Special Report
from BMO Capital Markets Economics

U.S. Financial Regulatory Overhaul: What a Mess

July 5, 2010

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The U.S. Financial Regulation Reform bill (FRR) is touted as the first major overhaul of the country's financial legislation since the 1930s. It provides a framework for future financial regulation, but the specifics of more than 150 different measures are largely left up to the regulators. The decisions made in coming months and years by the many regulatory bodies will determine just how effective this legislation will be in preventing a financial crisis in the future.

Moreover, many of the specific decisions on banking regulation could well be made by the Basel Committee on Banking Supervision (BCBS), the Secretariat of which is located at the Bank for International Settlements (BIS) in Basel. The BIS is a bank for central banks with representation from all G-20 countries. The member countries have pledged to comply with whatever new regulatory rules are suggested by the BCBS in its final report due late this year. There will no doubt be a significant phase-in period, but assuming there is eventual compliance, many regulatory decisions will be made on a global basis. Given the world's less-than-exemplary track record in unified action plans, it might be that capital, leverage and liquidity restrictions on banks are determined domestically by each country, at least for the first few years. The goal, however, remains that a level, regulatory playing field be the ultimate outcome for global banks.

One thing is for sure, FRR does not simplify the very cumbersome U.S. financial regulatory system. It does not set specific rules, nor does it deal directly with the 'too big to fail' issue, the debacle of Fannie Mae and Freddie Mac, or consolidate the overall number of regulators.

In Canada, most financial institutions come under the auspices of a single regulator, the Office of the Superintendent of Financial Institutions (OSFI), a very powerful body under the Minister of Finance that has historically had conservative capital, leverage and liquidity requirements. In contrast, the U.S. system remains full of potential loopholes and state versus federal inconsistencies.

Incredibly Complex U.S. Banking System

There are three types of U.S. commercial banks, depending on which government body charters them and whether they are members of the Federal Reserve System. Those chartered by the federal government through the Office of the Comptroller of the Currency (OCC) are *national banks*; by law, they are members of the Federal Reserve System. Banks

chartered by the states are divided into those that are members of the Federal Reserve System (*state member banks*) and those that are not (*state non-member banks*). State banks are not required to join the Fed System, but they may elect to become members if they meet the standards set by the Fed Board. As of June 2010, of the nation's approximately 6,700 commercial banks, about 2,300 were members of the Federal Reserve System—1,450 national banks and 850 state banks.

There are a handful of very large global banks in the U.S., and a larger number of regional banks, but most of the 6,700 commercial banks are small community banks (usually considered those with less than $1 billion in assets, the bulk of which have assets under $500 million). These community banks do business over a very limited geographical area, as opposed to regional banks, which are much larger and can span several states. This bifurcated banking structure resulted largely from a legal framework that, in the past, restricted banks' abilities to diversify geographically.

U.S. banks come under the supervision and regulation of their chartering authority, at either the state or federal level. The OCC, established in 1863 and the oldest of the bank regulatory agencies,,is the primary supervisory agency for national banks and is a bureau of the Treasury Department. The Fed (created in 1913) regulates and supervises the national banks and bank holding companies as well as state-chartered banks that choose to become Federal Reserve System members.

And, the Federal Deposit Insurance Corporation (FDIC), established by the Banking Act of 1933, is an independent federal agency whose main function is to insure deposits at commercial banks and thrift institutions. The FDIC also directly supervises and examines insured state-chartered banks that are not members of the Federal Reserve System.

If you aren't yet confused enough, there is also the Federal Financial Institutions Examination Council, which was created to promote consistency in the examination and supervision of financial institutions. The council is composed of the Comptroller of the Currency, one governor of the Federal Reserve System, the director of the Office of Thrift Supervision, and the chairmen of the FDIC and National Credit Union Administration Board. There is also a *regulatory agency* in every state to charter and supervise state banks. In most states, the agency also supervises other financial institutions. Banks chartered by the state must follow all applicable state laws and regulations. To add to the complexity, a host of other important state and federal agencies may regulate U.S. commercial banks and banking organizations including the Justice Department, the SEC, the Office of Thrift Supervision and other thrift regulators, state insurance commissioners, and the Federal Trade Commission (FTC).

The financial overhaul bill creates several new additional regulatory authorities and eliminates only one, the Office of Thrift Supervision.

In Canada, the strength of the banking system lies in the full compliance to the rules and principles-based system stipulated by OSFI. So, not only do Canadian banks refrain from benefiting from technical loopholes, but the requirements themselves are stricter than for U.S. and European banks. For example, leverage ratios for banks in Canada were no more than the regulatory requirement of 20-to-1, while they were higher in the U.S. and much higher in Europe. Tier 1 capital requirements in Canada have also been more stringent and today, Canadian banks are holding excess capital to the tune of over 600 basis points of risk-weighted assets. The current Tier 1 capital requirement in Canada is 7%, with most Canadian banks now holding more than 13%.

Canada's banks have been anxious for global authorities to finalize the specifics of capital requirements because holding so much more excess capital relative to other global banks puts them at a competitive disadvantage, limits lending and reduces earnings. OSFI has also prohibited Canadian banks from raising dividends or making major investments unless the banks are willing to raise even more capital. So for them, it's a waiting game. The G-20 postponed setting specific requirements until at least late November when they meet again in Seoul; in reality, it may take considerably longer.

U.S. Domestic Financial Reform

Financial markets are relieved to have some legislative certainty on the financial regulatory overhaul that has been fermenting for more than 18 months. There is also the feeling that the banks have dodged a bullet since the joint committee compromise bill, expected to pass both the House and the Senate, is far milder than the Senate bill, especially with respect to the degree of implementation of the Volcker rule, which prohibits banks from engaging in any proprietary trading, particularly in derivatives and other 'high-risk' investments.

The bill will restrain the activities of banks, especially the largest, and will be costly to implement. The impact on bank earnings is uncertain, but less severe than Wall Street might have feared. The bill does not address directly the 'too big to fail' issue as it does not break up large financial companies. The newly created Financial Stability Oversight Council ostensibly will have the authority to address this issue, but the process would be enormously unwieldy. The six largest financial firms—with combined assets of $9.4 trillion—will continue to dominate the industry.

The proposed legislation also does little to solve the danger posed by leveraged companies reliant on fickle markets for funding, which can evaporate in a panic like the one that spread in late 2008. But lawmakers did create a process for seizing and dismantling faltering companies, tools the government lacked in 2008. In addition, the bill does not address government-controlled Fannie Mae and Freddie Mac that remain a multibillion-dollar drain on the U.S. Treasury.

Most people don't believe this piece of legislation, by itself, is capable of preventing the next financial crisis. There is no leverage rule, and we still don't have clarity on some key issues, such as the level and definition of required Tier 1 capital, both of which await Basel III.

Initially, the proposed legislation coming out of the conference committees did deal more harshly with large banks than small and regional ones, imposing a $19 billion bank fee on financial institutions with more than $50 billion in assets and on hedge funds having more than $10 billion in assets, to cover the cost of the bill and its implementation. This fee was eliminated because it was a sticking point in passage through the Senate. It was replaced with slightly higher FDIC fees and an earlier end to TARP.

More Depth on the Proposed Legislation

Key Changes for Government

The compromise bill creates a ten-member Financial Stability Oversight Council, comprised of existing regulators charged with monitoring and addressing system-wide risks to stability. Among its duties, the council would recommend to the Fed stricter capital, leverage and other rules for large, complex financial firms that are judged to threaten the financial system. In extreme cases, the council would have the power to break up troubled large financial firms without taxpayer bailouts. The bill sets up a liquidation authority run by the FDIC. The Treasury would initially cover the costs of the resolution, but the bill creates a sector-rescue fund that would be financed by fees on other banks with more than $50 billion in assets, imposing an additional tax on large banks.

The proposed legislation gives the SEC new powers to regulate Wall Street. It requires hedge funds and private equity funds to register with the SEC as investment advisers and to provide information on trades to help regulators monitor systemic risk.

The Commodity Futures Trading Commission (CFTC) would also have new powers. The bill extends comprehensive regulation to the over-the-counter (OTC) derivatives market, including the trading of the products and of the companies that sell them. It requires many routine derivatives to be traded on exchanges and routed through clearing houses. Customized swaps could still be traded OTC, but they would have to be reported to central repositories so regulators could get a broader picture of what's going on in the market. The bill imposes new capital, margin, reporting, record keeping and business conduct rules on firms that deal in derivatives.

The bill also revamps the credit-rating industry, setting up a quasi-government entity designed to address conflicts of interest between the issuer who pays the credit raters, and the investor, for whom the ratings are meant to protect. It would also allow investors to sue credit-rating firms for a "knowing or reckless" failure to conduct a reasonable investigation, a lower liability standard than the firms were lobbying to get. The bill also

establishes a new oversight office within the SEC with the ability to fine ratings agencies and empowers the SEC to deregister a firm that gives too many inappropriate ratings over time. The bill, however, retains the rating-agency oligopoly, failing to open ratings to more competition. Considering that the ratings agencies were arguably one of the prime enablers of the crisis, this can be seen as a serious failure in the legislation.

The legislation also mandates a one-time audit of the Fed's emergency-lending practices and limits the Fed's emergency lending authority. It also eliminates the role of bankers in picking the presidents of the regional Federal Reserve Banks.

The Office of Thrift Supervision is eliminated. The Fed retains oversight of thousands of community banks and supervises the most-complex financial companies to understand better the risks they pose to the broader economy.

The bill creates a new Federal Insurance Office within the Treasury Department to monitor the insurance industry, recommending to the systemic risk council those insurers that should be treated as systemically important. Lawmakers will require the new office to report to Congress on ways to modernize insurance regulation.

Key Changes for Banks

Lawmakers agreed to a compromise version of the so-called 'Volcker rule' which prohibits FDIC-insured depository institutions from making risky bets with their own funds. Here, the bank lobbyists won a reprieve from the strict adherence to the rule proposed in the Senate bill, which would have prohibited proprietary trading, as well as the ownership of hedge funds or private equity funds, and forced banks to hive off their swap desks to separately capitalized subsidiaries.

In the final version of the bill, banks are allowed to invest modestly in hedge funds, private equity and real estate funds. Banks, however, are prohibited from providing more than 3% of a fund's equity, and are limited to investing up to 3% of their Tier 1 capital in hedge funds, private equity and real estate funds. That represents a ceiling of about $3.9 billion for J.P. Morgan, $3.6 billion for Citigroup and $2.1 billion for Goldman Sachs, according to the companies' latest quarterly reports. Currently, Goldman has an estimated $15.4 billion in total investments in such funds, so cutting that to $2.1 billion is a dramatic change. Banks are also prohibited from bailing out a fund in which they are invested.

But the bBanks are allowed to continue to manage other people's investments in these funds, which generate hefty fees. For example, J.P. Morgan owns the Highbridge Capital Management hedge fund, with about $21 billion under management. Bank executives on Wall Street believe J.P. Morgan will be able to keep Highbridge under the new rules, because it contains client money, not bank funds.

Morgan Stanley also faces possible sales of investments. Its investments in hedge funds, private equity and real estate funds totaled about $4.6 billion at the end of the first quarter, or 9% of its $50.1 billion in Tier 1 capital. To get down to the 3% requirement in the bill, Morgan would need to sell about $3 billion of its investments.

Both Goldman and Morgan could also look at unwinding their bank-holding company status, though neither bank has said it's considering such a move.

Provisions of the Volcker rule, which bars proprietary trading, also include exceptions to allow firms to hold government-backed debt such as Treasuries, as well as to hedge their own exposures and do more customer-related trading. Banks can continue to trade interest rate swaps, foreign exchange swaps and gold and silver swaps. They can continue to trade derivatives used to hedge their risks. Banks, however, would have to set up separately capitalized affiliates to trade derivatives in areas lawmakers perceived as riskier, including other metals, energy swaps, agriculture commodities, and uncleared commodities. They will have up to two years to move these riskier types of derivatives, such as credit default swaps that aren't standard enough to be cleared through a central counterparty, into their subsidiaries.

This is nowhere near as big a deal as people make it out to be because most of the derivatives trading at commercial banks is in interest rate and foreign exchange derivatives, and most of that takes place at the largest institutions. According to the OCC, U.S. commercial banks held derivatives with a notional value of $216.5 trillion in the first quarter, of which 92% were interest rate or foreign exchange derivatives. The five U.S. banks with the biggest holdings of derivatives—J.P. Morgan, Goldman Sachs, Bank of America, Citigroup and Wells Fargo—accounted for 97% of the total.

The bill also addresses securitization, which was another major contributor to the financial crisis. Banks that package these loans will, broadly, be required to keep 5% of the credit risk on their balance sheets. The bill does direct bank regulators to exempt from this rule a class of low-risk mortgages that meet certain minimum standards. Regulators could permit alternative risk-retention arrangements for the commercial mortgage-backed securities market.

The bill also sets new size- and risk-based capital standards, including a prohibition on large bank holding companies treating trust-preferred securities as Tier 1 capital. The bill grandfathers trust-preferred securities for banks with less than $15 billion in assets, enabling them to continue treating the securities as Tier 1 capital. Larger banks, however, would have five years to phase out trust-preferred securities as Tier 1 capital.

Key Changes for Consumers

The bill creates a new, independent Consumer Financial Protection Bureau within the Federal Reserve headed by a single director appointed by the president and confirmed by

the Senate. The bureau will have rule making and some enforcement power over banks and non-banks that offer consumer financial products or services such as credit and debit cards, mortgages and other loans. This consumer watchdog has the authority to examine and enforce regulations for all mortgage-related businesses; banks and credit unions with assets of more than $10 billion; payday lenders, cheque cashers and certain other non-bank financial firms. Auto dealers won an exemption after extensive lobbying efforts.

The bill establishes new, national minimum underwriting standards for home mortgages. For the first time, lenders would be required to ensure that a borrower is able to repay a home loan by verifying the borrower's income, credit history and job status. It also bans payments to mortgage brokers for steering borrowers to high-priced loans.

It is shocking that these mortgage regulations were not on the books. Canadian mortgage lenders would never have made loans to people with no documentation, let alone no income or assets.

Of all the regulatory changes in the legislation, the new mortgage rules seem to be the only ones that, if in place a decade ago, would have prevented (or at least dramatically mitigated) the crisis.

The proposed legislation allows states to impose stricter consumer protection laws on national banks, compared with the federal standard. National banks, however, could appeal for exemption from the state regulation if it "prevents or significantly interferes with the bank's ability to do business", which is a higher bar than is currently in place.

To protect investors, the bill gives the SEC the authority to raise standards for broker dealers who give investment advice to the level of fiduciary responsibility to which investment advisers are held. This would require broker dealers to give advice that is in the best interests of the customer.

In addition, shareholders of public corporations are given a non-binding vote on executive pay and golden parachutes. The bill also gives the SEC the authority to grant shareholders proxy access to nominate directors.

The bill permanently increases the level of federal deposit insurance for banks, thrifts and credit unions to $250,000, retroactive to when it was introduced as an emergency safeguard to January 1, 2008. This could increase moral hazard and taxpayer risk.

Bottom Line: The full effects of the financial overhaul legislation won't be felt for several years, as new regulations are drafted and implemented. The broad outlines of the bill have been known for some time and many financial institutions in the U.S. have already made adjustments to shrink their balance sheets, raise capital and reduce risk. New international capital requirements under consideration by the BCBS will also be important. The G-20

Finance Ministers and Central Bank Governors have committed to reach agreement on stronger capital and liquidity standards as the core of their reform efforts. At the G-20 Summit in Toronto, the communiqué stated, "*We support reaching agreement at the time of the Seoul Summit on the new capital framework. We agreed that all members will adopt the new standards and these will be phased in over a timeframe that is consistent with sustained recovery and limits market disruption, with the aim of implementation by end-2012, and a transition horizon informed by the macroeconomic impact assessment of the Financial Stability Board (FSB) and BCBS. Phase-in arrangements will reflect different national starting points and circumstances, with initial variance around the new standards narrowing over time as countries converge to the new global standard*."

So the G-20 nations will take their lead from the BCBS. The committee published two consultation papers in December 2009 (so-called Basel III), with several proposals on strengthening the resilience of the global banking system, including raising the quality and quantity of capital and liquidity, and asked banks for impact analyses. The general response was that the new requirements would be overly constraining, reducing lending and thereby GDP, as well as increasing the cost of capital and reducing bank earnings and return on equity. It is largely believed that the BCBS demands for much larger and better-quality capital requirements will be pared back somewhat.

While the Canadian banks are in relatively solid shape already, many European and U.S. banks argue they could not comply even if the requirements were set for no sooner than the end of 2012. Even watered-down Basel III proposals could make anything found in the U.S. banking reforms look mild. Many on Wall Street fear the worst. Even a pared-down version will mean even more regulation—and lower earnings—on top of the new requirements for capital and reduction in risk-taking activities.

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