

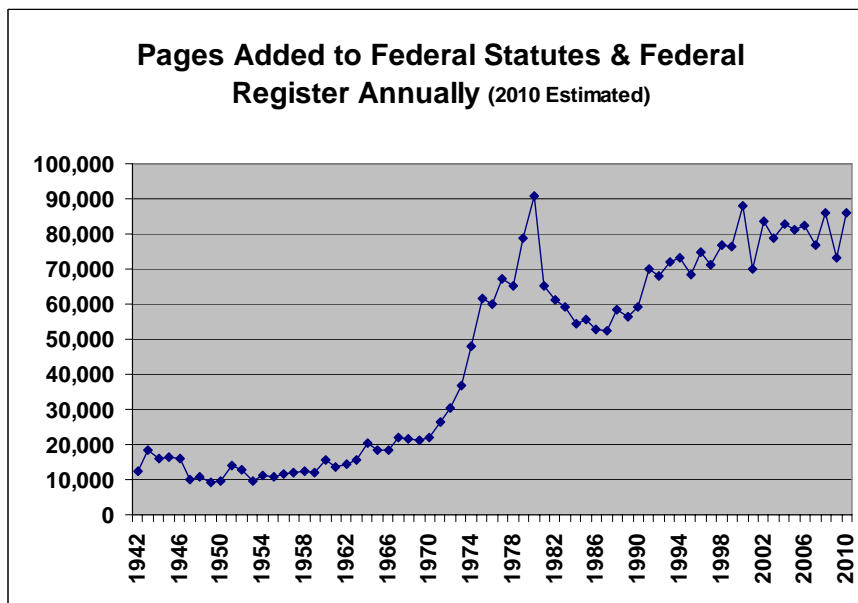
# SKBA CAPITAL MANAGEMENT

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## Financial Reform Made Easy

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The passage of the 2300 page “Wall Street Reform and Consumer Protection Act of 2010” has made a mess of cleaning up the financial excesses and systemic problems that led to the collapse of financial markets in 2008 and to the most severe recession of the post WWII period. Instead of clarifying the rules of the game and leveling the playing field, it has ushered in a period of renewed uncertainty and a potentially vast new regulatory burden. The graph below offers a rough approximation of the historical growth in the burden of regulation on the economy (both good and bad regulations) by highlighting the sum of the pages added to federal statutes (new laws passed by Congress) and the Federal Register (regulations) each year. It’s amazing that Congress and federal agencies can amass each year 70-80,000 pages of new laws and regulations to which *we, the people*, have to adhere. The years of stagflation during the Carter presidency in the late 1970’s are easily associated with the then spike in new regulations to nearly 90,000 pages in his final year, 1980. The Reagan years swept away some of these regulatory burdens (along with huge reductions in marginal effective income tax rates), freeing up the economy to grow again, only to see them rise again under the first Bush (HW) administration and then stay high during the Clinton, GW Bush and Obama (so far) years.



Source: Law Librarian’s Society of Washington DC; Federal Register & Statutes

Not only do we get snarled up in red tape, but trying to craft a global solution to all current and potential future systemic financial risks, noble as this objective might be, is fraught with unintended consequences and possible contradictory implications for financial market participants and financial stability. In our view, bad regulations are worse than no regulations. As a result, the passage of the “reform” seems to have become counterproductive to investor, lender and consumer confidence, to credit availability and to the reduction in current and future systemic risk. Furthermore, once all of the rules have been established through the myriad (hundreds) of

required fiat regulatory rulings that will require many months to resolve, it is not clear that sophisticated financial institutions won’t find ways to circumvent these regulations anyway. As a result, fewer and simpler are likely to be better.

We’ve identified ten reforms that would target the specific issues that helped create the current mess, while significantly reducing the onerous burden of the new regulations and compliance costs, and restoring the

strength of private sector financing. In the appendix that follows, these “simple” descriptions are followed by a more detailed discussion of the rationale for each proposal. So here’s the top ten list of risks and reforms:

- 1) ***Derivative securities collateral requirements*** – **Require** derivative contracts (commodity, interest rate and credit default swaps) to be registered with a clearing house and traded with standardized contracts on an exchange to increase transparency in price discovery and to reduce the risk of freezing up massive reserves in unproductive collateral accounts.
- 2) ***OTC derivative securities counterparty risk*** – **Permit** complex bi-lateral OTC derivative contracts to be written but **subject** them to bankruptcy law protections for counterparties’ collateral accounts, and **prohibit** collateral posting beyond the initial collateral required by the contract. This forces OTC participants to focus on the financial strength of their counterparties and would prevent collateral calls from triggering another financial freeze.
- 3) ***Raising bank capital ratios in Basel III*** – **Require** domestic and international banks to maintain a 6-7% equity capital ratio. The tentative Basel III agreements are where the action is on this front, not the U.S. financial reform legislation. Higher equity ratios reduce systemic risk but at a cost to credit availability.
- 4) ***Mortgage lending standards*** – **Require** residential mortgage lenders to document borrower income with a current pay stub and with either a prior year’s tax return or W-2. Poor documentation of a borrower’s ability to repay (whether due to mortgage broker sales pressure or liar loans) created significant and unchecked borrower default risk, and if income is properly documented, the mortgage pool investors should accept the default risk, not the originator.
- 5) ***Pricing of government mortgage insurance*** – **Require** the FHA to price its mortgage insurance contracts at higher than the average premium rate compared to the private mortgage-insurance market.
- 6) ***Securitization of mortgages into complex structures*** – The real issue for preventing these securities from freezing up and posing systemic risk is to **require** their indentures to clearly state which party has control over the decisions to declare a mortgage in the pool to be in default and authority to modify individual loan terms and when an originator has met its “representation and warranties” conditions.
- 7) ***Missions of Fannie Mae and Freddie Mac – The GSE’s*** - **Remove** Fannie and Freddie’s affordable housing mandate, **prohibit** them from purchasing subprime mortgages and from purchasing residential mortgages which have a greater than 90% loan to value ratio, and **require** them to meet the equity capital requirements of Basel III. With reckless lending and low capital ratios, the GSE’s are still a huge source of systemic risk and have driven private capital out of the market.
- 8) ***The tyranny of one price in mark-to-market requirements*** – Thankfully, the worst of the tyranny of rigid mark-to-market accounting has already ended for financial institutions, and it didn’t take the financial reform act to accomplish it. **Allowing** financial institutions to use a discounted cash flow approach to valuing risky securities or underlying mortgage pools (even if there is the possibility for manipulating assumptions) is superior in evaluating the risks to bank capital than to the strict tying of mark-to-market changes to such volatile benchmarks like the ABX indexes which overstated the negative impact on bank capital ratios – with a severe impact on lending.
- 9) ***Dependency on credit ratings*** – **Remove** all SEC and federal laws and regulations that require a bond prospectus/registration statement to contain credit ratings from one or more of the NRSRO’s (nationally recognized statistical rating organizations) or that require any purchasing organization to buy only NRSRO-rated issues. Excessive reliance on NRSRO credit ratings led to poor risk management.
- 10) ***Clearing toxic paper from bank balance sheets*** – **Restrict** the U.S. Treasury department from issuing TARP-like funds to banks and financial institutions to prevent their bankruptcy (ending “too big to fail”) and instead, **authorize** the Treasury department and the Fed to undertake a reverse auction process to purchase toxic debt on bank balance sheets in the recurrence of another financial crisis. Quick action to remove toxic debt from bank balance sheets could have ended the credit freeze far more rapidly than forced investment of TARP funds.

Now wasn't that simple and made easy? Clearly, we need to address the risks associate with derivative counterparties and collateral accounts, the mispricing of government mortgage insurance premiums, the GSE's dangerous competitive advantages, bank equity capital sufficiency (including the GSE's), the excessive dependence upon credit ratings, and toxic debt on bank balance sheets – all of which contributed to the credit freeze and recession. And yet, these proposals might take 23 pages of legislation, rather than the massive 2300 page bill passed on July 21<sup>st</sup>. With such clarity, financial markets would recover, banks would be willing to relax lending standards and lend again, and the economy would likely see a more normal economic recovery, not the subpar one we've experienced to date.

The “Wall Street Reform and Consumer Protection Act of 2010” appears to be filled with burdensome regulations that do not address systemic risk issues, but rather perceived issues of fairness. Certainly the above listed problems don't cover every systemic risk issue that might be considered, but they cover the major ones in our view, while having fewer potentially unintended consequences. At the same time, they would not halt the development of financial market innovations that have had or might have a positive and beneficial effect on the financial and real economy's ability to manage investment risks.

### **Additional Observations and Conclusions:**

A more detailed discussion of each of the 10 reforms is listed below.

- 1) ***Derivative securities collateral requirements*** – **Require** derivative contracts (commodity, interest rate and credit default swaps) to be registered with a clearing house and traded with standardized contracts on an exchange to increase transparency in price discovery and to reduce the risk of freezing up massive reserves in unproductive collateral accounts. The notional value of OTC derivative contracts grew hugely in the five years leading up to 2008. The OTC derivatives market (particularly for credit default swaps (CDS) and interest rate derivatives and swaps) became a major source of risk to both financial markets and the real economy, despite their introduction as a way to reduce and manage risk. These are bi-lateral contracts between two parties that required posting of collateral (cash usually, which is then invested in T-bills) to collateral accounts upon changes in security prices. When security prices became highly volatile as they did in 2008, investors caught on the losing side of these price changes were required to post potentially huge amounts of collateral to these accounts (that are usually invested in “safe” T-bills). If they own a book of winning and losing derivatives contracts, they don't get to offset or net the two against each other (for which the other side is posting collateral to protect the potential payment on your interest in the contract). With the extraordinary volatility in prices, these collateral accounts sucked \$1.5-2 trillion of capital out of the financial system and real economy in 2008 and early 2009. The clearing house allows collateral account requirements to be netted across all securities owned by the same investor (OTC contracts do not), reducing the risk that collateral calls might once again freeze up financial markets. The financial reform legislation accomplishes part of the change, but is incomplete and unnecessarily complex.
- 2) ***OTC derivative securities counterparty risk*** – **Permit** complex bi-lateral OTC derivative contracts to be written but **subject** them to bankruptcy law protections for counterparties' collateral accounts, and **prohibit** collateral posting beyond the initial collateral required by the contract. There are legitimate business reasons to issue OTC derivative contracts that go beyond real commodity-price hedging, but they posed/pose huge amounts of counterparty risk (ala AIG) and collateral posting requirements. Without the protection of the clearing house, OTC contract participants will want to be highly confident of the financial strength of their counterparties, making them more likely to use exchange-traded contracts, which pose far less systemic financial risk. Neither would such contracts be able to freeze huge amounts of collateral with commodity, interest rate or credit risk price movements nor tie up the system if a counterparty (like AIG) goes into bankruptcy or receivership.

- 3) ***Raising bank capital ratios in Basel III*** – **Require** domestic and international banks to maintain higher equity capital ratios. The tentative Basel III agreements are where the action is on this front, not the U.S. financial reform legislation. The two key issues are the required **equity** capital ratios and the timeframe over which they are achieved. It is pure common equity that provides the greatest cushion against prospective default risk, not all the other forms of capital. If we were to fault the process, it now appears to be too backward focused, fighting the issues of the last financial crisis, to the detriment of encouraging risk-taking and of expanding credit availability. A 6-7% common equity ratio appears to be about right as does an 8-year transition period, not higher ratios or a longer transition time period. There is no free lunch on this kind of risk reduction, however, as higher common equity ratios will either reduce the ability of banks to make loans or raise the interest spreads they must charge. But certainly systemic risk will be reduced. U.S. banks are at a relative advantage in this process, having already boosted equity capital compared to European banks.
  
- 4) ***Mortgage lending standards*** – **Require** residential mortgage lenders to document borrower income with a current pay stub and with either a prior year's tax return or W-2. Even without a single new regulation, banks have (and would have) tightened credit standards to prevent a replay of the residential mortgage market lending spree of 2004-2007. Yet most of the consumer loan regulations imposed by the reform bill have almost nothing to do with systemic risk issues. Surely it is a worthy goal to clarify and make more transparent loan application documents so that borrowers have NO doubt what they have signed on to (which the reform law does). Yet this offers no reduction in systemic risk. Although banks have appropriately taken the brunt of criticism over poor loan documentation, many borrowers took advantage of the situation as well by overstating their income (creating the infamous "liar" loans). So, this systemic risk issue was one of improper income documentation that falsely stated a borrower's ability to repay the mortgage loan. Given that the real issue is repayment ability, why would we now want to require banks to further tighten lending standards (that have led banks to impose the current 20% down payment requirement) via tightening various regulations, particularly when Fannie and Freddie can still currently issue loans with only 3.5% down? Furthermore, with the 30-40% decline in housing prices, the risk of further price declines is substantially mitigated, albeit not without some intermediate-term risk remaining. What mortgage originators do with the documented income data, to originate or not, to finance prime or subprime mortgages or not, or to issue jumbo or conforming loans, would be up to them, not controlled by regulation (accept as to the calculation of risk-based assets used in capital ratio calculations). But no one will have any excuses (neither lender nor borrower) if the borrower defaults on his/her loan where such data was properly disclosed.
  
- 5) ***Pricing of government mortgage insurance*** – **Require** the FHA to price its mortgage insurance contracts at higher than the average premium rate compared to the private mortgage-insurance market. We have sympathy for the belief that the mortgage-backed securities market cannot exist without viable mortgage insurance, and yet FHA and other government mortgage insurance plans have dangerously underpriced the real cost of mortgage insurance. This subsidy undermines the private mortgage insurance market as well, which otherwise is better at estimating insurance risks. With the private market better able to compete and with the FHA as more of a last resort insurer (at a higher price), the financial efficiency of pooling mortgages into securities to tap private investment can be preserved without the current government subsidy.
  
- 6) ***Securitization of mortgages securities into complex structures*** – The creation of mortgage-backed securities of geographically diversified mortgage pools has had beneficial effects on the mortgage market by increasing the capital available to the market and lowering rates and transaction costs. Typically, mortgage-backed securities (MBS) investors are protected in three ways: 1) the individual mortgages are protected by mortgage insurance, 2) the average loan to value ratio of the pool is low, and 3) the "representations and warranties" offered by the mortgage originator allow the pool "trustee" to require

the originator to repurchase a loan if the originator fails to follow its stated underwriting standards or commits or allows fraud in the process. The first two are well known at the formation of the mortgage pool and MBS based on that pool. Investors in MBS ought to therefore absorb all of the default risk or modification risk if economic conditions deteriorate, unless the originator has violated its “representations and warranties.” The real issue for preventing these securities from freezing up and posing systemic risk is to **require** their indentures to clearly state which party has control over the decisions to declare a mortgage in the pool to be in default, and authority to modify individual loan terms (and therefore proposals that require originators to maintain some economic interest or recourse in the pool are NOT helpful to clarifying this control issue). Perhaps the market for complex mortgage securities like CDO’s (collateralized debt obligations of subprime mortgage pools) will never recover. This might not be such a bad thing in itself. Certainly even without a single piece of new regulation impacting this market, market participants won’t soon again assume that their risks can be taken lightly. Yet the huge legal battle over which party (lenders or investors in securities based on mortgage pools) is responsible for taking losses on defaults and loan modifications has snarled up the clearing of the mortgage market. The freeze up in the processing of foreclosures and modifications, however, is directly related to this lack of clarity on loan originators “representation and warranties” regarding the quality of the loan and to the broken chain of title regarding which party has authority to make loan modification decisions. There is a good argument that the owners of the credit risk, through the bond trustees overseeing a specific pool, ought to have this decision-making authority. But if so, there should be no recourse back to the loan originator if it has properly documented the conditions of the mortgage and the borrowers (such as the borrower’s income as in reform #4), even if the borrower has committed fraud in his/her submission of such data. Therefore, part of the pool formation process would include providing standardized documentation that satisfies the “representation and warranties” conditions of the originator. This will prevent a replay of today’s legal mess in assigning responsibility for which party must take the losses from defaulting loans and mortgage modifications.

- 7) ***Missions of Fannie Mae and Freddie Mac – The GSE’s - Remove*** Fannie and Freddie’s affordable housing mandate, **prohibit** them from purchasing subprime mortgages and from purchasing residential mortgages which have a greater than 90% loan to value ratio, and **require** they meet the equity capital requirements of Basel III. Fannie and Freddie pose a huge systemic risk all by themselves, and nothing has so far been done to change this. The conundrum is that we need a functioning private mortgage market, but you can’t have such a market until Fannie and Freddie stop distorting it. So, each step to reduce their systemic risk needs to be accomplished over some transition period. Without an affordable housing mandate, why would Fannie and Freddie issue mortgages with as little as 3.5% down, which has clearly driven private mortgage lending out of the market? It does not appear that the country is ready to make the decision to abandon at least part of the role that the GSE’s play in mortgage finance, but by removing their systemically risky competitive advantage on capital ratios and loan-to-value ratios, the private market can progressively take over these functions and reduce the huge systemic risk these GSE’s still impose on financial markets. It would hardly matter then, whether or not the decision is ultimately made to close them down, to let their mortgage pools and imbedded losses run off over time, to privatize them or to have them continue to function as GSE’s with a more limited and less risky mandate. Their systemic risk impact would be substantially reduced nonetheless.
- 8) ***The tyranny of one price in mark to market requirements*** – Thankfully, the worst of the tyranny of rigid mark-to-market accounting has already ended for financial institutions, and it didn’t take the financial reform act to accomplish it. There isn’t one price that is suitable for the valuation of all mortgages or complex mortgage securities. The forced tying of CDO and mortgage pool valuations to the ABX indexes (which were one of the only vehicles that continued to trade during the financial crisis and that one shorted to reduce exposure to the mortgage market) at a time when the financial market freeze brought a halt to transactions in CDO and other securities artificially accentuated the decline in

bank capital, further triggering a contraction in credit. **Allowing** financial institutions to use a discounted cash flow approach to valuing risky securities or underlying mortgage pools (even if there is the possibility for manipulating assumptions) is superior to the strict tying of mark-to-market changes to such volatile benchmark securities.

9) ***Dependency on credit ratings*** – **Remove** all SEC and federal regulations that require a bond prospectus to contain credit ratings from one or more of the NRSRO’s (nationally recognized statistical rating organizations) or that require any purchasing organization to buy only NRSRO-rated issues. Interestingly, the SEC is working on just this very project. Unfortunately, the financial reform act nullified Rule 436(g) and made rating agencies face “strict liability” or “expert liability” for ratings that prove to be incorrect if they permit their ratings to be included in a prospectus. Since ratings are just opinions in the first place and subject to change over time, they are not intended to be subject to anything more stringent than the prudent man or even prudent expert rules. Why would any rating agency be willing to take on such liability risks? They wouldn’t, hence the immediate shut down of the new issue market immediately after the passage of the reform bill as rating agencies rightly refused to allow their ratings to be published inside a prospectus. Only the SEC’s decision to postpone the application of the new rule for six months unfroze the new issue market.

- a. One might as well start out by acknowledging that conflicts of interest exist throughout the financial services industry. They cannot be eliminated. When a rating agency collects a fee from a bond issuer to rate its bonds, there exists the potential for conflict of interest regarding receiving a fee in exchange for a favorable rating. Certainly the agencies were accused of performing shoddy research on CDO risks in exchange for the high fees they earned on rating such issues. Yet, just as often, the issuer, particularly a sovereign government issuer, howls when its debt is downgraded (e.g. Greece). So this is why rating agencies *properly* move slowly and deliberately in considering and making rating changes, particularly downgrades. This entire issue can be solved if the NRSRO’s are required to set up a compliance officer function that does not report to the line management for the ratings business that controls the sales or research functions (some of whom have already done this voluntarily).
- b. But there is no improvement in the efficiency and accuracy of this process by shifting from an issuer payment model (with ratings publicly available to all users) to a buyer payment model (which requires the users of ratings to pay a fee for them) or to, heaven forbid, a government-funded model of issuing ratings (which has even greater potential for conflicts of interest by politicians). If there was one source of error within the rating agencies themselves, it was that their compliance officer functions were weak and often reported to the line managers involved in generating sales (and this is addressed in the financial reform legislation). But agencies have strengthened their compliance functions and have them report above the sales function. So if there were abuses in the past, not just stupidity in making unrealistic default loss assumptions, they aren’t likely to happen again. But the systemic risk issue is one of the inappropriate reliance on ratings (by bond buyers) as a “permanent” indication of credit risk. By taking away the mandate that a bond prospectus must include ratings from an NRSRO, the playing field is leveled, healthy competition among rating agencies to issue sound ratings is enhanced, and systemic risk from excessive reliance on credit ratings is reduced.

10) ***Clearing toxic paper from bank balance sheets*** – **Restrict** the U.S. Treasury department from issuing TARP-like funds to banks and financial institutions to prevent their bankruptcy (ending “too big to fail”) and instead, **authorize** the Treasury department and the Fed to undertake a reverse auction process to purchase toxic debt on bank balance sheets in the recurrence of another financial crisis. In August of 2008, the U.S. Treasury had introduced plans to purchase “toxic” debt securities, taking them off of bank balance sheets. This idea was nixed, however, in favor of forcing banks to take TARP capital contributions because of the fear that the Treasury or Fed wouldn’t have the expertise to determine the

appropriate purchase price of such debt. The problem wasn't one of insufficient capital alone, it was one of the freeze of transactions of such toxic debt at any price, along with forcing banks to value their CDO's and other toxic debt at the extremely depressed prices driven by the plunge in value of the ABX indexes. These debt instruments still plague many bank balance sheets and contribute to their unwillingness to increase lending, despite the infusion of TARP capital. Rather than spending \$700 billion in the TARP funds (which have still not prevented many smaller banks from going into bankruptcy), the funds would have and could be spent more productively by establishing a reverse Treasury auction process to purchase such debt off of bank balance sheets. The process is quite simple. In regard to specific kinds of CDO collateral pools, the Treasury could have asked for offers to sell to the Treasury, for example, \$500 million of CDO's. Then, the Treasury would accept all offers from banks and other institutions up to the highest price necessary to reach the target goal for each purchase auction (in this case the \$500 million), but it would pay the same price for all offers, using the highest price offered necessary to fill the auction order. This would be repeated on different types of toxic debt collateral until the total target program is fulfilled or the market-based transactions are unfrozen again. The advantages of this program are it's 1) simplicity (Treasury uses competitive bids in the market to determine auction prices not it's own expertise, 2) voluntary nature as banks and other financial institutions participate voluntarily and know at what price they would be willing to sell based on their own financial position and capital needs, 3) improvement in liquidity as, again, in bank balance sheets, freeing up capital to lend, 4) ability to remove toxic debt from the financial system at the "right" market-based price, bringing price transparency and transactions back into the market for these troubled securities. Voila, the markets would be restored, and the Treasury and/or the Fed would manage in a run off mode this book of securities which were purchased at varying levels of discount to par value.

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