STANDARD & POOR'S

Financial Reform: How It Will Affect America's Biggest Banks

It appears likely that most banks will be able to weather the potential loss of revenue related to caps on proprietary trading.

The passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act is the first step in the establishment of a new regulatory regime for banks and other financial services institutions. In particular, the legislation signals the beginning of a significant shift in the way large U.S. banks operate. Following are some of the key provisions aimed at curbing the activities of banks and ultimately enhancing the safety and soundness of the U.S. financial markets.

Greater Oversight

In an attempt to avoid future financial crises as profound as the 2008 financial collapse, the bill establishes a 10-member oversight council to monitor and address risks to financial stability. It also includes measures that permit regulators to seize and break up troubled financial firms whose collapse might cause widespread damage to the economy. Regulators would recoup losses via fees on firms with more than $50 billion in assets.

The Volker Rule

The issue of proprietary trading - or using a bank's own funds to invest in vehicles such as hedge funds and private equity funds - was handled through the Volker Rule. Named after the former Federal Reserve Chairman Paul Volker, the measure generally bars the largest banks from holding no more than 3% of a fund's ownership, and using no more than 3% of the bank's Tier 1, or core, capital to fund such an investment. Many major banks, such as Goldman Sachs, J.P. Morgan Chase, and Wells Fargo & Co. are reported to have holdings that exceed that limit.[1]

Phasing out these investments presents one of the biggest challenges for banks. To address this issue the bill includes a provision that provides banks with up to seven years to unwind such investments - and more time to phase out illiquid holdings.

Under the Volker Rule, banks face new curbs on proprietary trading with their own funds.

	2009 Revenue	2009 Core Trading Revenue	Potential Revenue Hit to Proprietary Trading
Bank of America	$120.9	$20.5	$0.4
J.P. Morgan Chase	$100	$23.8	$0.5
Goldman Sachs	$45.1	$37.3	$1.5
Morgan Stanley	$23.3	$12.2	$0.2

Sources: *The Wall Street Journal*; Citi Investment Research & Analysis. Data in billions of dollars.

It appears likely that most banks will be able to weather the potential loss of revenue related to caps on proprietary trading. In addition, it is expected that despite the long implementation timeline, most banks should adhere to the new requirements sooner rather than later.

Derivatives Regulation

The bill also puts curbs on the derivatives trading activities of the largest banks. Specifically, the new law requires banks to conduct some of their derivatives trading outside of the bank in an affiliate operation. While designed to provide more transparency in operations and to isolate systemic risk, this aspect of the bill has the potential to significantly increase capital costs and funding requirements of the derivatives businesses at the largest banks.

Potential Implications for Investors

- Although it may be to early to fully assess the impact of reform on earnings, the costs of implementing this legislation and the loss of revenue from certain lines of business could be onerous, which could hurt bank earnings. However over time, the banking industry has shown an ability to counter earnings reductions with product restructurings and repricing strategies.[2]
- On a more positive note, many analysts expect the lower earnings to be accompanied by lower risk, less earnings volatility, stronger bank balance sheets, lower operational risk, and heightened prudential regulation.[2]
- Further, while many believe that reform may hurt banking profitability in the long run, the immediate effect could be positive. For example, markets will breathe sighs of relief that worst-case scenarios were averted and many of the regulations will take years to be implemented.
- Finally, some equity analysts suggest that some of the bill's new capital restrictions, consumer protections, and derivatives regulations may result in less available credit for consumers and businesses - ultimately a negative for the U.S. economy and for bank lending growth.

[1]Source: *The Wall Street Journal*, "Big Banks Lose, Fed Wins in New Bill," June 25, 2010.

[2]Source: Standard & Poor's, "The Financial Overhaul Bill: The Rules of the Road Have Changed, But Details Should Define by How Much," July 22, 2010.