JANUS

September 2010

U.S. Financials: Reform Implications

Gabe Bodhi, CFA
Equity Research Analyst & Team Lead, Financials Sector

At Janus, our goal is to deliver alpha by taking an in-depth approach to fundamental research. We extend this commitment to our clients and partners by providing access to the insights and opinions of Janus' seven global sector research teams via monthly analyst interviews. This edition of *Analyst Viewpoints* is the second in a two-part series examining the financial sector and features Janus' Gabe Bodhi discussing the recent U.S. financial reform legislation with Client Portfolio Manager Adam Schor. Bodhi outlines the potential impact the legislation may have on U.S. financial institutions and evaluates the challenges and opportunities ahead.

Q: The U.S. government recently enacted the Dodd-Frank Act. What are the biggest accomplishments of this significant financial reform legislation?

Gabe Bodhi: The new legislation addresses many of the major issues raised during the 2008 financial crisis. While it is far from perfect, it does cover several critical areas. For example, it creates an oversight council to help regulate the systemic risks posed by large, integrated financial institutions perceived as "too big to fail." It also establishes the Consumer Financial Protection Bureau (CFPB) to oversee the supervision and rulemaking around predatory lending behavior and other components of consumer financial protection. The reform also addresses banking behavior in derivatives trading, proprietary trading, capital requirements and some of the securitization elements that affected the markets in 2008.

Q: Do you think the passage of this legislation will help avert another financial crisis?

Gabe Bodhi: We think it is a step in the right direction. However, even if it had been in place in 2008, it is still unlikely the U.S. economy would have completely averted the economic crisis. This is the largest financial reform since the Great Depression, but like most things related to politics and lawmaking, it is incremental in the changes it introduces.

That being said, there are notable investment implications now that the bill has passed. The most significant is that managements and board of directors of larger U.S. financial institutions will have to be very wary of unnecessary or unwarranted risk taking. As a result, these firms will probably experience lower levels of profitability. While this affects all U.S. financial institutions, it has a specific impact on large banks. The second element to consider is that capital requirements, the cushion banks have to absorb future problems, will likely

Key Points

- Tighter capital requirements will reduce the risk appetite for banks, likely leading to lower profitability.
- Centralized clearing and derivatives trading firms should benefit, as well as financial exchanges set to increase derivative volumes, in our opinion.
- We think larger banks most affected by the legislation are trading at attractive valuations.

continue to rise, in reaction to both this law as well as globally coordinated recommendations issued from the Basel Committee.

Now that the legislation is finalized, the markets can put some reform uncertainties to rest, which will be a positive. However, many of the law's elements have yet to be determined and still need to be worked out by the regulators, as opposed to the lawmakers.

Q: How will the legislation shape investment opportunity in the financial sector?

Gabe Bodhi: Investing in financials today requires an element of quantifying the effects of this law and potential future regulatory changes that may result from it. From a fundamentals perspective, financial stock valuations in general are very attractive to us and already reflect many of the risks related to the legislation, even if there is a moderate to worse-than-moderate reform outcome.

Looking at the overall sector, we believe there are some relative winners and losers. The law most directly impacts large U.S. financial institutions, and companies with a preponderance of overall revenue associated with proprietary trading will likely be most negatively affected. Keep in mind, this is a piece of U.S. legislation and does not involve global banks. While U.S. subsidiaries of global banks will be covered by it, their non-U.S. subsidiaries will not. The possibility of global rulemaking coordination is reasonably limited. As a result, some global capital market firms should be positive beneficiaries of the required changes in the U.S., in our opinion.

We believe centralized clearing and derivatives trading firms should also benefit, and as volumes move out of the OTC market, financial exchanges and other platforms will likely profit from increased volumes. We've conducted extensive surveys of market participants and have talked to trading desks across Wall Street as well as major buy-side participants in the OTC trading markets to understand which OTC swaps clearing platforms are most attractive to the market. Based on this research, we think exchanges may experience up to 10-15% profit increases directly linked to the clearing of OTC derivatives over the next several years.

There are several other ways we've tried to quantify how the legislation may affect financial institutions. None are perfect, but they do offer insights. For example, the law limits the rate banks can charge for debit interchange transactions, which refers to the fees vendors and retailers pay when consumers use debit cards. We expect this to reduce debit interchange revenue somewhere between 30-50%, translating into 1-3% lower overall earnings for banks that rely heavily on this revenue source.

Another example is the potential cost impact connected with proprietary trading and derivatives reform. We've estimated that the banks most focused on capital markets could experience up to 2-4% revenue declines. It is slightly more difficult to measure the ramifications of the "too big to fail" resolution authorities and the CFPB, but it's probably safe to anticipate at least several percentage points of earnings forfeited to increased oversight and compliance costs.

Reduced overdraft fees on credit cards and checking accounts also affect profitable fee revenue streams. It's important to understand that as pricing becomes regulated in one aspect of a financial relationship, it is usually offset in another area. Consider free checking accounts, which have become status quo for the banking industry over the past 15 years. Prior to that, bank customers were charged for checking accounts. Banks will now likely raise checking account fees to make up for lost overdraft revenue, and free checking—or at least low-balance free checking—will probably end.

All in all, we expect a typical bank to experience net earnings declines somewhere in the 5-10% range as a result of this legislation. This includes any offsets from capital relief, as well as cost reduction and repricing potential. For example, a company that generates tremendous proprietary trading profits will usually allocate a large amount of capital to support that business. If the firm can no longer participate in that business, the profit is eliminated but so is the capital expense, which offers a redeployment opportunity to other profitable areas or to shareholder dividend distributions. This type of offset should help reduce the legislation's net impact on overall earnings.

Q: Does the U.S. legislation address capital ratios?

Gabe Bodhi: There aren't direct capital requirements. The Collins Amendment, named for Maine Senator Susan Collins, does address maximum leverage, which has moderate impact on capital ratios, but it isn't a gating factor for most financial institutions. As a result, ultimate rule making around capital ratios probably will continue to reside with regulators.

Q: Do you anticipate more or less loan growth as a result of the legislation?

Gabe Bodhi: The current lack of loan growth in the system is more demand driven than supply driven. Many companies have been reluctant to take on more leverage coming out of the recession, especially given the fact that the economic slowdown was largely the result of highly leveraged consumer and government balance sheets.

That said, clarity on capital ratios will likely make banks more comfortable implementing capital decisions, whether increasing lending or optimizing their capital structures. However, there will likely be a higher hurdle for risk-adjusted lending, which will probably translate into higher pricing, and loan growth may be slower to the extent that creditworthy borrowers may be less willing to pay increased costs. Loans that are made, however, could be more profitable on a risk-adjusted basis. This is another area where banks may capture some offsets.

Q: You mentioned larger U.S. institutions. Will the new law affect small- and mid-sized banks differently?

Gabe Bodhi: The greatest impact will likely be on large banks with capital markets and consumer banking activities, both money center banks and legacy investment banks, but there are several areas that will have an effect on all banks. One example is consumer-related protection issues, such as the Credit Card Accountability, Responsibility, and Disclosure (CARD) Act and Regulation E, which regulates consumer account overdraft fees. Another is mortgage lending and the increased mortgage brokerage oversight and new securitization requirements around loan origination. The decoupling of risk underwriting and risk ownership was one of the primary causes of the financial crisis. Historically, mortgages were made by local lenders, and these institutions held on to the loans, maintaining a direct interest in receiving timely payments. The sizable growth in securitization markets over the past decade resulted in a separation between loan underwriting and default risk, which increased some banks' risk appetite. The legislation includes a "skin in the game" element that requires 5% of securitization be held by originators, increasing their incentive for loan pools to do well.

These capital and consumer protection overhauls may have a slightly larger impact on mid-sized banks, which usually don't have significant capital markets activities. Many of the legislation's components have carve-outs for smaller banks under $10 billion in assets, and these institutions may be somewhat protected from the regulation's negative effects.

All banks, regardless of market capitalization, will probably face higher taxes. The 2008 TARP legislation included a clause allowing lawmakers to recoup net costs, resulting in a January 2010 proposal for a $90 billion tax, which has yet to be addressed. There has also been an increase in insurance fees associated with FDIC premiums, in the sense that base liabilities upon which these fees can be assessed have been increased, particularly for larger banks. In addition, a $10-12 billion tax proposal on banks with more than $50 billion in assets to pay for the legislation's implementation was ultimately removed to secure a 60-vote threshold, but it remains on many regulators' and policymakers' agendas.

Q: What is your outlook for regional banks?

Gabe Bodhi: Regional banks have larger proportional exposure to the U.S. commercial real estate market, primarily as a function of being local lenders. Many commercial real estate projects, both home and commercial building, were funded at a local level, and those markets' stabilization helped regional bank performance.

While these stocks now appear less attractive than the bigger banks, we think regional firms should benefit from credit normalization into 2011. Stronger economic activity, of course, is positive for the whole banking industry, but pockets of real regional growth, whether in the Southeast or in the West, will have a larger impact on regional firms compared to more diversified money center banks. However, these firms are unlikely to benefit from recovery in the capital markets, given their smaller capital markets businesses.

Q: Do you think the recent regulatory reform will increase industry consolidation?

Gabe Bodhi: There are approximately 8,000 U.S. deposit-taking institutions, nearly 50% less than the roughly 14,000 firms that were in existence 25 years ago. We expect this trend of consolidation to continue as managements across the country look to benefit from economies of scale, but the larger banks are unlikely to make any sizable deals going forward. There is a 10% deposit cap in the U.S., and three of the largest U.S. banks are already at that level.

The several hundred banks that have failed or have been seized by the FDIC could also accelerate consolidation. The U.S. government doesn't want to be in the banking business and has sold these assets at reasonable prices. We suspect there probably will be several hundred more failures before this economic cycle ends. During the S&L crisis in the late '80s and early '90s, almost 1,500 banks were seized by the FDIC.

A well-funded FDIC may be a bit more aggressive in seizing banks, but the top three institutions represent about 35% of the overall U.S. banking system and are largely out of the merger and acquisition game. Historically, these firms have been large buyers of other banks, and this may have an offsetting effect on overall consolidation.

Q: Do you think the U.S. legislation will affect the economic recovery?

Gabe Bodhi: The private sector, industrial America and policymakers have come to the realization that there is a clear need for a for-profit private banking system to maximize long-term U.S. economic growth. The lack of reform clarity that has hung over the financial sector for much of the year probably has restricted lending somewhat, although creditworthy borrowers have still been able to secure loans at reasonable prices. Overall, we don't think the overhaul will have a material negative effect on long-term economic growth. In fact, it could have a positive impact.

Q: Has the legislation changed how Janus approaches the U.S. financial sector?

Gabe Bodhi: Our process still focuses on extensive fundamental research. We've spent a significant amount of time in Washington meeting with regulators, lobbyists, banks and key staff members of Congress. This has given us tremendous insight into the legislative process and, ultimately, some of the compromises that came out of it. Banking has always been a highly regulated industry, and this is only going to increase during the next few years. Having a detailed understanding of regulators' and lawmakers' current thinking remains a critical component of our research, and we will continue to develop and leverage our contacts in Washington and through the various regulatory bodies.

Looking ahead, there are certain businesses which will likely either cease to exist or cease to exist in their current form. We are carefully evaluating how these changes might shape future earnings potential to the extent these businesses, such as proprietary trading, represent a large percentage of overall profit. Interestingly, the businesses most affected by the legislation, specifically some of the larger institutions and former investment banks that are now commercial banks, currently offer the most attractive valuations. Earlier this year, regional banks generally outperformed these firms as the proposed legislation was being digested by the market, but we expect this gap to reverse itself over time.

Q: Any final thoughts on the Dodd-Frank Act and the financial sector?

Gabe Bodhi: Much of the regulation's implementation has been left to regulators, which limits the ability to quantify its overall effects. While there isn't full clarity at this point, it is important to recognize that this is one of the largest pieces of financial legislation in the last 100 years, and the most significant since the 1930s. While politics are inherently messy, we think this reform is a step in the right direction for the health of the U.S. banking system's long-term profitability, as well as for the overall economic growth of America.

****

See last page for important disclosures.

About the Featured Analyst

Gabe Bodhi, CFA

Gabe Bodhi is an equity research analyst, primarily focusing on the financial services sector. Mr. Bodhi also serves as sector team leader of the financials team. Prior to joining Janus as a research analyst in August 2002, he was an investment associate at Putnam Investments and an associate at Stern Stewart & Co. Mr. Bodhi received his bachelor of science degree in finance with a minor in African-American studies from the Wharton School, University of Pennsylvania, and received his MBA from Stanford University. He holds the Chartered Financial Analyst designation and has 15 years of financial industry experience.

Alpha is a measure of a portfolio's risk relative to the market. An alpha of 1.0 means the portfolio outperformed the market 1.0%. A positive alpha is the extra return awarded to the investor for taking additional risk rather than accepting the market return.

Janus Distributors LLC (09/10)

JANUS

151 Detroit Street, Denver, CO 80206 I 800.227.0486 I www.janus.com