
Dodd-Frank Wall Street Reform and Consumer Protection Act / July 2010

CONNING REVIEW AND ANALYSIS

Introduction

The effects of the Dodd-Frank Wall Street Reform and Consumer Protection Act, (the “Law”), will take years to be fully manifested, but could have meaningful impacts on the long-term financial performance of the U.S. banking sector and the magnitude of potential economic growth. In this article, we offer our views on the key components of the Law and discuss the broader implications for consumers, investors, companies, financial markets and the economy.

Conning also expects to provide more extensive analysis in a future publication of two facets of the Law that may specifically affect the insurance industry, i.e., the establishment of the FIO (the Federal Insurance Office) and the potential relief for small insurers from the requirements of Sarbanes-Oxley Section 404a.

Conning believes that most of the new regulations, as well as the Credit Card Law enacted in 2009, could have a dampening effect on economic growth and the availability of credit, in particular to higher risk borrowers. Because the primary purpose of financial institutions in an economy is to provide a mechanism for the movement of financial resources between savers and borrowers, restrictions on this flow will be a drag on potential economic growth. In the intermediate to longer-term, we are also wary of unintended consequences that could arise as a result of this massive overhaul of the U.S. regulatory system.

On June 30, 2010, the U.S. House of Representatives approved (largely along party lines by a vote of 237 to 192) a comprehensive overhaul of the financial regulatory framework of the United States. On July 15, the U.S. Senate also passed the Law, by a 60 to 39 vote, with the help of three Republicans. Conning now expects that President Obama will sign it into law shortly; about one year after his framework was originally unveiled.

The Dodd-Frank Law, a 2,319 page behemoth with 350+ new proposed regulations, is the most significant financial reform bill since 1933, when Carter Glass and Henry Bascom Steagall succeeded in passing their 34-page reform bill that transformed the shape of banking at that time. Glass-Steagall was an emergency response to the failure of almost 5,000 banks during the Great Depression. It granted tighter regulation of national banks to the Federal Reserve while prohibiting bank sales of securities, and at the same time, created the FDIC.

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Principal Goals

The principal goals of the Dodd-Frank Law are:

- **Significantly bolster the financial regulatory oversight infrastructure in the United States**, permitting a way to proactively eliminate or significantly reduce the probability of a financial calamity similar to 2008-2009. To help accomplish this, the so-called “shadow” banking system (i.e., unregulated mortgage brokers and others) will now be captured under the regulatory net. Will this work? Former Fed Chairman Paul Volcker, who had significant input into the Bill, put it well: “The success of (this) approach is going to be heavily dependent on how aggressively and intelligently it is implemented.” Quoted recently in the *New York Times*, Volcker indicated that a new, 10-member Financial Stability Oversight Council authorized by the Bill will have to be “vigilant and tough” to prevent the largest banks and investment banks from pulling the country into “yet another devastating crisis.” “It is not just a question of defining what needs to be done, but carrying it out in practice, day by day, bank by bank.”
- **Eliminate or significantly reduce the need to provide taxpayer-funded bailouts to systemically-important “Too Big To Fail” financial institutions** by putting into place an infrastructure to wind down (in an orderly fashion without Lehman-like devastating consequences) troubled financial institutions. Will the Dodd-Frank Law make the financial system less crisis-prone so that taxpayers’ funds will not again be used? Conning believes that the answer to this is a qualified “yes.” Over the years, bankers have shown a remarkable propensity to make the same mistakes again and again, after the pain and memory of a cycle has sufficiently faded. Thus, we believe the Law will not fully eliminate the risk of another system-wide or individual-institution crisis. However, meaningful reduction of these risks has been made, even prior to the passage of the Law. Bloomberg data indicates that from the third quarter of 2007 to the present, approximately \$462 billion in capital has been raised by U.S. banks and brokers, including TARP and preferred-to-equity exchanges. Conning believes that as Dodd-Frank is implemented, capital (particularly better-quality forms of capital) and liquidity requirements will be **further raised**, strengthening balance sheets and potentially stabilizing credit ratings over the intermediate term as requirements are phased in. The removal of government support previously implied in NRSRO credit ratings of systemically-important banks could lead to rating downgrades for the largest U.S. banks, but not until early 2011 as the full impact of Dodd-Frank is assessed.

Overall, new regulations and capital requirements will limit loan growth and serve to permanently lower earned returns for banks in the coming years. *In Conning’s view, the lower loan growth resulting from a bank’s ongoing need to comply with higher capital and liquidity requirements could have a dampening effect on the rate of economic growth going forward.*

Figures 1 and 2 illustrate the recent contraction in commercial and consumer credit. We believe that as growth ultimately resumes, it will be below historical trends, as banks strive to comply with new capital standards and regulations. (We note that the “spike” in consumer loans in Figure 1 is solely the result of accounting changes, with balance sheet consolidation of securitizations [mostly credit cards] in early 2010). Consumer loan balances are expected to again show contraction in the second quarter of 2010.

Figure 1.

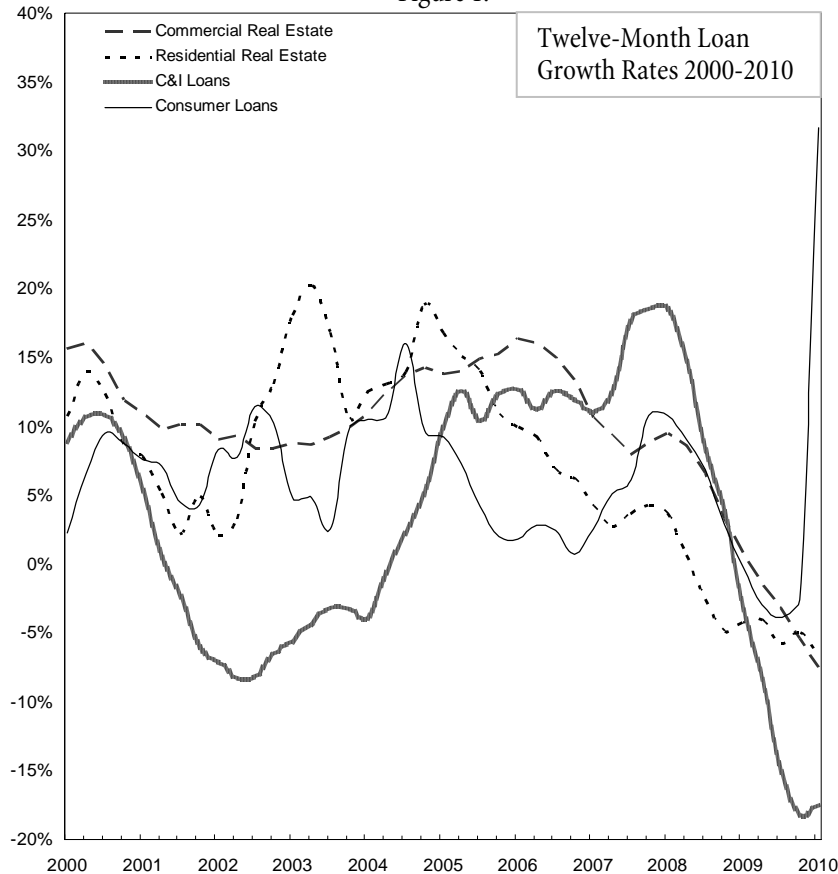
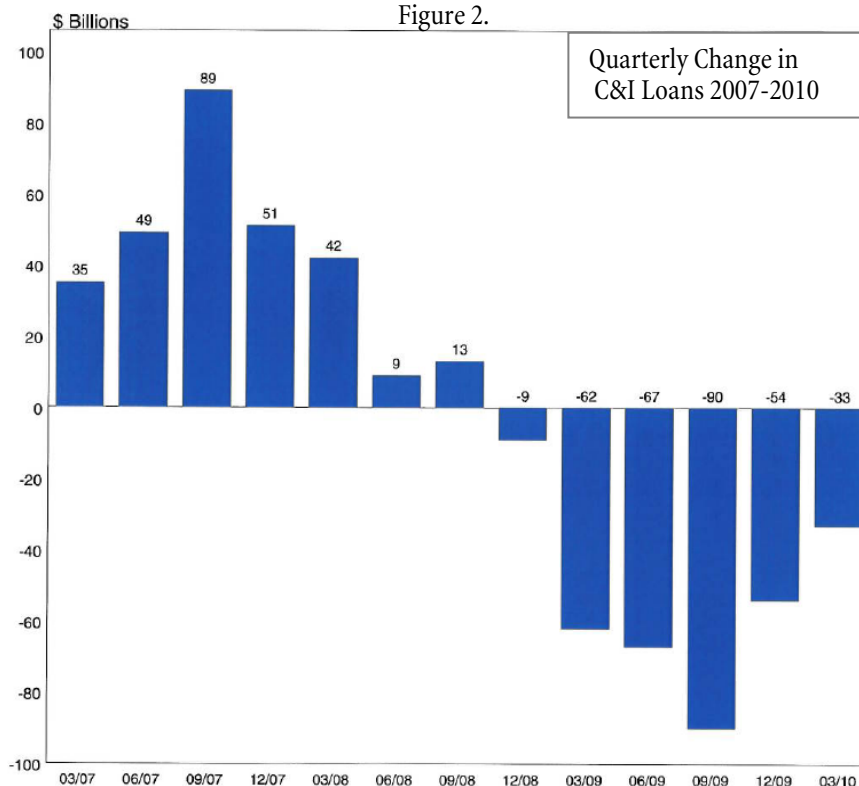


Figure 2.



Source (Figures 1 and 2): FDIC Quarterly Banking Profile

Principal Goals (cont.)

- **Establish a Consumer Protection Agency, housed within the Federal Reserve Board, that has jurisdiction over banks with over \$10 billion in assets.** The Consumer Agency is structured to have authority over predatory lending and misleading mortgage and credit card products, and over time, will develop and implement strong consumer lending standards and enforcement mechanisms. A recent Deloitte report indicated that banks (historically strong product innovators) may see less profitable new product innovation going forward, as they are forced to adapt products to new consumer protection standards. Conning believes a narrower scope of consumer credit products and lower growth in bank fee income will be the by-product of this more robust regulatory oversight, likely to be a factor in a downward trend in returns for the financial sector. ***Credit availability for subprime borrowers is likely to be constricted going forward, another dampening influence on the potential rate of economic growth.*** Importantly, more conservative underwriting standards, and the reining-in of previously aggressive practices of the “shadow” banking system will be a decided plus for the stability of the banks and the overall economy, potentially helping to avoid future housing price bubbles.
- We mentioned earlier that with a law of the broad scope of the Dodd-Frank Law, there is always a risk of unintended consequences, with a good portion of those consequences playing out over an extended period of time. The **International Swaps and Derivatives Association** recently indicated that the Law could require U.S. companies to post as much as \$1.0 trillion (yes, with a “T”!) in capital and liquidity requirements in order to continue using derivatives to reduce their business risk. A **Wall Street Journal** article further highlighted this risk, indicating that a number of non-financial companies that are “simply trying to manage their risks” could be faced with the need to pull liquidity out of “productive parts of the economy.”
- Over the course of the last few months, there has been considerable discussion with respect to the impact of the “Volcker Rule” provisions in the Law. Over time, the Volcker Rule will curb proprietary trading by the largest firms, with private equity investments limited to 3% or less of Tier I capital. The ultimate implementation of Volcker-related restrictions on proprietary trading and investing will require a six-month study, followed by a lengthy period of regulatory rule-making and final implementation, which could take up to four years, to July 2014. With this relatively long horizon until final implementation, Conning believes that the impact on the financial sector of the Volcker provisions in the near term will be relatively muted.
- Contrary to initial fears, banks will be able to keep significant portions of their existing derivatives/swaps operations within their banking subsidiaries; thus, in Conning’s view, the Dodd-Frank Law provisions (with central clearing of derivatives a plus) are not materially negative for the sector.

- Missed opportunities?? There has been a considerable amount of attention paid to the fragmented system of financial oversight in the United States, with a relative patchwork of federal and state regulators, and the role this shortcoming played in the financial crisis. The Dodd-Frank Law did not fully eliminate this, although a significant amount of power will now be placed in an Oversight Council to advise all regulators. As an example, while Citigroup's primary regulator remains the Federal Reserve, numerous agencies still share oversight of Citi and other complex financial companies, making it still difficult to determine fault for regulatory shortcomings.

Conclusion

Conning believes that the Dodd-Frank Law will help to incrementally reduce, through stronger regulatory oversight, as well as higher capital and liquidity requirements, the overall level of systemic risk in the U.S. banking system. However, a number of provisions of the Law will pressure the earnings capacity of the sector, with the average return on equity likely migrating from its historical level of about 15% to a level that may approach a still acceptable, but more utility-like 10%-11%. Higher capital and liquidity requirements and new consumer protections are likely to reduce the banks' ability to incrementally expand loan portfolios, hurting the ability of the overall economy to further expand.

A Final Note

For all the length and minutia of detail in the Dodd-Frank Law, much of the final implementation will be decided by regulators in Washington, away from the glare of the public spotlight. Financial institutions are masters of this behind-the-scenes game, and bright young Wall Street types are already tearing the Bill apart looking for ways to circumvent and side-step many of the pending regulations. To reiterate, Conning believes that the removal of government support previously implied in NRSRO credit ratings of systemically-important banks could lead to rating downgrades. However, we believe this will prove manageable, with the senior debt of selected banks currently exhibiting above-average relative value.

Ultimately, Dodd-Frank will succeed or fail in its goals based on the abilities of those enforcing its provisions to anticipate, rather than react to, future events. The historical track record in this regard is not encouraging. ♦

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