JACK BE NIMBLE, JACK BE QUICK -- OR BANK REGULATORS WILL HIT YOUR HEAD WITH A CANDLE STICK

It has been 11 months since Congress passed the Dodd-Frank Act (DFA). The Act gives federal regulators wide discretionary powers over how to interpret and implement this sweeping bill. For the curious, we present this link to the overall rulemaking process. It is quite a list. (http://www.knowledgemosaic.com/net/public/DoddFrankTracker.aspx?Agency=All)

One important rule will determine which companies are "systemically important financial institutions" or SIFIs. These decisions will be made by ten voting members of a Financial Stability Oversight Council (FSOC). Eight are known: Chairman *Timothy Geithner*, Treasury Secretary; *Ben Bernanke*, Federal Reserve Chairman; *Sheila Bair*, FDIC Chairman; *John Walsh*, Acting Comptroller of the Currency; *Mary Schapiro*, SEC Chairman; *Gary Gensler*, Commodity futures Trading Commission Chairman; *Edward DeMarco*, Federal Housing Finance Agency Acting Director; and *Debbie Matz*, National Credit Union Administration Chairman.

Investors should consider FSOC the "Supreme Court For Finance" because they will have the last word on issues affecting the largest 35 banks operating in the U.S:

BANK OF AMERICA CORPORATION	AMERICAN EXPRESS COMPANY
JPMORGAN CHASE & CO.	CITIZENS FINANCIAL GROUP, INC.
CITIGROUP INC.	REGIONS FINANCIAL CORPORATION
WELLS FARGO & COMPANY	FIFTH THIRD BANCORP
GOLDMAN SACHS GROUP, INC.	NORTHERN TRUST CORPORATION
MORGAN STANLEY	KEYCORP
METLIFE, INC.	RBC USA HOLDCO CORPORATION
TAUNUS CORPORATION	UNIONBANCAL CORPORATION
HSBC NORTH AMERICA HOLDINGS INC.	HARRIS FINANCIAL CORP.
U.S. BANCORP	BANCWEST CORPORATION
BANK OF NEW YORK MELLON CORP.	M&T BANK CORPORATION
PNC FINANCIAL SERVICES GROUP, INC.,	DISCOVER FINANCIAL SERVICES
CAPITAL ONE FINANCIAL CORPORATION	BBVA USA BANCSHARES, INC.
TD BANK US HOLDING COMPANY	COMERICA INCORPORATED
ALLY FINANCIAL INC.	HUNTINGTON BANCSHARES INC.
SUNTRUST BANKS, INC.	CIT GROUP INC.
STATE STREET CORPORATION	ZIONS BANCORPORATION
BB&T CORPORATION	Source:: FFEIC; contains links to bank profiles

All of these institutions automatically are SIFIs under the Dodd-Frank Act because they own bank holding companies with at least $50 billion in assets.

For FSOC, Choices, Choices

FSOC also has the discretion to expand its vast oversight empire, at will, to large non-bank financial institutions. These are some of the non-bank institutions that will learn whether they are SIFIs after FSOC has completed a rulemaking underway to make these determinations:

Property/Casualty Insurers			**Life/Disability Insurers**	
Berkshire Hathaway	BRK.A		MetLife	MET
American International Group	AIG		Prudential Financial	PRU
Allstate	ALL		AFLAC	AFL
Hartford Financial	HIG		Lincoln National	LNC
Travelers Cos.	TRV		Genworth Financial	GNW
Nationwide	NFS		Principal Financial	PFG
Progressive	PGR			
Loews (CNA)	CNA			
Chubb	CB			

There is more. FSOC also is evaluating whether to regulate the nation's largest mutual funds, largest hedge funds, and largest private equity investors as SIFIs. **GE** also could be named.

In a separate proceeding, FSOC is examining which companies are essential "financial utilities," companies that occupy strategic niches in the economy. FSOC might decide to regulate **Visa**, **Mastercard,** and **American Express** for example. It also may decide that the **NYSE** and **NASDAQ** should be SIFIs.

Will FSOC Beat Up SIFIs?

A few commentators have suggested that being called a SIFI is a good thing. The argument goes that formally being labeled "too big to fail" will convince creditors that if a SIFI fails, the federal government will honor all its unsecured debts. After all, the government did so in 2008 and 2009. In effect, creditors will believe that any SIFI would be treated like Fannie and Freddie after they entered conservatorship. SIFIs therefore will enjoy a sizable cost of capital advantage because their debt obligations will trade like agencies.

During her testimony on May 12 before the Senate Banking Committee, FSOC member Sheila Bair stated than as of February 2011 Moody's has up-rated the eight largest banks by an average of 2.2 notches, reflecting the rating agency's views on the likelihood of federal bailout assistance. However, Ms. Bair went on to say that the disadvantages of being named a SIFI outweigh the advantages. She points out that SIFIs must de-lever after being named and must be "resolvable," meaning FSOC has in hand credible extensive wind down plans, "living wills," that will allow the FDIC to liquidate any firm quickly, without ever stepping into bankruptcy court. If regulators had had resolution authority on non-banks prior to 2008, then it could have liquidated Lehman Brothers and AIG, without exposing taxpayers to their losses:

"It is important at the outset to clarify that being designated as a SIFI will in no way confer a competitive advantage by anointing an institution as Too Big to Fail. The reality is that SIFIs will be subject to heightened supervision and higher capital requirements. They will also be required to maintain resolution plans and be required to restructure their operations if they cannot demonstrate that they are resolvable. In light of these significant regulatory requirements, the FDIC has detected absolutely no interest on the part of any financial institution in being named a SIFI. Indeed, many institutions are vigorously lobbying against such a designation." http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=05607bb5-db07-4d22-9feb-e4a8acf981e8&Witness_ID=7a4c5e92-8d8d-44af-9de7-7563773e7d4a

It is easy to confirm Ms. Bair's statement. Filings by large non-bank financial services companies in response to the FSOC proposed rule make clear that they not want to be SIFIs http://www.regulations.gov/#!docketDetail;dct=FR+PR+N+O+SR+PS;rpp=10;po=0;D=FSOC-2011-0001. Visa, Mastercard, and American Express also would prefer not to join this club and have said so in similar filings. **The day a nonbank institution is named a SIFI is the day its stock price goes down.**

Larger Banks, Including SIFIs, Already Face Dilution-Forcing Capital Calls

On September 12, 2010, central bank governors in the first world agreed to boost capital requirement under their Basel III agreement, according to the schedule that follows. Common equity requirements will rise from 3.5 percent to 4.5 percent of assets and Tier I capital, which includes common equity and instruments like mandatory convertible bonds, must rise from 4.5 percent to 6.0 percent. International regulators also want to create two new "capital buffers," a 1.5 percent conservation buffer and a 2.5 percent countercyclical buffer. The countercyclical buffer amounts to a rainy day fund built up in good times. Meeting the new Tier 1 requirement in the U.S. is harder than it looks because of adoption of the "Collins Amendment," named after its author Susan Collins (R-ME), as part of the Dodd-Frank Act. Large banks currently have $150 billion in "Trust Preferred Securities" outstanding, and they qualify as tier 1 capital. After

December 31, 2015, institutions with more than $15 billion in assets cannot count Trust Preferreds toward Tier I capital.

Types of Capital	2011	2012	2013	2014	2015	2016	2017	2018	2019
	Begin Liquidity Coverage Ratio				*Minimum Liquidity Coverage Ratio*				
	Monitor leverage		*Parallel run Leverage Ratio*						
Min. Common Equity Capital			3.5	4.0	4.5	4.5	4.5	4.5	4.5
Min. Conservation Buffer						.0625	1.25	1.875	1.5
Min. Total Capital plus Conservation Buffer			8.0	8.0	8.0	8.625	9.25	9.875	10.5
Min. Countercyclical Buffer						.0625	1.25	1.875	2.5
Min. Total Capital plus Conser-vation & Countercyclical Buffer									13.0
Minimum Tier I Capital			4.5	5.5	6.0	6.0	6.0	6.0	6.0

Source: Basel Committee on Banking Supervision announcement September 12, 2010, p7

Lean Years -- Maybe Even a Decade -- Ahead for Banks

For bank SIFIs, it gets worse. As Bair testified, SIFIs will be subject to higher capital requirements than Basel III requires. Three days ago, Federal Reserve Governor Daniel Tarullo announced that the Fed was considering insisting on risk-base capital of 8 percent to 14 percent, compared to the Basel III requirement of 7 percent. With the Case-Shiller housing index declaring a housing double dip has just started, bank industry earnings, which are at near record levels, may stall, just as regulators begin their push for mandatory common equity offerings which will dilute earnings per share. It may be 2020 before shareholders of the largest U.S. banks steer through the worst.

Life will be no better for European banks, where regulators are maintaining their schedule for Basel III rules, despite some calls to delay higher capital requirements due to the current Eurozone fiscal crisis. Historically, European banks have been more highly leveraged than American ones, and must overcome a greater drag on earnings to reach the capital levels that regulators are imposing globally.

Congress to the Rescue? Don't Count on It

President Obama considers the "Wall Street Reform and Consumer Protection Act" to be one of the his top accomplishments. Although House Republicans oppose the thrust of much of this bill, they criticize the Administration for going soft on the largest banks that the market considers Too Big to Fail.

House Republicans may, in fact, accelerate the earnings fall SIFI banks face. As CAN wrote in its last paper, "Starting Soon -- the Budget-Cutting Knife Fight," Republicans believe that the Dodd Frank Act did not truly end "too big to fail" by implicitly guaranteeing that large banks would have access to FDIC dollars to pay off creditors (see http://budget.house.gov/UploadedFiles/fy2012FullReportText.pdf, pages 81-82). GOP deficit hawks may seek to wall off any possibility that SIFI institutions will have access to another federal bailout by making this a condition for passing a increase in the federal debt ceiling. If they are successful, this will end overnight the credit advantage the nation's largest bank enjoy due to implied federal guarantee.

Both ends of Pennsylvania Avenue, it would seem, have plans to lower SIFI earnings per share.

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