



Merganser Investment Memorandum

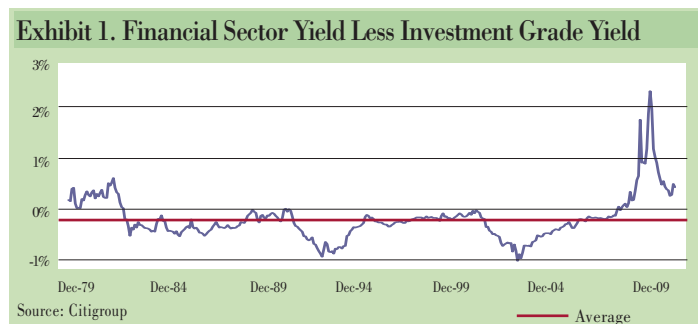
Financial Regulatory Reform: Implications of the Dodd-Frank Act

Summer 2010

The Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) was signed into law on July 21, 2010. The new legislation is intended to address the conditions that led to the near collapse of the US financial system during the credit crisis. In essence, the DFA is aimed at providing more oversight of consumer finance activity and regulating capital markets activity in order to maintain the integrity of the US financial system. In this memo, we discuss the DFA and reassess the relative value of the financial sector.

To the diverse constituents of the financial system, the DFA will have varying degrees of impact, as well as conflicting benefits and drawbacks. As fixed income investors, we will witness these effects firsthand, particularly in high quality financial corporate securities issued by the banking, brokerage, insurance and consumer finance sectors. Merganser has long found the risk/reward proposition of those investments to be favorable, and we believe that the DFA will make the largest financial services players more utility-like in terms of risk profile. In the context of current spreads, many financial issuers offer an appealing yield advantage should the DFA successfully meet its goals.

A recent history (30 years) of corporate spreads illustrates that financial institutions were considered by fixed income investors to be a relatively safe sector within the broader investment grade corporate index. The financial sector has for many years traded at a narrower spread than the investment grade corporate index as a whole (see Exhibit 1), implying lower perceived risk in the sector. Tighter spreads among financial issuers reflected the higher average credit rating of the group, which in



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turn reflected required regulatory capital the group kept on hand and the implicit support banks received from the federal government in the form of discount window funding and FDIC insurance. As Exhibit 1 illustrates, the spread level of financial institutions currently offers a meaningful advantage versus the historical relationship between financials and the broader index.

Banks' imbedded support mechanisms were clearly insufficient in the face of huge write-downs of sub-prime mortgage and derivative exposures during the credit crisis, particularly given the outsized leverage that many financial institutions employed. Federal support of financial institutions became virtually explicit, as the US Treasury invested hundreds of billions of dollars in preferred stock of bank and finance companies and extended special funding support in the form of FDIC-insured debt issuance in order to support banks of systemic importance. Due to political constraints (politicians are loathe to help Wall Street) and financial realities (the US government cannot afford another bail out), the government is now hoping that the DFA will ensure that it will not have to step in again to support the financial system.

In order to meet policymakers' goals, some of the broad areas of financial regulation that the DFA addresses include the following:

New capital requirements are aimed at not only increasing the level of Tier I capital at banks but also eliminating certain kinds of eligible capital and improving the quality of bank's capital reserves. By increasing Tier I capital requirements, the DFA is effectively limiting the amount of leverage banks can employ. Also, larger

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banks would no longer retain capital benefits from trust preferred securities (TruPS) (though the rule is only applicable to those banks with total assets of greater than \$15 billion). Ratings agencies currently exclude the capital benefit of TruPS and few large banks rely heavily on TruPS as a source of capital, suggesting minimal impact on the money center banks and large brokers, which is where Merganser typically invests. We believe the DFA's capital requirement language is a positive step toward risk reduction in the sector due to the leverage limitation and the improved quality of capital on hand.

Restrictions on private equity (P/E) investments and proprietary trading activities, known as the Volcker Rule, which requires that financial institutions limit their investments in P/E and proprietary trading to a small portion of the firm's overall risk profile – measured as 3% of the firm's Tier I capital. The Volcker Rule should better align institutions' incentives with those of their clients, restoring the intermediary function of the sector. The restrictions on P/E and proprietary trading, however, may have a negative impact on potential earnings capacity, which is a trade-off for lower risk.

Derivatives use at banks will be limited to those contracts that are relatively straightforward in nature and are traded via a clearinghouse. Derivatives trading has become a significant earnings source among banks and brokers, as the notional value of derivatives contracts held at the largest US commercial banks topped \$200 trillion at year end 2009. The new legislation stipulates that the trading of more exotic derivatives, including commodity swaps and equity-related swaps, will be prohibited at the bank holding company level, forcing many institutions to move that form of derivatives trading to separately capitalized subsidiaries. Plain vanilla hedging activities should be unaffected by the regulations. By ring-fencing some of the more volatile derivatives activity at financial institutions, the DFA should effectively de-risk holding company debt.

Resolution authority allows the FDIC to unwind failing financial institutions but bars it from using taxpayer funding. Resolution authority is likely the most negative aspect of the DFA for bondholders, as it represents the elimination of the "too big to fail" systemic support enjoyed by the US financial system through the credit crisis. Additionally, the initial interpretation of the legislation suggests that unsecured bondholders would be at risk of impairment alongside shareholders, despite recovery precedent found in bankruptcy law. Resolution authority may well prompt ratings agencies to downgrade financial

institutions that currently benefit from systemic support, though ratings actions would not hit the sector until mid-2011 at the earliest. However, recent earnings results from financial institutions have been strong, due to robust capital markets activity, a rebound in risky asset valuations, a favorable yield curve (which is likely to persist for some time) and a large reversal of credit provisioning. The marked rebound in earnings power and the meaningful decrease in the size of balance sheets across the sector have already bolstered the capital position at most firms, which we believe offsets potential downgrade risk.

Consumer protection measures include the creation of a Consumer Financial Protection Bureau and reduction of fees that hit consumers. The diminution of what are known as interchange fees, the fee that a bank charges merchants for a debit card transaction, could be another hit to bank earnings but many analysts believe that these fees will be largely recouped through higher fees on other services or new fees that have recently been free of charge, such as free checking. From the bondholder perspective, we believe this aspect of the DFA will have little impact.

In conclusion, the factors included in the recent legislation appear likely to be a positive step toward a safer banking system, where it will be harder for individual institutions to amass risk exposures that would pose a systemic risk. The legislation is lengthy and leaves room for interpretation, while also providing time for implementation. Thus, the full impact on financial institutions will be drawn out, allowing financial institutions time to reconfigure operations and capital structure as necessary. Notably, the long implementation time table affords financial institutions time to earn their way back to healthy capital positions. These benefits may be partially offset by the unintended consequences of such far reaching legislation, such as the possibility it restrains a more robust economic recovery. Other risks include the new hurdles to securitized debt issuance included in the initial language and a broader limit in the availability of consumer credit, as banks deploy capital more conservatively.

On balance, we believe that the DFA will reduce the volatility and overall risks of unsecured corporate debt issued by US financial institutions. At current spread levels, the financial sector offers an appealing risk/reward proposition that Merganser will continue to exploit as opportunities for incremental portfolio benefits arise.

Merganser Investment Team



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