Letter from the President

Three Years After the Crisis: Regulatory Reform Moves Forward

A perspective from the SIFMA Annual Meeting and Conference
November 7, 2011

Three years ago, the global economy was in meltdown, and the heart of the problem was Wall Street. How much progress has been made in regulatory reform since then, and what more needs to be done? I got a chance to learn more about the answers to those two questions when I attended the SIFMA Annual Meeting and Conference in New York City on November 7. The conference, entitled "Global Reform: Industry Impact", explored the progress on regulatory reform and its impact on the U.S. securities industry. The conference embraced three interconnected themes:

- Progress on regulatory reform – what is being done and what needs to be done;
- The impact of the reform measures on the U.S. securities industry: and
- The fiscal crisis at home and abroad (U.S. and Europe), failure to address sovereign indebtedness, and the consequences for economic recovery and the markets.

Regulatory Reform: A Slow – But Solid – Pace

Regulatory reform in the United States has had a tsunami-like impact on the securities industry and markets over the past three years, with several more years to go before full rule implementation is in place. Banking and securities reform has been comprehensive and far-reaching across the securities industry and capital markets, embracing the Dodd-Frank legislation and the G20 reform agenda. The enormity of the rule-making process has meant that reforms have fallen behind schedule, reflecting the complexity of the proposed rules, the need for analysis and extensive consultation with market participants and limited resources of the regulator. So far about 126 deadlines out of 235 rule-making initiatives have been missed.

Even though reforms have moved more slowly than planned, much has been accomplished both in terms of the specific rule framework as well as steps taken to improve the health of U.S. financial institutions. Leverage in the U.S. banking system has been reduced on average from an estimated 16:1 to 11:1, and loan loss reserves have been built up substantially. The TARP funds have been fully repaid, with a $20 billion profit to the federal Treasury.

Regulators and the securities industry are not disappointed with the slower pace of reform. It is indicative of more time spent on study and analysis, and on consultations to ensure rules are properly formulated and effective. The need for comprehensive research and analysis, and a formal cost-benefit approach to get the rules right was echoed several times throughout the conference by industry participants and the regulators. The recent collapse of MF Global has given market participants a further reminder of the importance of moving forward with the reform agenda, particularly increased transparency and mandated transaction flow through clearinghouses.

Regulatory Reform: Some Key Areas

The conference discussions on regulatory reform focused on four key segments of the regulatory agenda: the Volcker rule regulating "off the floor" trading and hedge fund ownership, the swap "push out" from dealers, the fiduciary standard for broker-dealers and the Basel III liquidity and capital standards. There was broad agreement among conference participants on the decision to address the conflict between proprietary trading, including "off the floor" trading and hedge fund ownership, and market-making for clients. Regulators and industry participants recognize the difficulty segmenting "off the floor" trading from legitimate market making, and no one is convinced an effective rule can be designed to market clear distinction between these activities. The Volcker Rule, however, will complicate compliance and likely adversely affect trading activity.

First, it will ultimately trigger a shift of proprietary trading in debt and derivative securities to a variety of smaller non-bank "shadow" institutions such as hedge funds. Second, the authorities will likely give considerable latitude to bank financial groups in the construct of the final version of the rule to ensure U.S. financial institutions are not at a competitive disadvantage to their global counterparts, and that large fund management companies such as Blackrock have sufficient liquidity to facilitate large-scale portfolio adjustments. These fund companies require large intermediaries with significant capital to provide needed market-making for liquidity, particularly in debt securities.

The Dodd-Frank legislation establishes specific registration requirements for broker-dealers engaged in swap dealing. Registration imposes new rules related to the reporting and trading of swap instruments, and as a consequence may result in the "push out" of swap business to separate affiliate firms. The new rules for swap dealing, particularly those related to capital margin requirements and clearing through central clearing parties, will squeeze operating margins on a growing and important business activity.

The private wealth business remains concerned about the Dodd-Frank provisions that impose a fiduciary standard on broker-dealers. After extensive consultation with the regulators, the industry awaits the outcome of the SEC study on extending the fiduciary standard to broker-dealers, new rules and guidance for broker-dealers, a clean definition of personalized investment advice, and a proposed regulatory framework. All this is expected sometime next year. The securities industry supports the imposition of a fiduciary standard conditional on effective rules that avoid unintended consequences and interfere with consumer choice. The industry has argued that regulators should rely more heavily on disclosure than prohibition on certain transactions to address conflicts of interest. When released, the proposed SEC rule on a fiduciary standard will undoubtedly become the focal point for intensive industry representation.

The Dodd-Frank legislation will recognize the Basel III rules as the capital and liquidity rule standard for U.S. financial institutions. This will be a major adjustment in capital requirements for the U.S. financial groups, given that these groups were not previously subject to the Basel II standards. Moreover, in addition to these rules, the Financial Stability Board has identified 29 systemically important global institutions, with U.S. firms accounting for about 8-9 of these institutions. These 29 systemically important global firms will be subject to a capital surcharge of 100 basis points to 250 basis points.

What Has Been the Impact on the Industry?

Several of the panelists focused on the earnings and profitability impact of the new regulatory requirements, particularly restrictions on proprietary dealing from the Volcker rule and the tougher Basel III liquidity and capital requirements. Equity returns at the large financial groups now average about 7 ½ percent, mainly reflecting stiffer capital rules and depressed business conditions. It was noted that current valuations of institutions in the financial sector are roughly consistent with ROEs more in the historic range of 11-13 percent, suggesting share prices have limited upside in the short-run and equity financing will be expensive. These large financial groups are taking steps to strengthen profitability and return on equity. The main strategy continues to be aggressive cost-cutting, a process recognized as well underway but only partially completed. Other strategies include selective disposition of assets, the increased adaption of technology in both front and back-office operations, internet enablement for client communication and financial activity, and increased revenue through approaches such as building out existing businesses in the global marketplace and setting up new niche businesses. The financial groups expect over time to benefit from improving conditions in the marketplace.

Panelists recognized the option for bank financial groups to dismantle the banking holding company structure to escape some of the regulatory burden as a non-starter. Several of the bulge-bracket firms, notably Goldman Sachs and Morgan Stanley, had reorganized under the banking holding company structure in 2008 to access Federal Reserve funding and lender of last resort facilities. It was made clear from discussion that large institutions outside the holding company structure would still be subject to a similar regulatory framework given their systemic importance to the U.S. capital markets. The significant downsizing of operations could be a strategy to ease the regulatory burden. However, to meet this objective, asset disposition would be substantial, as these firms have assets in the $500-$800 billion range while non-systemic firms are more in the $50 billion range, entailing a ten-fold reduction in asset size. The decrease in operating margins from the significant loss of scale would probably offset any savings from a reduced regulatory burden.

The conference discussed the profound uncertainty among investors in global markets that has contributed to the "risk-on,-risk off" nature of markets, causing wild swings in asset prices and reduced investment and financing activity. Much of this uncertainty and lack of confidence in the outlook can be traced to the inability of policy-makers in Europe and the United States to come to grips with sovereign indebtedness and the underlying structural policy problem – the welfare state. Don Kohn, former Governor of the Federal Reserve, noted that in mid-2010 the Fed had revised down its outlook for U.S. economic growth in response to sluggish recovery in the U.S. housing market, and the feed-back of the fiscal crisis to uncertainty and reduced business and consumer spending. The mid-term outlook is for modest economy recovery, barring a full blown financial crisis in Europe spilling into the global markets. Kohn stated that a return to normalcy required Europe to find an effective solution to sovereign indebtedness by rising above national political interests, and the Super Committee in the U.S. Congress to reach agreement on a credible long-term fiscal plan. Vikram Pandit, CEO of Citigroup, stated that it is imperative that governments get in front of the capital markets with constructive policy actions instead of playing a dangerous game of catch-up that could trigger an unraveling of confidence and full blown financial crisis.

Conclusion: Modest Optimism

The U.S. securities industry has gone through the crucible of fire in the three years following the financial crisis, with events ranging from a widespread institutional collapse and restructuring in the financial sector, a hesitant economic recovery, roiling market activity and the steady drumbeat of regulatory reform. Now the inability to find a credible solution to sovereign indebtedness threatens to spiral into another crisis on the scale of the 2008 meltdown. The modest consolation in all of this is that continued violent swings in markets signal to politicians that they must move forward expeditiously to make responsible policy decisions, contain the market turmoil and get the global economy back on course. The conference participants were only modestly optimistic in the near term that American and European policy-makers would rise above narrow political interests to implement effective solutions to managing the sovereign indebtedness problem, and addressing the social policies that caused it.

Yours sincerely,

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