



Fort Washington Investment Advisors, Inc.

A member of Western & Southern Financial Group

APRIL 2010



John J. O'Connor, CFA
Managing Director
Investment Research &
Private Equity

Investing Environment

“Progress is cumulative in science and engineering but cyclical in finance.”

— James Grant
Editor
Grant’s Interest Rate Observer

We are going to be hearing much about financial regulation in the coming months. As this is written, Senator Christopher Dodd, Chairman of the Senate Banking Committee, has just introduced legislation to overhaul the nation’s financial system. The stakes are high. Financial reform, as an issue, is too big to fail. As we learned in the recent crisis, the financial system, through its control of the payments system and the credit creation process, is vital to the health of the world’s economy. However, in a political environment characterized by acrimonious division and massive amounts of lobbyist cash, it is tough to be optimistic that wise legislation can be crafted.

Before addressing the question of what a reform package should consist of, one might ask whether reform is necessary. Some argue that bubbles are endemic to market based systems and that the public should accept bubbles as the price of admission to a market based system which has generated much wealth over several centuries. I would argue that such a laissez-faire mindset is appropriate for many sectors, but not the financial system. If technology investors temporarily lose their minds, there are few systemic implications as we learned in the aftermath of the Technology bubble. In this case, a light regulatory hand is best; more about that later. But financial services are different, given the centrality of the payment system and the credit formation process to the healthy functioning of the economy. Incentives for financial services companies need to be aligned not just with the interests of the shareholders, but also with those of the broader public. The incentive model that led up to the financial crisis is that gains were privatized while losses were socialized. In other words, firms and employees had the incentive to take a great deal of risk; if the risk plays out, great riches accrue to the firms and individuals; if the risks don’t play out, the taxpayers are left holding the bag. That model is unacceptable to voters on both sides of the Atlantic.

Something must be done. The cautionary note is the “something must be done” refrain heard around the country following the accounting scandals surrounding companies such as WorldCom, Tyco, Adelphia Communications and, most prominently, Enron, resulted in the Sarbanes-Oxley Act of 2002. The legislation set new or enhanced standards for public company boards, management, and public accounting firms. SarBox, as it is known, had some major unintended consequences. One of the biggest unintended consequences was the decimation of the Initial Public Offering (IPO) market. While causation can be difficult to ascribe with certainty, most market observers have concluded that by virtue of its annual fixed cost component of \$2-3 million, Sarbox has been a meaningful damper on IPO activity, and that is a bad thing from a public policy standpoint. A moribund IPO market discourages big thinking by entrepreneurs who are now focused on selling out to Cisco, Oracle, Google or



one of the other big technology companies. As a thought experiment, imagine if Microsoft had been acquired by IBM early on. Does anyone believe that Microsoft would have become the huge wealth and job creation vehicle that it proved to be if it had been buried somewhere on IBM's organization chart?

So something must be done, but that "something" needs to be very well thought through with an eye toward avoiding unintended consequences. Moreover, legislation must address not only the sources of the recent crisis but also attempt to prevent future crises. Legislation must avoid the mistake of the proverbial general fighting the last war. But the last war is a good place to start. My June 2007 *Investing Environment* took up the question of where the blame lies for the recent fiasco. Here are the suspects and charges that have been leveled against them¹.

Suspect	Charges
1. Federal Reserve (FOMC)	Over aggressive easing of monetary policy.
2. Mortgage Brokers	Enticed borrowers with loans the borrowers couldn't handle to keep the volume of loan production flowing with very little regulatory oversight.
3. Appraisers	Friendly (i.e. high) appraisals kept the volume flowing, leading to more appraisal business.
4. Banks	Banks that bought the loans and packaged them for sale had no incentive to carefully underwrite the loans since the loans would be on their balance sheet for only a short time. As such, capital levels were very thin.
5. Borrowers	Failed to do their homework and took on obligations beyond their ability to pay.
6. Wall Street	Massively overleveraged their balance sheets and packaged loans into securities with little regard for credit quality as long as there was a willing buyer.
7. Rating Agencies	Worked closely with Wall Street and rated paper AAA and AA that was later exposed as junk.
8. Hedge Funds	Spurred by large performance fees, Hedge Fund managers had every incentive to take large risks that, if bad things happened, left their investors holding the bag. Credit defaults were an instrument of choice.
9. Hedge Fund Investors	Seeking high returns, they sought out risk and found it.

As you can see, there is no shortage of theories as to where the blame lies. In my June 2007 letter I argued that we face a situation like Inspector Hercule Poirot in Agatha Christie's *Murder on the Orient Express* where each clue pointed to a different suspect. Poirot found that all the suspects were guilty because there is no other way the murder could have taken place.

Indeed, there is much blame to go around. Ultimately, however, the crisis boils down to the fact that commercial and investment banks were operating with capital levels that were far too thin given the level of risk embedded in complex, highly inter-connected financial products and markets. In a spirit of public service, set forth below are a few of my ideas for how to recast the financial system:

¹Some have argued that the Community Re-investment Act (CRA) is partially responsible for the financial crisis. This strikes me as nonsense. CRA is legislation requiring banks to lend in low income neighborhoods where they take deposits. CRA was passed in 1977. Aside from the obvious point that it seems silly to blame a 2004-2007 crisis on a 1977 law, most subprime loans were made by firms not subject to CRA. According to testimony by University of Michigan law professor Michael Barr in testimony before Congress, 50% of subprime loans were made by mortgage companies not subject to CRA and another 30% were made by affiliates of banks or thrifts not subject to routine supervision or examination.



- **Impose tight leverage limits on investment banks².** One of the biggest regulatory mistakes of my lifetime was the SEC's 2004 decision to allow investment banks to maintain significantly higher leverage. Lehman and Bear Stearns were levered over 33:1. Small problems turn into big problems when magnified by leverage at that level. Many large investment banks have converted to Bank Holding Companies so this point may be moot for now, but to prepare for the future, tighter leverage limits must be put in place.
- **Coordinate and Raise Regulatory Capital Ratios Globally².** One way to reduce the likelihood of systemic meltdown is to require higher capital ratios. The catch is that if the United States acts alone to raise capital ratios, our banks will suffer a competitive disadvantage globally. There are global accords on bank regulation, the most prominent of which is Basel II published in June, 2004. The challenge for such accords is accommodating differing cultures, accounting standards, and existing regulations. Moreover, enforcement is the responsibility of local regulators and there is no global enforcement mechanism. Officially US banks are required to have 6% Tier 1 capital, but the unofficial requirement is to have a minimum of 8% with 10% highly encouraged. The problem is that the rest of the world's banks operate with Tier 1 minimum of 4%. The administration should work hard to engineer an increase in the Basel minimum to at least 6%, ideally 8%. If such efforts prove unsuccessful, the US faces a difficult choice: implement capital standards necessary to put the system on solid ground but risk disadvantaging our banks relative to global competitors, or live with lower capital standards and hope for the best. In my view, the US should lead by example and implement capital standards that we need to ensure safety and soundness. Discerning customers will recognize the value of dealing with strong financial institutions, particularly in the wake of the financial crisis.
- **Require banks to issue contingent debt.** Contingent debt securities are converted to equity at the regulators' discretion in the event of a crisis, in effect, a preplanned recapitalization. The presence of such securities on a bank's balance sheet will decrease the incentive to take excessive risk to keep the cost of contingent debt down and to reduce the risk of triggering the dilutive conversion. Such securities have been issued in Europe as part of recapitalizations and should become a part of every balance sheet.
- **Regulate Credit Default Swaps (CDS)³.** CDS did not cause the financial crisis but they played a central role, particularly at AIG which wrote massive volumes of CDS on subprime mortgage-backed securities. The regulation should take several forms:
 - Plain vanilla CDS should be traded on an exchange to bring better transparency to pricing.
 - Treat CDS as an insurance policy against default. If CDS were treated as insurance policies, two changes would occur:
 - The writers would be regulated by state insurance commissioners and would need to maintain reserves against potential claims.
 - Buyers would need to demonstrate an "insurable interest" by owning the bond on which they purchase insurance in the form of a CDS. I can't buy a fire insurance policy on your house because otherwise I would have an interest in your house burning down. Too often in the crisis hedge funds with no "insurable interest" used their CDS markets to create mischief in markets.
 - Proprietary trading activities, often heavily involved in CDS, should be housed in separately capitalized subsidiaries subject to strict leverage and concentration limits.
- **Rationalize Bank Regulation.** Depository institutions are regulated by a veritable alphabet soup of regulators who often work at cross-purposes and battle fiercely to protect turf. The Federal Deposit Insurance Company (FDIC) regulates banks with FDIC insurance. The Office of the Comptroller of the Currency (OCC) regulates some nationally chartered banks. The Office of Thrift Supervision (OTS) regulates nationally chartered thrifts. The Federal Reserve (Fed) regulates bank holding companies. State regulators monitor state chartered institutions. Two proposals to rationalize this structure include:

²There is much talk these days of "too big" and "too interconnected" to fail. The thrust of this paper is that systemic risk should be dealt with through increased capital in various forms rather than a break-up of large firms which could have unintended and unforeseen consequences.

³A credit default swap is simply a financial instrument for swapping the risk of a credit default with another willing party.



- Eliminating the thrift charter and the OTS.
- Create a single regulator by combining the powers of the Fed, the OCC and the FDIC. Importantly, the senior officers of the regulatory bodies must be independent of the political process serving long, perhaps even lifetime terms like the Supreme Court.
- **Change the Accounting Governance of Loan Loss Reserves.** The current accounting for loan loss reserves follows the “matching” principle in accounting whereby period revenues and expenses are matched. Loans booked today will result in some losses so a reserve for future losses is established based upon historical loss experience. Accountants and regulators are leery of “over-reserving” during good times for fear of managing earnings. Fair enough. But basing reserves on loss experience when times are good can lead to material under reserving when times are bad. Reserves should be based on loan type across the cycle and be maintained throughout the cycle even as losses themselves rise and fall.
- **Change the Rating Agency Model.** The current rating agency model is flawed. Under the current arrangement, the fee of the rating agency is paid by the firm or the issuer of the security being rated. This creates an obvious conflict of interest. The payor should be the user of the service, that is, the investor community. There are multiple ways to achieve that end and I would suggest that further study is needed to select the proper methodology, but the direction the industry must move seems quite clear.
- **Off-Balance Sheet Accounting.** Next to “It’s different this time,” “off-balance sheet accounting” is the most dangerous phrase in our business. Apparently, nothing was learned in the Enron fiasco which centered around off-balance sheet vehicles. End the practice now.

This is not an exhaustive list of needed measures. Moreover, to state the obvious, this point of view is that of an investor; lawyers, accountants, regulators and politicians will rightly have their say in this process. But that’s my two cents worth.

One final thought: at the highest level, the goal of the financial system should be to direct savings, domestic and globally, into investments in property, plant equipment and human capital that provide the greatest increase in a nation’s wealth protecting all the while personal freedoms. The key question for policymakers, in light of the recent failure of risk management and regulation, is whether greater regulation will inhibit or enhance through greater stability, the generation of national wealth. With this important caveat in mind, my proposals have centered around initiatives that will increase stability of the system (greater capital, regulating CDS, changing loan loss provisioning policies etc.) rather than other proposals likely to impede credit intermediation such as the proposed new consumer protection agency.

A handwritten signature in black ink that reads "John".

John O’Connor
March 2010

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