

THE FINANCIAL SERVICES ROUNDTABLE

Financing America's Economy



Inside the Beltway: The Changing Political and Regulatory Landscape for the Financial Industry

Statement by the

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The purpose of my speech today is two-fold: to give the outside the beltway story of the financial services industry, which is often untold, and the inside the beltway story, which focuses on the changing legislative and Dodd-Frank related regulatory changes. Financial institutions affect every intersection and district of the real world outside the beltway, yet today, inside the beltway is shaping the world of financial institutions significantly more than economic forces. What I do not plan to discuss are the details of Dodd-Frank as it relates to the private equity world as there are experts better than I that will go into that immediately following

me. After comments, I will open it up for questions on the topics I cover or any other topics. I am happy to further elaborate on the Volcker Rule, talk about the 2012 elections, or the corporate tax structure, federal deficit or the Dallas Cowboys.

Before I go any further, let me say thank you to Jeff Gendel and Private Equity International for inviting me to speak with you all today. With over 2,300 firms in the US and eight million employees worldwide, the private equity industry is an extraordinarily significant piece of the economic puzzle. The fact is that private equity invested nearly \$150 billion in U.S. companies in 2010 alone. You make companies better, stronger and more competitive. The American economy gets a double whamie from the private equity world:

1. You create a stronger company than the one you inherited, by definition.
2. More importantly, that stronger company – by raising the competitive edge – makes the industry stronger. This is true whether its office supplies, sporting goods, chain drug stores, or doughnuts.

Private equity has even started to play a role in presidential politics through Mitt Romney. Thank god for presidential politics to focus a spotlight on the good things private equity does for you. When you look behind the veil, it means that

through you, major companies like Staples, Hilton Worldwide, Sports Authority and Dunkin' Donuts now employ hundreds of thousands of Americans and create billions in wealth. You each play a significant role in helping to rebuild this economy and I thank you for the work you do each and every day.

A Word to the Side about the Economy

Somewhere in the Bible it says that in the beginning, there was the economy. As we start the New Year, it is becoming increasingly clear that the economy will continue to improve and the outlook for 2012 looks reasonably solid, not great perhaps, but solid. On the other hand, I read that four months ago, 57% of you believe the U.S. economy will remain stagnant, while 23% believe that a double-dip recession is likely. You were a pessimistic bunch and many may still be. Small businesses tend to agree with you. In a Chamber poll released this week, 85% of small businesses believe the economy is on the wrong path. The truth is that the economy is showing some life.

- A projected 2.8% GDP growing during 2012.
- Inflation expected to remain very low throughout the year.
- Consumer Confidence by Gallup remains at a seven-month high.
- In my world, lending is reasonably robust. Aggregate lending is back to pre-crisis levels, reaching nearly \$7 trillion in November, 2011.

- And the U.S. jobless rate was 8.6% in November, 2011 – the lowest in 2.5 years – which is still too high for a robust economy, but is moving in the right direction.

This is definitely not a boom time, but 2012 will be a year of steady progress.

Outside the Beltway

Now, the big untold story in America today is the role of the financial services industry in maintaining quality of life and standard of living. Quite simply, if you live in it, work at it, wear it, insure it, go to school to study it, eat it or drive it, the financial services industry financed it or it didn't happen. While Main Street is starting to hear the story, the truth is that much of it remains unknown and in some cases, untold. So, I'm going to lay it out for you today.

Key to Economic Recovery

The industry's most basic function is to finance both the American and Global economy. If we do not finance it, it is not going to happen. Let's start with lending. I mentioned earlier that lending is back to pre-crisis levels of nearly \$7 trillion. The truth – and we often hear otherwise – is that business lending was up \$100 billion in 2011, or 8% year over year, and small-business lending hit a four-year high in November. My organization conducted a survey in the fourth quarter of 2011 of about 40 of our large and medium-size institutions – mostly banks –

and found that in virtually all cases, lending to small businesses was up in 2011 over 2010. 20 of the largest banks publically pledged \$100 billion in small business loans over the next three years. My guess is that they will far exceed that pledge.

- PNC originated or renewed \$1 billion in small-business loans in the third quarter of 2011 alone.
- US Bank set a new all time company record for SBA loan approvals in 2011.
- Allstate invested over \$165 million for nearly 2,000 women-and minority-owned businesses.
- Nationwide built a common network to facilitate communications among small business owners to talk to each other in real-time.
- JPMorgan Chase provided more than \$12.6 billion in credit to over 300,000 small businesses in the first three quarters in 2011.
- Raymond James provided over 128 public financings in 2011 for small companies.
- Citizens Financial Group more than doubled its small business lending.
- Citi pledged \$24 billion in U.S. small business lending over the next three years.

Now, it is important to note that while the industry is lending, we are not going back to the days of making bad loans, nor should we. A well-capitalized borrower

with good, proven cash flow can get a loan. A bank loan is not equity. It is a loan that has to be repaid. Cash flow and collateral are still the foundation.

Committed to Safety and Soundness

Second, the safety and soundness of a financial institution is essential to the economic recovery. In 2008 and 2009, financial institutions had their own financial difficulties and the economy suffered. As a result of the real changes made by Congress and supervisors, but also as a result of financial institutions themselves, we are climbing our way back. In particular, risky practices, such as no doc loans and bad underwriting, have been eliminated, banks are at the highest capital level in history (\$1.5 trillion), and the largest U.S. banks have increased Tier 1 capital by nearly 50% since 2007. Stress tests, resolution plans and orderly liquidation authority resulted in a far more secure protections so that if one financial institution were to fail, we believe it wouldn't become systemic as it did in 2008.

Back to the Basics

To be the foundation of the economy, financial institutions have to start by doing right by our customers and our communities. A few examples:

- The industry has completed 5 million permanent mortgage modifications for homeowners since 2007, including 1 million in 2011 alone.

- About 66% of the proprietary modifications completed significantly lowered principal and interest payments and about 83% of those same modifications were fixed-rate modifications.
- The industry also completed 300,000 community service projects in 2011, including 30,000 financial literacy classes.
- Financed retail sales day through online banking.
- Hosted special hiring programs for Veterans.

The industry did make a lot of mistakes going into 2008 and 2009 and we paid heavy prices for that, as well we should have. But the untold story tells us that without a robust financial services industry, the rest of the economy cannot function.

Inside the Beltway

Turning to Dodd-Frank and the Inside the Beltway regulatory story. I read a few articles and saw that more than half of you believe that complying with the new regulations is a “difficult and time-consuming process.” I’m sure that’s true, but my companies, already in a regulated world, have a stress test imposed, which requires them to determine in advance what they would do in five years in the event of unemployment at 13% and the Dow Jones at 5,700. Welcome to my world ladies and gentleman. Excessive regulation can be a migraine headache.

It has been 16 months since the passage of the Dodd-Frank Act. Since then, federal financial regulators have been working diligently to complete the 400 studies and regulations required by the Act. Davis Polk issued a progress report for Dodd-Frank and showed that 149 rules have missed their deadline, while only 86, or 22%, of the rules have been finalized.

Let me offer a few high-level comments on Dodd-Frank. First, it was designed to protect the system from systemic risk. That's the good part. The core of the recent economic crisis was that a bad decision in one place – say a poorly written mortgage – could infect the entire system and compounding securitization creates an ocean of toxic assets.

Second, while any individual rule or regulation may be harmless or even laudatory, the cumulative weight of 400 new rules is a problem in itself. After Jamie Dimon asked his famous question on the cumulative weight of Dodd-Frank, we provided the answer from multiple sources and found that GDP will decline 2.6%, 4.6 million jobs will be lost, \$1.25 billion in budgetary costs will be incurred by next year, bank lending rates will increase, among many other unintended consequences.

Third, and this is important, the regulatory agencies are doing the best they can with the hand that was dealt to them, but they cannot change the statute. We need

to suggest the best way to implement, both in the short-term and long-term. My advice to my members – and my advice to you – is to comment on everything that moves, and then comment on the comments. The regulators read your comments and use them to draft the regulations.

Fourth, and let me be clear, the financial services industry is not trying to repeal Dodd-Frank, but rather, trying to improve it. It is incumbent upon Congress and the Administration to change the underlying statute, improve it, reform the reform and build on what we know now. Dodd-Frank is 2,300 pages and written in the space of six months. Some elements, with 18 months hindsight, should be reconsidered.

Volcker Rule Implementation

Let's start with the Volcker Rule, which I believe you all are familiar with. The rule was a last-minute addition to Dodd-Frank and was intended to ensure that insured deposits by banks not be used for proprietary trading and to limit banks' relationships with covered funds– despite the fact that such activities did not contribute to the financial crisis.

In October, federal regulators issued a proposed regulation to implement the Volcker Rule. What started out as a three page letter from Mr. Volcker to Mr. Obama outlining his plan later became ten pages in the original Dodd-Frank

statute and has now turned into a nearly 300-page rule, with over 1,300 questions seeking industry input on about 400 topics. Further, compliance with the regulation will require banking institutions to spend millions of dollars and millions of hours on new systems and procedures. Even the author of the provision, former Federal Reserve Board Chairman Paul Volcker, told the New York Times in October of the proposed regulation, “I don’t like it, but there it is. I’d write a much simpler bill.”

An Oliver Wyman study found that investors in U.S. Corporate bonds could suffer a \$315 billion loss as a result of the Volcker Rule. Surely that could not have been an intended consequence. Other unintended consequences could be significant, including less efficient markets, higher transaction costs for market participants, and the movement of important financial market activities to foreign markets.

The regulators are doing as well as they can to implement the Rule, however, given its complexity, Congress needs to conduct a full and open review of the Rule. Two House Financial Services Subcommittees took the first step by holding a hearing this week to evaluate the proposed Volcker Rule, compliance costs, perceived benefits, and its impact on the economy, jobs, businesses and investors. Congress should start over and rewrite the rule with clarity to say that banks and bank holding companies not use insured depository funds to trade on their own

accounts. But should be able to trade on behalf of their customers and invest in covered funds.

Interchange Fees

The Durbin Amendment was also one of the late additions to Dodd-Frank. No hearing, no committee consideration, a one-hour debate and the final Durbin Amendment written in pencil on the Senate floor. The price controls imposed are based on flawed understanding of the factors that affect such fees. The amendment cost the industry \$9.4 billion, and consumers have not seen lower prices as a result. In fact, the Electronic Payments Coalition released a white paper in December 2011 showing that 76% of retailers have raised their prices, or kept them the same since the implementation on October 1, 2011. Durbin was misguided and should be repealed.

Derivatives

Title VII implements a wide set of reforms with the goal of improving both the transparency and stability of derivatives. We fully support these goals, however, some changes are needed to reduce unintended consequences to some of the provisions. For example:

- Transactions with swap-like characteristics that are conducted between affiliates of the same company should not be subject to the same clearing, trading and reporting standards that are required of bi-lateral transactions;

- Transactions between two foreign parties, including the foreign affiliates of US based organizations, should not be subject to Title VII,
- The definitions of “swap dealer” and security-based swap dealer” should be given a *de minimus* standard to avoid covering small entities with an insignificant level of derivatives-related business,
- The “Lincoln” amendment, which requires banks to “push out” derivative activities to affiliates should be repealed.

Consumer Protection

On the positive side, the CFPB could bring consumer protection to the wild, Wild West of the unregulated industry. They can go after fraudulent scams and simplify disclosure statements so the average consumer can understand it. The Roundtable believes that a single Director should be replaced with a bi-partisan board – that is the norm of financial regulation from the SEC to the CFTC to the FDIC and beyond. The CFPB’s mission should also be consistent with the federal consumer protection laws that the Bureau enforces. No agency should be permitted to write new law by regulation. The CFPB also should be explicitly required to weigh the impact of consumer protection regulations on the safety and soundness of the financial service providers that it supervises.

Mortgage Lending

We strongly support the goal of Dodd-Frank to ensure that mortgage originators fully verify a borrower's ability to repay a loan. In this case, Dodd-Frank did not go far enough and should create a legal safe harbor for lenders who make qualified mortgages. Further, the proposed Premium Capture Cash Reserve Account requirement simply adds to the cost of a non-qualified residential mortgage with no economic benefit.

Capital

Section 171 of the Dodd-Frank Act (the so-called "Collins Amendment") codifies the Basel I standards originally adopted by the U.S. in 1989. Since that time, we've gone through Basel II and now on to Basel III. To avoid unnecessary conflict between the old and new capital standards, we recommend that Congress repeal the Collins Amendment and deal directly with Basel III.

Whistleblower

The so-called whistleblower provisions, one of more insidious and counter-productive parts of Dodd-Frank. In essence, this provision pays a bounty to an employee as a reward for avoiding internal controls and refusing to report wrongdoing internally. The whistleblower provision should be repealed or at the very least, self-reporting to a company should be a condition of receiving the reward.

Insurance

During consideration of the Dodd-Frank Act, Congress recognized the strength of insurance by excluding insurers from many of the Act's provisions. Nonetheless, there are some provisions in the Act that create unintended consequences for insurers and their customers. We propose that these provisions be refined to:

- expressly exclude insurers from designation as systemically important unless the insurer is affiliated with a company that the Financial Stability Oversight Council;
- permit insurers that own depository institutions to establish intermediate holding companies;
- require the Office of Financial Research (OFR) and the Federal Insurance Office (FIO) to obtain data on insurers only from state regulators; and
- expressly exclude insurers from the orderly liquidation provisions of the Dodd-Frank Act.

As I mentioned previously, only 22% of the rules have been finalized. So we have a long ways to go with the implementation process.

Democracy is Not a Spectator Sport

To conclude, as an industry, we are and need to continue proactively working with customers, shareholders, legislators and regulators to make sure the changes are

done right. Our job is to finance the economy – consumers and businesses alike – within the framework of the regulatory system. As one last final thought, I will say that democracy is a participatory sport. As we near the 2012 election, I encourage you to get involved in the process as private citizens and within your companies. The outcome is up to you.

[Questions]

To close, I'm going to leave you with the story of a Chinese philosopher whose student presented him with a conundrum. The student said, "In this hand, I have a small delicate bird. Is it dead or alive?" The Chinese philosopher knew it was a conundrum. If he said the bird was dead, the student would open his hand and let the bird fly away. If he said the bird was alive, the student would surely crush the bird with his fist. So the Chinese philosopher wisely answered, "The answer, dear one, is in your hands."