

Josh Mandel, State Treasurer of Ohio



Cash Management 225

Regulatory & Legislative Updates – How Are You Impacted?

Center for Public Investment Management

Overview



- Past banking crises suggest the return to previous risk-and-return norms take multiple years.
- The response to this crisis includes sweeping legislative and regulatory changes which should speed the level of change.
- Bank regulation is migrating to a far more capital intensive and liquidity focused approach.

Current Environment



Global Environment

- Growing dominance of a few, very large financial institutions that operate in more than one country.
- Cross-border ownership of most securities exchanges.
- Technology allows a financial institution to conduct business virtually anywhere in the world.



Past Banking Crises



Panic of 1819: 1819-1823 (4 years)

Panic of 1837: 1837-1843 (6 years)

Panic of 1873: 1873-1879 (6 years)

Panic of 1907: 1907-1913 (6 years)

Great Depression: 1929-1937 (8 years)

Savings & Loan Crisis: 1986-1995 (9 years)

Great Recession: 2007-2009 (2 years)

Standard Path of Crises



- Deregulation

- Rapid Credit Expansion

- Asset Price Appreciation

- Bubble Bursts

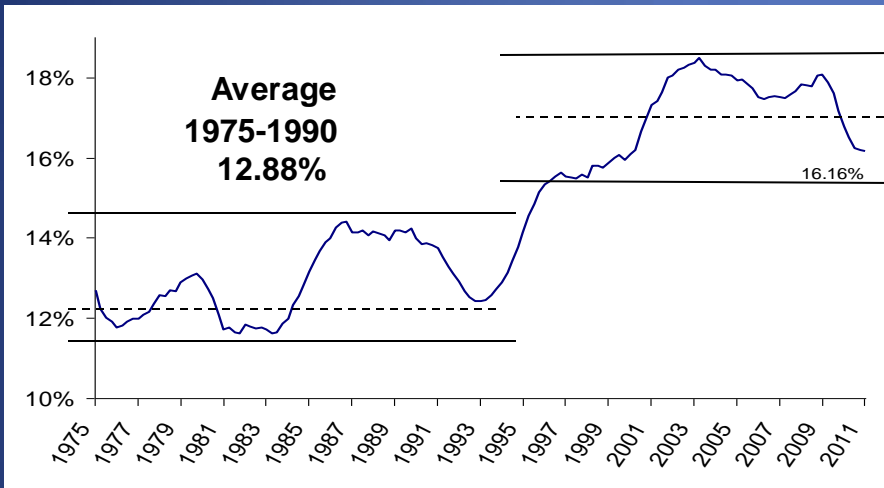
- Credit Loss Acceleration

- Credit Availability Deteriorates

- Government Engagement

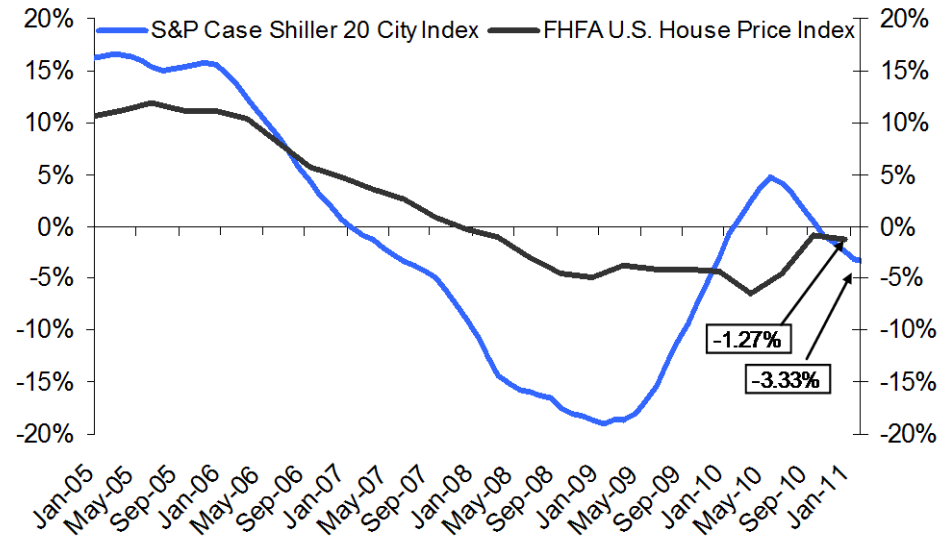
Consumer Debt & Housing Appreciation

Average: 1995-2005
16.71%

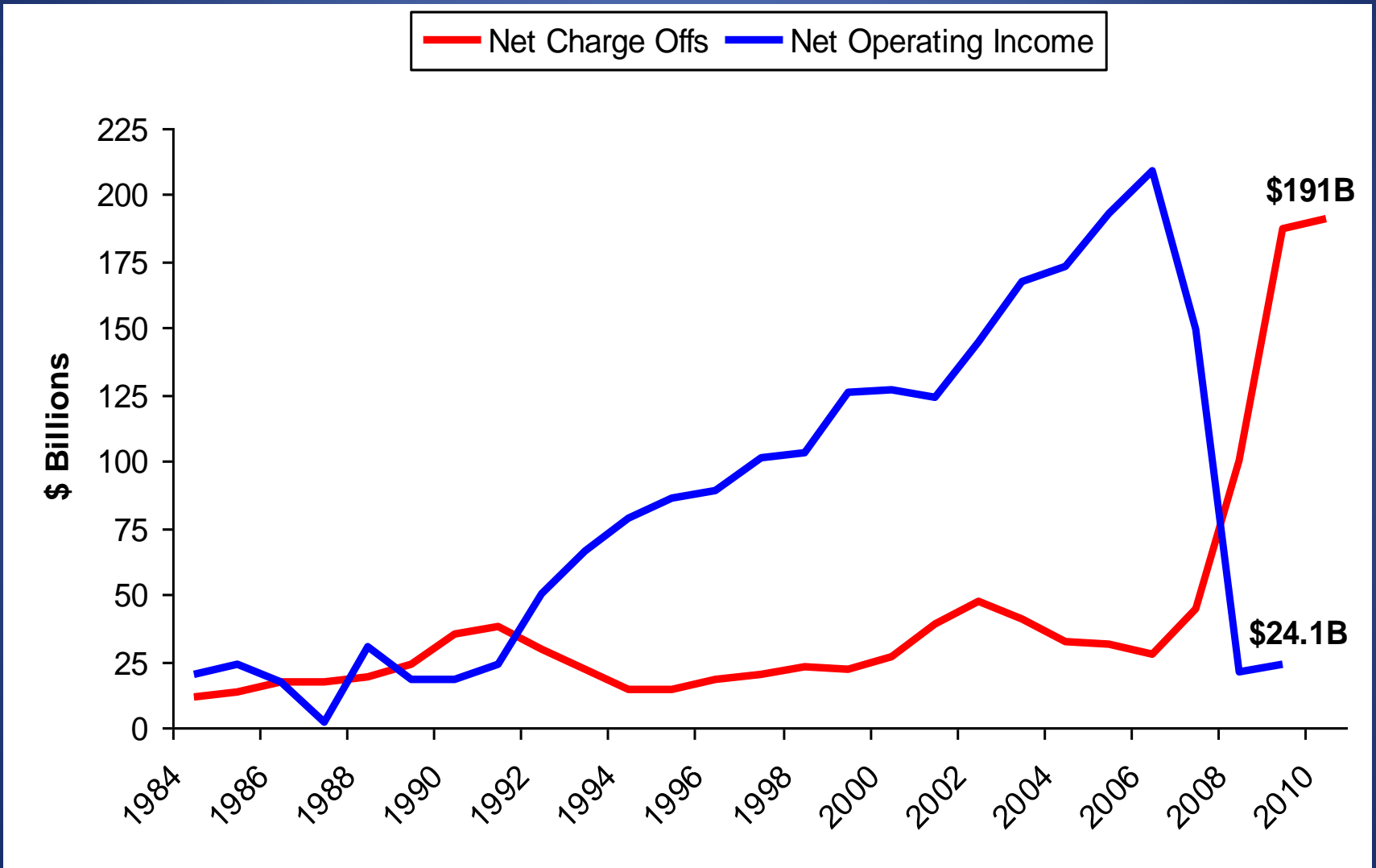


Housing Price Appreciation

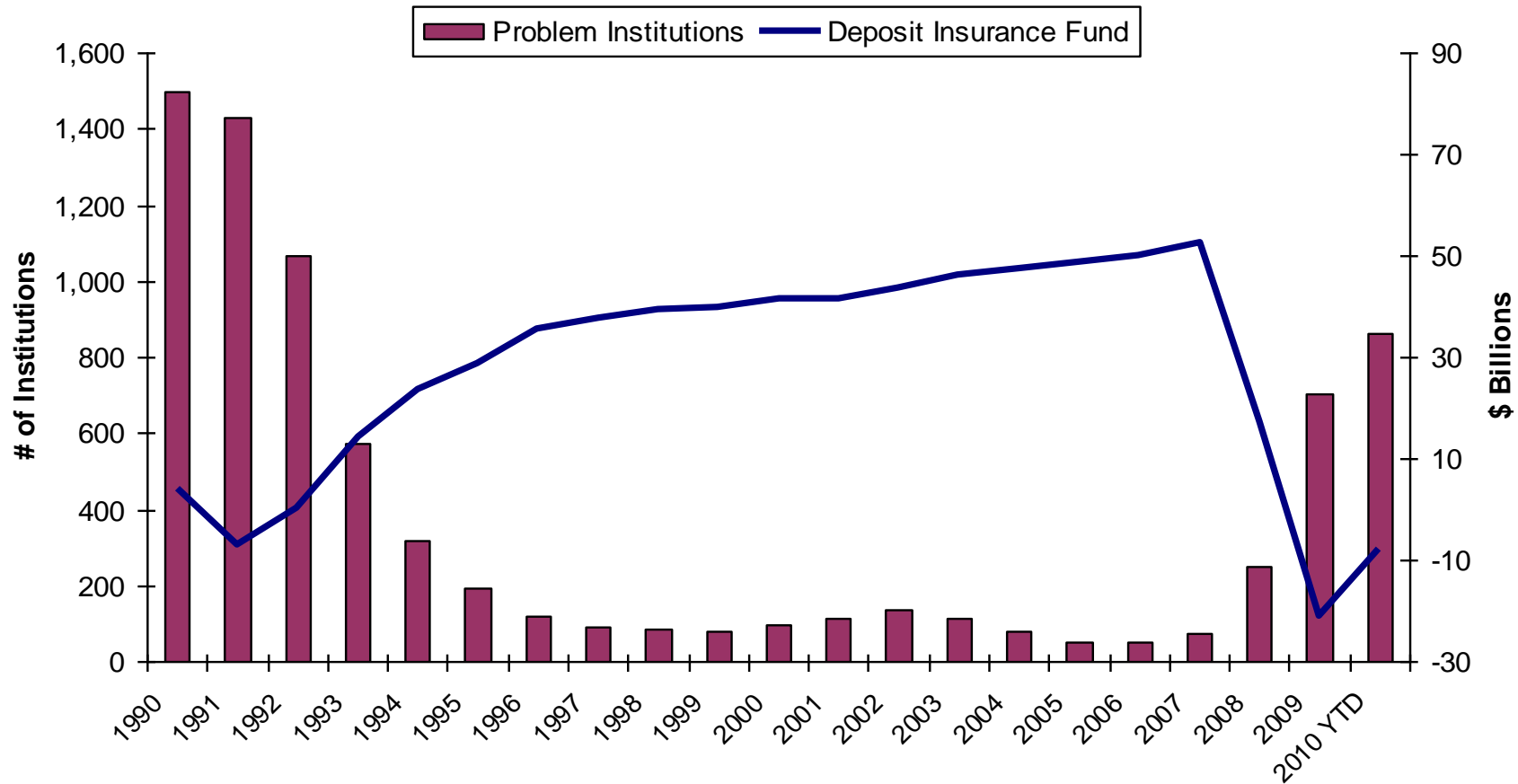
Consumer Debt As % of GDP



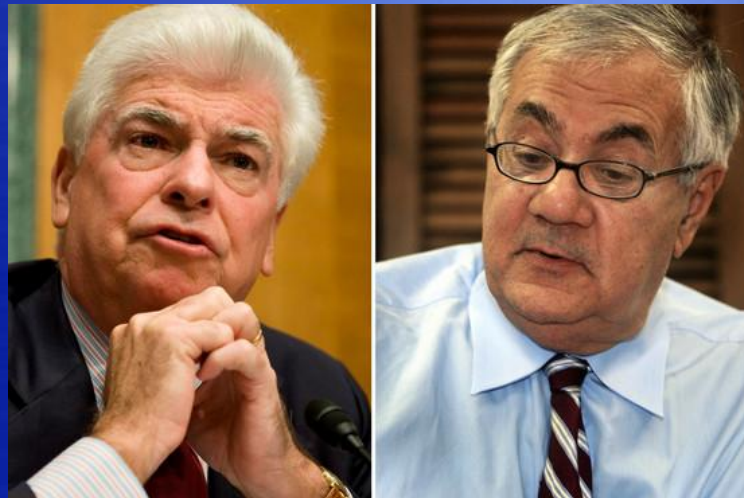
FDIC Institutions Charge Offs & Income



FDIC Problem Institutions & Deposit Insurance Fund



Dodd-Frank Wall Street Reform & Consumer Protection Act of 2010



Objective



To promote the financial stability of the United States by:

- Improving accountability and transparency
- Ending “too big to fail”
- Protecting taxpayers from bailouts and abusive financial services practices.

There are more than 243 provisions calling for 67 studies and 22 periodic regulatory reports.

Highlights of Dodd-Frank



- New Regulation & Supervision of Financial Institutions
- Repeal of Regulation Q authorizing interest bearing transaction accounts for corporations
- Volker Rule restricts banks from making certain types of private equity and hedge fund investments
- Changed FDIC limits, assessments and guarantees
- Durbin Amendment provides the Federal Reserve regulatory power over interchange

New Regulation & Supervision of Financial Institutions

- ***Ends Bank Bailouts*** – Creates safe ways to liquidate failed banks and mandates new capital requirements.
- ***Increases Regulation of Payment, Clearing & Settlement Systems*** – Provides uniform risk-management standards for bank payment, clearing, and settlement activities.
- ***Exposes Executive Compensation & Corporate Governance*** – Gives shareholders a non-binding vote on executive compensation and golden parachutes.



New Regulation & Supervision of Financial Services



- ***Increases Transparency & Accountability for Exotic Instruments*** – Provides more regulation for asset-backed securities, hedge funds, and over-the-counter derivatives.
- ***Provides More Protection for Investors*** – Increases accountability and transparency for credit rating agencies.
- ***Enforces Oversight Regulations*** – Allows regulators to pursue financial fraud and conflicts of interest.

Monitored How?



Newly-Created Agencies:

- Financial Stability Oversight Council
- Consumer Financial Protection Bureau
- Office of Financial Research
- Financial Insurance Office
- Office of Credit Ratings

Financial Stability Oversight Council



Responsibility is to prevent systemic risk from threatening the stability of the financial system.

- Monitor the sizes of financial institutions, non-bank financial companies, and large, complex companies that pose risk to the financial system.
- Set capital standards for companies in an effort to ward off threats to the financial system.
- Creates a system for the FDIC to orderly liquidate failing companies.

The Consumer Financial Protection Bureau

Independent consumer protection entity within the Federal Reserve.

- Consolidate and strengthen consumer protection laws that ensure fair, non-discriminatory access to credit.
- Examine and enforce regulations for banks and credit unions with assets exceeding \$10 billion.
- Regulate all mortgage-related businesses, payday lenders, and student lenders.
- Creates the Office of Financial Literacy to educate consumers on fair practices.

Other New Agencies



Office of Financial Research: Staffed with economists, accountants, lawyers, former supervisors and other specialists to support the Council's work.

Financial Insurance Office (FIO): Monitor the insurance industry for systemic risk purposes and provide guidance.

Office of Credit Ratings: An SEC Office with its own compliance staff to conduct annual compliance examinations of rating agencies making findings public, and having the ability to fine rating agencies. In an effort to improve transparency, the OCR would set uniform rating standards and require rating agencies to disclose their methodologies, their use of third parties for due diligence efforts, and their ratings track record.

FDIC Insurance Expansion



- FDIC coverage permanently increased to \$250,000.
- **UNLIMITED** FDIC deposit insurance is available for all *noninterest-bearing transaction accounts* until December 31, 2012.
- Interest on Lawyers Trust Accounts (IOLTAs) are now included within the definition of a "noninterest-bearing transaction account."

FDIC Insurance Expansion



- FDIC insurance assessment is based on the average total of consolidated assets minus the average tangible equity.
- This shifts the burden to large banks. The share of fees for banks with assets greater than \$100 billion increases from 48% to 57%.

FDIC's Federal Liquidity Programs

Temporary Liquidity Guarantee Program (TLGP)

- Created to strengthen confidence and encourage liquidity in the banking system by guaranteeing newly issued senior unsecured debt of banks, thrifts and certain holding companies.
- Provides full coverage of non-interest-bearing deposit transaction accounts, regardless of dollar amount.
- Expiration date of December 31, 2012.

FDIC's Federal Liquidity Programs

Temporary Guarantee Program for Money Market Mutual Funds

- Created to address concerns about safety and accessibility of money market mutual fund investments.
- Enhance market confidence.
- No expiration date established.

FDIC's Federal Liquidity Programs

Public-Private Investment Program (PPIP)

- Created by FDIC and Treasury.
- Address challenge of legacy assets and cleanse bank balance sheets of troubled legacy loans.
- Combines FDIC guarantee of debt financing with equity capital from private sector and Treasury to support loans from insured depository institutions.

FDIC's Federal Liquidity Programs



Capital Purchase Program (CPP)

- Created to stabilize financial markets by providing capital to healthy institutions – increasing flow of credit to businesses and consumers.
- Treasury will purchase up to \$250 billion of senior preferred shares on standardized contracts.
- No expiration date.

Durbin Amendment



- The ***Durbin Amendment*** requires the Federal Reserve to adopt rules that restrict the amount of interchange fees banks can collect on debit transactions.
- There was a proposed amendment in Senate Bill 493 (“The Tester Bill”) that would have potentially delayed the implementation of this rule for two years. Tester failed and new rules to were start 7/21/11 – the was again delayed now with new rules to 10/1/11.

Changes to Interchange Rate



- The Federal Reserve must implement ***“reasonable and proportional” interchange fees*** for debit card transactions.
 - Interchange fees are fees assessed by Visa and Mastercard on debit card transactions.
 - Generally, they are paid by the merchant, but can be passed along to the cardholder.
- There are exceptions carved out for government programs that utilize reloadable debit cards. Prepaid debit cards exempt too.

What Are the New Rules? Now...



- Debit card interchange fees to be reduced from range of \$0.63 to \$0.44 to now \$0.21 (first proposal was \$0.12).
- Plus .05% per transaction and \$0.01 for fraud.
- Must allow merchant ability to choose lowest cost network for settlement (to include new players (like STAR, NYCE, PULSE)).
- Must process through at least 2 unrelated networks.
- Transaction minimums and maximums can now be set.
- Discounts can now be offered for payment with other sources of funds than credit/debit.

Changes to the Interchange Rate



Potential Side Effects

- Reduced amount of funds set aside for fraud and risk protection – could mean less coverage as potential effect
- Higher banking fees
- Increase in limits imposed on transactions
- Potential loss of rewards programs

Possible Side Effects



Req Q Effects:

- Significantly impact the way in which banks structure their product offerings.
- Influence the way in which banks calculate account analysis.

FDIC Effects:

- Increases potential banking fees to you as higher FDIC rates are passed through
- Reduces rates banks are willing to pay

Changes Related to Debt Issuance



- Creates the Office of Credit Ratings within the Securities & Exchange Commission.
- Requires credit rating agencies to use uniform rating systems for all securities.
- Ratings must be based on the likelihood that the issuer will default or otherwise not make timely debt payments.

Changes Related to Debt Issuance



- Assesses a fee on new bond issuances to provide stable funding for GASB.
- Non-broker/dealer municipal financial advisors must register with and are now governed by the Municipal Securities & Rulemaking Board (MSRB).
- Allows investors to bring a lawsuit against a rating agency for recklessly or knowingly failing to conduct a reasonable investigation of an entity.

Basel III Accords



The BASEL III Accords are new regulatory standards released by the Basel Committee on Banking Supervision that address capital adequacy and liquidity of banks.

“A landmark achievement that will help protect financial stability and promote sustainable economic growth. The higher level of capital, combined with a global liquidity network, will significantly reduce the probability and severity of banking crises in the future.”

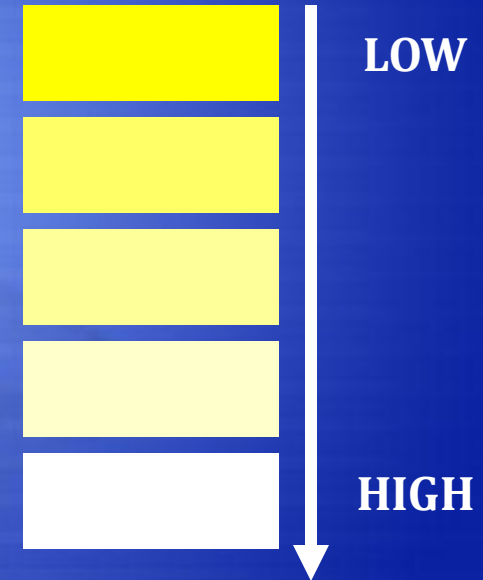
– Nout Wellink, Chairman
Basel Committee on Banking & Supervision

Capital Evolution

Regulatory capital is evolving toward economic capital.

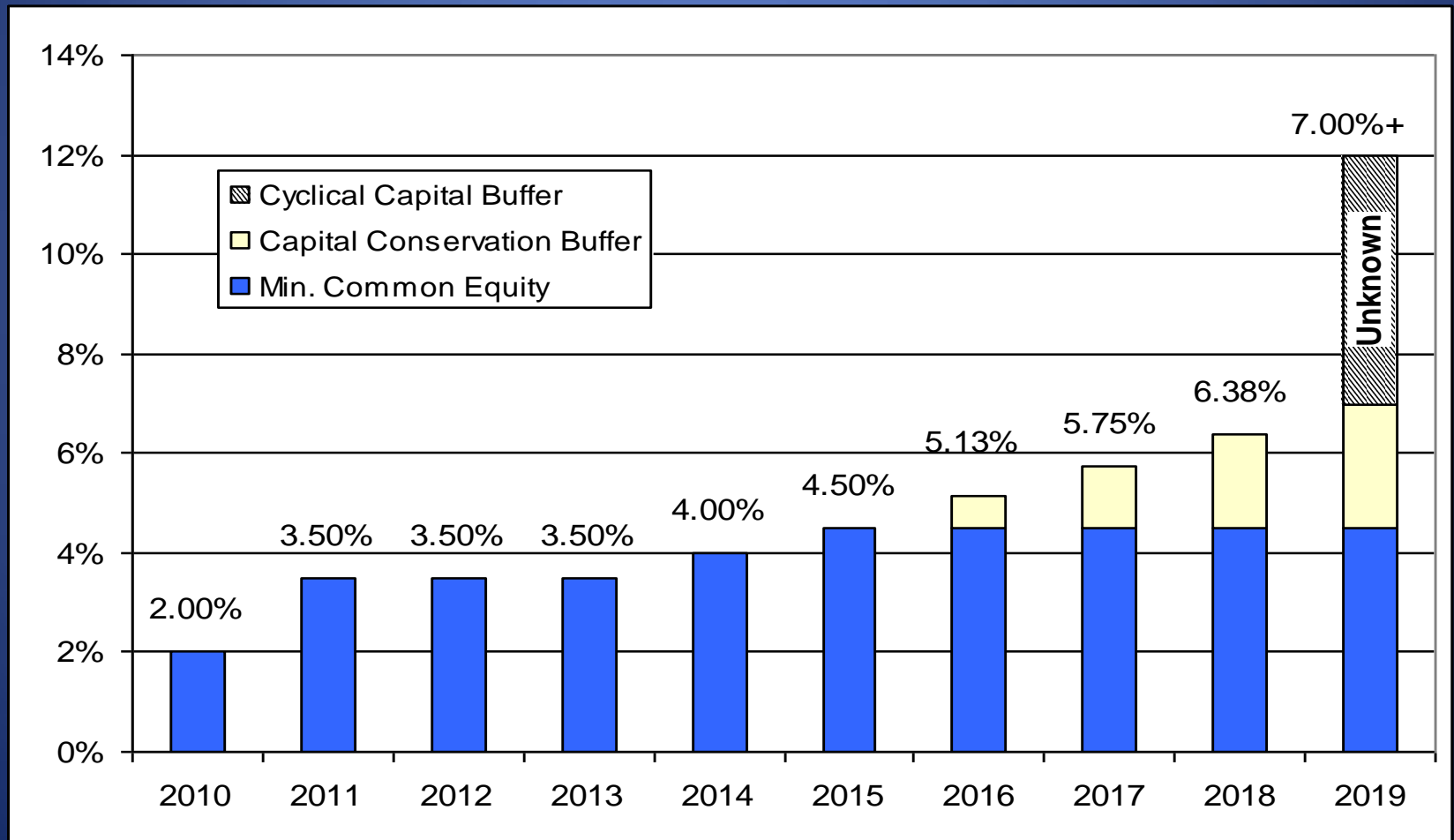
- 1981 (and prior) – “Examiner” capital
- 1988 – Basel I credit “risk weighted assets”
- 1991 – Capital-to-RWA targets introduced
- 1996 – Capital rules for trading employ VaR
- 1998 – Basel II - Economic Capital Framework
- September 2010 Basel III minimum capital and liquidity guidelines proposed.

Transparency



Liquidity is now just as important as capital.

Basel III will require an increase in the amount and quality of bank capital over the implementation period. The impact of a cyclical buffer remains unknown.



Basel III's Approach to Liquidity

- Focuses on unencumbered liquid assets on the bank's balance sheet – **Liquidity Coverage Ratio (LCR)**
- Liquid assets should be sufficient to cover “acute liquidity stress scenario” – which assumes significant deposit runoff and high loan commitment takedowns.
- Result will be larger balance sheets, higher proportion of securities, and increased pricing for committed facilities, assets, and liabilities.

Liquid Assets

(Cash, Treasuries, Limited Agencies)

$\geq 100\%$

Stressed Cash Outflows

(Liquidity Crisis: Withdrawals of Deposits, Draws on Letters of Credits, etc.)

Basel's Significant Regulatory Impact

- Historically, the focus of regulatory structure has been capital, not liquidity – provided by the Federal Reserve Discount Window, Federal Home Loan Bank System and other banks.
- The future focus will be on capital **AND** liquidity. Bank balance sheets will be “de-risked” holding more lower risk securities and few loans.

	2010	2015
Bank Holding of Treasuries	\$181 billion	\$675 billion
Total Treasuries Outstanding	\$8.4 trillion	\$12.5 trillion
Bank Ownership Share	2.2%	5.4%

Where Do We Go From Here?



- Past banking crises suggest that the return to previous risk-and-return norms takes time.
- However, the federal government's legislative response overhauling the regulatory environment should increase the speed at which changes are made.
- Bank regulation is migrating to a more capital intensive and liquidity focused approach.