

M&A ACTIVITY IN THE FINANCIAL SERVICES SECTOR:

Seeking Certainty in an Uncertain World

Statement by the
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Let me begin by thanking our hosts, Debevoise & Plimpton, for all you do: convening this extraordinary conference, for inviting me to speak with you today, and most important for the professional strategic advice you provide the Roundtable and our members regarding the implementation of Dodd-Frank. We speak with them weekly, daily and sometimes hourly and have come to rely on their judgment.

Paul Lee, Greg Lyons, David Luigs and Sam Proctor provide us with insight, analysis and a tremendous amount of writing as we comment on the hundreds of regulations emerging from the Dodd-Frank Act, including issues

related to living wills, bank holding companies, thrifts, brokered deposits and so many more.

Thank you for all you do.

****INTRODUCTION*

The title of my talk is “Certainty in an Uncertain World,” but if you think I can create certainty from this, I’m sorry to say - you are mistaken.

“The only things certain in this world are death and taxes,” as Benjamin Franklin said. And today, even the shape of taxes is uncertain.

In terms of financial services, certainty is a desired direction, not an end result these days. I cannot predict how the industry is going to look in five or ten years. But some pretty clear trends are taking shape. My goal is to give you the big picture, forecast the trends, and perhaps describe how they could impact the M&A landscape.

Ordinarily, I would give you three takeaways. That’s what they taught me in Speech 101. Unfortunately, this is an unordinary time. In fact, last time I gave a speech similar to this, I had 20 conclusions.

The good news is this is a high-level crowd, and I got it down to eight points. But that involved leaving a whole bunch out – like the Volcker Rule,

derivatives, executive compensation, whistleblower provisions, and others. So if you want to talk about any of those, we can discuss them in questions.

As for the main eight, I'm going to run through them pretty fast....

FIRST, capital is king. Our companies have increased capital by 30% over the last three years as a result of regulatory requirements, stress tests, market discipline, instruction by shareholders, common sense, and leadership by the industry. Jamie Dimon's early pronouncements about a Fortress Balance Sheet turned some heads.

Most everyone agrees that increased capital is a good thing. It increases stability and makes our system stronger. The problem is, you actually can be too rich or too thin, and too much capital required has the potential to sink the economy by choking off lending.

Today, banks need 6% of Tier I capital to be considered well capitalized. Under Basel III, the base Tier I capital number will rise to 8.5%.

Then, Basel III allows for the regulators to demand up to an additional 2.5% in a "counter-cyclical" cushion. So, a bank may be required to hold 11% in Tier I capital under Basel.

On top of all this, some banks may be required to hold what is fondly known as a “SIFI surcharge.” This surcharge is currently rumored to be as high as 3%.

So, if all of these layers were applied, the required Tier I capital would be 14%, two and a half times the amounts considered well capitalized today.

But the increased ratios only tell part of the story. What is not widely recognized is that the underlying Basel III measurements are much more conservative than before. In other words, even if the required ratios stayed the same as today, achieving those ratios would be far more burdensome.

Not only is the rock that bankers push up the hill more than doubling in size, the grade is getting steeper too, and the hill is twice as tall.

This added burden will significantly limit lending, diminishing the ability of banks to finance the economy. We do want safety and soundness; but we also want a robust economy.

From an M&A perspective, the result of ever-increasing capital requirements means that those companies that already *have* significant capital access will do well. Those that don't - won't.

SECOND, banks have the potential of significantly reduced revenue - thanks to the Durbin Amendment. The Durbin amendment is the single

most destructive provision in the Dodd-Frank Act. It places price controls on debit cards. And amazingly, it never had any nexus to Dodd-Frank in the first place.

Debit cards are extremely popular. Consumers love them, merchants benefit from them, and the system is competitive.

In response to the Durbin amendment, the Federal Reserve will slash bank earnings by \$15 billion a year. The result will be consumers will pay for what is now free, banks will limit debit cards in the first place, merchants will actually have higher costs in processing cash, checks and credit cards, technological innovation in this space will cease in this space, and fraud will increase.

My belief is at the end of the day, Congress will reverse debit card price controls, but I don't know when.

THIRD, compliance is costly. The cost of just existing in the banking business is going up, by a lot.

One original goal of regulatory reform was to consolidate agencies, making oversight and rulemaking more streamlined and effective. Instead, as you know, Dodd-Frank created 300 rulemakings and studies, and two new rule-making bodies.

For the sake of time, I'm going to focus on those two: the Consumer Financial Protection Bureau (CFPB) and the Financial Stability Oversight Council (FSOC).

First, an acceptance of responsibility: As I and others in the industry have said many times, in the events leading up to the crisis, consumer protection was compromised - in some cases, severely. Some banks made loans that could not be repaid, some borrowers borrowed money they could not repay, and too often regulators looked the other way.

The good news is the industry has corrected itself, and while we are not perfect, we do put fairness and good underwriting standards at a high place in practice.

And the other good news is we will have an agency, the CFPB, that will focus on provide consumer protection. The CFPB has some problems in its structure, but it does provide for consumer protection in a uniform way, crossing state lines and all types of charters. And the CFPB does create a presumption for plain language.

In fact, just last week, the CFPB presented its new mortgage disclosures, consolidating TILA and RESPA, which were a "breath of fresh air." Now, no doubt there are always details to be argued over, – but if we – the government

and the industry – can't get a simplified disclosure for homebuyers, then we're not worth our weight in salt.

Here are a few details of TILA/RESPA proposal:

- Uniform across state lines
- Uniform across charters
- Pre-empt state laws
- A one-page, consumer-friendly disclosure
- Combine TILA/RESPA, two statutes which at least purport to do the same thing
- Be the same disclosure for consumer commitment as for closing.
- AND the boilerplate language would be moved off-site, as to not complicate the single page.

This is good news. The CFPB has a potential for good.

So what's the problem?

First, CFPB's broad authority is virtually unlimited. Unlike other similar statutes authorizing, regulation, in this case the Director is provided open ended authority to protect consumers. The decades of established case law and rule

writing concerning “unfair and deceptive practices” are upended with the undefined term “or abusive”.

Second, the Director unilaterally determines the Bureau’s expenditures, with neither Congressional nor OMB oversight.

Third, and worst, the Director unilaterally determines the regulations and the enforcement actions. One person. No appeal. No review. As Senator Bob Corker said the other day, “Hell, I wouldn’t give myself that much power”. That is contrary to virtually all other Federal agencies whose decisions are made by Boards: Think SEC, Federal Reserve, FDIC, FTC, CFTC, FEC, FCC. Or if it’s a department, the OMB and ultimately the President and Congress can override.

And one more point to ponder: the term “abusive practice” is undefined in the statute, and described in legislative language as determined based on consumer understanding – not actual disclosure.

We in the industry are not seeking to repeal the CFPB. In fact, we accept it and welcome its consumer protection features. But the current statute does call out for some clarity and restrictions on its unlimited authority. Several improvements could be made. The most likely and most important would be to place its governance into a 5 member Board.

Regarding the Financial Stability Oversight Council – or FSOC, the FSOC has designated 36 bank holding companies as systemically important, or “SIFIs” as we call them. Truth be known perhaps a third of those are not in fact systemic, but they will be regulated as if they are, creating significant and counterproductive compliance costs. Those smaller SIFI’s will be impelled to get a lot larger, or a bit smaller.

Further, designation process for *nonbank* SIFI’s has been anything but transparent. Transparency seems to only come in the limited appeals process following the designation. Additionally, appointments for the FSOC, particularly the insurance slot, are still incomplete, after almost a year which has many insurance companies frustrated, understandably so.

Designation, however, is not the biggest cost. It is what happens *after* the firms are designated. “SIFIs” will be subject to increased prudential standards and other restrictions, such as more frequent stress tests and living will requirements. Possibly the trickiest question is how any of these standards will apply to nonbanks who already have their own system of oversight in place.

Additionally, in terms of compliance, the industry at large is preparing for the ricochet effect from FSOC. If FSOC sets a 12% capital level for large

banks and it works well, those same prudential standards could be demanded for smaller firms.

So, what can you conclude from an M&A perspective about FSOC?

If you have a company right on the threshold of \$50 billion, logically that company will likely get a whole lot bigger, or they will sell off assets so that they don't have to comply with the additional mandates of being a SIFI.

And the costs of compliance for SIFI's are likely to be quite high.

OVERALL, the cost of additional compliance from FSOC, CFPB, SEC, CFTC are mandatory. Agency requests are not questions or hypotheticals. We at the Roundtable recently surveyed our companies and identified 165 separate periodic data reports from 16 financial regulatory agencies. And that is before Dodd-Frank.

Most analysts would conclude that a midsize bank with \$300 million in assets or so probably can't afford to pay for this additional compliance. Time will tell, but it's not good news for a smaller firm.

FOURTH Point, implementation is not free. In addition to complying with the rules issued in light of Dodd-Frank, it is also the responsibility of the industry to *proactively shape the rules*. At the Roundtable, we are knee deep

into the comment process; The Roundtable has filed over 80 comment letters in the last 8 months. That compares with an average of 15 per year in prior years.

I'm not asking for relief because it's important to comment on everything – because that's how this process was designed. While some Congressmen are financial services experts, most are not. While some regulators have worked in financial institutions at some time, others have not.

It is the industry's responsibility to make sure these rules actually work in practice.

As different types of companies express how different rules will impact them, the companies that have the most resources dedicated to this process will be the ones that are heard. Those will be the companies best suited to the new regulatory regime, and these will be the companies making acquisitions in the future. Other companies may decide that they can't keep up, and they will pursue different lines of business.

FIFTH, the future of the Dodd-Frank Act

Let me say here and now, that financial services companies will continue to start-up, and innovate, grow, and be successful in America. That's what we do. We have some incredible companies here and regulators who are really trying to be thoughtful in their implementation of rules.

The Dodd-Frank Act is here to stay. To go back to the Benjamin Franklin quote, there are three certainties in this world, “Death, taxes, and Dodd-Frank.” Companies will need to be well-resourced, adaptive, and come to grasp the new regulatory reality. But Dodd-Frank has massive breadth, was drafted in a breathtakingly short period of time, and can be improved.

Here’s my FEARLESS PREDICTION: In Fall 2011, there will be Congressional oversight hearings to improve the Dodd-Frank Act. No doubt these hearings will have some raw edges, but no one will try to repeal Dodd-Frank, and no one should insist it is perfect.

My belief is over the fullness of time, legislative improvements will be introduced, fully debated, and adopted into law. That could happen as early as Spring of 2012 or as late as end of the year 2013. But it will happen. Once the raw edges of politics get out of the way, policy will drive some reforms. My request to you is to make a list of these improvements yourself and start communicating them to your elected officials.

Some of the Roundtable’s suggested improvements will include:

- Decriminalize Compliance Officers
- Prioritize Regulations and Revise Rulemaking Deadlines.
- Streamline Data Reports.

- Eliminate some of the silly extraneous stuff, such as Section 953 which requires all public companies to report the median salary of all employees.
- Require whistleblowers to make a good faith attempt to internally report problems before seeking the bounty.
- Reinstate arbitration clause in several places.
- Harmonize prudential standards with international standards.
- Provide for an independent chair for the FSOC.
- Give FSOC oversight of FASB for safety and soundness.
- Modify the prohibition of use credit ratings
- Expand qualified mortgages to include 10% if properly underwritten.

This is just a partial list of changes I believe will be and ought to be considered. The process will be transparent and widely debated. And I believe will result in a better statute.

As important as Dodd-Frank is, a few other issues are in the big picture in Washington.

The Debt Limit is all-consuming in Washington right now.

While extending the debt limit borrowing authority is the imminent trigger for this summer's pending drama, the underlying issue of the federal debt, largely driven by entitlement spending and increasing health care costs is what is important. You have all heard the statistics:

Federal debt is now at an astounding 62% of GDP. The Congressional Budget Office projects that if we continue on our current course, federal debt will reach almost 90% of GDP by 2020. By 2025, government revenue will only be able to finance interest payments, Medicare, Medicaid, and Social Security. Clearly that is an unsustainable course.

So in a way, we are fortunate to have this pending debt limit deadline. The good news is I believe Congress and the President will reach agreement to both extend the debt limit *and* to adopt structural fiscal reforms to put a cap on spending, to gradually reduce deficits over a predetermined period of time, and to provide a framework for entitlement reform. Both need to be done. The US can neither afford to default on our bonds, nor can we afford to ignore the pending fiscal crisis of deficit spending in such alarming proportions.

Things might get testy this summer, but I do believe leadership of both the House and the Senate and the President will reach an agreement.

I can elaborate more in questions.

The next Big Picture Item is corporate tax reform. In my opinion, it will happen sooner as opposed to later.

The current rates are simply not sustainable. At 35%, the United States has the highest statutory corporate tax rate in the OECD - impacting our nation's investment, competitiveness, and economic growth.

We also have a worldwide taxation system, which basically means that companies can choose their taxes by country. But worse, while we first encourage corporations to park their earnings in low tax rate countries, we then declare it virtually "Hotel California", stranding capital in those countries for all time.

There's nothing about the current tax system that makes sense. That's not just me talking, that's President Obama, Representative Paul Ryan, the National Commission on Fiscal Responsibility and Reform, Senate Finance Chairman Max Baucus, Ways and Means Chairman Dave Camp and more.

What will likely happen is that we'll see corporate tax reform by 2013. We'll see a substantial decrease in the nominal rate, an elimination of many existing exemptions, and a territorial taxation system, where those funds can be repatriated into the United States. And that will be good news for the US economy.

And one more, the inaction on outstanding trade agreements borders is madness.

The United States has had pending trade agreements since 2007 with Colombia, Panama, and South Korea. According to a study by the U.S. Chamber, this has put 380,000 American jobs in jeopardy. This is unforgiveable.

The vast majority of the world's purchasing power (73%), economic growth (87%), and consumers (95%) are *outside* of the U.S. – but that's the reality. We are an increasingly small island.

More than 100 market-opening trade agreements are under negotiation worldwide. The United States is at the table in just one of these. **AND** there are 262 free trade agreements in force around the globe today, but the United States has free trade agreements with just 17 countries.

This summer, Congress will finally consider those agreements, which is long-overdue. It's been 4 years since the agreements were signed in good faith, and ratification is necessary for all kinds of reasons.

Thank you for your attention and for your commitment to good public policy on behalf of you clients. At this point I will take questions on any of the

topics I have raised, or if you'd like to know how John Boehner and Barack Obama really get along or any other topic, just ask.

Questions and answers

I'm often approached by bankers and insurers who ask what they can do to succeed in this reality. How can they keep their companies competitive? How will American financial services companies fare globally?

I tell them this story: There's a 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."