

FINANCIAL REFORM

Some Legislation Highlights and Investment Implications

MATTHEW L. RUBIN
DIRECTOR OF INVESTMENT STRATEGY

July 23, 2010

President Obama signed into law this week the biggest overhaul of the financial industry since the Great Depression. The Dodd-Frank Wall Street Reform and Consumer Protection Act touches virtually every corner of finance, from credit card fees to derivative trades. Prompted by the 2008 credit crisis, the legislation establishes new consumer protections, subjects more financial firms to federal oversight, sets new standards for the derivatives market and gives regulators greater power to dismantle firms on the verge of collapse. Although the passage provides some degree of clarity, rulemaking is far from complete and makes the road ahead less than certain. Here, we provide a brief high-level overview of some of the features of the Act, and offer some perspective on its potential impact.

KEY ELEMENTS OF THE FINANCIAL REFORM

Highlight	Policy
Creates the Consumer Financial Protection Bureau	A new government watchdog to regulate mortgages, credit cards and other consumer financial products. Its aim is to ensure Americans receive accurate information on these products and to police hidden fees and deceptive practices.
Monitors Systemic Risks	A council of regulators, chaired by the Treasury Secretary, to monitor and respond to emerging risks in the financial system. Among other things, the council and the Federal Reserve could break up companies that threaten the financial system.
Ends Bailouts	Creates an "orderly liquidation" system so that failing financial companies could be broken up and liquidated without government bailouts. The legislation requires firms to create "funeral plans" that describe how they could be shut down quickly.
Regulates Derivatives	Over-the-counter derivatives trading would be re-routed through exchanges and central clearinghouses. Traders will be required to disclose pricing data to improve market transparency.
Restricts Bank Trading Activities	Establishes the Volcker Rule which restricts banks from proprietary trading activities and allows banks to invest only up to 3% of their Tier 1 capital in private equity and hedge funds sponsored by the banks.
Regulates Investment Advisors	Requires many more investment advisors of hedge funds and private equity firms to register with the Securities and Exchange Commission, exposing them to more scrutiny about their trades and portfolios.
Reforms Mortgage Industry	Establishes a federal standard for all home loans so that institutions must assess a borrower's ability to repay the loan before it is sold. It will also prohibit pre-payment penalties and bonuses to lenders for selling more costly loans.
Reforms Credit Agencies	Creates an Office of Credit Ratings at the Securities and Exchange Commission to provide enhanced regulation, transparency and accountability for credit rating agencies.
Includes Other Reforms	Among other things, it sets new rules on golden parachutes for employees, abolishes the Office of Thrift Supervision, creates a new federal office to monitor the insurance industry and limits the Federal Reserve's emergency lending authority.

While the final impact of the passed legislation may not be felt for some time, we believe financial markets should benefit from greater clarity.

We anticipate that the shifting regulatory environment will prompt many financial executives to transform their business models.

IMPACT ON INVESTING

For several months, the Obama administration and members of Congress have crafted legislation with the hope of promoting stability, accountability and transparency in the financial system. In so doing, however, policy makers have exerted great influence over capital market participants and cyclical economic forces. As a result, a cloud of uncertainty has surrounded financial companies and has contributed, in our opinion, to a lowering of price/earnings multiples within the sector and broader equity market. While the final impact of the passed legislation may not be felt for some time, we believe financial markets should benefit from greater clarity and companies will be able to make changes to their business plans now that the “ground rules” have been established.

Still, just as the legislation prompted intense debate and wrangling by Democrats and Republicans, so too does the topic of its ultimate impact on the financial markets as a whole. Democrats say the law will restore investor confidence in the U.S. financial markets, protect consumers and reduce the odds of another crisis hitting the economy. Republicans say the law could jeopardize the recovery by hampering the banking industry, creating vast new bureaucracies and undermining the competitiveness of the American economy.

IMPLICATIONS FOR FINANCIAL STOCKS

While the effect of the reform varies by sub-sector within the financial industry, we anticipate that brokers and the money center banks could be potentially the most negatively affected by the regulatory changes, as most of the reforms affect capital markets businesses, consumer businesses and large companies. The trust banks, however, should be the least affected.

Overall, we anticipate the final impact on banks’ earnings to eventually be reduced as there will be offsets from repricing products or exiting unprofitable segments. Other products will also change as higher capital charges or lower flexibility to price for risk are taken into consideration. To the extent that banks exit certain businesses, capital will be freed up which can be redeployed.

Since the director of the Consumer Financial Protection Bureau (“the Bureau”) will be a presidential appointee, the Bureau could be potentially harmful to the profitability of consumer businesses. However, changes in government could determine how powerful the Bureau really is. We anticipate that the shifting regulatory environment will prompt many financial executives to transform their business models and many legislators will roll back or amend some rules that are not working.

LOOKING AHEAD

To some, the law’s passing is just the beginning of the process as it could be heavily influenced by lobbyists and take years to implement. The devil is in the details, with hundreds of new rules to be created and new regulators to be appointed. There is also a long implementation period for many key provisions such as the Volcker Rule, which will give companies enough time to adjust their business models. As details of the regulations evolve, we will continue to anticipate and evaluate the investment implications.

Source: Dodd-Frank Wall Street Reform and Consumer Protection Act.

This material is presented solely for informational purposes and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation or solicitation to buy, sell or hold a security. Investing entails risks, including possible loss of principal. This material has been prepared by Neuberger Berman on the basis of publicly available information, internally developed data and other third-party sources believed to be reliable. Neuberger Berman has not sought to independently verify information taken from public and third-party sources and does not make any representation or warranty as to the accuracy, completeness or reliability of the information contained herein.

No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were, or will be, profitable. All information is current as of the date of this material and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole. Publications referenced herein are intended solely for your information and should not be construed as an endorsement by Neuberger Berman. Neuberger Berman is not responsible for the content of these publications or to update this information. Third-party economic or market estimates discussed herein may or may not be realized and no opinion or representation is being given regarding such estimates. Certain products and services may not be available in all jurisdictions or to all client types. Data is not representative of any Neuberger Berman investment product or service and does not reflect the fees and expenses associated with managing a portfolio. Indexes are unmanaged and are not available for direct investment. Unless otherwise indicated, returns shown reflect reinvestment of any dividends and distributions. Investing entails risks, including possible loss of principal. Past performance is no guarantee of future results.

Neuberger Berman Asia Limited 紐伯格伯曼亞洲有限公司 is a Hong Kong incorporated investment firm licensed and regulated by the Securities and Futures Commission of Hong Kong; it is registered as a foreign company under the Corporations Act 2001 (Australian Registered Body Number 137189176).

This material is issued for use in Europe by Neuberger Berman Europe Limited which is authorized and regulated by the UK Financial Services Authority ("FSA") and is registered in England and Wales, Lansdowne House, 57 Berkeley Square, London, W1J 6ER. Neuberger Berman LLC is a registered Investment Advisor and Broker-Dealer. Member FINRA/NYSE/SIPC.

K0384 07/10 ©2010 Neuberger Berman LLC. All rights reserved.