

# Financial Regulatory Reform: How Does It Help, How Does It Hurt?



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## Panel Detail:

Monday, May 2, 2011, 11:00 AM - 12:15 PM

## Speakers:

[Kenneth Griffin](#), Founder and CEO, Citadel

[Raymond McDaniel Jr.](#), Chairman and CEO, Moody's Corp.

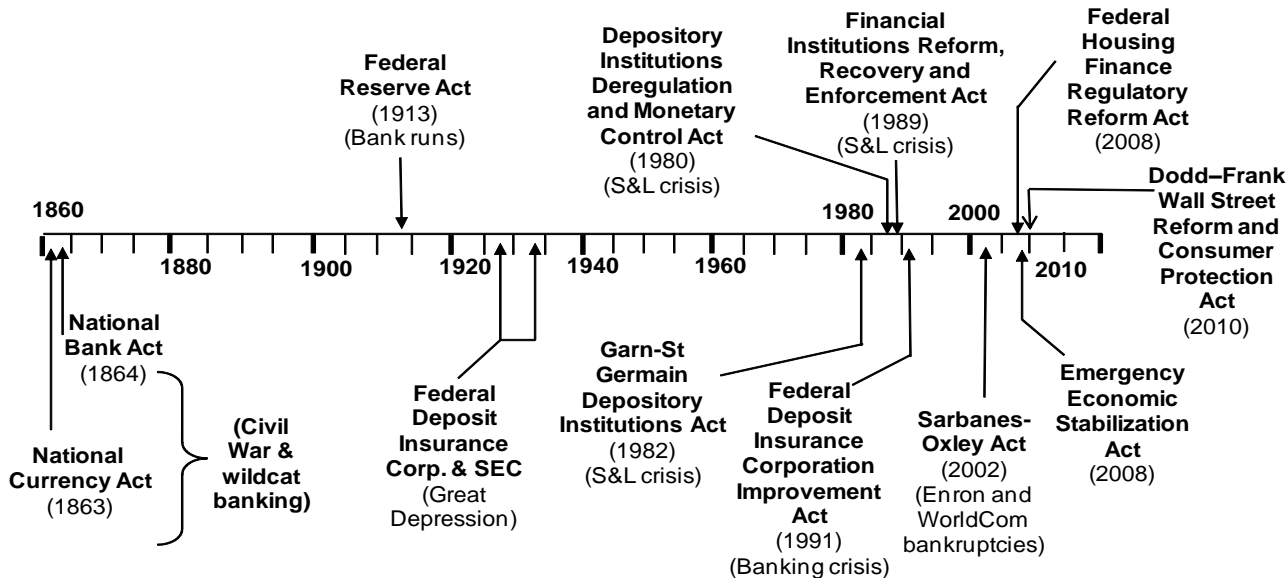
[Jim Millstein](#), Chairman, Millstein & Co. LLC; former Chief Restructuring Officer, U.S. Treasury Department

[Thomas Wilson](#), Chairman, President and CEO, Allstate; Deputy Chairman, Federal Reserve Bank of Chicago

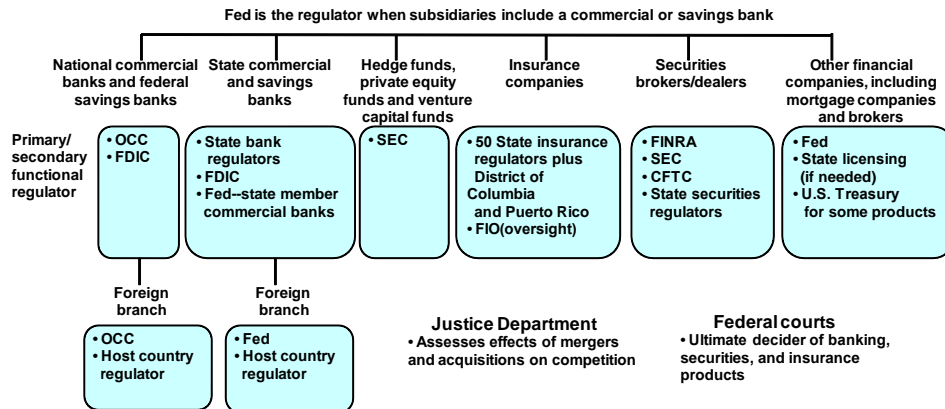
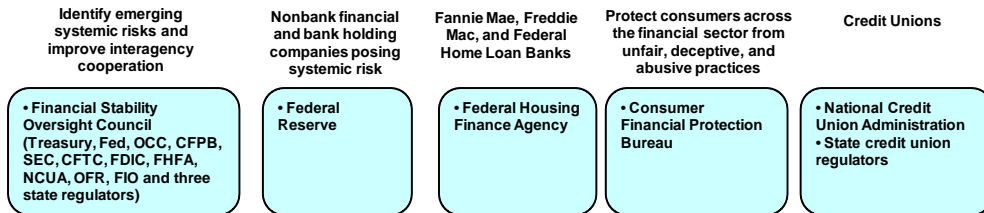
## Moderator:

[Alan Schwartz](#), Executive Chairman, Guggenheim

# A history of crises and new banking laws despite promises of 'never again'!



# U.S. regulatory structure: Overlapping, costly

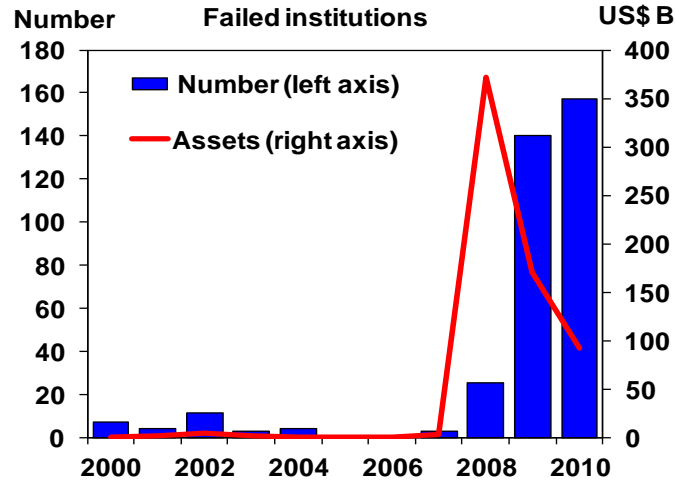
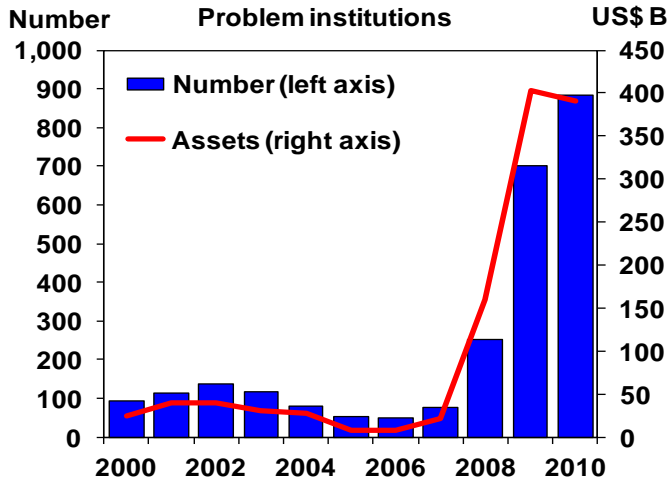


# Troubling trend: Have bank failures peaked?



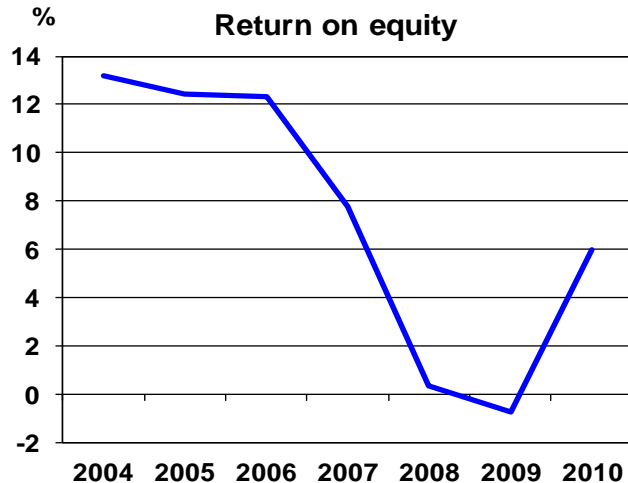
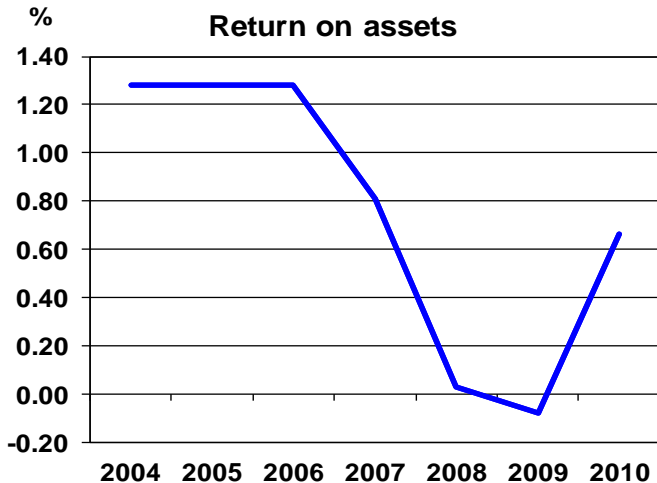
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2000 to 2010

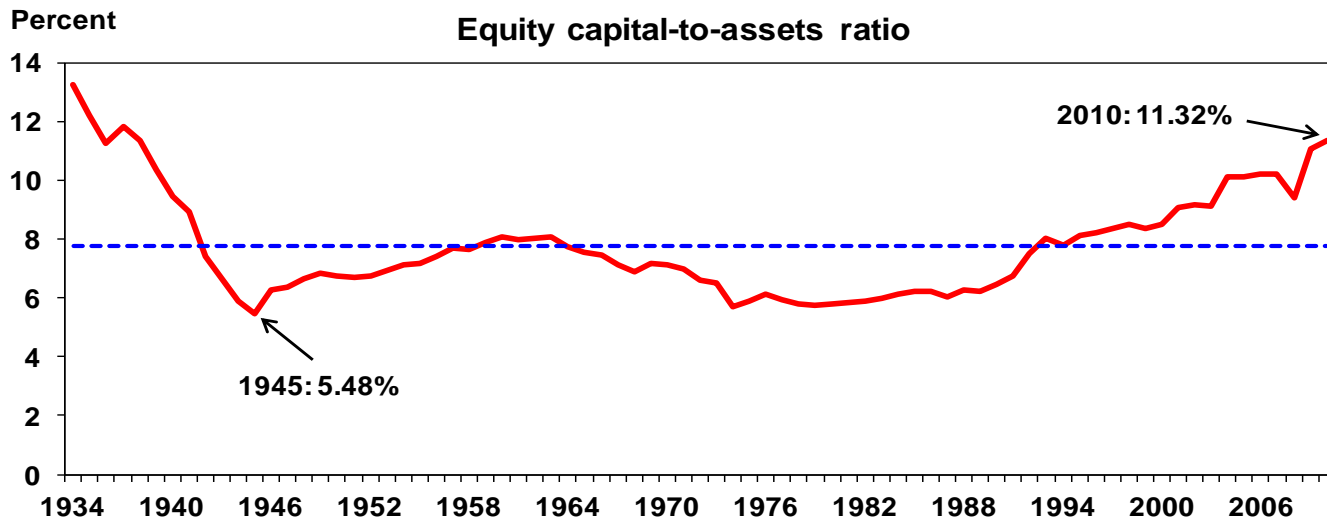


Sources: FDIC.

# Bank profitability trending up



# Equity capital-to-assets ratio for U.S. banks



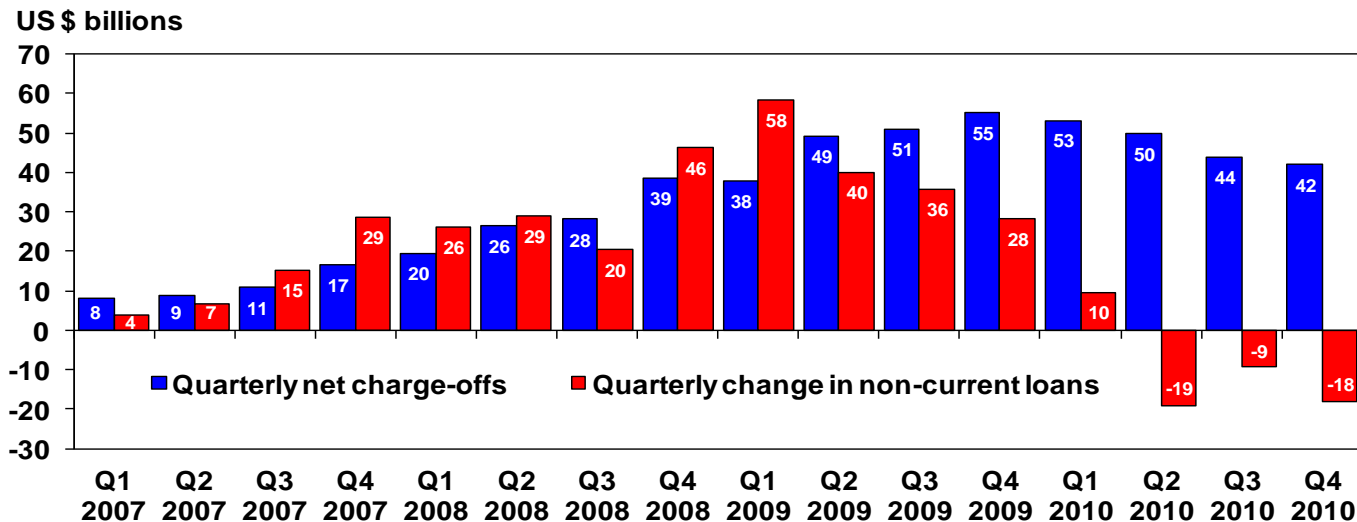
Sources: FDIC, Milken Institute.

Note: Equity capital-asset ratio for FDIC-insured commercial banks.

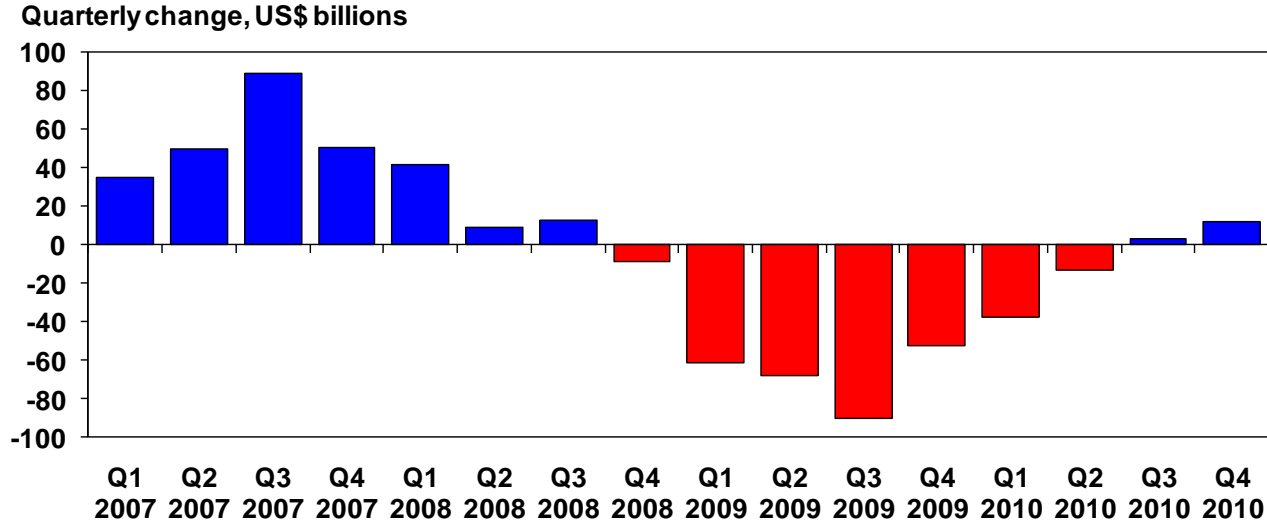
# Bank asset quality indicators show further improvement



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# Industrial and commercial loans by all U.S. depository institutions





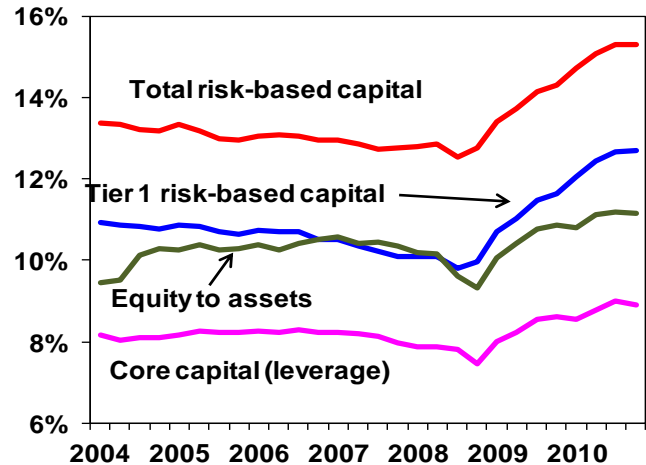
# Reality check: What is the most appropriate capital measure for banks?



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## *U.S. regulatory capital requirements and selected capital ratios*

	Core (leverage)	Tier 1 risk-based	Total risk-based
Well capitalized	$\geq 5\%$	$\geq 6\%$	$\geq 10\%$
Adequately capitalized	$\geq 4\%$	$\geq 4\%$	$\geq 8\%$
Undercapitalized	$< 4\%$	$< 4\%$	$< 8\%$
Significantly undercapitalized	$< 3\%$	$< 3\%$	$< 6\%$
Critically undercapitalized	Tangible equity capital ratio that is $\leq 2\%$		



# Are the biggest banks too big to fail?

## Trillion-dollar banks, ranked by assets, 2010

Bank	Country	Total Assets (US\$ trillions)	Market Cap (US\$ billions)
1 BNP Paribas	France	2.7	92
2 Deutsche Bank	Germany	2.5	56
3 HSBC Holdings	U.K.	2.5	192
4 Barclays	U.K.	2.3	59
5 Royal Bank of Scotland	U.K.	2.3	77
6 Bank of America	U.S.	2.3	138
7 Mitsubishi UFJ	Japan	2.2	62
8 Credit Agricole	France	2.1	40
9 JPMorgan Chase	U.S.	2.1	188
10 ICBC	China	2.0	258
11 Citigroup	U.S.	1.9	131
12 Mizuho Financial	Japan	1.7	33

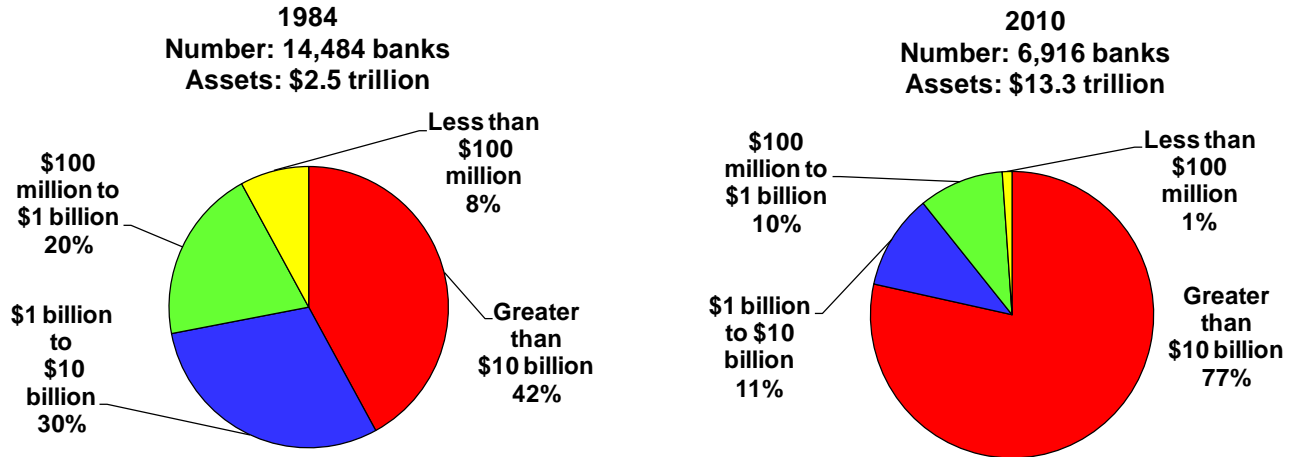
Bank	Country	Total Assets (US\$ trillions)	Market Cap (US\$ billions)
13 China Construction Bank	China	1.6	240
14 Banco Santander	Spain	1.6	102
15 Bank of China	China	1.6	150
16 Agricultural Bank of China	China	1.6	146
17 Lloyds Banking	U.K.	1.5	69
18 Societe Generale	France	1.5	50
19 UBS	Switzerland	1.4	71
20 Sumitomo Mitsui	Japan	1.3	41
21 Wells Fargo	U.S.	1.3	169
22 Credit Suisse	Switzerland	1.1	52
23 Commerzbank	Germany	1.0	11

Sources: Bloomberg, Milken Institute.

Note: Market capitalization is from April 6, 2011.

# Big banks increasingly dominate the U.S. banking industry; is this a problem?

## Asset shares by bank size



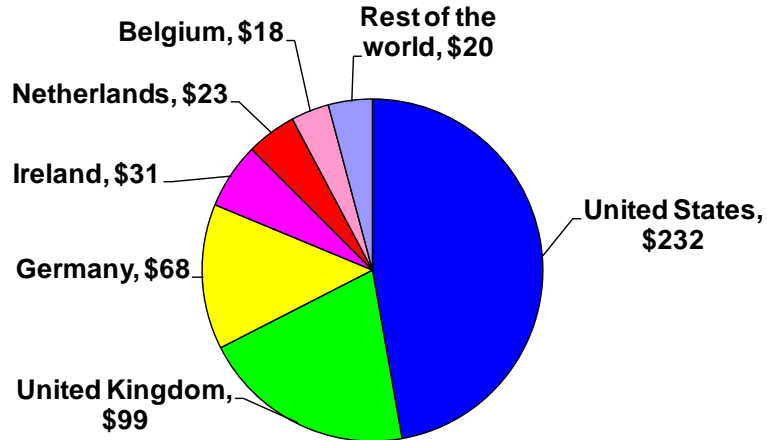
# Government capital investments in financial firms



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*Most recently available data, as of April 6, 2011 (US\$ billions)*

**Total outstanding = \$491 billion**

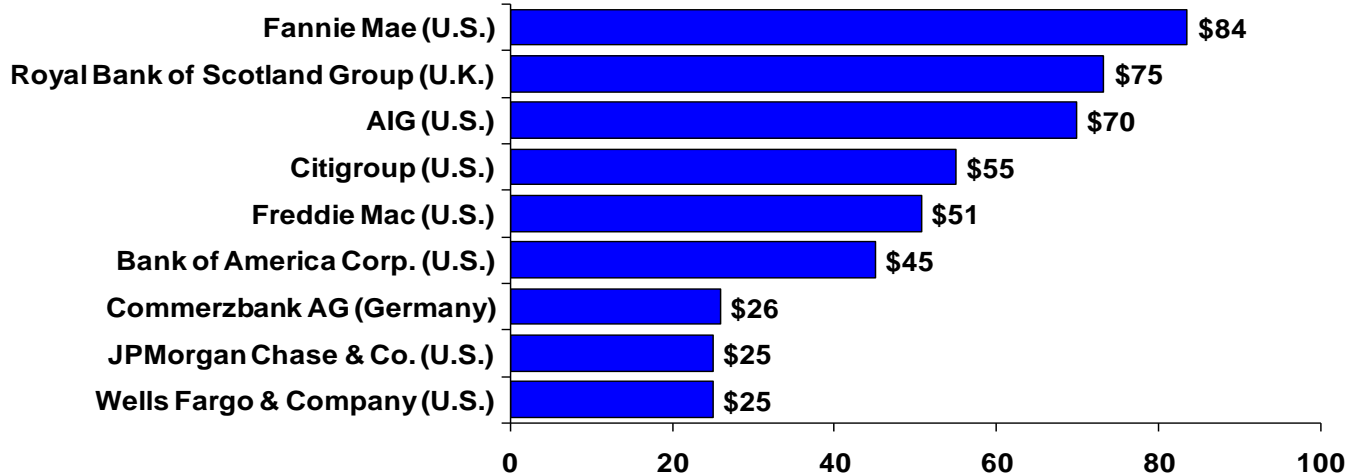


Source: Bloomberg.

# Financial institutions received largest government bailouts (all countries)



Bailout funds received from governments (US\$ billions)



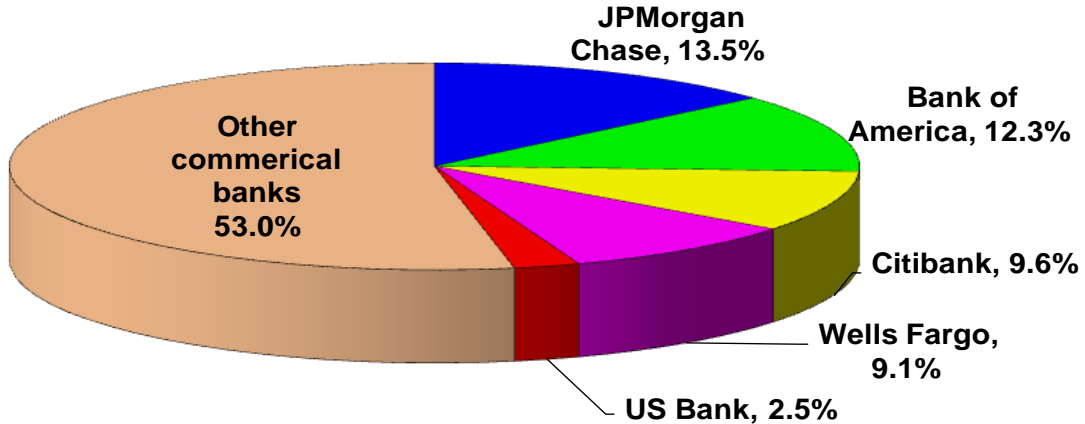
Note: Data are as of April 20, 2011.

Source: Bloomberg.

# Five largest banks control almost half of U.S. national banking assets (2010)



All FDIC insured commercial banks  
Total assets = US\$12 trillion; Total number = 6,529 banks

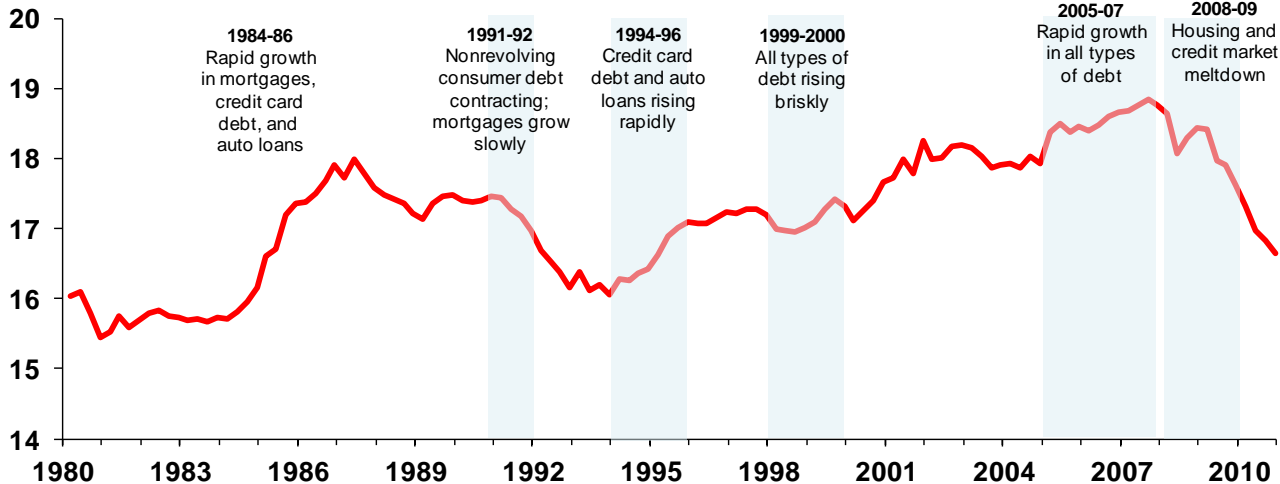


# Historical trend of U.S. household financial obligation ratio



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## U.S. household financial obligation ratio, percent



Sources: Federal Reserve, Milken Institute.

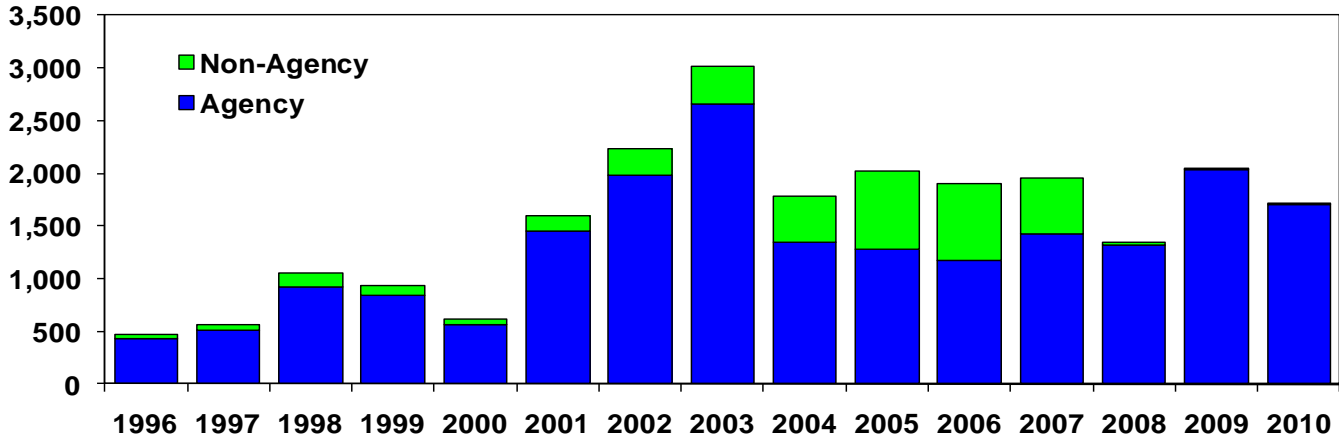
Note: Financial obligation ratio: An estimate of the ratio of revolving and non-revolving debt payments to disposable personal income.

# Non-agency residential mortgage-related securities market has died out



US\$ billions

## U.S. residential mortgage-related securities issuance



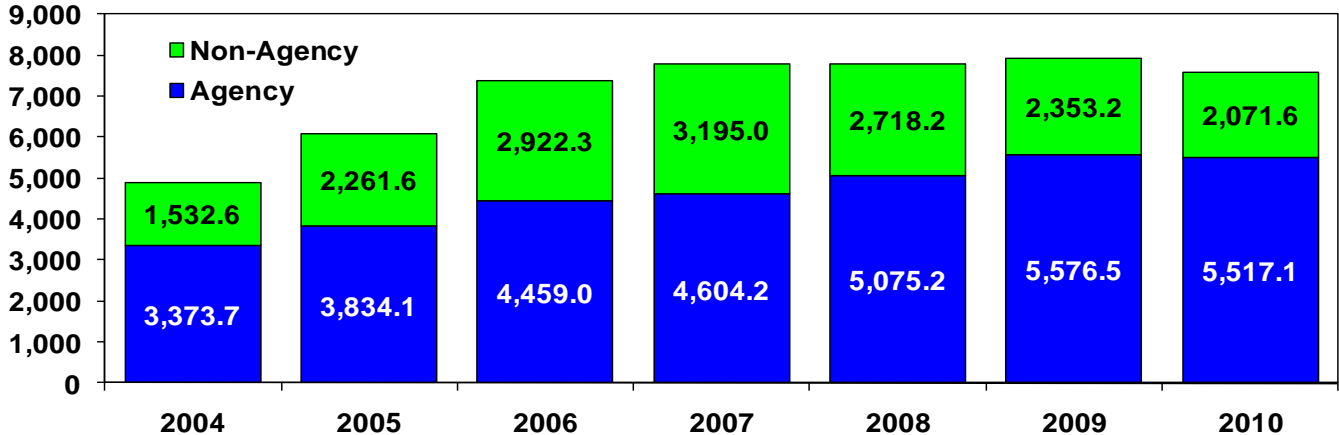




# U.S. mortgage-related securities market

US\$ billions

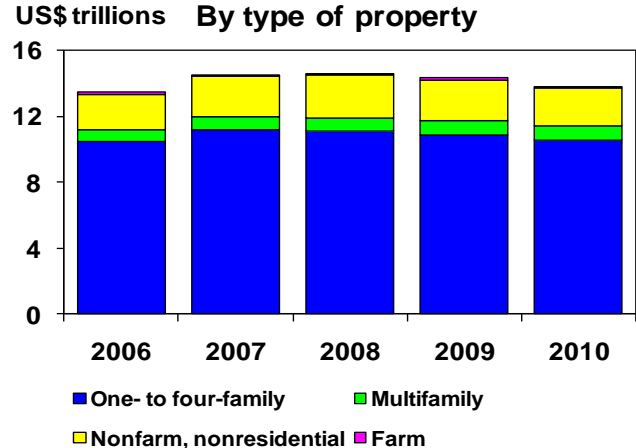
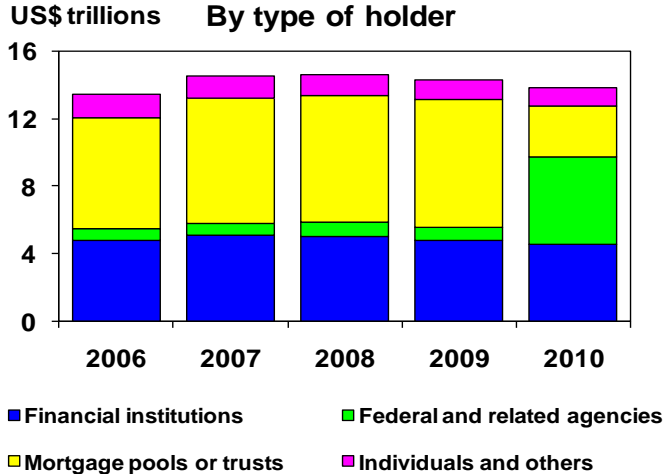
## U.S. mortgage-related securities outstanding



# Mortgage debt outstanding: Government holdings significantly increase

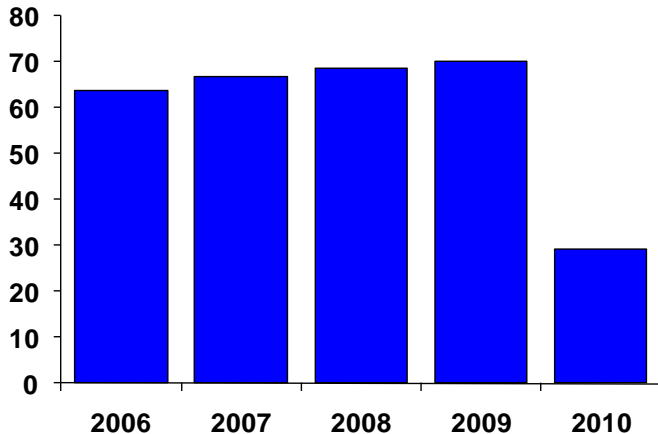


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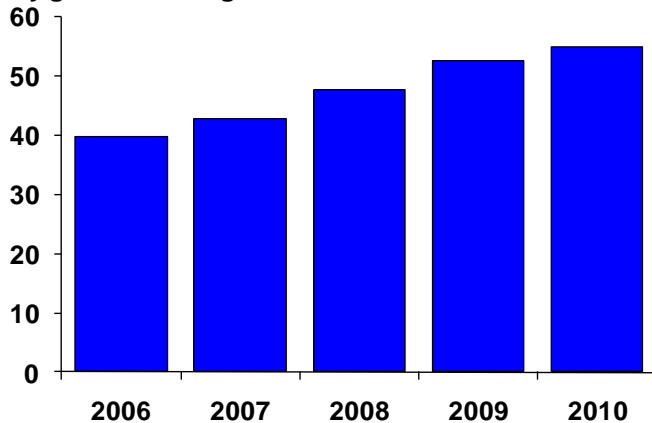


# Changing landscape of U.S. mortgage market

Percent of home mortgage loans securitized



Percent of home mortgage loans held or securitized by government agencies and GSEs



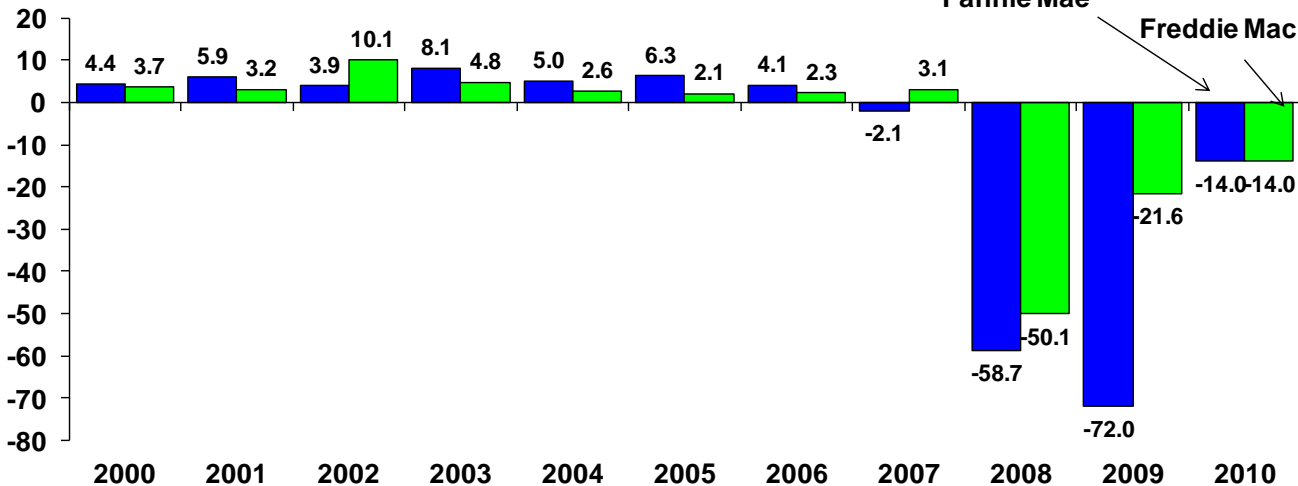
Sources: Federal Reserve, Milken Institute.

Note: Estimates based on single-family home mortgages.



# GSEs suffer significant losses

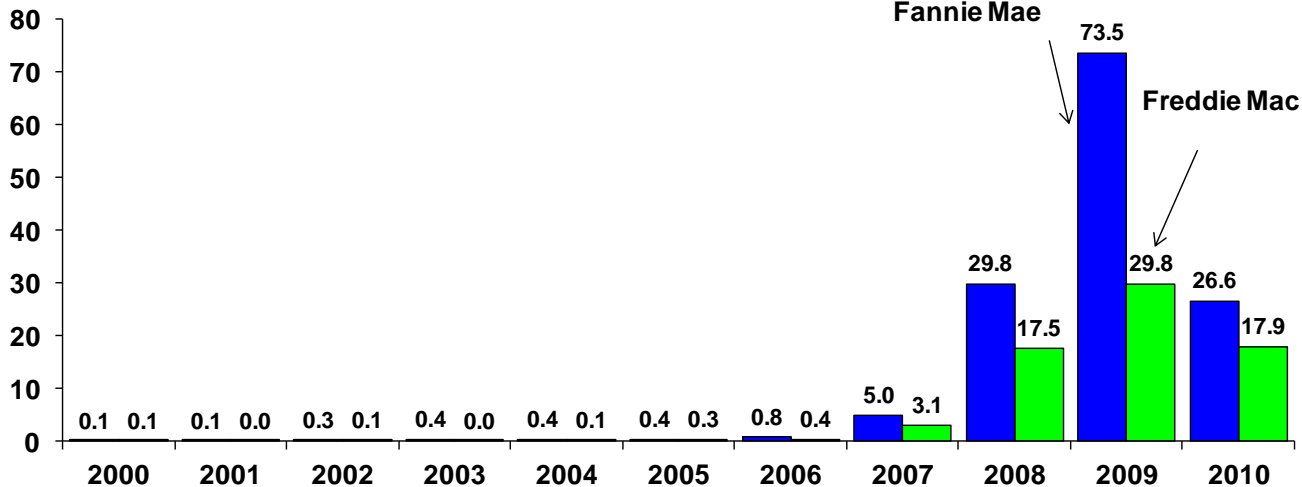
Net income, US\$ billions



Sources: Fannie Mae, Freddie Mac, FHFA, *Inside the GSEs*.

# Elevated credit expenses at GSEs

Credit-related expenses, US\$ billions



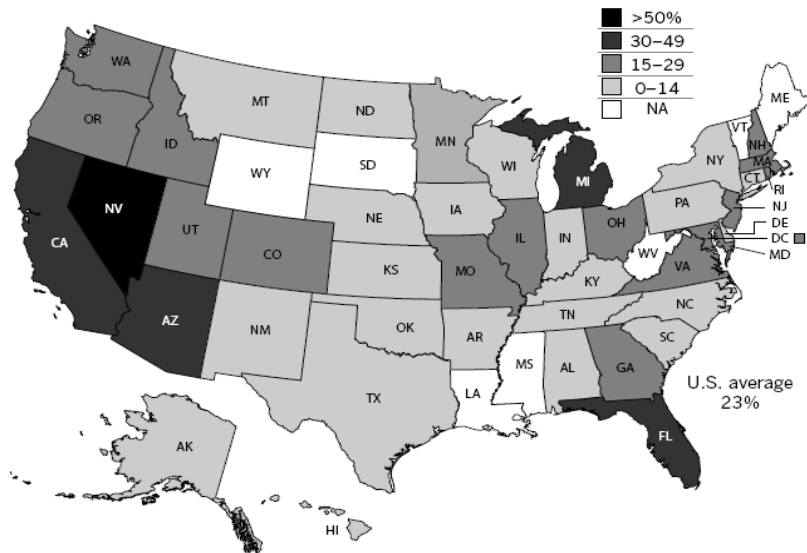
Sources: Fannie Mae, Freddie Mac, FHFA, *Inside the GSEs*.

# 'Underwater' mortgages

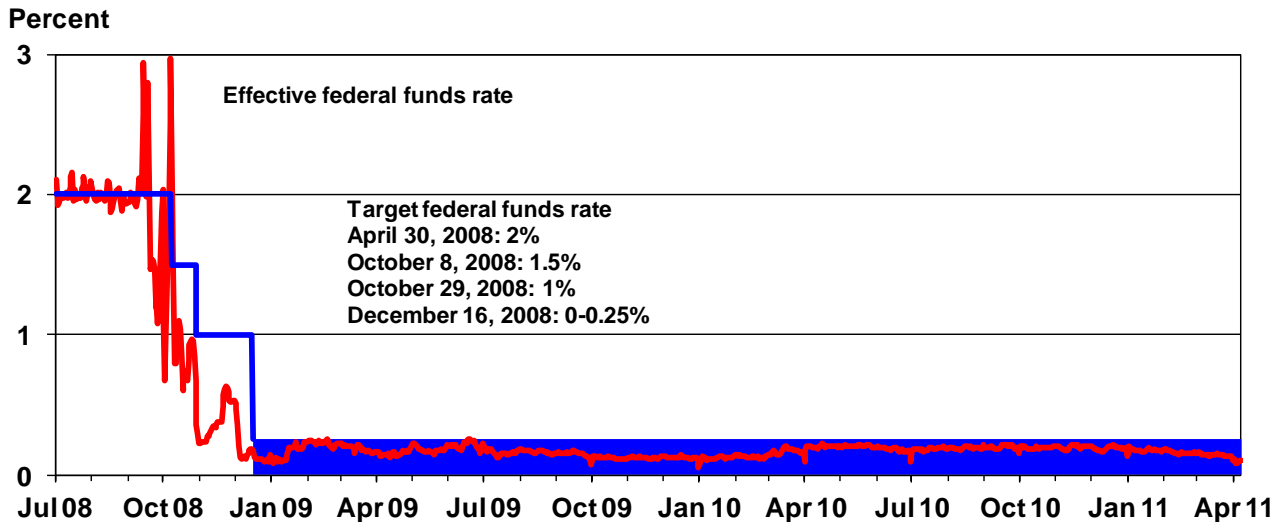


*Many mortgage holders find themselves underwater; that is, owing more than their homes are worth. This is particularly true in Arizona, California, Florida, Michigan, and Nevada.*

SHARE OF LOANS WITH NEGATIVE EQUITY, THIRD QUARTER 2010

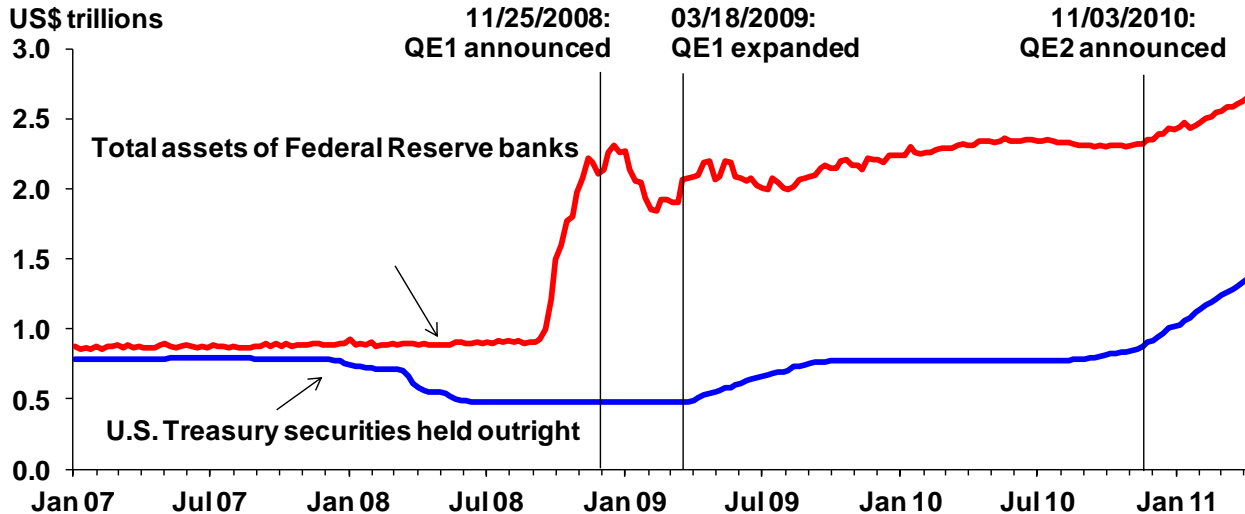


# Federal Reserve has little room to maneuver



Sources: Federal Reserve, Milken Institute.

# The Fed engages in quantitative easing



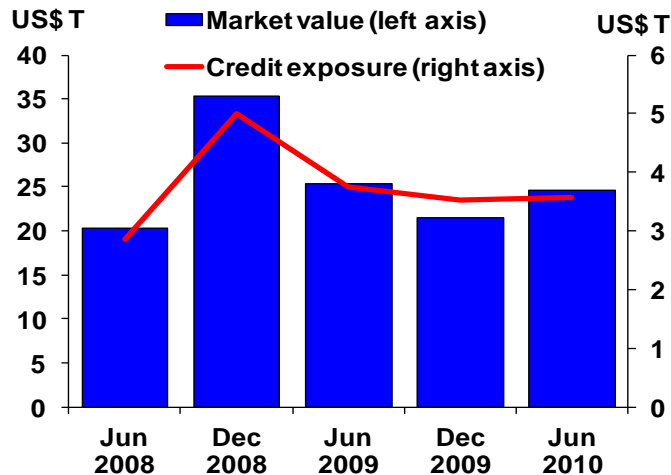
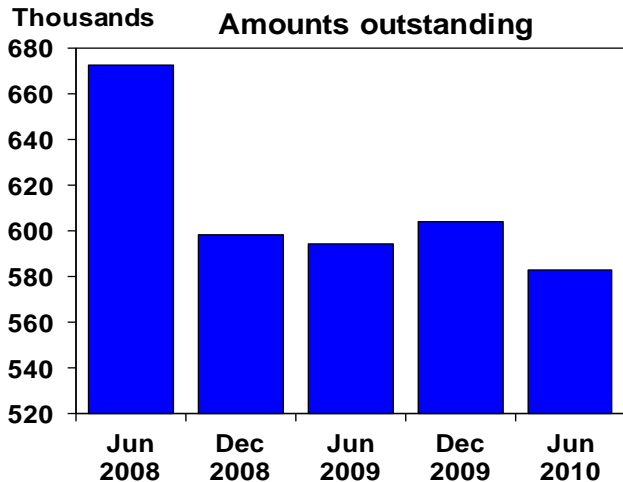
Sources: Federal Reserve, Milken Institute.



# Amounts outstanding and market value of OTC derivatives

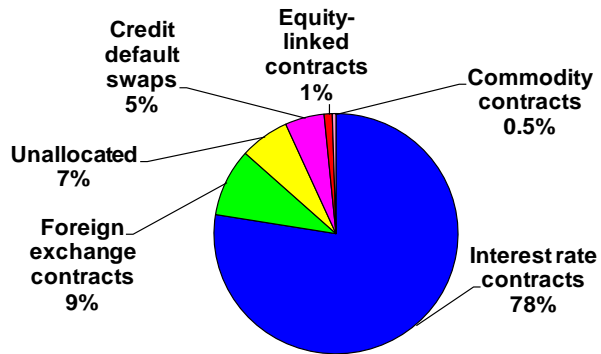


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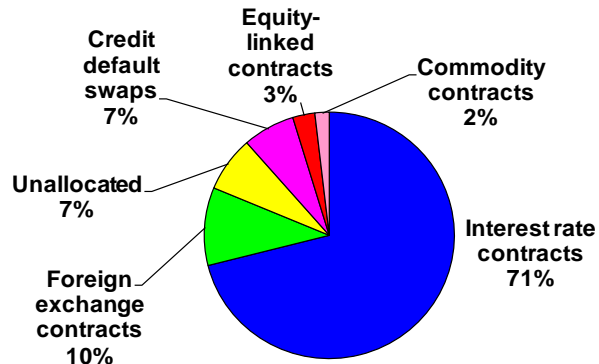


# Composition of OTC derivatives by risk category and instrument, June 2010

### Amounts outstanding



### Market value



# Credit default swaps

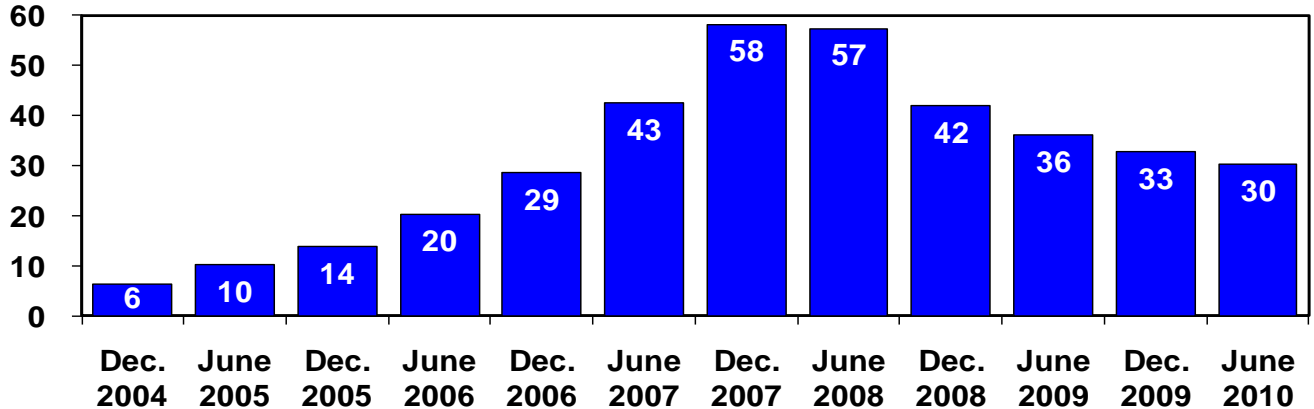
*Notional amounts outstanding*



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## Credit default swaps outstanding

US\$ trillions



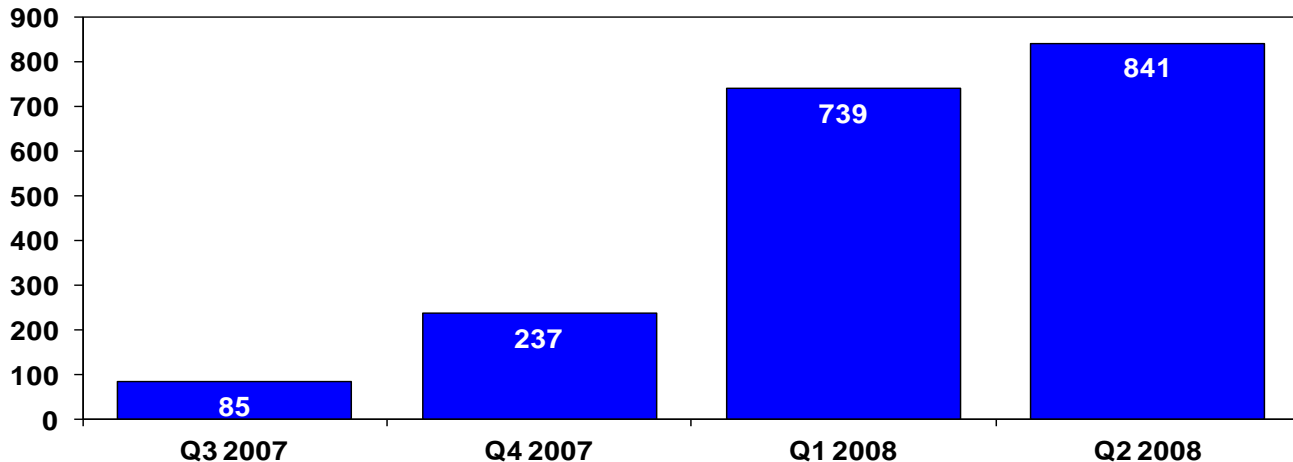
# Credit rating agencies' downgrades through 2007 and 2008



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US\$ billions

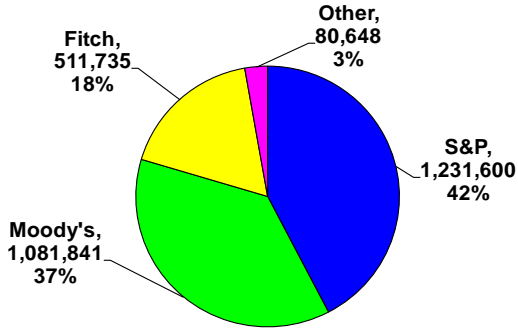
## Mortgage-backed securities downgrades



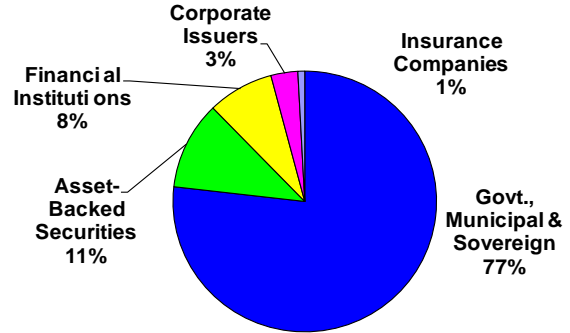
# Outstanding credit ratings 2009



### Outstanding credit ratings by agencies



### Outstanding credit ratings by issuers





# Systemic risk regulatory proposals

	United States		United Kingdom	European Union
	House of Representatives	Senate		
Systemic risk regulator	Financial Services Oversight Council (FSOC)	Financial Stability Oversight Council	Council for Financial Stability	European Systemic Risk Board (ESRB)
Institutional arrangements	A council of Treasury secretary (chair) and heads of federal regulators; resources provided mainly by Treasury	A council of Treasury secretary (chair) and heads of federal regulators and an independent member	A council of heads of Treasury (chair), Financial Services Authority, and Bank of England	A council of central banks and regulators; secretariat provided by European Central Bank



# Systemic risk regulatory proposals

Powers	United States		United Kingdom	European Union
	House of Representatives	Senate		
Assessment of systemic risk	yes	yes	yes	yes
Making recommendations	yes	yes	n.a.	yes
Identification of systemic firms	yes	yes	n.a.	n.a.
Rule making	no	no	no	no



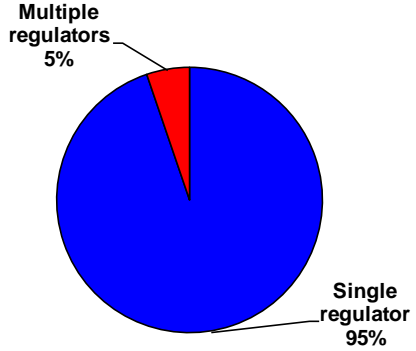
# Systemic risk regulatory proposals

	United States		United Kingdom	European Union
	House of Representatives	Senate		
Central bank in microprudence	Fed supervises all systemic firms regardless of their legal structure	Fed supervisory authority narrowed	No change	No change
Restrictions to lender of last resort	Determination by FSOC and consent by Treasury secretary required for section 13 (3)	Liquidity assistance under section 13 (3) limited to market-wide systems or utilities	No	No
Enhanced resolution mechanism	Systemic dissolution fund is to be established for systemic firms	Orderly resolution fund is to be established for systemic firms	Special resolution regime for major banks has been established	No

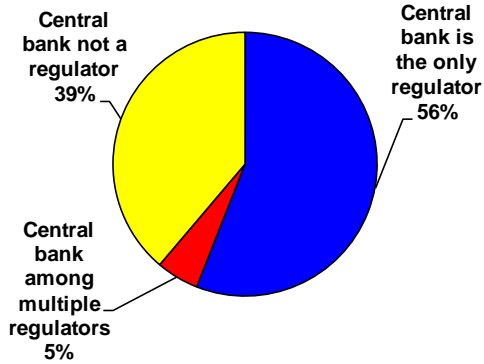


# Most countries have a single regulator and it only regulates banks; what should the U.S. do?

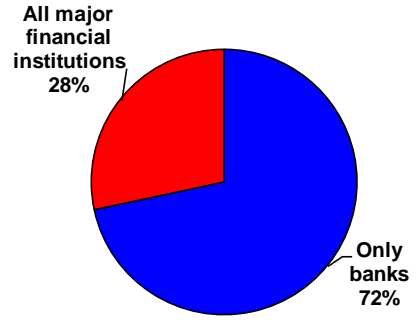
**Single vs. multiple bank regulators**  
Based on 134 countries



**Is central bank a bank regulator?**  
Based on 134 countries



**What's the scope for the bank regulator?**  
Based on 134 countries

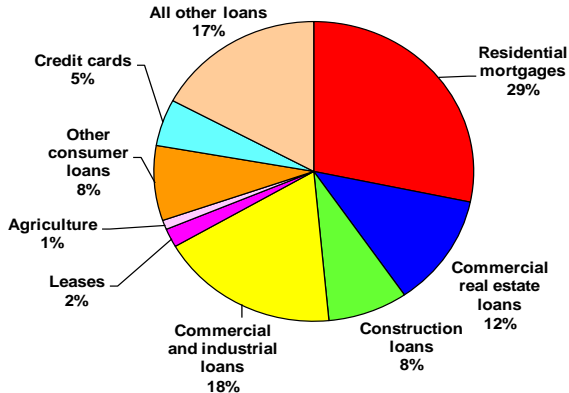


Source: World Bank Survey III.

# Systemic risk: Should regulators have focused on real estate assets or simply individual banks?

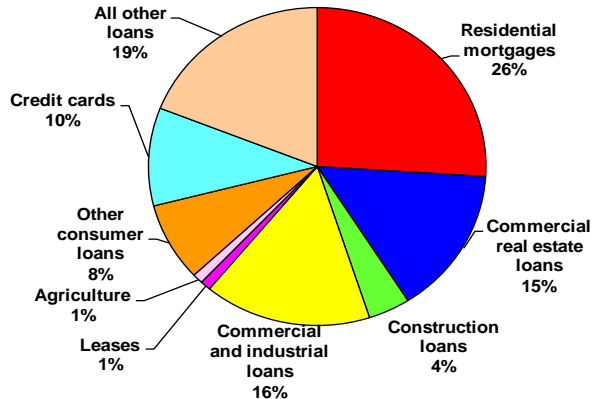
December 2007

Total loans = \$7.9 trillion



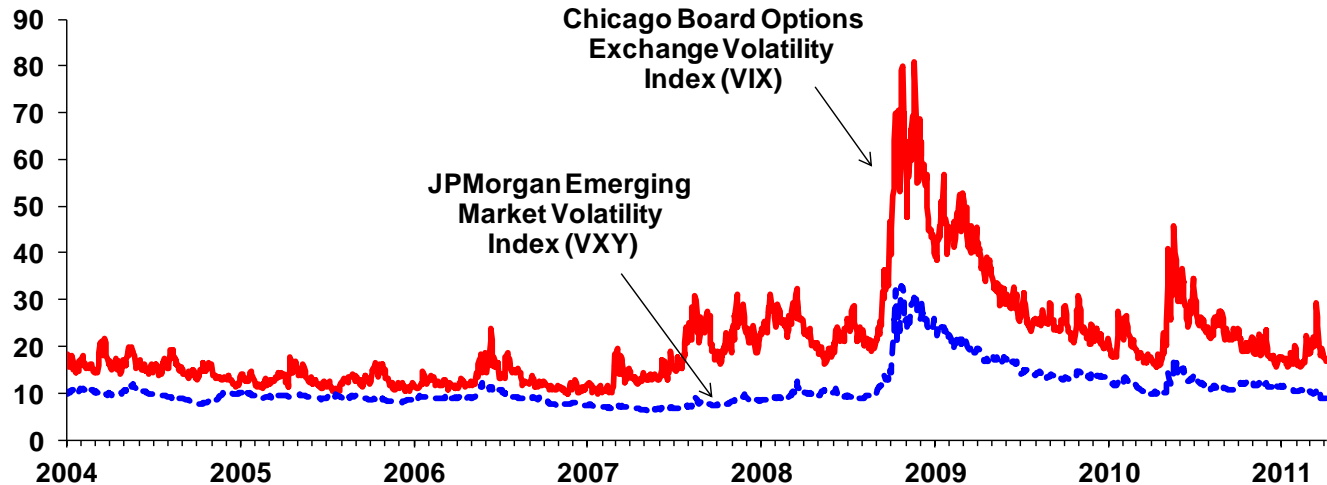
December 2010

Total loans = \$7.4 trillion



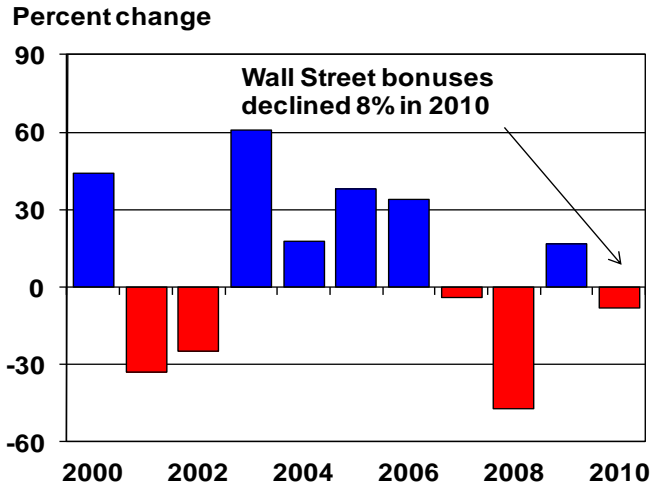
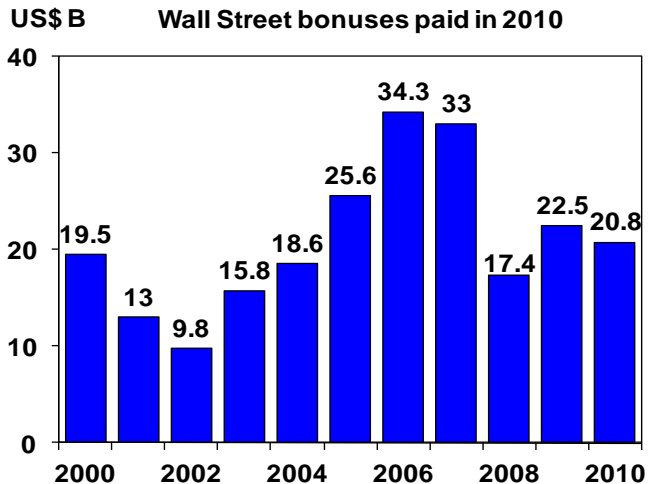
# Implied volatility: U.S. vs. emerging markets

Implied volatility, percent



Source: Bloomberg.

# Wall Street bonuses slightly decline





## **Kenneth Griffin's slides**

# Example of good writing in Dodd Frank; or why lawyers make so much



“SWAPS.—Nothing in this Act (other than subparagraphs (A), (B), (C), (D), (G), and (H) of subsection (a)(1), subsections (f) and (g), sections 1a, 2(a)(13), 2(c)(2)(A)(ii), 2(e), 2(h), 4(c), 4a, 4b, and 4b–1, subsections (a), (b), and (g) of section 4c, sections 4d, 4e, 4f, 4g, 4h, 4i, 4j, 4k, 4l, 4m, 4n, 4o, 4p, 4r, 4s, 4t, 5, 5b, 5c, 5e, and 5h, subsections (c) and (d) of section 6, sections 6c, 6d, 8, 8a, and 9, subsections (e)(2), (f), and (h) of section 12, subsections (a) and (b) of section 13, sections 17, 20, 21, and 22(a)(4), and any other provision of this Act that is applicable to registered entities or Commission registrants) governs or applies to a swap.”

# Orderly liquidation?



- United States Supreme Court, 1988: “The statutory language and the legislative history [of the bankruptcy code] clearly bar any expansion of any exception to the absolute priority rule beyond that recognized in our cases at the time Congress enacted the 1978 Bankruptcy Code.”
- Dodd Frank: “...the Corporation shall seek to harmonize applicable rules and regulations promulgated under this section with the insolvency laws that would otherwise apply to a covered financial company.”
- Dodd Frank: “All claimants of a covered financial company that are similarly situated under paragraph (1) shall be treated in a similar manner, except that the Corporation may take any action...that does not comply with this subsection, if the Corporation determines such action is necessary...”

# Who's on first?



## **Section 1011: Establishment of the Federal Bureau of Consumer Financial Protection**

“There is established in the Federal Reserve System, an independent bureau...which shall regulate the offering and provision of Consumer financial products or services under the Federal consumer financial laws.”

## **Section 1042: Preservation of Enforcement Powers of States**

“...the attorney general...of any State may bring a civil action in the name of such State...to enforce provisions of this title or regulations issued under this title...”

And further....

“No provision of this section shall be construed as altering, limiting, or affecting the authority of a State attorney general or any other regulatory or enforcement agency or authority to bring an action or other regulatory proceeding arising solely under the law in effect in that state.”