

# R I V E R P O I N T R E P O R T

**June 30, 2010**

## **FINANCIAL OVERHAUL BILL CLOSER TO BECOMING REALITY**

The U.S. Congress is set to deliver a sweeping re-write of the Wall Street rulebook to President Obama. The legislation, which was hammered out over a marathon 20-hour session ending the morning of June 25, is designed to close the gaps in the current regulatory framework and end the rampant speculation and irresponsible lending that are widely blamed for the 2008 financial market crisis. While we prefer less regulation in most cases, the recent crisis highlighted pockets of recklessness and imprudent behavior in the financial system; to us, this bill touches on those areas without over-stepping into an area of “too much” regulation. Other causes of the crisis – namely consumers borrowing too much and investors dealing in securities they didn’t fully understand – were insufficiently addressed, in our opinion. Following is a summary of some of the major provisions of the bill. Please note that the death of Senator Byrd at age 92 has re-opened some areas of this bill to further negotiation and could delay the final vote on the matter beyond the original target of July 4.

Preventing a repeat of the 2008 financial crisis was one of the main objectives in drafting this legislation, and lawmakers have attacked this goal from many angles. For many on Capitol Hill, eliminating the idea of “too big to fail” was priority number 1 in this whole process. To that end, the new law would establish a Financial Stability Oversight Council (FSOC) to be led by the Treasury Department. The FSOC will monitor the interconnection between large financial firms and will attempt to respond to emerging threats to the financial system. In carrying out its duties, the FSOC will be able to change capital requirements for financial institutions and force companies to divest holdings deemed to pose a “grave threat” to U.S. financial stability. In extreme cases, the FSOC can even break up failing firms, with the Federal Deposit Insurance Corporation (FDIC) in charge of the liquidation process. This liquidation would be paid for by fees imposed on the country’s largest financial firms (financial institutions with more than \$50 billion in assets). Although this power sounds great in theory, identifying problems before they occur is always a tremendously difficult task, even for the best and brightest. Frankly, we question the ability of the FSOC to succeed at this endeavor.

Regulators also addressed the “too big to fail” issue by introducing changes to banks’ capital requirements. The intent behind these reforms is to prevent the American taxpayer from having to pony up in order to save failing financial companies that threaten the stability of the entire financial system. Tier 1 capital is essentially the first layer protecting bank balance sheets from losses. The financial reform bill calls for “trust preferred” securities – a.k.a. TruPs, which are part-equity and part-debt – to be phased out of Tier 1 capital over the next several years and replaced with common stock (the phase-out period differs depending on the size of the bank). The purpose of this is to give banks a higher-quality capital base to protect against losses in the future. Also, the measure is intended to preclude financial firms from needing emergency aid from the government in order to stay afloat during times of crisis. It is important to note that this change in classification from a regulatory viewpoint in no way impacts the investment merits of trust preferreds. The government restructuring of Citigroup provided a strong precedent for the relative value of trust preferreds in a firm’s capital structure, ranking just behind corporate debt in order of safety. At RiverPoint, we continue to invest in trust preferreds in many of our client accounts for companies that are in sound financial condition

and offer attractive yields. Stronger capital requirements will put banks in a position of greater financial strength should another crisis hit.

Lawmakers also targeted some of the “riskier” activities of large financial firms in this legislation. The proposed ban on proprietary trading – nicknamed the “Volcker Rule” after former Federal Reserve Chairman Paul Volcker – was softened during the Senate negotiations.

However, the provision still packs some punch. Banks will be prohibited from conducting proprietary trading operations – in which a firm bets its own money – but will be allowed to make small investments in hedge funds and private-equity funds. The ban on proprietary trading could materially impact profits at some firms, like Goldman Sachs which made nearly \$1.2 billion from proprietary trading in 2009. For our client portfolios we have been avoiding shares of firms heavily involved in proprietary trading for fear that the “Volcker Rule” would become law. Hedge funds were also targeted by lawmakers, and now have to register with the Securities and Exchange Commission (SEC) so that their activities may be reviewed in order to gauge their impact on the stability of the broader financial system.

Derivatives have been front and center in the debate over Wall Street reform after losses on derivatives trading pushed American International Group (AIG) to the brink of bankruptcy in 2008. The financial reform bill allows banks to maintain their derivatives trading operations so long as they are used to hedge other risks. Other derivatives operations will have to be spun out into separately-capitalized subsidiaries. This separation is designed to keep losses in the derivatives operation from negatively impacting the banks’ “traditional” operations. Also, derivatives trades will have to be routed through a central clearinghouse or reported to a regulator, making it easier for the market and regulators to track activity in the financial system (and should be a positive for the NYSE and other exchanges that would benefit from increased volumes). These measures will enhance the strength and stability of the overall financial system, give the derivatives market more transparency, and limit (but not eliminate) the systemic risk that rampant speculation in esoteric financial products can create.

The interests of the American consumer are also addressed in the financial overhaul bill with the creation of a new Consumer Financial Protection Bureau (CFPB) within the Federal Reserve. The CFPB will be charged with “watching the consumer’s back” in dealings with financial institutions. The CFPB will be granted many powers over financial firms. For example, the CFPB could require banks to reduce interest rates on credit cards. Also, mortgage lenders are expected to be subject to tougher rules and stiffer documentation guidelines when lending to homebuyers. Additionally, the bill seeks to help consumers by targeting the fees that merchants pay to banks for each debit card transaction. The bill also permanently increases the FDIC guarantee on bank deposits to \$250,000. Although we support the idea of the CFPB, we are concerned about our government’s growing involvement in business in general.

Another pro-consumer aspect of the bill is the requirement that the SEC study whether securities firms should be made more accountable to individual investors. After a six-month study period, the SEC may require stockbrokers abide by the same standards of care as those required of investment advisors like RiverPoint. Currently, stockbrokers are only required to consider whether or not an investment idea is “suitable” for their clients; for example, a broker may recommend a bond mutual fund to a client, but instead of recommending the fund with the best performance history and lowest management fees, the fund that earns the broker the highest commission can be deemed “suitable” for the client. On the other hand, true investment advisors like RiverPoint have a fiduciary duty to always act in the best interest of their clients.

At this stage, it is difficult to predict the ultimate winners and losers of the financial regulation reform bill. One thing is clear, though – now financial companies and investors have some idea of what the regulatory landscape will look like in the future. The biggest risk with this reform bill is that unintended consequences cause unforeseen problems in the future. However, we are relieved to have much of the uncertainty surrounding this legislation behind us. As a risk-reduction technique, we

avoided shares of companies that we felt were most at-risk of being negatively impacted by the financial reform bill. Looking ahead, the macroeconomic outlook remains mixed, with continuing global concerns and issues in Europe dulling the prospects of an economic rebound in the United States. While decisive measures have been taken across Europe to begin to address that region's financial problems, we are remaining on the more conservative end of each client's asset allocation range until we see evidence of success there and a continued recovery of the global economy.

<b><u>Market Summary</u></b>	<b><u>6/29/10</u></b>	<b><u>2010 Price Change</u></b>
Dow Jones Industrial Average	9,870	-5.3%
Nasdaq Composite	2,135	-5.9%
Standard & Poor's 500 Index	1,041	-6.6%

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