

financial reform is ok for bank bonds

After the Financial Crisis of 2008, there was a strong desire to de-risk the system to prevent a future crisis. The Dodd-Frank legislation seeks to strengthen the banking sector by increasing the quantity and quality of both capital and liquidity while also decreasing the risk taking permitted with FDIC insured deposits.

While Congress continues to investigate what caused the financial crisis, the President has signed into law the “Dodd-Frank” financial reform package. Dodd-Frank represents the first major overhaul to US financial regulation since the Glass Steagall act, which was passed in 1933. While passage of the 2,000+ page Dodd-Frank bill into law was a big milestone in US history, the impact will largely be delayed as regulators need to create rules underneath the legislated construct and many of those rules will then also have phase-in periods further delaying the impact.

As fixed income investors, we expect to benefit from the intended result of having better capitalized, more liquid and less volatile banks to invest in, even if those intuitions are somewhat less profitable (estimates are that the major banks could see a 5-10% decrease in earnings) in 3-6 years. In the meantime, offsets to the decreased profitability should include banks’ cessation of reserve builds as well as being beneficiaries of a stronger (as compared to today) US and global economy. We will of course remain watchful for signs of unintended consequences.

The main features of the Dodd-Frank legislation are as follows:

Proprietary Trading (aka the Volcker rule)

Defining the difference between what is proprietary trading and what is considered market making activities is the key to the implementation of this rule. The Volcker rule will limit bank investment in private equity and hedge funds to 3% of their Tier 1 capital and 3% of the fund’s capital. The law calls for a study, rulemaking period and then a 2 year phase in with compliance set for July 2014, but with a potential for an additional 3 year extension.

Derivatives (aka the Lincoln Amendment)

Banks may continue to act as swap dealers for interest rates, FX, cleared credit default swaps on investment grade entities and gold and silver related swaps plus those swaps that are considered to be reducing the bank’s commercial risk. Other swaps, including non-cleared CDS, commodities, and equity related swaps will need to be moved into separate affiliates within the bank holding company. Banks would have 2 years to set up the new entity, then 2 years to transfer the swaps in.

Resolution Authority

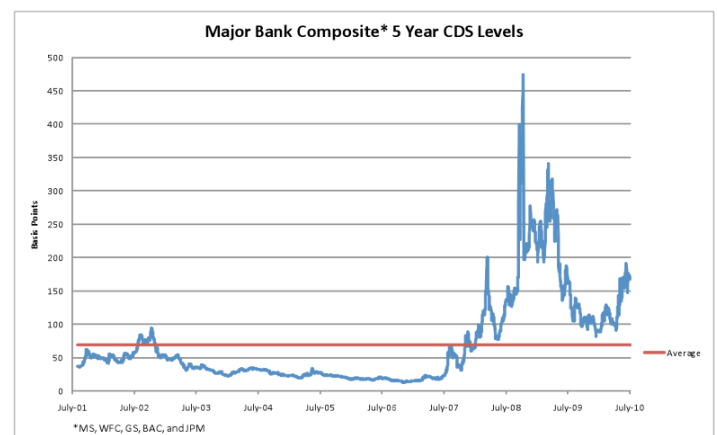
The Resolution Authority gives the FDIC power to unwind financial firms and prohibits the use of taxpayer funds to rescue said firms. Previously the Fed had the right to take over/unwind bank operating companies but this regulation allows for the same powers to be deployed at the bank holding company as well. This is the aspect of financial reform that most caught the rating agencies eyes in terms of less implied support from the government going forward as compared to the uplift currently incorporated in bank credit ratings. The agencies have refined their views to a more balanced approach and have deferred judgment on rating changes.

Capital Requirements (aka the Collins Amendment)

While higher capital requirements are to be expected, the bill does not reveal what those new minimums might be and how they might be calculated as these details have been left to the regulators. The bill does seek to improve the quality of Tier 1 capital by making Trust Preferred securities ineligible for banks with assets in excess of \$15 billion, but implementation is gradual and begins in 2013 and concludes in 2016.

Conclusion

In summary, we feel that while the passage of financial reform is historic, the effects will likely be deferred both due to regulators needing to study and fill in the blanks with specific regulations and phase-in periods. We are constructive on investing in fixed income instruments from major banks as they will be required to hold higher/better quality capital and liquidity levels and be discouraged from overly risky activities, while current valuations offer a higher margin of safety than in the past.



Source: Bloomberg

about the author



*Jeffrey Bernstein, CPA
Director*

Mr. Bernstein joined the firm in 2008 as a fixed income analyst focusing primarily on the financial institutions sector including banks, brokers, finance, and insurance companies. He concentrates on credit management for Cutwater's Core, ALM, HY and Third Party investment portfolios. Prior to joining Cutwater, he held similar roles at Schroder Investment Management and at Credit Suisse. Preceding his Credit Suisse role, Mr. Bernstein was with PWC where he provided security valuation to hedge fund and brokerage clients. He began his career by spending 7 years as a commercial lending officer. He has a bachelor's degree from Albany University, a master's degree from New York University, and is a Certified Public Accountant (CPA).

Cutwater Asset Management
113 King Street
Armonk, NY 10504
800-937-2624
www.cutwater.com