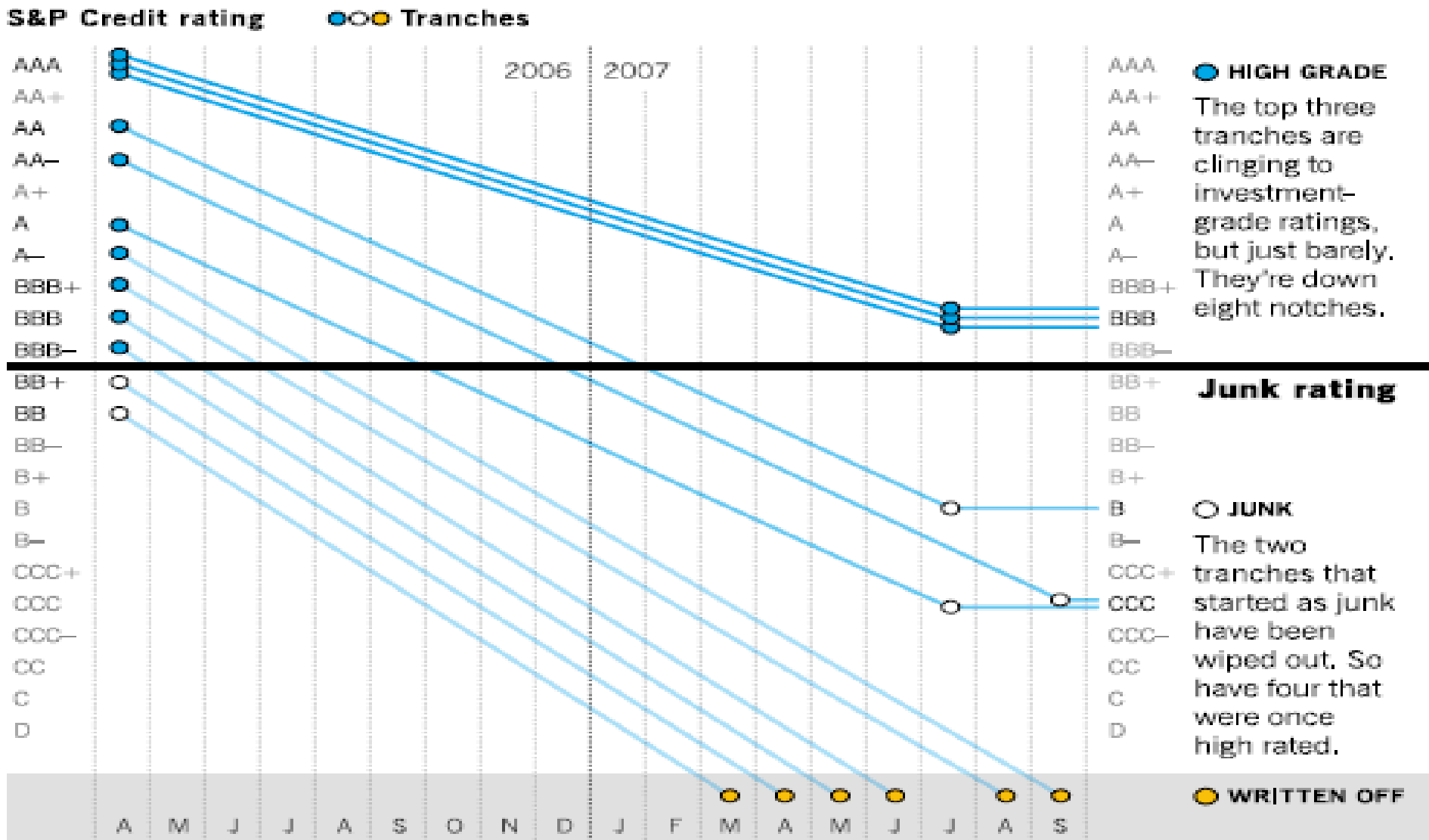
GS Trust 2006-3

From AAA to BBB in 16 Months

Source: House of Junk, Allan Sloan

How Did We Get Here? (cont.)

Tranches of one mortgage-backed security issued by Goldman Sachs



Timeline

What Happened	Who Was Blamed	Reaction
Foreclosures rise (2006)	Subprime mortgage lenders	<ul style="list-style-type: none">• Call for mortgage reform• Federal Reserve notes “froth”
Losses mount on subprime MBS (2007)	Blame spreads to “originate to sell” model, Wall Street and credit rating agencies	<ul style="list-style-type: none">• Subprime originators file for bankruptcy• Wall Street losses perceived as retribution• Homeowner protection is focus: President Bush calls for public-private partnership to address foreclosure
Losses spread to other MBS and more complex securities (2007)	Credit rating agencies targeted	<ul style="list-style-type: none">• Wall Street losses continue to be seen as isolated – Not “Main Street” problem• Credit rating agency reform begins in earnest
Losses continue and confidence in system begins to falter (beg. 2008)	FAS 157 and accounting comes under pressure	<ul style="list-style-type: none">• Federal Reserve launches series of programs and rate cuts in earnest
Write-downs continue and broader economy suffers	Financial industry broadly	<ul style="list-style-type: none">• Congress allocates \$700 billion to Treasury• Bailouts of AIG, Citi, auto industry, broker-dealers become BHCs
Nothing gets better	Government failed to address root causes of problem – no wonder nothing has gotten better	<ul style="list-style-type: none">• Obama stimulus, foreclosure plan, TALF, PPIP and regulatory reform are focus of government

How Did We Get Here? (cont.)

	2006	2007	2008
US Public RMBS	\$570 billion	\$439 billion	\$21 billion
US CMBS	\$214 billion	\$236 billion	\$16 billion
US Public ABS	\$726 billion	\$438 billion	\$120 billion

Summary of Proposed Securitization Related Reforms

Change incentive structure for securitization participants

- Risk retention of 5% of the credit risk of securitized exposures
- No hedging of retained risk
- Tie broker, originator and sponsor compensation to the long-term performance of the securitization
- Disburse fees and commissions of loan brokers/officers over time—and reduce compensation if asset quality problems emerge
- Eliminate current GAAP gain on sale accounting; instead recognize income over time
- Require “many” securitizations to be consolidated on originator’s balance sheet

Gain-on-Sale and On-balance Sheet Accounting

- Observations
 - While on-balance sheet treatment arguably promotes “skin in the game,” the ability of financial institutions to lend will be sharply curtailed by capital constraints
 - Gain-on-sale and off-balance sheet treatment permitted the massive transfer of financial assets and risk to the global capital markets, and drove the robust housing markets of the last decade
 - This is a reversion to the “portfolio lending” model used by banks until the advent of securitization in the 1980s and 1990s—banks hold loans in portfolio and re-lend only when old loans are repaid

Gain-On-Sale and On-Balance Sheet Accounting

- Implications for originators and sponsors
 - Sensible or not, it is clear that more and more securitizations will remain on-balance sheet—if not because of regulatory reform, then because of accounting changes that are already in place
 - Two basic structural choices:
 - “Traditional” securitization structure, except that it fails accounting tests for off-balance sheet or non-consolidation (examples: “on-balance sheet securitizations” done by many mortgage REITs)
 - Covered bonds
 - Advantages of covered bonds
 - Free substitution of collateral
 - Government support of concept
 - Avoids securitization stigma

Additional Securitization Related Reforms

- Require standardized, stronger representations and warranties
- Require enhanced disclosure, including loan level disclosure and disclosure regarding the compensation for the broker, originator and sponsor (but not clear that disclosure was really the problem)
- Require conflicts of interest policies and procedures for credit rating agencies
- Differentiate structured finance ratings
- Require credit rating agencies to explain the meaning of their ratings for ABS and the way in which such ratings differ from corporate debt ratings
- Require credit rating agencies to disclose information on methodologies and originator reviews

Credit Rating Agency Reforms

- Conflict of interest policy and procedures for CRAs
- Differentiate structured finance ratings from “unstructured” corporate debt ratings
- Require CRAs to explain the meanings of ABS ratings and the ways in which such ratings differ from corporate debt ratings
- Regulators to reduce use of credit ratings in regulations and supervisory practices

Query: is legislation really needed: Most of these items already subject to extensive SEC rulemaking proceedings

III. Protect Consumers from Abuse

Consumer Financial Protection Agency

- A Consumer Financial Protection Agency (“CFPA”) would be established to protect consumers of financial products and services—and to regulate the providers of such products and services:
- Rationale for taking this authority away from bank regulators:
 - Bank regulators didn’t enforce consumer financial services regulations or prevent abuses (took until Dec 2005 to propose and until June 2007 to finalize supervisory guidance on subprime and nontraditional mortgages)
 - Safety and soundness is a different mission (consumer protection given a bank seat)
 - In current system, oversight of compliance with consumer protection is fragmented among four agencies

Consumer Financial Protection Agency

- Sole authority to promulgate and interpret consumer financial regulations, including for nonbank providers (but not entities regulated by SEC or the CFTC)”; can’t impose usury limits
- Supervision and examination authority over banks (and residual authority over nonbank providers, with states as primary regulators)
- Enforcement authority, but state AG’s would also have enforcement authority (with right of CFPA to intervene). State AG’s would also have right to subpoena records from banks, including national banks
- Funding from fees assessed on entities and transactions across the financial sector
- No pre-emption of state laws that are more onerous
- White paper proposed to include CRA authority (but excluded in House legislation)

Consumer Financial Protection Agency Act ("CFPAA")

- Would apply to “consumer financial products or services” (primarily for personal, family or household purposes)—this would include mortgage products
- Would require that a consumer be offered a “standard consumer product or service” and that the consumer have the ability to avoid more sophisticated “alternative consumer products or services”
- Many mortgage products that are currently offered and popular would be regarded as “alternative consumer products or services”
- The CFPAA would not pre-empt state laws that are more onerous than the CFPAA

The CFPAA

- CFPAA would have the following authority:
 - to restrict/bank mandatory arbitration clauses
 - to prevent or make unlawful “unfair, deceptive or abusive acts or practices.” (“Unfair” has meaning from FTC Act. “Abusive” is not defined).
 - to prescribe rules to ensure effective disclosures and communications to consumers
 - to prescribe rules for appropriate sales practices
 - to impose a duty of “fair dealing” with consumers
 - to require licensing of nonbank mortgage lenders; payday lenders; check cashers, etc.

The CFPAA: Opposition

- Critics to varying degrees (ABA, ICBA; Fed; OCC, OTS, Financial Services Roundtable). Major themes:
 - Shouldn't separate prudential supervision and enforcement from consumer compliance supervision and enforcement.
 - Shouldn't allow states to promulgate tougher rules
 - Shouldn't allow states to subpoena bank records (especially national banks)
 - Shouldn't require government mandated standard products
 - Shouldn't impose a "Duty of fair dealing"
- Potential for increased burden on banks without demonstrable benefit to consumers

The CFPAA—Impact on Community Banks

- Most community banks are state banks and already are subject to state laws and states AG enforcement
- CFPAA will likely consist of staffers from consumer divisions of existing agencies (HUD, OTS, OCC, FDIC, Fed)
- CFPAA requires CFPAA to balance costs and benefits. Are fears of over-regulation overblown?
- Most community banks offer “plain vanilla” products. Will the regulation in this area be so difficult?
- Hardest hit will likely be the national providers of consumer financial services
- The current scheme of regulation didn’t work well (some say, it has been a disaster) and, in particular, didn’t regulate mortgage companies, mortgage brokers, payday lenders, check cashers, etc. There is a strong public mandate for regulation in this area. It will come in one form or another. Is it better to have everyone playing on the same field?

Conclusion

- On balance, community banks should be able to live with these reforms
- Real challenge is to manage through the economic downturn and come out stronger than ever at the other end
- Also need to manage regulatory relationships deftly. Regulators are under more pressure than ever and are giving no ground. Regulatory enforcement orders are common
- Time to look inward at your institutions, manage your relationships with you regulators and let the financial services reform chips fall where they may