

10 Minutes on US Financial Reform

What you need to know about emerging topics essential to your business. Brought to you by PricewaterhouseCoopers.

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What evolving financial reform means for US businesses

Highlights:

- In reforming the financial system, the Dodd-Frank Act introduces new regulators and extends regulation over new markets, entities, and activities.
- Regulators get expanded authority to define which financial firms are systemic — those which by their size, scope, and interconnectedness with other institutions can pose risks to the entire system.
- Corporate end-users should monitor the development of rules on over-the-counter derivatives that could affect their hedging activities.
- The Act emphasizes stronger consumer and investor protections and begins to address the orderly resolution of large failures in ways that limit losses to taxpayers.

The Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act or the Act) just signed by President Obama ushers in a new financial regulatory architecture. To be sure, it promises to significantly change the way financial institutions conduct business. But beyond Wall Street, what are the implications for Corporate America? While not clear cut as yet, the impact may be far reaching.

Of chief concern to business leaders: How will the Act affect my company's ability to fund its needs, maintain liquidity, earn competitive rates on cash and investments, manage commodity and financial risks through derivatives, and provide financing to my customers?

The way that financial firms advise corporate customers on a host of financing activities — M&A, raising debt and equity, creating structured products, and financing international trade — may also change.

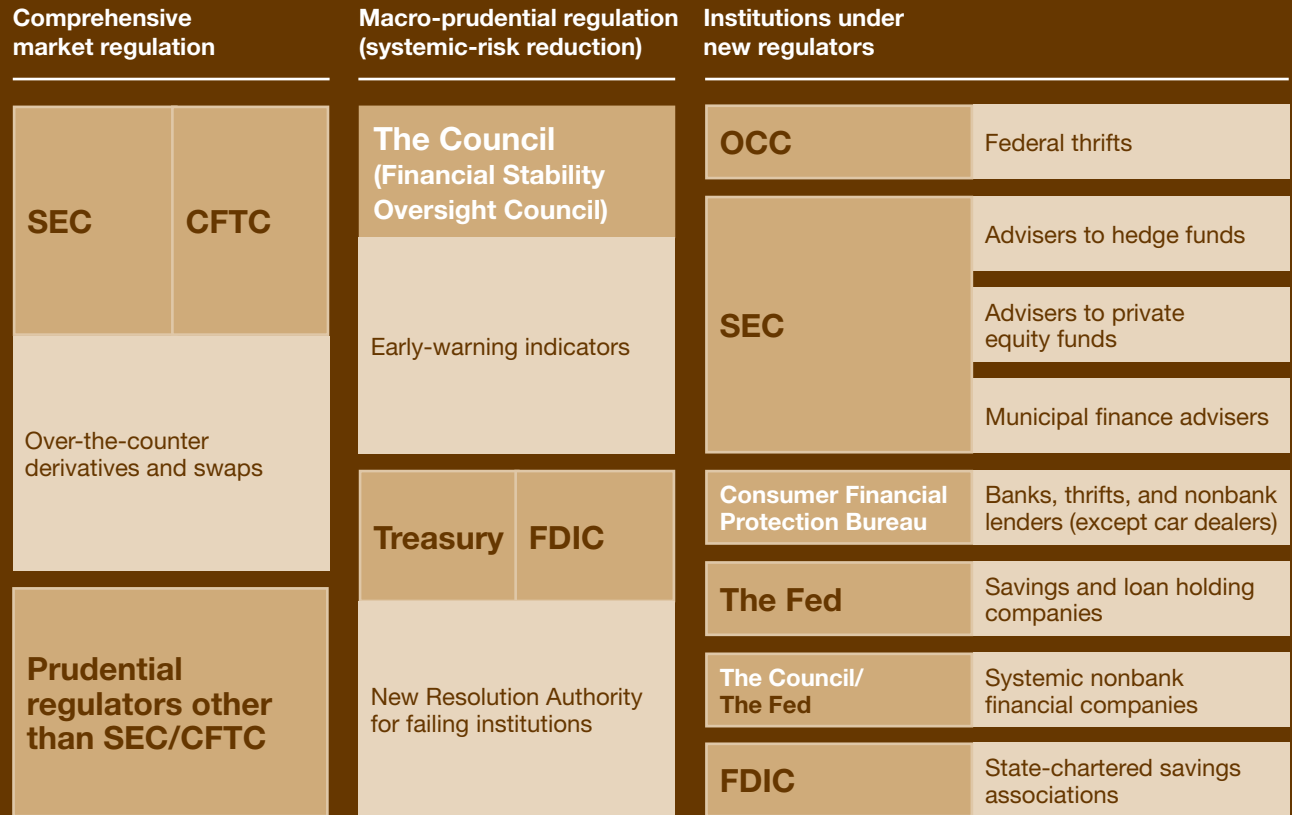
True impact to unfold over several years

- While the framework of the reform has a clear shape, the law requires more than 533 rules, 60 studies, and 93 reports — over the next four years — to clarify and implement the Act's requirements.
- Banks and nonbank financial companies will need time to assess impacts on their operations, risk management, regulatory reporting, corporate governance, and compliance.
- The burden will fall heaviest on large, diversified financial holding companies and those entities that will be subject to new and broader areas of regulation, such as advisers to hedge funds and private equity funds by the Securities and Exchange Commission (SEC), as well as systemically important institutions by the Federal Reserve.
- How quickly financial institutions and other affected organizations adjust, in turn affects the pace and magnitude of the impacts on corporate users.

At a glance

The new financial regulatory architecture

The Act significantly reshapes financial regulation by regulating new markets, creating new regulators (as labeled in white below), bringing new firms into the regulatory arena, and providing new rulemaking and enforcement powers to the regulators.



Snapshot of the new rules

Figure 1. The work ahead: rulemaking to implement the Dodd-Frank Act

| Rules by agency | Number of rules |
|---|-----------------|
| Securities and Exchange Commission | 205 |
| Consumer Financial Protection Bureau | 70 |
| Commodities Futures Trading Commission | 54 |
| Federal Trade Commission | 45 |
| Federal Reserve | 30 |
| Government Accountability Office | 19 |
| Federal banking agencies | 17 |
| Treasury | 15 |
| Federal Deposit Insurance Corporation | 11 |
| Board of Trade | 9 |
| Financial Stability Oversight Council | 6 |
| Federal Institution Examination Council | 5 |
| Prudential regulators | 5 |
| Office of the Comptroller of the Currency | 4 |
| Federal Courts | 1 |
| Federal agencies | 1 |

Source: PricewaterhouseCoopers analysis based on Chamber of Commerce, <http://www.chamberpost.com/2010/07/financial-regulatory-reform-uncertainty-grows.html>, July 2010.

The Dodd-Frank Act creates new regulators, regulates new markets, brings new firms into the regulatory arena, and provides new rulemaking and enforcement powers to existing agencies.¹ It is designed to address risk at two levels.

Macro-prudential focus: addressing risks to the system

The focus on financial stability is built on a series of provisions: (1) to identify at an early stage any issues of systemic concern at large institutions in the financial system, (2) to require more stringent regulation of systemic firms so they don't find themselves in situations where capital or liquidity are threatened, (3) to provide regulators the ability to break up large firms when they pose a grave danger to the financial system, and (4) to have in place the means for an orderly resolution of large nonbanking financial companies in ways that should not expose the taxpayer to loss.

Micro-prudential focus: addressing risk at individual institutions

As one way to encourage more prudent risk-taking, the Act requires that banks and

other originators of assets for securitization keep at least 5 percent of the credit risk of securitized assets on their balance sheets, except for low-risk mortgages.

Comprehensive oversight

The Act also replaces the existing regulatory framework—a patchwork of agencies and rules—with a more centralized approach. Oversight of bank, financial, and savings and loan holding companies, plus systemically important nonbank financial companies will be centralized within the Federal Reserve (Fed). Regulation of federally chartered banking institutions will be consolidated into the Office of the Comptroller of the Currency (OCC).

New investor protections

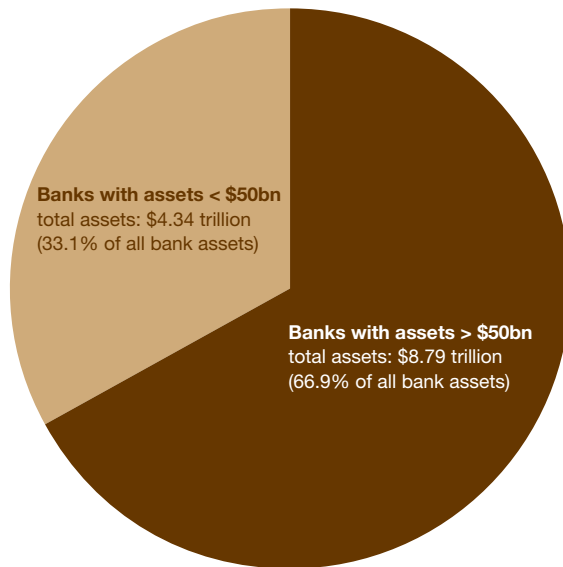
The Act also includes expanded regulation targeted at the so-called “shadow financial system.” The Act calls for regulation and collection of more information on advisers to hedge funds and private equity funds, as well as increased transparency regarding derivatives.

¹ For an overview of the Act, see PricewaterhouseCoopers, *Financial Regulatory Reform—The New Regulatory Architecture—Will it be a Global Blueprint?*, Financial Services Regulatory Highlights Special Edition, June 2010.

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Sizing up the impact on your business

Figure 2. Systemically important banks hold the lion's share of total industry assets



Source: PricewaterhouseCoopers analysis based on FDIC data.
Note: Data refer to end-of-year 2009.

Could your organization be subject to enhanced regulation?

To be designated as *systemic*, the following criteria apply:

- Bank holding companies (BHC)—Those with total consolidated assets of \$50 billion or more are automatically designated as systemically important. These include the top 36 BHCs.
- Nonbank financial companies—To be designated as systemic by the Financial Stability Oversight Council (Council), a US or foreign company must be “predominantly engaged” in financial activities in the United States. This means at least 85 percent of its annual gross consolidated revenues, or at least 85 percent of its consolidated assets, are derived from *external* financial activities.
- Insurers—The Federal Insurance Office makes recommendations to the Council, as to which insurers, including their affiliates, are systemically important.

Could enhanced capital requirements on systemic institutions increase your cost of credit?

While the true impact on cost of credit is not yet known, there are a number of factors in play. The Fed will establish

prudential requirements—either on its own or by recommendation of the Council—for systemically important bank and nonbank financial institutions. These include risk-based capital requirements and leverage limits that are “more stringent” than those applicable to non-systemic firms. The Fed may also differentiate among companies or by category. For example, it could decide capital requirements are not appropriate for asset management companies.

The Collins amendment to the Act applies the same leverage and risk-based capital requirements to bank holding companies and systemically important nonbank companies that apply to insured depository institutions.

A significant increase in both the amount and the quality of capital is also being considered by the Basel Banking Committee. But Basel members intend to phase in the new standards over a timeframe that is consistent with “sustained recovery and limited market disruption,” aiming for implementation by the end of 2012. The economic impact of higher capital will be considered in the transition mechanism.²

² PricewaterhouseCoopers, *Response to Basel Committee on Banking Consultative Proposals to Strengthen the Resilience of the Banking Sector*, April 2010.

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Understanding how the new derivatives regulation affects corporate users

The Act's new derivatives regulation bears particular scrutiny by businesses. More than 90 percent of Fortune 500 companies and half of mid-sized firms use derivatives to hedge their day-to-day business risks, from interest rates to the price of oil.³

Under the Act, over-the-counter (OTC) derivatives will be regulated by the SEC and the Commodities Futures Trading Commission (CFTC). More transactions will be required to go through central clearinghouses and trade on exchanges. Swap dealers and major swap participants will be subject to capital and other prudential requirements, and all trades will be reported so that regulators can monitor risks and improve transparency in this complex market.

During consideration of the Act, many large corporations expressed concern about a number of issues: (1) the reach of mandatory clearing or exchange trading requirements, (2) the cost and availability of cash collateral they would have to post on a daily basis to protect clearing entities from the potential credit exposure on trades, and (3) that the standardization of contracts associated with exchanges would afford them less

protection than the customized contracts available in the OTC market.

To address these issues, the Act excludes from the definition of major swap participant a company that uses swaps to hedge or mitigate commercial risk. It also excludes from the clearing requirement, derivatives involving at least one counterparty that is not a financial entity, where the counterparty is using the derivatives contract to hedge commercial risk and notifies the CFTC or SEC as to how it generally meets its obligations under non-cleared contracts.

Unresolved corporate concerns

Last-minute changes in the wording of the Act were made, which could lead to margin requirements for all OTC derivatives that are not cleared. The original text of the Act would have explicitly exempted corporate end-users from margin requirements on such transactions.

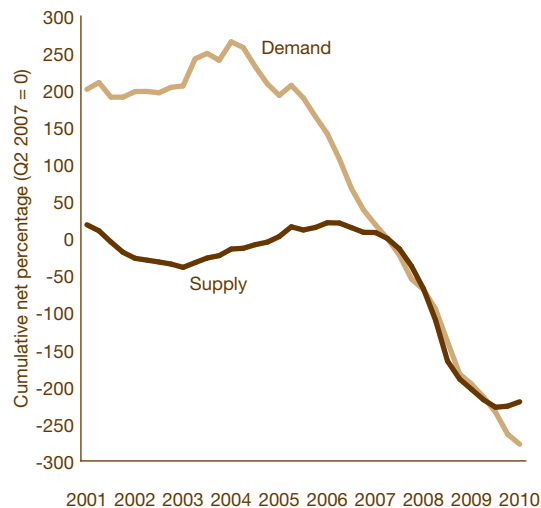
This and other technical issues are likely to be addressed in a Technical Corrections Bill, which appears almost certain to be considered by Congress at some point. Other interpretations will have to come from the regulatory agencies through the rulemaking process.

³ PricewaterhouseCoopers, *OTC derivatives: Should all customized derivatives be standardized?*, Point of View, July 2009.

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Assessing the impact on confidence in the financial system

Figure 3. Consumer loan supply has bottomed out, but demand is still falling



Supply is the cumulative net percentage of domestic respondents reporting increased willingness to make consumer installment loans. Demand is the cumulative net percentage of domestic respondents reporting stronger demand for consumer loans.

The indices have been standardized by setting the respondent average during the pre-crisis period (data from Q1 1990 to Q2 2007) equal to zero.

Source: PricewaterhouseCoopers analysis based on data from the Federal Reserve Senior Loan Officer Survey.

Will better consumer protection help lift credit demand?

A new Consumer Financial Protection Bureau, housed in the Fed but led by an independent director, will be devoted to protecting consumers in virtually all financial products. This feature of the Act, as well as provisions for mortgage reform, are intended to restore consumer confidence in the fairness of the credit process by targeting certain abuses that occurred in mortgage lending by certain firms. The intent is to make consumers more willing to borrow.

The Act also includes potentially significant changes in the amount of interchange fees that banks can receive in connection with debit card transactions. When combined with the number of consumer credit reforms that were passed over the past 12 to 18 months on credit cards and overdraft fees, banks may be feeling a squeeze on the profitability of their consumer business.

The ultimate effect on the cost of credit and consumers' willingness to borrow depends on, among other things, the ability of banks to modify their retail business model in order to sustain profitability.

How will a flare-up of systemic risk be handled differently in the future?

A guiding principle throughout the Act's legislative process was to arrive at a set of reforms that would make the "too big to fail" scenario remote, if not impossible. The Act calls for developing an orderly process outside the bankruptcy courts for the seizure, winding up, and liquidation of systemic nonbank financial institutions.

Next year, the Administration and Congress will consider reforming Freddie Mac and Fannie Mae. With the recovery still considered fragile, addressing the status of these government-sponsored entities (in conservatorship) in this Congress would have added more complexity to the adjustments that banks and nonbanks have to make post-reform.

Financial reform on the international agenda

In changing the fundamental tenets of regulation, the Act aims to establish principles and standards that the Obama Administration will urge other nations to follow. G20 and Basel, among others, will also shape the eventual new architecture of financial regulation.

Upcoming 10Minutes topics

From crisis mode to sustainable efficiency

Companies have yet to ease up on cost-reduction measures, and many are now rethinking their operating models to deliver more value at lower cost. 10Minutes looks at how companies are embedding lessons from the crisis into more-disciplined management of corporate performance.

The changing face of financial reporting

Standards setters have proposed fundamentally changing the ways in which public companies gather and display financial data for investors and the general public. 10Minutes discusses what's changing and how it will affect your company's systems, processes and controls, key financial ratios, operations, and shareholder communications.

Emerging technologies: Balancing IT security risk and business return

Emerging technologies have great potential for spurring breakthroughs in productivity and innovation. But they often pose new risks, including IT security challenges. Instead of slowing down the company's ability to take advantage of new technologies, boards and CEOs can arm themselves with fundamental questions to ask about their company's ability to manage IT security risks.

How PwC can help

To have a deeper discussion about the implications of financial reform on your business, please contact:

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Over the next weeks, months, and years, this landmark legislation will be implemented by federal regulatory agencies whose task will be to parse the language of the law, consider its legislative history and purpose, and achieve the intended results. Future PwC papers will continue to analyze the new law, the numerous mandated studies, and the resulting implemented regulations.

To follow updates on financial reform, please visit:
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