

Remarks as Prepared for Delivery by Barbara Rehm, Editor at Large, American Banker
July 25, 2012
***Navigating Transformational Change of the Global Financial Landscape* Opening Dinner**
Bretton Woods Committee, Deloitte, University of Maryland Smith School

Hello everyone. It is a thrill to be here and I realize I am standing between you and dinner so I will be brief.

As Cliff said I am Barb Rehm and I have been working in the Washington bureau of American Banker for the past 25 years, covering the intersection of government and your industry. It's been a busy intersection with lots of traffic, plenty of accidents, especially of late, and no shortage of cops on the scene.

Today is much the way it was when I started at American Banker in 1987... the S&L crisis was brewing and I covered the two reform laws that followed – FIRREA for the FI Reform, Recovery and Enforcement Act of 1989 and then two years later Congress passed FDICIA, or the FDIC Improvement Act, which included Prompt Corrective Action.

I bring this up because I remember back then how worried bankers were that PCA would lead to horrible overreaching by the regulators.

As you probably recall PCA was designed to impose harsher regulatory sanctions against a financial institution as its capital declined. When a bank's capital fell to 2% the govt could step in and take it over. That was a pretty scary prospect.

But in practice regulators didn't require struggling companies to write down assets, so capital levels didn't fall, and sanctions didn't follow. I'm oversimplifying. Some banks were victims of PCA but the law did not have the widespread impact that bankers feared.

If you are hoping Washington will repeat that cycle with the Dodd-Frank Act I am afraid you are going to be pretty disappointed.

Regulators are either scared or mad (some are both) and they see no downside in implementing the Dodd-Frank Act as strictly as possible. I think that's been clear so far and I really think we are on the verge of it getting a lot worse.

When I discussed with your hosts what I should talk about tonight we agreed on three basic areas: where things stand today, where they are headed and what should you be doing.

And it's interesting but if I were giving this speech just say 5 months ago I would have described all three areas differently.

But the onslaught of bad news lately – Barclays and Libor; money laundering and HSBC; the trading mess at JPMorgan Chase; mortgage discrimination at Wells Fargo; deceptive marketing at Capital One – raise serious, legitimate questions about:

- the culture inside some of the world's largest banks
- the quality of bank risk management
- the effectiveness of bank boards
- and even whether these companies are simply too complex to manage.

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But all these problems also raise questions about the quality of oversight by regulators. And that in turn is coloring the relationship between regulators and bankers.

If a regulator has a choice between protecting his job and throwing the industry under the bus, you better look both ways before you cross any street.

Trust is gone. The regulators are going to shoot first and they may not even bother to ask questions later and I don't see that changing for a long time.

I know this crowd is well-versed in all things Dodd-Frank, especially when it comes to systemically important institutions so I will use a pretty broad brush here to outline where things stand.

Dodd-Frank gave us Living Wills and Orderly Liquidation Authority – two sides of a coin designed to shine more light on how these giants are structured and give more authority to the FDIC to step in and take over one should it fail.

Clearly this is the heart of what Dodd-Frank was supposed to accomplish – the analysis and means necessary to keep the system from melting down.

Regulators have done a good job of implementing these provisions so far. Whether the government will blink when faced with a potential failure and just opt for a bailout remains to be seen though I count myself in the minority who think the regulators will act.

Whether the living wills can live up to their potential is also unclear. It's too soon to tell but I personally think the Living Wills, done right, are a brilliant compromise to calls to simply break up the biggest banks.

And I know this will sound naïve to some of you but I think the Living Wills could be, should be, a tool banks can use to map a strategy for their future.

Blowing this stuff off will come with a high price tag -- Any giant bank that does not get its house in order, that cannot file a comprehensive living will, that does not impress during a stress test, will be forced to reduce risk, raise capital and, yes, to shrink.

I can't leave the "where things stand" section of this talk without mentioning the other big pieces of Dodd-Frank that affect SIFIs -- stress tests and Section 165...

I realize this is not a good analogy for a dinner speech but I've reached the age of colonoscopies so it's all I can think of when I think about the 165 rules because they will reach into every nook and cranny of your operations looking for problems.

These rules will govern everything from counterparty risk to leverage to who sits on your board's risk committee. In fact 165 is basically a super amped up version of PCA.

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And on to the stress tests... the analysis of how systemically important firms would perform under hellacious economic conditions. These are a great idea – and I don't hear much debate about that – but I also think the Fed needs to explain its models better.

I know bankers who were left scratching their heads over the conclusions the Fed drew. Both the Fed and the banks had the same data. Different results. No explanations.

I'm also worried that the tests will morph into a means for the Fed to get whatever information it wants from banks. I know some bankers are worried about losing the privileged status some information if the Fed inadvertently discloses it or is forced to under a congressional subpoena.

In particular the Fed is pushing for more granular disclosure of reserves set aside to cover litigation and maybe that's necessary but I do worry about the Fed just being able to do whatever it wants.

That's pretty much where things stand -- and I want to share something an executive at one of the Big 4 – JPM BAC C and WFC – recently said to me... I'm not naming the bank to protect the identity of the innocent... But this person, who I have known for 20+ years and has spent a good chunk of his career both on the Hill writing banking laws and as a regulator trying to enforce them and is now a banker trying to comply with them. And here is what he said: "There is no way for a bank to navigate the current regulatory system."

No punches pulled there, right? NO WAY to navigate the current regulatory system.

This banker wasn't complaining. He was stating a fact, as he saw it. And really just marveling at the enormous challenges the industry faces in complying with DF.

I respect this guy and I agree with the industry's complaint that all this "reform" is being done incrementally rather than comprehensively.

No one did any sort of principal-components analysis here and figured out what reforms were really needed. There was no cost-benefit analysis to ensure all this is worth it.

But because the public and policymakers have lost trust in the industry, bankers have lost the power to make the case that oversight is too onerous, too fragmented, or too expensive.

As Tom Hoenig at the FDIC said to me on Monday – if you're going to be a complex financial institution then you are going to have to have complex oversight.

And I think most bankers get that...A CEO of one of the top 10 financial companies in the world told me that the Libor mess was the straw that crippled the camel – things that would not have happened will – transaction taxes, more activity limits, tougher rules, maybe even breaking the banks up.

I agree. I do think we've reached a tipping point where the prospect of rational rule-writing and oversight are dim.

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The chance for executives and regulators to sit down and have a reasonable conversation about the impact of a regulation... that's just not in the cards right now.

Of course there will be exceptions – like the Fed trying to reshape its proposed counterparty risk limits so they don't bring markets to a standstill. But that is an exception. The regulators are not in the mood to deal and even if they were they don't see it as in their self-interest.

And that gets to the comment I made earlier about regulators being scared.

I hope I'm not telling tales out of school here but I know a lot of the regulators who are attending the conference tomorrow aren't here tonight because they were worried how it would look to be socializing with bankers.

I think that's sad. Relationships are important and they are cultivated at events like this.

Ok this takes us to -- Where are things going?

All the missteps have led us down a path toward greater structural intrusion by government into financial services.

That means going beyond safety and soundness types of rules like capital and liquidity to true structural changes. It's already happening in the US with Volcker and in the UK with Vickers.

I predict this trend will intensify and could lead to governments having even more say over how financial firms are structured and what they can do, what products and services they can offer.

The ultimate policy move would be to break up the big banks. Obviously the US has resisted doing that and may continue to do so in the future but I think the recent blow-ups have given this much more momentum.

Heck even Sandy Weill – the man who nearly single-handedly repealed Glass-Steagall, said on CNBC today that commercial and investment banking should be separated – which of course is one way of breaking up the big banks.

In fact that whole TBTF debate seems to be shifting from one about size – let's make the banks smaller – to one about complexity – let's make the banks simpler and safer.

Even if Congress never makes another move in this direction, I do think it's a real possibility that regulators will use the Living Wills to force significant changes at large institutions.

I would like to make an aside here... It's important to remember that we've only had ultra-large financial companies for 5 years. It feels like forever, doesn't it?
But really we are just learning how to run them, how to supervise them, how to get our arms around the complexity they present.

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I don't think we know how big too big is yet. We don't know how large we need financial institutions to be to support our economy. I just think people forget that all this is still pretty new territory.

But whether we ever get to that policy point of breaking up the big banks will turn on whether banks clean up their acts or continue to get tarred by scandals. Just how big and bad the LIBOR mess gets could have a big impact on policymaking.

The other big unknown is how quickly the economy recovers.

But the easy money is more blowups and a weak economy for the near term.

And there is no denying that the onus has shifted from the regulators to the industry. By that I mean, a couple months ago regulators were on the ropes, the Fed was trying to defend or at least explain why its Volcker proposal was such a mess.

Today I think the burden has shifted to the industry and it faces an uphill battle to watering down any new rules.

Lest you think I'm in love with the regulators let me make another aside... Clearly there is still a lot we don't know about the Libor manipulations. But it sure seems to me that it exposed the complicity of regulators. They knew what was going on and either didn't think it was a big deal or they didn't do anything for fear of spooking the system. I think it's the later and I think this culture among the regulators of downplaying problems is backfiring.

I get that they are trying to instill confidence, but when you repeatedly say "everything is under control" when the public clearly can see that it isn't, it undermines your credibility. I thought that watching Ben Bernanke testify before Senate Banking – the Fed did nothing about Libor manipulations because it had no power to? I just don't buy that and I don't think others do either.

Still it's clear the debate over "reform" is past the point where there is any reasonable debate over whether "more is better."

We all know that only better is better but for policymakers now, no demand is too much.

They all have watched the Comptroller, Tom Curry, testify over JPM and HSBC and Wells Fargo and apologize for not acting sooner and tougher and pledging to change the agency's culture.

The OCC is in a hurry to shed its image as being "on the industry's side." None of this is lost on the Fed or the FDIC and officials there will do everything necessary to avoid following Curry into the witness seat.

If the agencies have a choice between measured implementation and a crackdown they are going to go with crackdown.

There is no downside in it for them.

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Ok with that depressing sketch of the coming landscape, let's talk about what you should be doing.

I admit up front that I have no EASY answers for you but as IMF Chief Christine Lagarde is fond of saying that does not mean there are NO answers.

At the risk of sounding trite it really boils down to a simple idea -- Do the right thing.

Instill a culture of making decisions based on what's best for the customer, the client. And prove that you mean it by firing people who screw up and clawing back whatever salary or bonus you can.

JPM did a pretty good crisis-communications job but imagine how much better the company would have looked had people in the Chief Investment Office been canned right away and stripped of whatever comp was possible.

Ditto Barclays. Why throw the chairman overboard and hope that will "be enough." When Bob Diamond testified, he actually had the nerve to say to a member of Parliament who'd made a statement, "Is there a question?" That kind of arrogance just has no place in the industry right now.

For its part, HSBC was super contrite and handled its congressional testimony well but again has any one been fired? What about Wells. Who was responsible for that third-party mortgage operation? Are they gone? Did they have to repay any salary or bonus?

To put it simply -- Banks need to start living Dodd-Frank.

And when it comes to complying with Dodd-Frank, you can't react on a regulation-by-regulation basis. You need to take an integrated approach and figure out what all the regulatory changes mean. How do you need to restructure your capabilities starting from the board all the way down to how you do resolution and recovery planning, capital planning, stress testing.

And you need a data infrastructure - a platform that can feed multiple demands both internal and external.

Banks that move proactively now to embrace the new regulatory regime, to work with regulators, will be the banks that win in the marketplace.

In an industry as regulated as financial services you cannot survive, much less thrive, unless you have a cooperative relationship with your regulators. For example, use the living wills as a way to really figure out where you stand – how you are structured and where you are strongest and weakest.

The days of being everything to all people are over. Figure out how the most efficient use of your capital and start getting rid of peripheral businesses.

Citigroup is a great example of this. Whether it is moving fast enough or far enough only time will tell but I think it's clear that under Pandit that Citi finally seems to get it.

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The whole business is shrinking and becoming more of a commodity. To win you have to be the provider that's trusted and viewed as providing value.

And there is an emerging feeling, I think, that the largest firms are too reliant on trading revenues. Two senior regulators – one opposite sides of the Atlantic – made this point this week. Federal Reserve Board Governor Sarah Raskin in a speech Monday and Adair Turner, the head of the Financial Services Authority in the UK on Tuesday. (If you haven't read Turner's speech, you should. It's on the FSA website and it's titled: Banking at the Crossroads: Where do we go from here?")

Both regulators argued that banks have gotten too far away from their traditional role of taking deposits and making loans. They want banks doing things that benefit society and the economy – not just get paid for moving money around for no useful purpose.

As I mentioned earlier, I think boards of directors need to take a much more active role.

The CEO should not be the chairman – why the banking industry is taking so long to accept this common corporate governance practice is beyond me. Only C and BAC have made the split and that's because the government forced them to. Yesterday's WSJ had a cool story on Citi's chairman Mike O'Neill deciding to take a much more "hands-on" approach. I think that's critical.

I don't doubt that the directors at all these banks are well-intentioned and hard working but I don't think they are doing the job that needs to be done.

I don't think they are forcing senior management to take a long-term view that creates value for shareholders, that properly aligns incentives for making money and managing risks, and demands the firm play a positive role in society. The board has to help lead the organization.

The biggest irony of Dodd-Frank is that lax oversight got us into this mess -- and yet Dodd-Frank relies on great regulation to prevent a repeat of the financial meltdown.

On its face, that doesn't make any sense.

But the reality is the regulators are in charge, and Congress has no alternative but to use them to try and make the system safer.

Surely at some point regulatory costs get so high that the pendulum swings back.

But if you stand by waiting for that day you won't be in business when it arrives.