Weekly Market Commentary

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Financial Regulatory Reform

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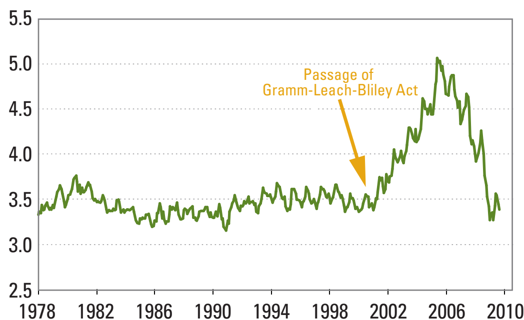
Highlights

- This week marks the 10th anniversary of the passage of the Gramm-Leach-Bliley act (passed November 12, 1999). This financial "reform" act helped to sow the seeds of the recent financial crisis by effectively repealing the Great Depression-era Glass-Steagall act of 1933.
- With sweeping financial industry reform again on Washington's agenda our enthusiasm for the financial sector is limited since it is difficult to quantify the risks and understand the earnings power going forward. Financials have been the worst performing sector in the S&P 500 in the fourth quarter.
- The currently proposed reform measures have the potential to limit future financial crises; however, they also pose the threat of unintended negative consequences over the long-term, as Gramm-Leach-Bliley did.

1 Passage of Financial Reform 10 Years Ago Helped Inflate Housing Bubble
Median Home Price divided by Median Family Income



Source: LPL Financial, Census Bureau, National Association of Realtors

This week marks the 10th anniversary of the passage of the Gramm-Leach-Bliley act (passed on Nov. 12, 1999). This financial "reform" act helped to sow the seeds of the recent financial crisis by effectively repealing the Great Depression-era Glass-Steagall act of 1933. The Glass-Steagall act had separated lending and investing for many decades after combining both activities in the same financial institution had led to abuses that threatened the stability of the financial system and worsened the Great Depression. The financial "reform" act passed 10 years ago this week allowed for consolidation between commercial banks, investment banks, and insurance companies, blurring the distinctions between lines of business and regulatory oversight. The unintended outcomes of this transformation was an explosion in the volume of mortgage originations and the use high amounts of leverage by investment banks that ultimately threatened the stability of the financial system.

Proposed Reforms

With sweeping financial industry reform again on Washington's agenda what should investors be watching? Last week, the House Financial Services Committee took up debating the major proposals. The big issues to be debated in the coming months include:

- **Too-big-too-fail institutions** - A proposal would create a designation for financial institutions that are systematically important and subject them to special regulation. The outcome of this legislation is likely to have a market impact. At first glance, this designation would give an institution a competitive advantage because it would have what amounts to Government Sponsored Enterprise status with an implied government guarantee. This competitive advantage for Tier 1 institutions to access capital cheaply may result in consolidation of the industry among a few systemically important institutions rather than a larger number of competitors that would pose less individual risk to the financial system – which would be counter to the intention of the legislation. However, the additional cost to these firms in the form of higher capital requirements, contributions to pre-fund a bailout fund, and the threat of a break-up may have negative consequences. Last week, the UK regulators forced Royal Bank of Scotland to sell some business lines to reduce the size of the institution and the stock reacted poorly falling over 10% in a couple of days. Clearly, how this issue is dealt with is very important to the financial services industry. This is the most contentious issue and is unlikely to be resolved before the end of the year resulting in lingering uncertainty for the sector.

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- Consumer Financial Protection Agency - The Obama administration has proposed the creation of a new agency intended to protect consumers purchasing financial products. The focus has shifted from regulating the types of products that can be sold, (which would eliminate complex financial products and ensure only plain vanilla products are marketed) to making sure the disclosure is appropriate on products that are more complex. The reach of this agency to regulate what products are sold, how they are marketed, and perhaps even how they are priced is critical to the size and profitability of the financial industry. This could be a positive for the sector if it lessens the risk of default or litigation risk for lenders, but presents challenges if it forces consolidation as the products become commoditized.
- Consumer Lending Rules - Last Wednesday, the House passed a bill by a wide margin to move up the start date to limit banks' rate increases on existing credit-card balances. The Financial sector swooned by a few percentage points as soon as the bill passed. There will be increased scrutiny of many of the lines of lending from credit cards to student loans.
- Credit Default Swaps - Right now, many derivative agreements are private one-on-one contracts in what is called the over-the-counter market. These opaque transactions are outside the view of the public or regulators and are dependent upon the parties remaining solvent. If one party becomes insolvent, it may take the other with it. This lack of transparency in volume, size, and counterparties proved disastrous in the financial crisis. In the bailout of American International Group, tens of billions of dollars went to settle these contracts to avoid a domino effect. The reform proposals require that many derivatives be traded on public exchanges providing transparency on the volume and size of the market and providing each party an exchange whose creditworthiness would be backed by the entire industry. Forcing these contracts to be traded on an exchange may limit the risk they pose to the financial system.
- Consolidation of bank regulators – Currently, there are four major bank regulators: Office of the Controller of the Currency (OCC), Federal Reserve (Fed), Federal Deposit Insurance Corporation (FDIC), and Office of Thrift Supervision (OTS). We think it is most likely that the OCC and OTS are merged into a new National Bank Supervisor (NBS), but more aggressive consolidation is also possible. Senator Christopher Dodd's recently proposed combining all four and stripping the Fed and FDIC of their regulatory functions. In addition, there are proposals to merge other agencies involved in the regulation of financial markets, including the Security and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). Also, non-federally regulated financial institutions (such as AIG and Countrywide) were prime contributors to the financial crisis. Bringing these financial institutions under the scrutiny of the federal regulatory umbrella is likely to be part of the consolidation.
- Systemic risk regulator – The gaps in the patchwork of financial industry regulators contributed to the series of failures that led to the financial crisis. The Obama administration's proposal to grant enhanced authority to the Fed to oversee overall financial system risk appears to be losing favor to the idea of creating a Financial Services Oversight Council to make

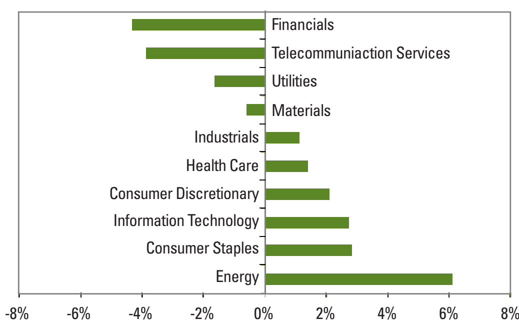
recommendations on preventing systemic risk. This is very likely to get passed in some form.

- Other measures include requiring hedge funds to register with the SEC, restructuring Fannie Mae and Freddie Mac, and increasing SEC regulation of the credit rating agencies and even consider changing their business model.

Financial Sector Caution

2 Financials are Worst Performing Sector so far in Fourth Quarter

S&P 500 Sector Performance Quarter-to-Date



Source: LPL Financial, Bloomberg

The S&P 500 Index is and unmanaged index which cannot be invested into directly. Past performance is no guarantee of future results.

The uncertainty surrounding the outcome of the pending legislation and regulatory changes keeps a lid on our enthusiasm for the sector since it is difficult to quantify the risks and understand the earnings power going forward. These risks may be impacting the performance of the sector. The financial sector led the market to the downside during the bear market and to the upside in the rally since the March 2009 low. However, Financials have been the worst performing sector in the S&P 500 in the fourth quarter even as the economy has continued to strength and credit markets improve.

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Long-Term Threats Posed by Reform

Beyond the performance of the Financial sector, there may be farther reaching implications for the markets and economy. Many changes to the financial industry and institutions have already taken place such as the investment banks converting to commercial banks under the jurisdiction of the Fed, greatly reducing leverage, and revamped landing practices. The additional reform measures detailed above have the potential to limit future financial crises; however, they also pose the threat of unintended negative consequences over the long-term, as the Gramm-Leach-Bliley act did. Several potential consequences include:

1. Institutions designated as Tier 1 may have cheaper access to capital owing to their implied government-backing. This could result in industry consolidation that would concentrate the industry in the hands of fewer, larger, and more systematically important institutions rather than a larger number of smaller institutions that would pose risk individually to the financial system. If this occurred it would be contrary to the supposed intention of the legislation.
2. Stripping the Fed of its regulatory function may limit the information necessary to make informed and effective monetary policy decisions.
3. A Consumer Financial Protection Agency may politicize financial product offerings and pricing to promote social outcomes. Even without an agency dedicated to consumers the desire in Washington to promote homeownership was a contributor to the subprime mortgage boom and subsequent bust.
4. These reforms fall short of creating a global financial framework for dealing with financial crises. There is little hope of broad reforms in the near future. Europe remains divided with each country regulating its own financial industry. Without a global framework among the G20 to oversee

the global financial industry, the patchwork of regulatory oversight will remain with the potential for loopholes and the ability of institutions to seek jurisdictions with the lightest regulation.

There is some pressure to pass some reforms during the next year ahead of the November 2010 mid-term elections. These reforms are likely to have both short and long-term impacts on the markets. We will continue to respond to how the legislative and regulatory reforms evolve and influence investment decision making over the coming months and in 2010.

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Stock investing involves risk including loss of principal Past performance is not a guarantee of future results.

Small-cap stocks may be subject to higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.

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