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The Hamilton Financial Index:

A semi-annual report on the state of our financial services industry

February 2012

With a review of the economic impact of the Durbin Amendment

About Hamilton Place Strategies

Hamilton Place Strategies is a consultancy based in Washington, DC with a focus at the intersection of business and government. HPS Insight conducts in-depth analysis on public policy issues.

This report was prepared under the direction of Matt McDonald, a partner at HPS. Prior to HPS, Matt was a consultant for McKinsey & Co., an aide to President Bush and served as an advisor to senior leaders in both government and business. He received his MBA at the MIT Sloan School of Management and has a degree in economics from Dartmouth College.

Patrick Sims and Russ Grote of HPS conducted the analysis contained in this report.

Introduction

America's financial institutions are significantly safer and stronger than in years past. Both banks and insurance companies are well capitalized, addressing ongoing risks and are in a strong position to deliver value and support to the economy as the recovery continues.

Our financial services often exist as a backdrop to our lives, with not much thought beyond the swipe of a card. We may not realize it, but financial services firms have changed significantly since 2008 and are stronger for those changes. This is not to say that today's economic climate is without challenges. U.S. financial institutions and the global economy are still recovering and there remain issues to work through.

This is the first in a series of semi-annual reports to coincide with the Federal Reserve Chairman's Humphrey-Hawkins testimony before Congress. The aim of these reports is to provide a clear evaluation of the safety and soundness of the financial services sector and the value it provides to the economy during the crisis and the ongoing recovery.

This report introduces the Hamilton Financial Index, a snapshot of both risk in the system and how firms are meeting the challenge. We also look at regulatory issues and the intended and unintended impact on the financial sector and the economy. The regulatory spotlight begins with a look at the outcomes of implementing the Durbin Amendment.

This report has been commissioned by the Partnership for a Secure Financial Future. It was prepared independently by Hamilton Place Strategies, and the conclusions contained in this report are our own.

Hamilton Place Strategies

Matt McDonald
Partner

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Executive Summary

Overall, the financial sector has made remarkable changes to strengthen itself against ongoing risks. It continues to provide robust value to the economy while simultaneously addressing the exogenous economic challenges in the current environment.

The key findings of the report are:

- The new Hamilton Financial Index, which measures the safety and soundness of the financial services industry, has risen since the crisis. It is now 15 percent above normal levels of safety and soundness.

- US commercial banks' Tier 1 Common Capital levels are at an all-time high and the ratio of loans to deposits has declined 20 percent since 2007, pointing to a strong foundation for higher levels of lending.

- Insurance firms' Capital and Surplus are also at all-time highs despite an increase in unexpected expenses from natural disasters in 2011.

- Insurance companies had record payouts to the many individuals who suffered from natural disasters in 2011.

- While business loans have lagged due to a slow recovery, consumer loans increased dramatically during the recession, helping individuals weather the crisis.

- The private sector continued to reduce outstanding debt in 2011, declining 17 percent from the highs.

- The total U.S. retirement market is valued at $17 trillion, an increase of 21 percent since 2008.

- Lastly, our regulatory spotlight found that in the first four months of the Durbin Amendment's implementation, consumers have seen no decline in merchant prices and reduced account benefits from their debit cards. Foreseeable but unintended consequences of this regulation have resulted in a clear loss of value for consumers.

The Hamilton Financial Index:
A Snapshot of Firm and Systemic Risk

What is the appropriate capital level for a financial institution to hold in order to absorb losses resulting from unexpected shocks to the system?

This question comes up frequently and is heavily debated. Industry professionals ask the question from a performance standpoint – what level of capital can we hold, but still remain profitable? At the same time, lawmakers look to regulations to increase industry-wide safety.

It is important that both industry and regulatory leaders come together to figure out what is appropriate, and mitigate any unintended consequences.

Rarely does one look at how much risk there is in the system and compare it to another metric such as capital. More often, they are viewed as separates. However, placing the two together is increasingly seen as a key measurement of the safety and soundness of the financial services industry.

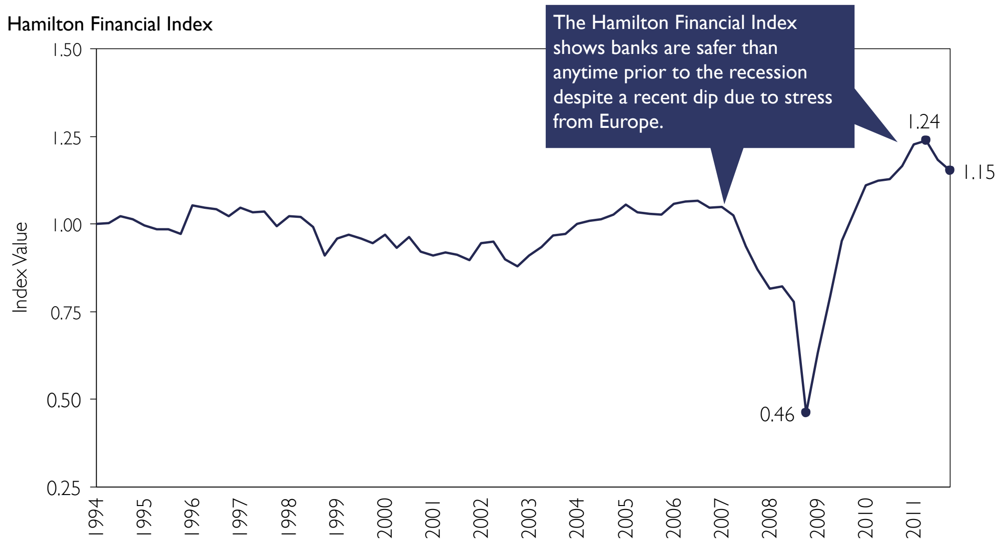
Therefore, the Hamilton Financial Index combines both systemic risk and capital levels into one index to provide a snapshot of the safety and soundness of the financial sector. The results show a significantly safer financial sector with an index value 15 percent above "normal" levels (Exhibit 1).

Key Findings:

- The Hamilton Financial Index combines firm-level and systemic level views of risk to show an overall snapshot of risk within the Financial Services Sector
- The Hamilton Financial Index value exhibited "normal" levels around a value of 1 prior to the financial crisis
- At the end of 2011, the Hamilton Financial Index was at 1.15, dramatically up from crisis levels of 0.46 and 15 percent above even normal pre-crisis levels

Exhibit 1

HAMILTON FINANCIAL INDEX SHOWS BANKS SAFER THAN PRE-RECESSION



Source: HPS Insight, St. Louis Federal Reserve, SNL Financial

Methodology

The Hamilton Financial Index is measured by using two commonly accepted metrics:

1. The St. Louis Federal Reserve Financial Stress Index captures 18 market indicators and is a well-established indicator of financial stress

2. Tier 1 Common Capital Ratio for commercial banks measures financial institutions' ability to absorb unexpected losses in an adverse environment

To get the index value, we simply subtract the quarterly average of the Financial Stress Index from the quarterly Tier 1 Common Capital Ratio for the commercial banking industry. In order to index the values, we used the first time-series data point, the first quarter of 1994, as the divisor for all periods. This set the first data point equal to one. Therefore, all data points are relative to the value of one.

The value of one also happens to be the average of all time periods from the first quarter of 1994 to the fourth quarter of 2011. Observed values around one are consistent with the historical norm of a safe financial industry.

St. Louis Fed Financial Stress Index

The first variable in the Hamilton Financial Index is the St. Louis Financial Stress Index, which combines 18 market variables segmented into three sections: interest rates, yields spreads and other indicators.

Interest rates help determine the market's assessment of risk across a number of different sectors and time periods. High interest rates represent an increase in financial stress. The interest rates in this section are:

- Effective federal funds rate
- 2-year Treasury
- 10-year Treasury
- 30-year Treasury
- Baa-rated corporate
- Merrill Lynch High-Yield Corporate Master II Index
- Merrill Lynch Asset-Backed Master BBB-rated

Yield spreads help determine relative risk across time and space. For example, the Treasury-Eurodollar (Ted) and London Interbank Offering Rate–Overnight Index Swap (LIBOR-OIS) spreads capture risk not just in the U.S., but also throughout the globe. A higher yield spreads suggest greater systemic risk. The yield spreads in this section are:

- Yield curve: 10-year Treasury minus 3-month Treasury
- Corporate Baa-rated bond minus 10-year Treasury
- Merrill Lynch High-Yield Corporate Master II Index minus 10-year Treasury
- 3-month LIBOR-OIS spread
- 3-month (TED) spread
- 3-month commercial paper minus 3-month Treasury bill

Other indicators fill in important pieces not captured by interest rates or yields. The Chicago Board Options Exchange Market Volatility Index captures the market's expectation of volatility with higher volatility associated with increased stress in the financial system. The indicators in this section are:

- J.P. Morgan Emerging Markets Bond Index Plus
- Chicago Board Options Exchange Market Volatility Index (VIX)
- Merrill Lynch Bond Market Volatility Index (1-month)
- 10-year nominal Treasury yield minus 10-year Treasury Inflation Protected Security yield (breakeven inflation rate)
- Vanguard Financials Exchange-Traded Fund (equities)

Each indicator captures an aspect of financial stress within the system with some overlap. Collectively, they provide a snapshot of systemic risk in financial markets.

St. Louis Fed Financial Stress Index

	2001	2003	2004	2005	2006	2007	2008	2009	2010	2011
High	0.58	0.68	-0.27	-0.68	-0.98	0.40	4.82	3.73	0.56	0.88
Low	0.12	-0.09	-0.65	-0.82	-1.04	-1.12	0.93	0.58	0.18	-0.07
Average	0.28	0.28	-0.44	-0.76	-1.01	-0.48	2.03	1.99	0.34	0.33

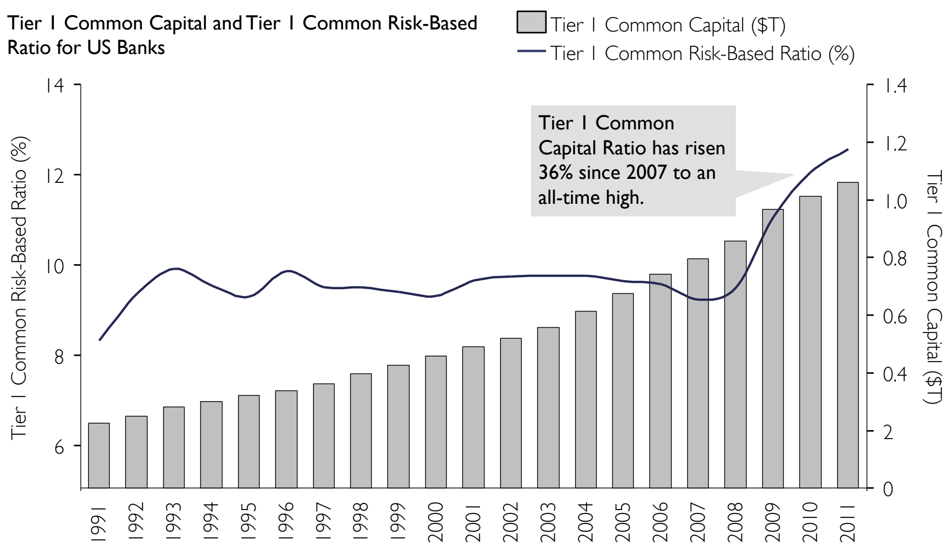
Tier 1 Common Capital, Risk-Weighted Assets and Tier 1 Common Ratio

The second variable in the Hamilton Financial Index is the Tier 1 Common Ratio, which is calculated by taking the industry's Tier 1 Common Capital (numerator) as a proportion of its Risk-Weighted Assets (denominator). Tier 1 Common Capital acts as a cushion in case of unexpected losses. Therefore, any increase in Tier 1 Common Capital (numerator) improves safety and soundness, all else equal. Concordantly, any decreases in the holding of risky assets as measured by Risk-Weighted Assets (denominator) will improve a bank's capital position.

$$Tier\ One\ Common\ Capital\ Ratio = \frac{Core\ Equity\ Capital}{Total\ Risk\ Weighted\ Assets}$$

Exhibit 2

CAPITAL LEVELS AND TIER 1 COMMON CAPITAL RATIO ARE AT AN ALL-TIME HIGH



Source: FDIC, SNL Financial

Tier 1 Capital is the core measure of a bank's financial strength from a regulator's point of view. It is based on core capital, which consists primarily of common stock and disclosed reserves. Tier 1 Common Capital is a more strict measurement than Tier 1 Capital in that it excludes preferred shares and minority interest, often seen by the industry as non-common elements.[1]

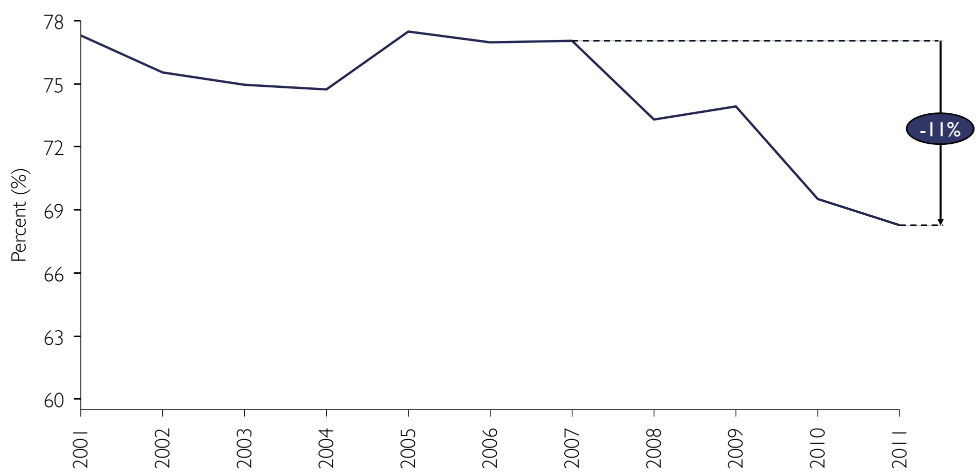
At the end of 2011, the banking industry had an aggregate Tier 1 Common Capital over $1.1 trillion and a Tier 1 Common Capital Ratio of 12.56 percent, an all-time high (Exhibit 2).[2] The ratio boasts a remarkable 36 percent increase from its low-point in 2007, and a 51 percent increase from 1991, the first period on file. This increase follows a steady decline between mid-2006 to the crisis in the fall of 2008.

Along with increases in Tier 1 Common Capital, Risk-Weighted Assets have declined. As a portion of Total Assets, Risk-Weighted Assets have decreased 11 percent since 2007, and continue to trend downward (Exhibit 3). Reduction of risk-weighted assets over the past several years has lead to an overall increase to the Tier 1 Common Capital Ratio.

Exhibit 3

US COMMERCIAL BANKS HAVE REDUCED THEIR HOLDINGS OF RISK-WEIGHTED ASSETS

Risk-Weighted Assets as a Percent of Total Assets for US Banks



Source: FDIC, SNL Financial

Risk-Weighted assets are the portions of assets that are assigned a higher level of credit risk as per regulatory guidelines, and are the denominator in the Tier 1 Common Capital Ratio.

The combination of increased capital levels and reduced risky assets results in less leveraged and safer financial institutions. Per the FDIC's Quarterly Banking Profile (Q3'11), "At the end of the quarter, more than 96 percent of all FDIC-insured institutions, representing more than 99 percent of total industry assets, met or exceeded the quantitative requirements for well-capitalized status."[3]

The combination of increased capital levels and reduced risky assets results in less leveraged and safer financial institutions.

The Hamilton Financial Index Summary

As of the fourth quarter of 2011, the Hamilton Financial Index was valued at 1.15, 15 percent above the historical norm. This value is down from a high of 1.24 in the second quarter of 2011, though significantly higher than the index bottom of 0.46 in the third quarter of 2008.

Financial institutions are in a better position today than they were even in the years prior to the crisis.

We can see the decline in safety and soundness prior to the financial crisis. In mid-2007, before both the recession and the financial crisis, the index begins to dip below one. The index value declines to 0.82 in the quarter prior to the collapse of Lehman Brothers in the third quarter of 2008.

Unlike prior to the crisis, current capital levels are at an all-time high and stress has been reduced, although not completely. The St. Louis Federal Reserve Stress Index showed higher levels of stress during the debt ceiling negotiations and the European crisis. These events caused the Hamilton Financial Index value to drop, despite high capital levels in recent quarters. If market stress subsides, we expect the index to increase back toward all-time highs.

The Hamilton Financial Index weighs both the level of risk in the financial system and the amount of capital financial institutions hold to deal with that risk. Importantly, it shows that financial institutions are in a better position today than they were even in the years prior to the crisis.

Safety and Soundness:
Foundation for Growth

Bank capital levels and systemic stress indicators provide a helpful look into how effectively financial institutions can mitigate market risk. The Hamilton Financial Index outlined in section one illustrates the achievements of the industry since the crisis.

In addition to these metrics, this section outlines other important indicators that measure the safety and soundness of the financial services industry.

The Loan-to-Deposit (LTD) Ratio measures a bank's liquidity. Our observations of changes in this ratio indicate that the industry is more safely funded by a higher proportion of deposits and less reliant on other borrowings than prior to the crisis. The industry is now more liquid than in years past.

This section also outlines key performance measures for financial services firms, and goes on to evaluate additional metrics for the insurance industry, namely Property & Casualty (P&C) and Life & Health (Life) sectors. Observations in these industries also indicate a strong recovery, and in some cases, the data illustrates that the industry is in better shape than in pre-crisis periods.

Key Findings:

- Banks' core funding has increased as Loan-to-Deposit ratios has fallen 20 percent since 2007
- Property and Casualty and Life Insurers have increased their Capital and Surplus levels 16 percent and 25 percent respectively, since 2008
- US financial institutions have significantly reduced their exposure to Europe's periphery during 2011, including a 34 percent reduction in exposure to Spain

Finally, this section details potential impediments to growth and stability, addressing the impact of catastrophic events on the insurance industry, deterioration of asset quality in bank lending and financial institution exposure to the European crisis.

Overall, the current snapshot of the financial sector shows the industry moving quickly in the right direction to protect all of us from further shocks.

Loan-to-Deposit (LTD) Ratio

How banks and financial institutions receive their funding is an issue that receives constant attention, and rightly so. In the event of a liquidity crisis, the ability to fund operations bears the key to survival. Liquidity was a central challenge for firms during the 2008 crisis. A simple examination of the banking industry's LTD Ratio is a common measure of liquidity.

The LTD Ratio assesses a bank's liquidity. Deposits are considered the core funding of a bank's operation. Therefore, a higher LTD ratio means that a bank might not have enough liquidity to cover any unforeseen fund requirements. A lower ratio may indicate that a bank is not earning as much as it could. Balance is necessary.

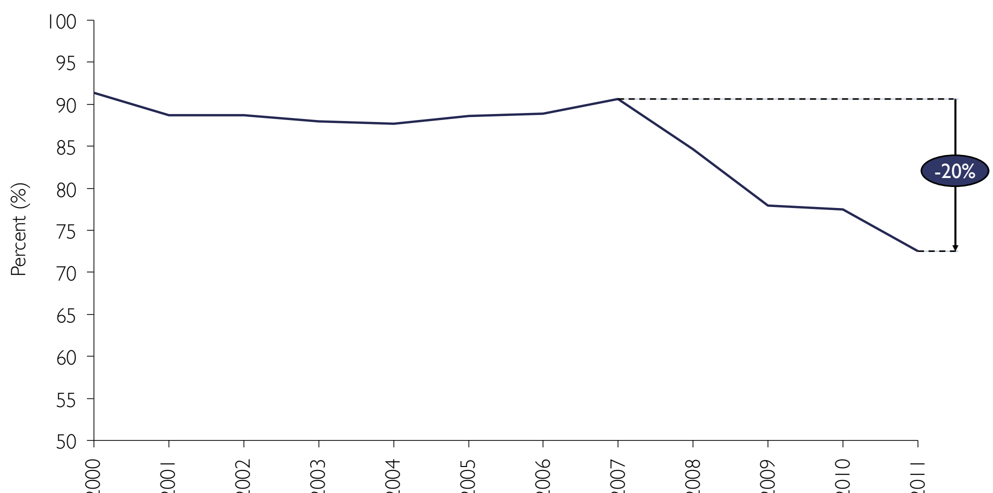
In regards to liquidity, banks are now in a much safer place and poised to lend at higher levels as the economy grows.

From 2000 to 2008, the banking industry had an average LTD Ratio of 88.58. It reached its peak in 2007 at 90.65. Due to an increase in deposits and lower amount of loans, the ratio now sits at 72.53, a 20 percent decrease from pre-crisis highs (Exhibit 4). In regards to liquidity, banks are now in a much safer place and are poised to lend at higher levels as the economy grows

Exhibit 4

CORE FUNDING INCREASES AS LOAN-TO-DEPOSIT RATIO FALLS 20% SINCE 2008

Total Loans as a Percent of Total Deposits for US Banks



Source: FDIC, SNL Financial

Insurers' Capital & Surplus (C&S)

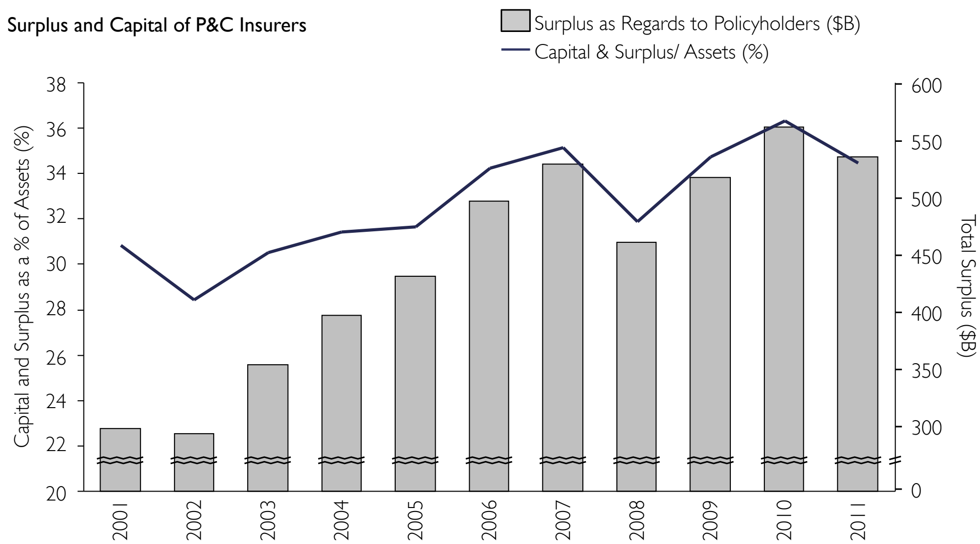
Although the financial crisis affected banks more than most industries, the insurance industry also suffered due to the market downturn. At the time of the financial crisis, outside of insurance companies with a high degree of exposure to mortgage securities, such as AIG, the U.S. International Trade Commission considered the insurance industry "…one of the healthier subsectors of the financial institutions industry."[4]

One commonly accepted way to measure the capitalization of the insurance industry is with the metric Surplus as Regards to Policyholders, known as Capital and Surplus (C&S). The Property & Casualty Insurance sector (P&C), which includes reinsurance companies, maintains high C&S levels despite a series of catastrophic events in 2011 caused by natural disasters. As of the third quarter, the aggregate Surplus value was $535.4 billion, a 16 percent increase compared to 2008 when it was at $461.8 billion (Exhibit 5).

Given the nature of the industry, the Life Insurance sector (Life) had less exposure to losses from catastrophic events in 2011. As of the third quarter of 2011, the Life Insurance sector had C&S of $313.6 billion, the highest on record. Moreover C&S as a percentage of assets bounced back rapidly during the crisis and currently stands 12.5 percent above the crisis low-point and slightly above its pre-crisis levels (Exhibit 6).

Exhibit 5

P&C INSURERS REBOUNDED QUICKLY FROM THE RECESSION, AND NEVER FELL BELOW 2002 LEVELS

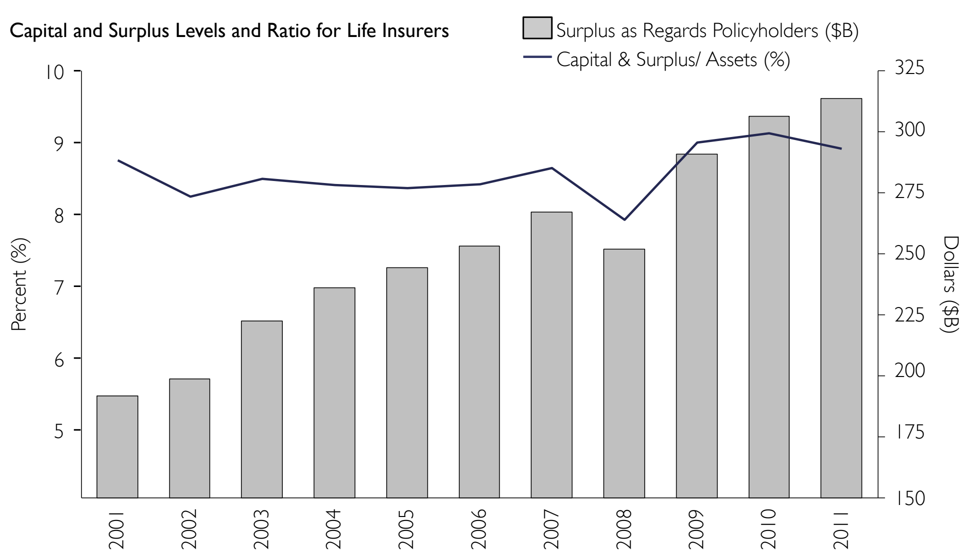


Source: NAIC, SNL Financial

Surplus as Regards to Policyholders represents the difference between the statutory admitted assets and the statutory liabilities. Surplus is viewed as the net financial resources available to support growth.

Exhibit 6

LIFE INSURERS CAPITAL AND SURPLUS HAS RISEN SINCE 2008



Source: NAIC, SNL Financial

Rebound in Performance

Beyond capital levels, commercial banks' and insurance companies' market performance is critical to ongoing safety and soundness. Improved performance allows banks to raise more equity. And, if a financial institution can more easily raise capital, it will be able to provide more lending to businesses and consumers.

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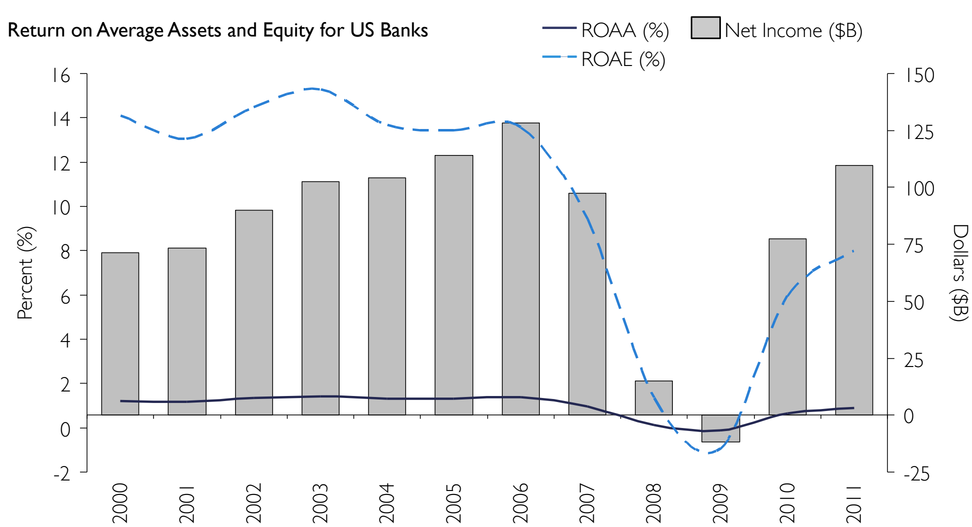
Bank Net Income, Return on Average Assets (ROAA) and Equity (ROAE)

The banking and insurance industries are not only well capitalized, but their ability to increase net income provides extra cushion in the event of an unexpected crisis.

For banks, 2008 and 2009 were frightful times. Bank Net Income took a nosedive in 2008, going from $97.5 billion in 2007 to just $15.1 billion in 2008. While still profitable in 2008, the industry eventually took on the full-effect of the financial crisis and saw red in 2009 with a Net Income of negative $11.7 billion. Since then, the industry's recovery is well underway. Bank Net Income in 2010 was $77.6 billion and $109.6 billion in 2011, just shy of its 2005 level (Exhibit 7).

Exhibit 7

PERFORMANCE MEASURES BOUNCED BACK QUICKLY FROM 2009 LOWS



Source: FDIC, SNL Financial

Insurance Net Income, Return on Average Assets (ROAA) and Equity (ROAE)

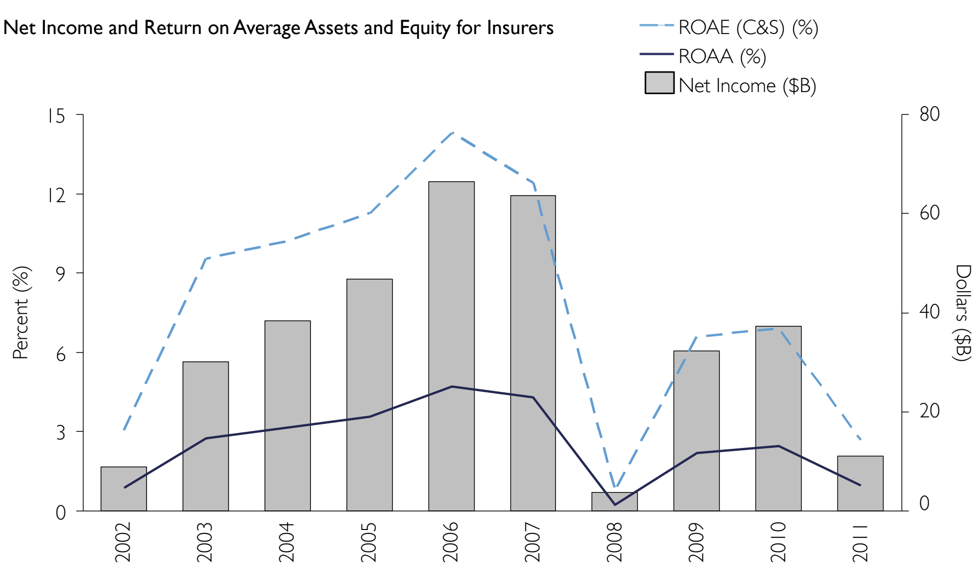
P&C Insurance Net Income also took a major hit in 2008. As previously discussed, the insurance industry's operations differ from that of banking (lending), and therefore the P&C industry did not experience a Net Income loss from the financial crisis.

The industry did, however, see Net Income plummet from $63.6 billion in 2007 to just $3.7 billion in 2008 due to losses in investment holdings. The industry began to recover in 2009 and 2010, with Net Income of $32.2 and $37.2 billion, respectively. Following that, 2011 was a year filled with catastrophic events on a historic and global scale that eroded insurers' earnings. While still profitable and above crisis levels, 2011 Net Income is well below pre-crisis levels (Exhibit 8).

Exhibit 8

DESPITE A STRONG REBOUND, DISASTERS IN 2011 REDUCED PROFITABILITY FOR P&C INSURERS

Net Income and Return on Average Assets and Equity for Insurers



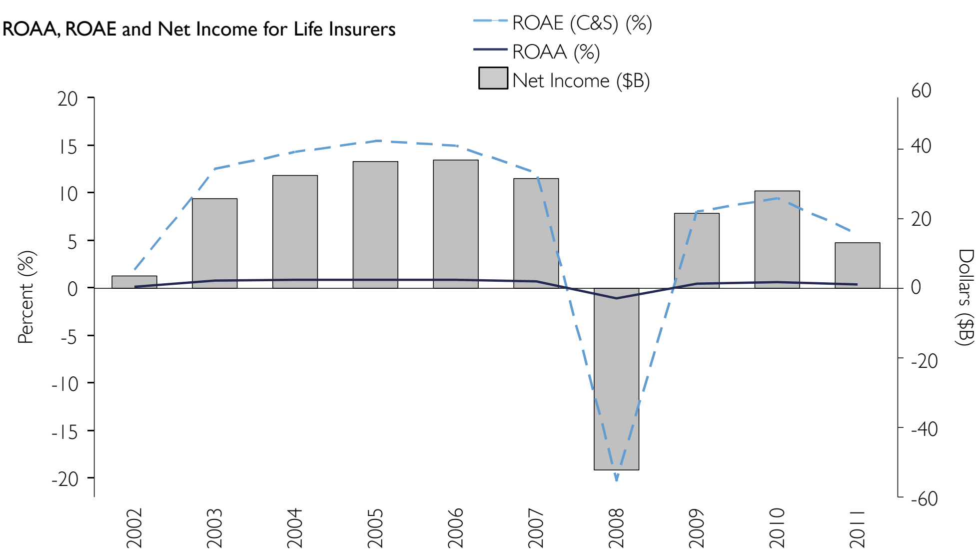
Source: NAIC, SNL Financial

While the P&C sector's income remained positive in 2008, the Life sector did not. Industry Net Income dropped to a negative $52.3 billion in 2008 from a positive $31.6 billion in 2007. The recovery took place in 2009 with Net Income roaring back to $21.5 billion and again to $28.0 billion in 2010 (Exhibit 9). Volatility in the markets contributed to lower earnings in 2011, but the industry is expected to stay profitable and stable based on strong balance sheet fundamentals cited above.[5]

Exhibit 9

RETURNS AND NET INCOME HAVE IMPROVED SINCE 2008 FOR LIFE INSURERS

ROAA, ROAE and Net Income for Life Insurers



Source: NAIC, SNL Financial

Potential Roadblocks to Growth and Stability

Based on the Hamilton Financial Index and the supplementary metrics outlined in this section, the financial services sector has improved its balance sheet and is in a significantly better position to absorb any unexpected shocks.

While these indicators are useful in providing a high-level view of systemic risk, we can also look more closely at the performance of assets on a bank's books and gauge the amount of risk still in the system.

Outlined below is an examination of the potential impact of catastrophic events, noncurrent loans, specifically in real estate, and the European debt crisis on the financial industry. While these risks are important to monitor, as discussed above, financial institutions' ability to handle shocks has never been better.

Catastrophic Events

Losses associated with tornados in the South and Midwest were labeled by the Insurance Information Institute as the fifth-costliest catastrophic event in U.S. history. Hurricane Irene and several other natural catastrophes across the globe, such as the Japanese earthquakes, also contributed to the highest combined losses in industry history.

Industry losses were relatively offset by the large amount of premiums being written, but it was nonetheless a tumultuous year of natural disasters.

> **While these risks are important to monitor, as discussed above, financial institutions' ability to handle shocks has never been better.**

A year-end industry report by Fitch Ratings, a global credit ratings agency, stated that events in 2011 led to the highest loss experienced since 2005, the year of Hurricanes Katrina, Rita and Wilma. Still, the industry is expected to recover in 2012 through a return to underwriting discipline and improved earnings. Fitch assigned the P&C industry a "stable" outlook.[6]

Asset Quality – Noncurrent Loans & Charge-offs

At the beginning of the 2008 financial crisis, loans with poor credit quality began to default, and banks began to face liquidity and solvency issues. While the Troubled Asset Relief Program (TARP) has turned a profit for taxpayers and helped rid banks of many risky assets, the sluggish recovery has continued to take a toll on the quality of loans. More specifically, as housing prices continue to fall wiping out home equity, unemployment and stagnant wages make it difficult for individuals to pay debts.

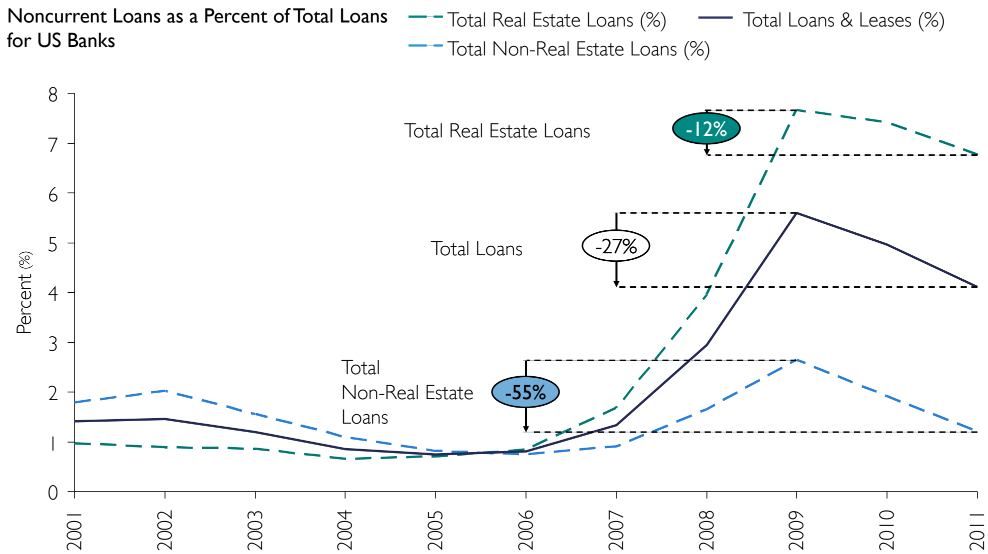
Therefore, a continued concern is whether a significant amount of these loans may still be on banks' books. We can look at some aggregates to partially gauge banks' success in cleaning up their balance sheets.

The industry measures the amount of loans at risk of defaulting by calculating the amount of Noncurrent Loans as a percent of Total Loans. Noncurrent Loans are loans that are behind on the payment schedule and are at greater risk for default.

As a portion of Total Loans, Noncurrent Loans were at a low of 0.75 percent in 2005. In 2008 the industry reached a point where the ratio was closing in on three percent, a level not seen since the early 1990s when the banking industry was recovering from the Savings and Loan Crisis of the late 1980s (Exhibit 10).

Exhibit 10

NONCURRENT LOANS AS A PERCENT OF ALL LOANS ARE IMPROVING ACROSS THE BOARD



Source: FDIC, SNL Financial

$$Percent\ of\ Noncurrent\ Loans = \frac{Loans > 90\ days\ past\ due + Nonaccrual\ Loans}{Total\ Loans}$$

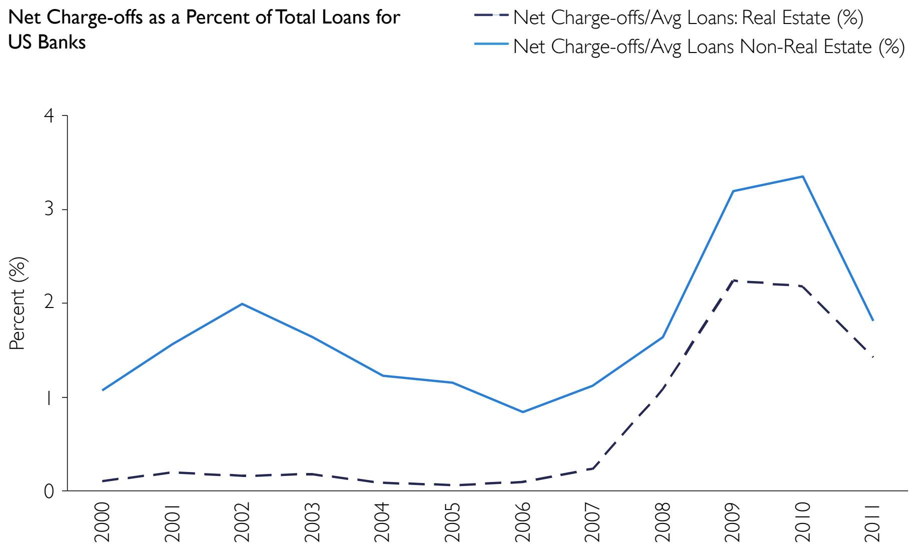
2009 was the peak of distress and Noncurrent Loans represented 5.6 percent of Total Loans outstanding. As banks began to work through these loans by restructuring and charge-offs, the industry began to recover. As of the end of 2011, the percent of Noncurrent Loans sits at 4.1 percent, a 27 percent decrease from the 2009 high.

Although the level of Real Estate Loans that are Noncurrent is also below the 2009 highs, the overall level still remains above industry norms. These loans have only been reduced by 12 percent from their peak and still stand well above pre-crisis levels at 6.8 percent.

Moreover, Charge-offs on these types of loans never reached the level of Non-Real Estate Loans. These aggregates suggest that banks, while making progress, are still exposed to risks in this market (Exhibit 11).

Exhibit 11

TOTAL CHARGEOFFS AS A PERCENT OF TOTAL LOANS PEAKED IN 2010



Source: FDIC, SNL Financial

Net Charge-offs (NCOs) are the dollar amount representing the difference between gross charge-offs and any subsequent recoveries of delinquent debt.

$$Percent\ of\ Net\ Charge\ offs = \frac{Net\ Charge\ offs\ of\ Loans}{Average\ Loans}$$

In sum, the aggregates suggest that banks have worked through some of the bad loans on their books, but high levels of Noncurrent Real Estate loans show there is still exposure.

European Distress – U.S. Exposure to Europe

Although U.S. financial institutions have begun to pave a path to recovery, it is possible that over-exposure to European debt could lead to financial contagion in the event of a significant crisis.

Beginning in 2010, Greece's sovereign credit rating was downgraded by several ratings agencies. Sovereign credit ratings of several other European countries were also downgraded, namely those of Portugal, Ireland, Italy and Spain. Other countries around the globe also saw their sovereign credit rating downgraded, including the U.S.

U.S. banks have altered their portfolios to reduce their exposure to Europe's risky assets.

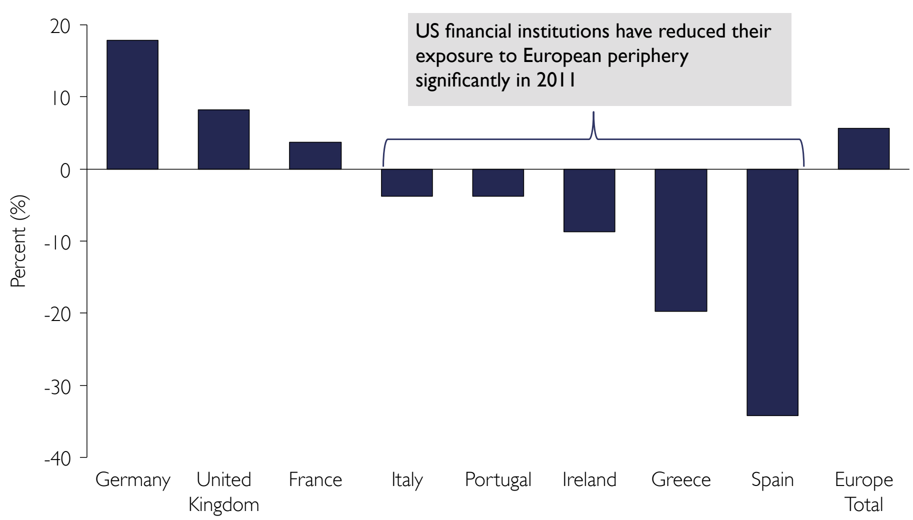
A number of actions have been taken place in recent periods to reduce both the likelihood and magnitude of a potential contagion event. While the European Central Bank and the International Monetary Fund have extended liquidity to help calm markets and avoid bank runs, U.S. banks have also altered their portfolios to reduce their exposure to Europe's risky assets.

While U.S. banks have *increased* their exposure to European countries by nearly 5.6 percent over the past quarter and nearly 10 percent since the start of 2011, U.S. banks have *decreased* exposure to the troubled periphery (Exhibit 12). The increase in exposure is focused on a few targeted countries, particularly Germany and Switzerland. Decreases occurred in Portugal (3.8 percent), Italy (3.8 percent), Ireland (8.7 percent), Greece (19.7 percent) and Spain (34.2 percent), among a host of others. Exposure to Spain saw the largest percentage decrease as of the third quarter of 2011.[7]

Exhibit 12

US FINANCIAL INSTITUTIONS HAVE REDUCED EXPOSURE TO THE EUROPEAN PERIPHERY

Percent Change of Country Risk Claims from Q2'11 to Q3'11



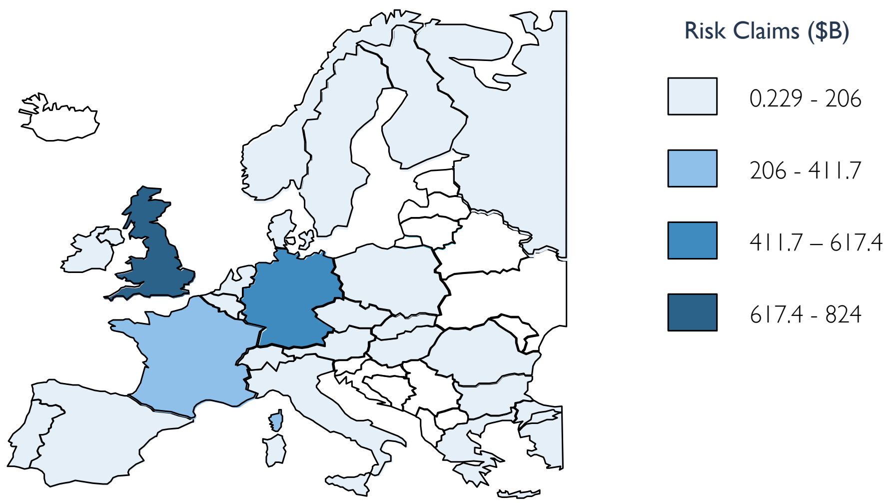
Source: FFIEC, HPSInsight

Switzerland and Germany are seen as Europe's safe havens. A flight to safety occurred over the last quarter as banks increased their exposure to these countries by 61.2 percent and 18 percent, respectively. The United Kingdom also saw a positive change of 8 percent (Exhibit 13).

Overall, exposure to Greece is small. U.S. commercial banks have roughly 100 times less exposure to Greek risk claims than they do the United Kingdom. In fact, of total U.S. bank exposure to European claims; Germany, France and the United Kingdom account for 68 percent, while Greece accounts for less than 1 percent.

Exhibit 13

US BANKS HAVE LESS EXPOSURE TO THE EUROPEAN PERIPHERY THAN CORE



Source: FFIEC, HPSInsight

Data on non-U.S. exposures are reported on the Country Exposure Report (FFIEC 009). All data are on a fully consolidated basis and cover 71 U.S. banking organizations (including U.S. holding companies owned by foreign banks, but excluding U.S. branches of foreign banks). Respondents may file information on a bank only or consolidated bank holding company basis.

The group of institutions responding to the quarterly survey consists of a panel of 71 U.S. banking organizations each holding $30 million or more in claims on residents of foreign countries.

Safety and Soundness Summary

Our analysis shows that while people may not be aware of the changes that have taken place, banks as well as insurance companies are significantly safer than in the years leading up to the crisis. The Hamilton Financial Index shows significant improvement. Loans and deposits have returned to healthier levels. Insurance companies, which were strong throughout the crisis, now have historically high C&S ratios despite record payouts for P&C insurers.

The financial services sector is still working through troubled loans, and the European crisis continues to threaten recovery. While these concerns should be noted, the industry is clearly moving in the right direction and is stronger than any time in recent history.

Value to the Economy:
Safe Haven During the Recession

The value of financial services is so integrated into our everyday lives that we often forget how highly developed and beneficial our system has become. In 1995, only 17.7 percent of households owned a debit card. Today, over 76 percent of households have cards[8]. Online banking was negligible ten years ago. Now, consumers have the ability to check balances and deposit checks on their smart phones. We've come a long way in a short amount of time.

Beyond consumer banking, the financial services sector contributes in a host of ways. Apple's global supply chain needs banks to manage their foreign exchange. Our favorite time-waster, Zynga (gaming), requires an investment bank to underwrite its IPO so that it can raise more capital for a better version of Words with Friends. Insurance products are widespread and can protect our homes, cars and loved ones from unexpected tragedies. Retirement security has increased dramatically with the rise of new fund types, better life insurance and accessibility to expert advisory services.

Key Findings:

- Deposit accounts acted as a shelter during the recession as total deposits increased 25 percent from 2008 to 2011
- Property & Casualty Insurers paid a record $350 billion annualized in claims through the third quarter of 2011, helping people cope with disasters
- The total U.S. retirement market reached $17 trillion by the third quarter of 2011, 21 percent above 2008 levels

Covering all the benefits of modern financial services would take a library to explore. For this report, we will focus on the core functions of financial services:

- Serving as a financial shelter
- Extending credit to businesses and individuals
- Insuring against risks
- Saving for the future

Financial Shelters

The primary function of a bank is lending. In order to lend, banks take deposits; and in times of economic distress, these deposits are a shield from market volatility for individuals. Our analysis of the volume, composition and growth rates in deposits shows that U.S. bank deposits are seen as a safe haven in volatile times.

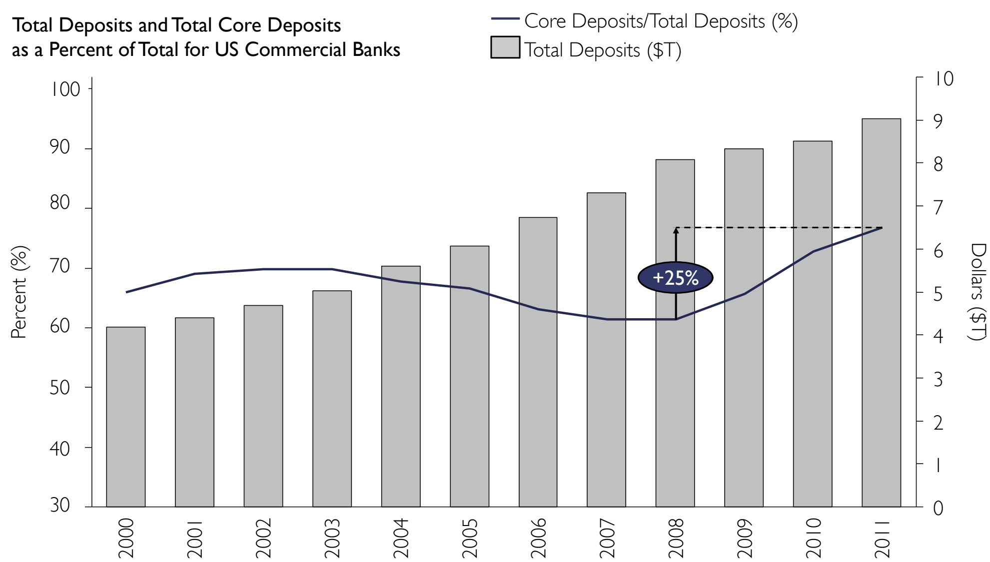
Deposits as a Flight to Safety

In the fall of 2008 the FDIC took steps to shore up the safety of consumer deposits by temporarily increasing insurance coverage up to $250,000 per depositor. In the spring of 2009, Congress extended the $250,000 insurance coverage through 2013; and in the summer of 2010, the extension became permanent. Even further, the Dodd-Frank Deposit Insurance Provision states that the FDIC will insure unlimited deposit amounts in non-interest bearing accounts until the end of 2012.

Although the crisis has been quelled and strengthening the recovery is now the foremost issue, bank deposits are still increasing. Per 2011 year-end filings, bank deposits grew 8.5 percent to roughly $9.04 trillion from 2009 to 2011(Exhibit 14).

Exhibit 14

DEPOSITS CONTINUED TO CLIMB THROUGHOUT THE RECESSION AND RECOVERY



Source: FDIC, SNL Financial

Many industry observers attribute the rise in deposits to a reaction to stock-market volatility, and see the increase in U.S. bank deposits as a flight to safety. There are several types of deposits that make up the total composition of deposits. The bulk of the deposit base is known as "core deposits." These deposits are made up of accounts holding $250,000 or less, excluding brokered deposits. These deposits are seen as highly liquid. Clients can add or withdraw with ease, and they cost little for a bank to hold. Core deposits are the basis for lending.

The ratio of core deposits to total deposits was at a decade low of 61.4 percent in both 2007 and 2008. Core deposits at 2011 year-end now represent nearly 76.8 percent of the total amount for U.S. banks. There is no question that economic volatility and the increase in FDIC insurance coverage have influenced these values.

The market is giving the financial services industry a vote of confidence with regard to safety.

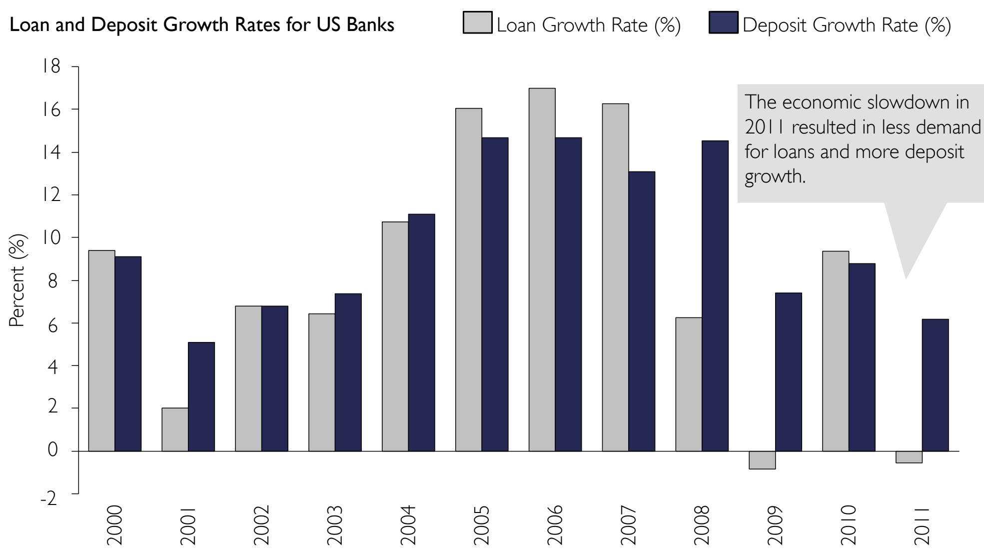
Although the increase in core deposits is a sign that individuals and businesses are taking less risk, it speaks well of U.S. banks, as the market is giving the financial services industry a vote of confidence with regard to safety.

Deposit and Loan Growth Rates

The dynamics between loan and deposit growth rates further illustrate the role deposits played during the crisis. The negative loan growth rate for 2009 and continued growth of deposits reflects the U.S. economic contraction. Loan growth was strong in the years leading up to the crisis, topping out at 16.98 percent in 2006 and 16.26 percent in 2007. In fact, loan growth outpaced deposit growth in both years (Exhibit 15).

Exhibit 15

LOAN AND DEPOSIT GROWTH RATES BOUNCE BACK POST-RECESSION



Source: FDIC, SNL Financial

During the financial crisis, this relationship reversed. Loan growth slowed to 6.23 percent in 2008, and then collapsed in 2009 to negative 0.83 percent. After an increase in 2010, loan growth dipped slightly throughout 2011. Meanwhile, the deposit growth rate increased over 14 percent in 2008 and stayed positive through 2011.

As the economy continues to recover and loan demand increases, the rise in deposits will position U.S. banks to increase lending at growth rates seen in the years prior to the crisis.

Providing Credit

While banks safeguard money through deposits, which are insured up to $250,000, their primary purpose is to route savings into investments. By collecting small pools of idle money and lending to consumers and businesses for investment, banks solve a major coordination problem in economies. On the consumer side, loans are available for buying homes, purchasing automobiles and obtaining the necessary funds for education. Businesses use loans to aid in growth and expansion.

Acting as boosts when the economy is growing, credit can also be a lifeline when the economy is faltering. An existing company may request a loan for the necessary funds to weather a crisis. Individuals may draw on credit to bridge financing gaps for essential needs.

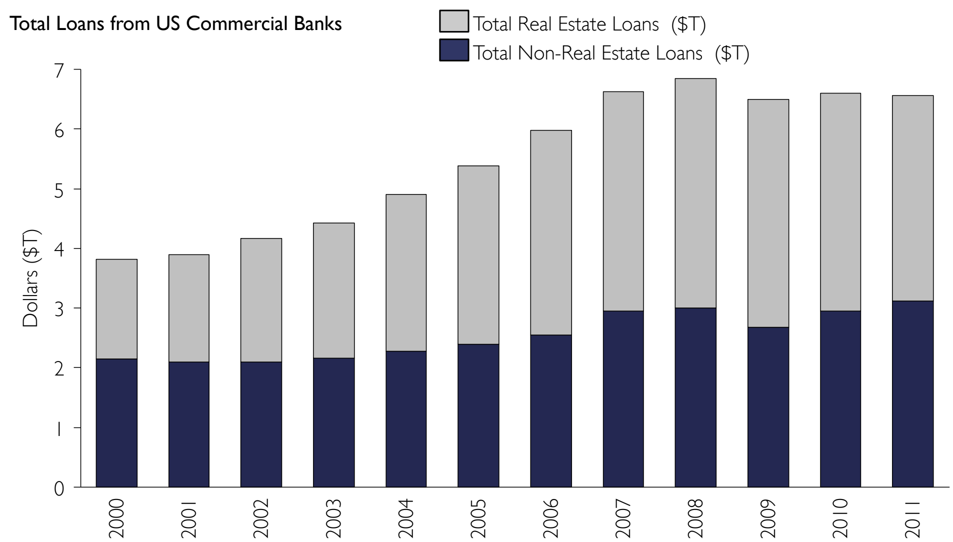
However, as credit helps to support an economy, high debt levels can endanger an economy. Prior to the recession, the U.S. private sector built up tremendous debt levels that left families and businesses underwater when the economy collapsed. This section will examine both the levels of credit provided to businesses and consumers, as well as private sector debt levels to evaluate the overall health of commercial banks' credit provision.

Total Loans

Total loans and leases for 2011 year-end were over $6.6 trillion, just below $6.84 trillion in 2008 but above 2009 levels.

Exhibit 16

REAL ESTATE LOANS HAVE CONTINUED TO FALL WHILE OTHER LOANS HAVE GROWN



Source: FDIC, SNL Financial

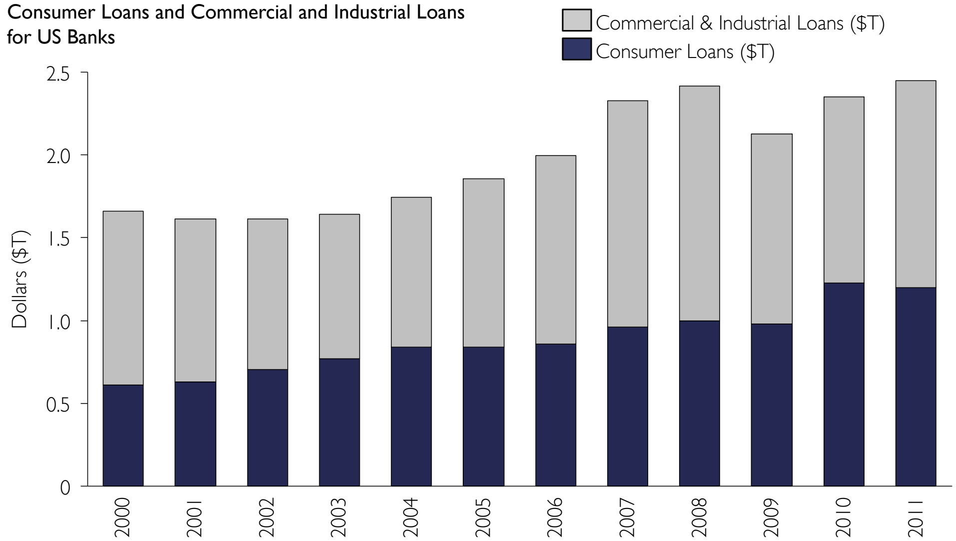
Loans outlined in Exhibit 16 are broken down into two main categories: Real Estate and Non-Real Estate. Given the weakness of the housing market, Real Estate loans have continued to decline. Meanwhile, Non-Real Estate loans rebounded quickly and are now above pre-recession highs. At the end of 2011, commercial banks held $3.1 trillion of Non-Real Estate loans, up from $2.7 trillion in 2009 and the pre-recession peak of $3 trillion in 2008.

A deeper examination of Non-Real Estate loans shows that consumer loans have been the main driver of growth (Exhibit 17). The two main categories of Non-Real Estate loans are Commercial and Industrial loans and Consumer loans. Consumer loans increased above pre-recession highs in 2010 and have slightly dipped in 2011. This trend within consumer loans is explained by the rise in credit card loans (Exhibit 18).

Exhibit 17

CONSUMER LOAN GROWTH HAS DRIVEN NON-REAL ESTATE LOANS TO NEW HIGHS

Consumer Loans and Commercial and Industrial Loans for US Banks

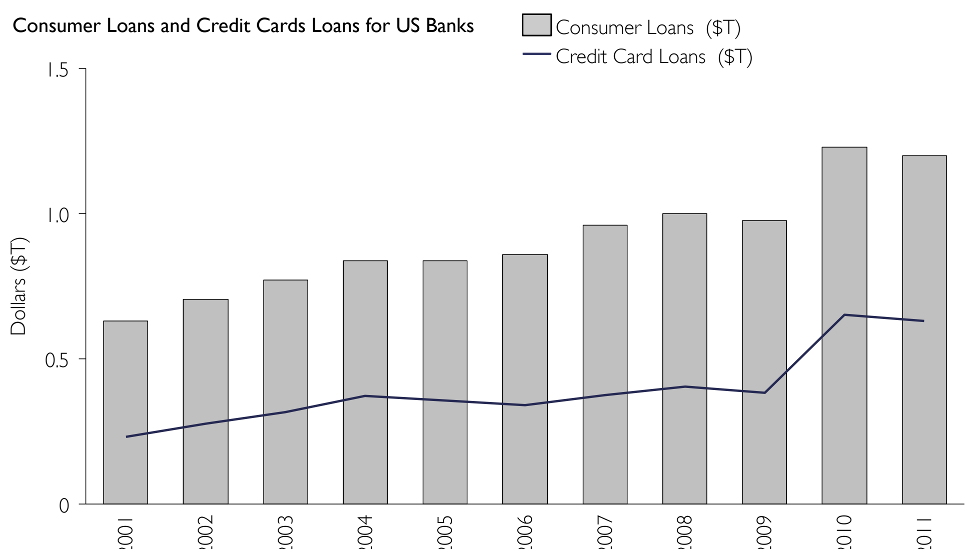


Source: FDIC, SNL Financial

Exhibit 18

CONSUMER CREDIT WAS EXTENDED TO AN ALL-TIME HIGH DURING THE RECESSION

Consumer Loans and Credit Cards Loans for US Banks



Source: FDIC, SNL FInancial

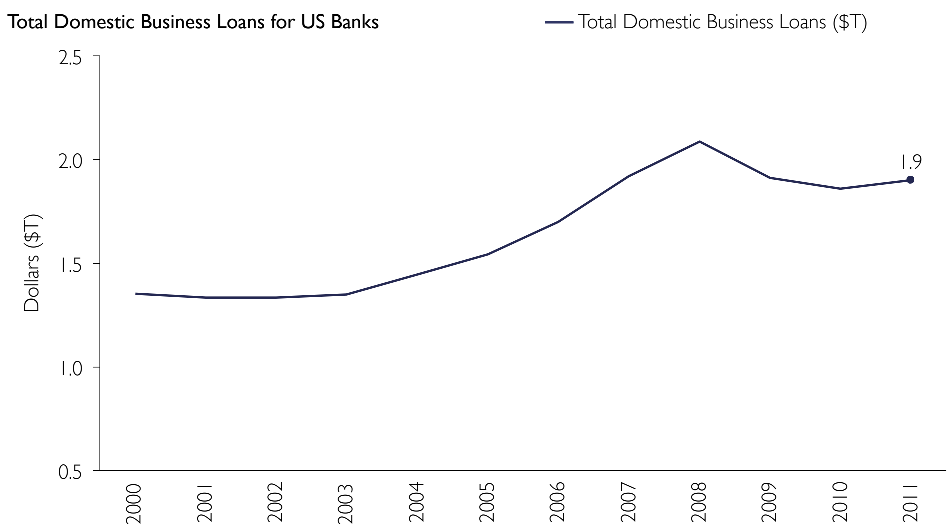
This breakdown shows the role U.S. commercial banks play during a recession. Individuals still have bills to pay and families to feed. With reduced income, individuals require credit to get over the hump in bad times, and data shows U.S. commercial banks have dramatically increased credit to those in need. In fact, credit card loans rose to an all-time high over 2009 and have decreased as the economy slowly recovers.

Business Loans

As detailed above, a recession followed by a slow recovery will reduce the demand for business loans. Total business loans are trending up but have not quite reached their pre-recession peak (Exhibit 19).

Exhibit 19

TOTAL DOMESTIC BUSINESS LOANS HAVE INCREASED IN 2011 TO $1.9 TRILLION

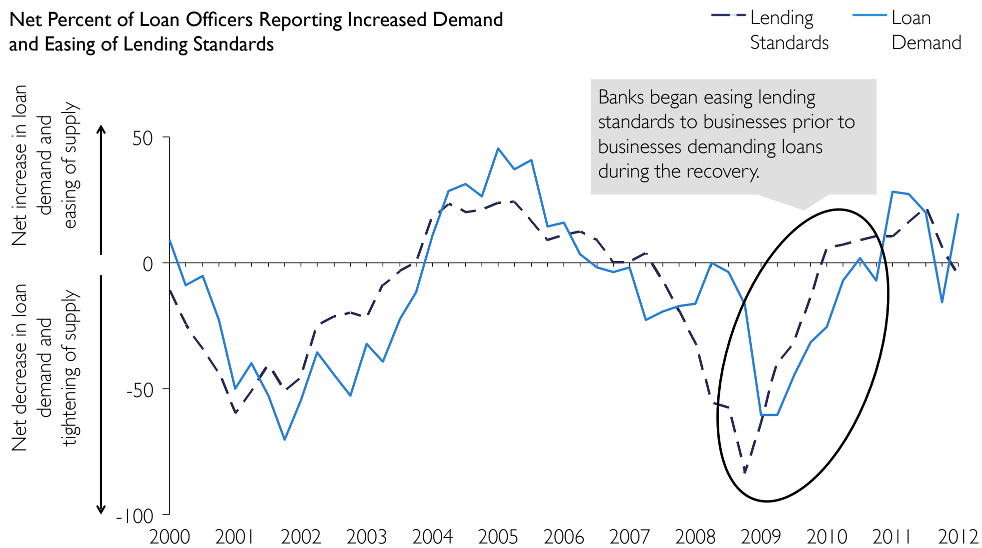


Source: FDIC, SNL Financial

This lag is a function of the economy. For medium and large firms, loan officers reported less demand for loans throughout the crisis (Exhibit 20). Meanwhile, more loan officers reported that lending standards remained eased prior to the collapse and before the rise in demand. These measures suggest that while U.S. commercial banks responsibly tightened lending during the economic recession, lending standards tightened after demand fell and eased before demand rose. Thus, U.S. commercial banks remained supportive to U.S. business borrowing needs.

Exhibit 20

BANKS HAVE EASED LENDING STANDARDS FOR BUSINESSES AS DEMAND HAS INCREASED



Source: Federal Reserve Senior Loan Officer Survey

Spotlight: Support for St. Paul Stamp Works

America's small businesses rely on the financial sector for support, regularly seeking loans they need to grow and hire. Consider St. Paul Stamp Works, a fifth generation small business in Minnesota that locals go to for their stamping, embossing and printing needs.

St. Paul Stamp Works' current President is 62-year-old Ed Mellgren, a direct descendent of the Scandinavian immigrant who founded the company 140 years ago. "I'm convinced you need to have a good relationship with your bank," he says, referring to his lender, U.S. Bank, a subsidiary of Minneapolis-based U.S. Bancorp. "They have always been there and always provided financing for us, even in 2008 and 2009."

Recently, Mellgren used a U.S. Bank loan to purchase a laser cutter and high-tech digital printer that has helped the company cut costs and hire three new workers. He says that although profitable and financially sound, the company sometimes needs loans when its cash is not in a readily available form. Mellgren's relationship with U.S. Bank proved fruitful, as his business was able to receive loans during the economic downtum.

Mellgren also offers high praise for Milwaukee-based Northwestern Mutual Life Insurance Corp. Securing life insurance has given Mellgren and others peace of mind that the family business will have the necessary funding to continue in the event of an unexpected illness or death. The comfort in knowing that future events will not bankrupt the business allows St. Paul Stamp Works to focus on enhancing their products and growing its customer base.

Small Business Lending

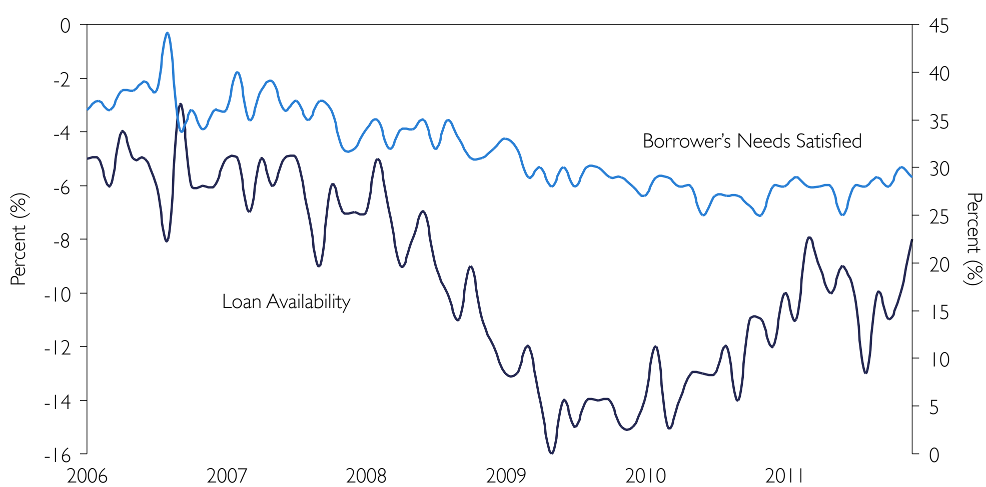
In the fourth quarter of 2011, the Thomson Reuters/Paynet Small Business Lending Index jumped to levels not seen since the beginning of 2008. Similar to medium and large firm lending, small business lending increased slowly during the recession. But, like large and medium firms, our analysis of the Federal Reserve's latest Senior Loan Officer Survey shows that lending standards have eased faster than loan demand has increased.

Surveys of small business owners also report greater levels of borrower satisfaction and loan availability as the economy has recovered (Exhibit 21).

Exhibit 21

SMALL BUSINESSES LOAN AVAILABILITY AND BORROWER SATISFACTION ARE TRENDING UP

Net Small Business Owners Responding Loan Availability is Increasing vs. Decreasing and That Borrowing Needs Are Satisfied



Source: NFIB Small Business Optimism Survey

Private Sector Debt Level

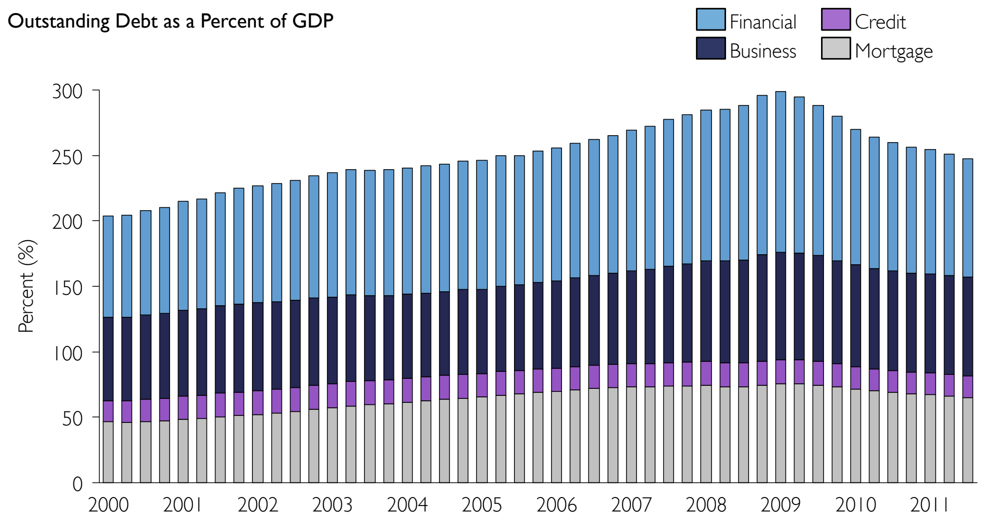
As detailed above, while overall lending is still down from pre-recession levels due to reduced demand in the housing market, U.S. commercial banks are still providing credit in the form of business and consumer loans. The extension of consumer credit has been remarkable during the recession. However, recent experience shows that while lending and credit can finance booms, too much can make for painful busts. Prior to 2008, private sector debt levels rose to unsustainable levels.

> **The U.S. private sector continues to deleverage albeit at a slower pace over the past year.**

Therefore, rather than just tracking the level of credit provision, it is important to monitor private sector debt levels to see the overall health of this sector. Our analysis shows that the U.S. private sector continues to deleverage, albeit at a slower pace over the past year (Exhibit 22).

Exhibit 22

PRIVATE SECTOR DEBT HAS DECLINED SIGNIFICANTLY SINCE ITS 2009 PEAK



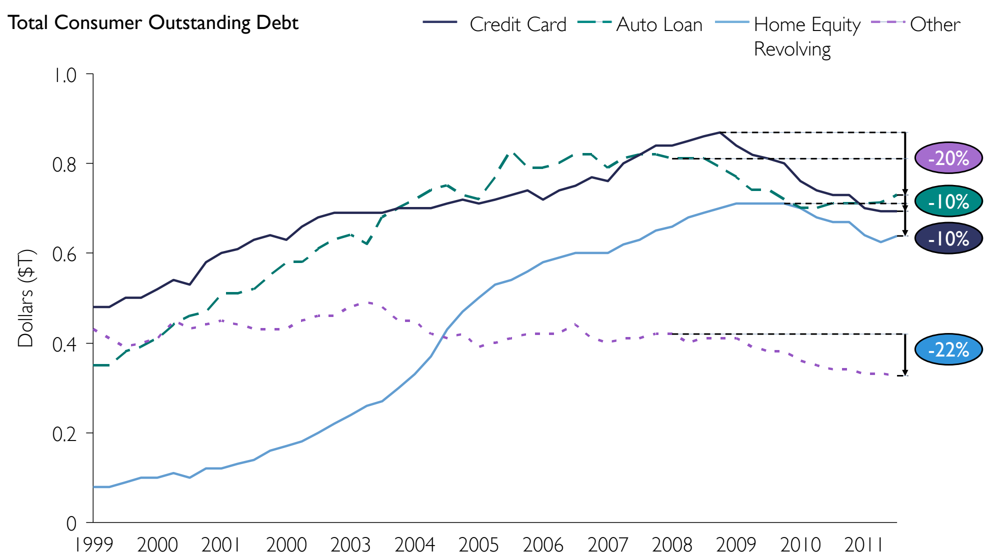
Source: Federal Reserve Flow of Funds

Outstanding debt in the financial and non-financial business sectors is down 26 percent and eight percent since their respective 2009 peaks. On a consumer level, total outstanding debt is down 11 percent from its peak in 2008, according to the New York Federal Reserve Consumer Credit Conditions.

Moreover, this decline extends throughout various loan types such as auto, home equity and credit card (Exhibit 23). Mortgage and home equity outstanding debt are down 10 percent from their peak, credit card debt is down 20 percent, auto loan debt is down 10 percent and other non-student loan categories are down 22 percent from their respective peaks. These numbers suggest that individual balance sheets are stronger on the liability side. While an estimated 60 percent of this reduction is due to defaults, the scope and magnitude of deleveraging are promising. In fact, a McKinsey Global Institute study recently found that the United States has reduced its overall debt burden (including federal government debt) more than Germany, France and the United Kingdom.[9]

Exhibit 23

PRIVATE SECTOR CONTINUES TO SHED NON-MORTGAGE DEBT SINCE RECESSION

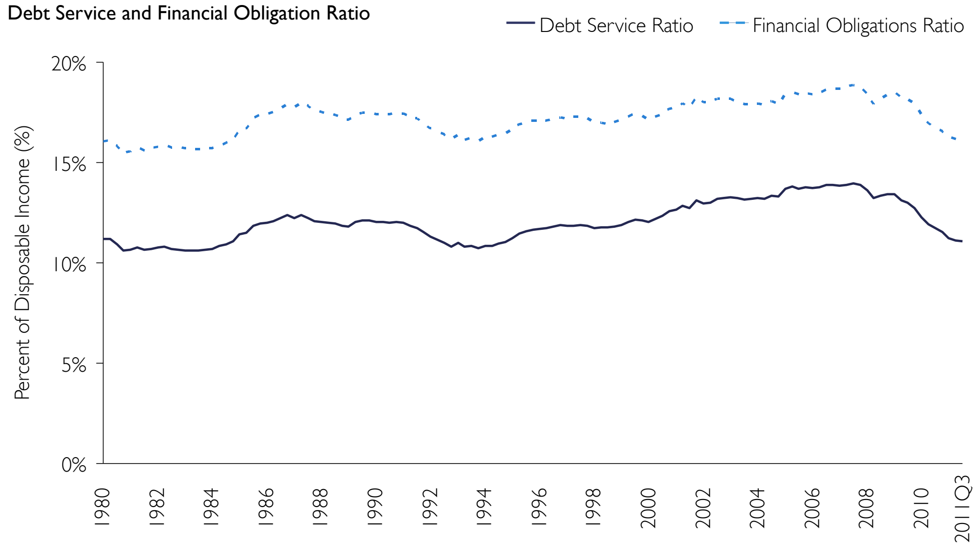


Source: NY Federal Reserve

While debt is down, unemployment is up and wages are stagnant. These dynamics may have counteracted individuals' debt reduction over the past several years. Yet, there is a third variable: interest rates. Interest rates have plummeted during the recession and the subsequent stagnant recovery. Individuals have been able to refinance into lower rates across a number of debt instruments. The ability to refinance lowers monthly payments. In fact, on average, individuals now face the lowest monthly payments as a percentage of their income since the early 1990s (Exhibit 24).

Exhibit 24

MONTHLY DEBT AND FINANCIAL OBLIGATIONS ARE AT EARLY 1990 LEVELS



Source: Federal Reserve

The debt service ratio is the amount of monthly debt service as a percentage of personal disposable income. The financial obligations ratio adds rent, homeowner's insurance, property tax and auto payments. Both are down to 1994 levels as of the third quarter of 2011.

These trends suggest that the private sector has adjusted since the recession. Debt levels are falling and monthly debt burdens are at historic lows. Healthier household balance sheets improve the safety and soundness of the financial sector as well as lay the foundation for future credit provision in two ways: 1) Outstanding loans are less likely to default as these levels continue to decline; 2) As economic growth returns, individuals will be in a stronger position to afford new loans to invest in real estate or make purchases.

Examining trends in lending shows the role of financial services' extension of credit during the recession. While businesses required less in loans, individuals needing to finance essential purchases received record levels of credit. Moreover, in the most recent quarters in which business demand increased, loan officers reported easing lending standards, and small businesses access to credit and borrower satisfaction increased.

Protection from Loss

While banks act as financial shelters, insurance companies act to hedge risk, compensating the insured party in the event of loss. Insurance companies pool clients' risks to make payments more affordable for the insured.

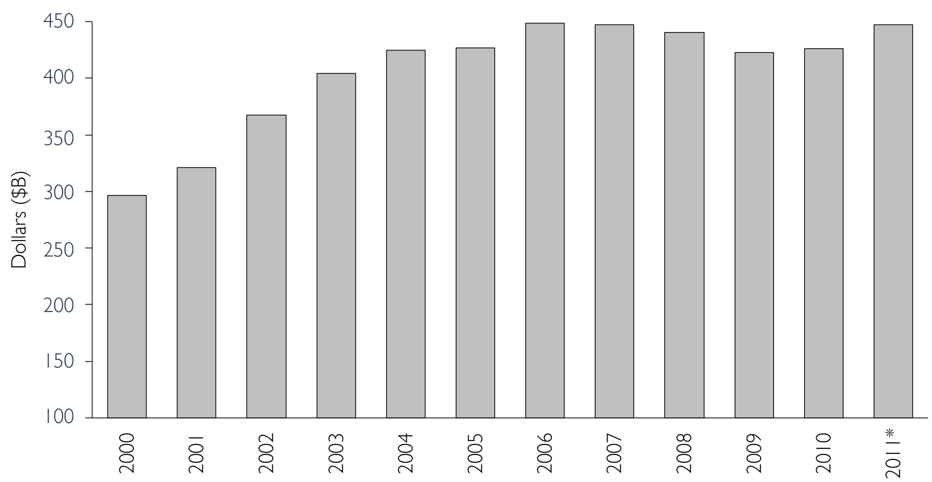
The P&C insurance industry insures homes, automobiles, individuals and businesses in case of loss, injury or legal claims. There are a host of other insurance products for both personal (individual) and commercial (business) lines.

Premiums are the dollar value paid to the insurance company in exchange for coverage. As of the third quarter of 2011 year-to-date, net premiums written for the P&C industry totaled $335.7 billion. On an annualized basis, 2011 year-end premiums are roughly $447.6 billion. Industry totals have not reached that mark since 2007 (Exhibit 25).

Exhibit 25

P&C INSURERS PREMIUM REMAINED STRONG THROUGHOUT THE RECESSION

Net Premiums Written for P&C Insurers



* Annualized based on third quarter year-to-date

Source: FDIC, SNL Financial

Net premiums written for a specific line of business is an insurers' retained premium income, which is either direct business or assumed reinsurance minus payments made for reinsurance ceded, for this specific line of business.

Spotlight: Support in Joplin, MO

One place where the insurance system worked as well as expected – in fact even better than expected – was Joplin, Missouri. The southwestern Missouri city was devastated on May 22, 2011by a massive tornado that claimed more than 150 lives and tore apart 7,000 homes and 2,000 buildings.

The deadly tornado produced more than 15,000 insurance claims, and Missouri's insurers were lauded for the quick, helpful and compassionate work they did in the aftermath. "This is the largest insurance event in Missouri history," said John Huff, Director of Missouri's Department of Insurance, Financial Institutions and Professional Registration. "The industry should be commended for the response thus far. Within 100 days after the event, they had paid out $1 billion to policyholders."[10]

> **"The industry should be commended for the response thus far. Within 100 days after the event, they had paid out $1 billion to policyholders."**

Loretta Bailey is an Allstate agent who experienced the tornado first-hand and played an integral role in helping her customers rebuild their lives. Hearing sirens indicating bad weather is common in this area of the U.S. This time was different, as the warnings advised that the tornado was headed straight into Joplin. Bailey rushed home, parked her car in the garage, and joined her boyfriend in the basement just as the tornado was close enough to make the fans in the home's furnace rapidly spin.

The damage was catastrophic. While Bailey survived the tornado, her house and car did not. She decided to head to the Allstate office, which she initially couldn't get to due to the town's wreckage. Eventually, she and some of her colleagues set up shop with laptops in a nearby business, and immediately started giving their fellow community members the checks they needed to get basic necessities in addition to funding for new residences and cars. Allstate was widely praised for its efficiency in the days and weeks after the tornado.

Bailey proudly tells the story of one elderly couple that rode the tornado out inside a fireplace. Significant damage was done to their residence, and within seven days they were given a claim check and the ability to purchase a permanent home. "I realized why I do what I do," she says. "I realized what I am giving back to the community. People would come in, and I would tell them what their policy pays them, and see the relief on their faces and the words 'we're going to be ok. It's going to be alright.'"

"People ask, 'How can you help others when you're hurt yourself?' I told them that when I signed on to be an Allstate agent, I signed on to help people. People were coming to us and saying, 'My neighbors had [Allstate] as an agent, and had a check in their hand so quickly. You were out there, you weren't just sitting in the office waiting to be called.'"

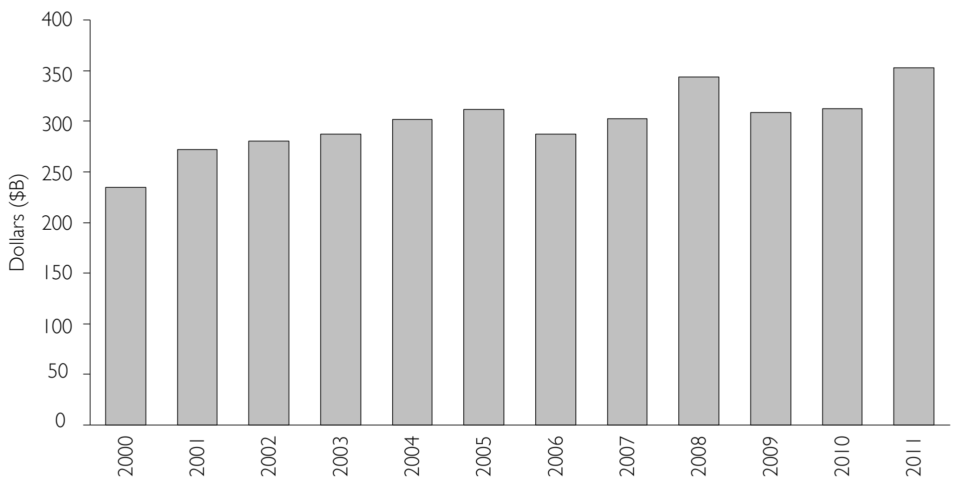
Based on policy coverage, when the insured party experiences a loss, the insurer must reimburse in the form of a monetary benefit. Total benefit or "payouts" for the P&C industry amounted to $264.6 billion year-to-date as of the third quarter of 2011, for an annualized amount of roughly $352.8 billion. If year-end values prove to be around the annualized amount, payouts in 2011 would be the highest on record (Exhibit 26).

2011 was a bleak year for catastrophic events, and this contributed to the large amount of payouts. While these losses are not favorable to the industry, they are extremely helpful to the insured parties, providing monetary benefit in time of need.

Exhibit 26

P&C INDUSTRY PAYOUTS WERE AT AN ALL-TIME HIGH IN 2011

Loan & Loss Adjusted Expense



* Annualized based on third quarter year-to-date

Source: FDIC, SNL Financial

Also affected by the large amount of losses due to catastrophic events was the reinsurance industry. In order to reduce risk, insurance companies transfer risk to a reinsurance company, which assumes all or part of the risk. This reduces the overall amount one company can pay for a specific claim. Instead, the premiums and losses are shared. The process is known as 'reinsurance'.

Although 2011 produced record losses that affected reinsurance performance, as a whole, the industry remains strong with stable capital and performance ratios well situated.[11]

Whereas the P&C industry covers losses on physical and economic assets along with other liabilities, the Life industry provides coverage to a decedent's family or other beneficiaries in the case of loss of life, illness/disability and other events. Life insurance can provide those left behind with a lifetime of financial security.

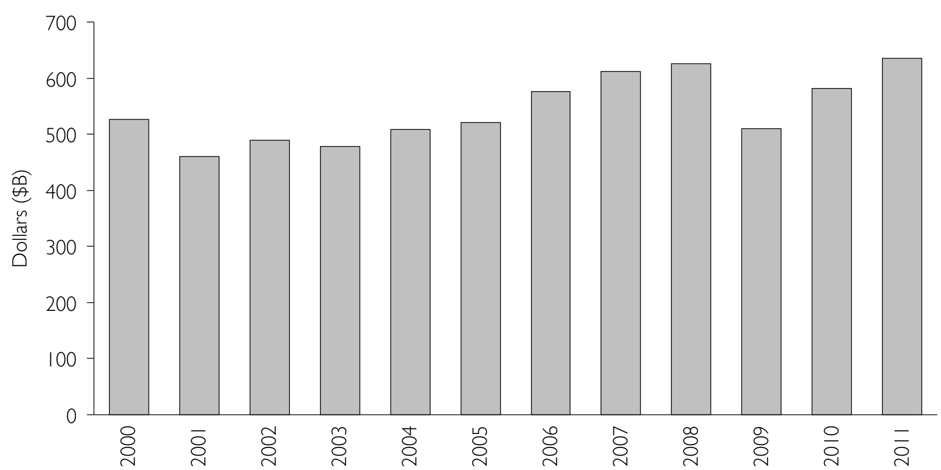
The method of obtaining a policy follows the same process as it does for the P&C industry – payment of premiums (annuities or deposits) in exchange for coverage.

The Life industry had Premiums, Consideration and Deposits (a comparable metric to Net Premiums for the P&C industry) of $476.8 billion as of the third quarter of 2011, and an annualized amount of roughly $635.7 billion (Exhibit 27). Given three consecutive quarters of growth in 2011, the year-end value would represent the highest amount for the industry on record.

Exhibit 27

LIFE INSURERS' ANNUITY AND LIFE INSURANCE PREMIUMS HAVE STRONGLY REBOUNDED

Net Premiums, Considerations and Deposits for Life Insurance



* Annualized based on third quarter year-to-date

Source: FDIC, SNL Financial

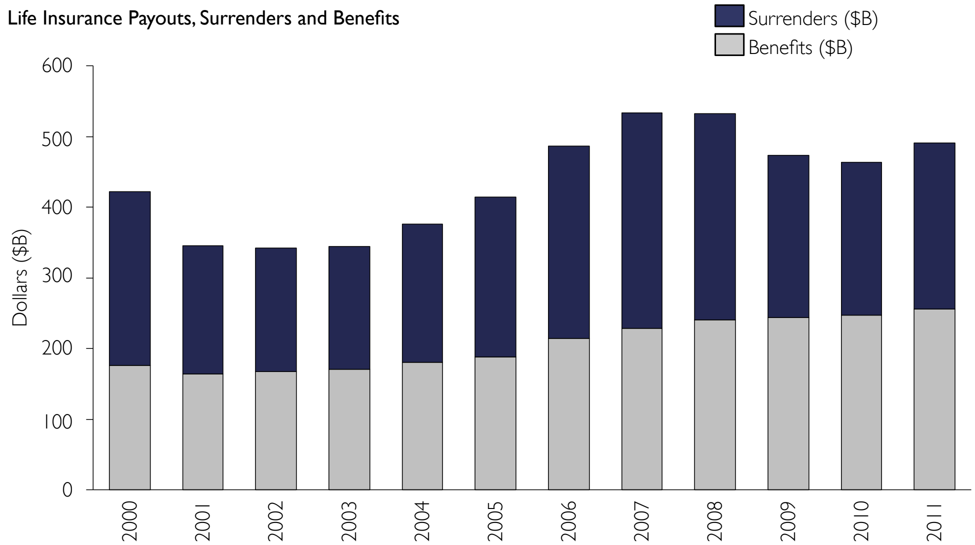
Life insurance payouts are measured in the form of Benefits and Surrenders. Year-to-date payouts as of third quarter of 2011 for the industry amounted to $368.3 billion, with an annualized amount of $491.1 billion, which is in line with historical levels (Exhibit 28).

Benefits include death benefits, matured endowments, annuity benefits, accident & health benefits, guarantees, group conversions, and life contingent contract pay.

Surrender benefits and withdrawals for life contracts include all surrender or other withdrawal benefit amounts incurred in connection with contract provisions for surrender or withdrawal.

Exhibit 28

LIFE INSURERS HAVE INCREASED PAYOUTS SINCE 2010



Source: FDIC, SNL Financial

The industry's main role is to provide coverage in the event of loss; however, investments made by the P&C and Life industries in stock markets, bonds and other asset classes contribute to economic growth.

The benefit of investment income is vast. In short, companies are able to use invested funds to expand (increase employment) and increase shareholder value, while governments at the national, state and local levels are able to use the funds to the benefit of the taxpayer.

As a whole, the insurance industry (including Health insurers) had cash and investments of $4.65 trillion in 2011. These investments are used to generate earnings, which are then used to provide payouts to insured parties and pay dividends to investors and policyholders.

Spotlight: Financial Planning

One particular bright spot in the financial services industry is the planning and advisory sector. Retiring Americans are increasingly reporting positive, comforting results when it comes time to leave the workforce and enjoy the next phase of their lives.

David L. Blaydes, CFP, MS says his clients are regularly surprised and relieved to see that their retirement packages withstood the recent recession and will indeed allow them and their loved ones a pleasant retirement. Blaydes, a Certified Financial Planner with a Masters in Financial Planning is Founder and President of his own firm, Retirement Planners International, Inc. in Naperville, IL. He tells a particularly powerful story of one such client.

Blaydes' client was a successful Chicago-area attorney who planned to retire on his 65th birthday in 2011. This client had invested wisely, heeding Blaydes' advice about how much to invest in his 401(K), and how to diversify it according to the rate of return needed to accomplish his goals. Importantly, this resulted in a substantial reduction of risk before the 2008 market downturn. The client was pleased with his retirement plan, and told Blaydes he was ready to cash out on his life insurance policy and start making use of that money.

Blaydes advised his client against this decision and used data from the client's own plan to show him why the insurance was, from a planning perspective, still a wise investment. The client took the advice, which Blaydes was able to objectively offer as a financial planner, not an insurance underwriter. Within a month, the client asked Blaydes to visit him at his home. House visits are not in the typical course of business, and this caused Blaydes some anxiety as to what the issue could be. Upon arrival, Blaydes was given the sad news that his client had just learned he had only six months to live. He asked Blaydes to assure his wife that she would have what she needed without him, and thanked Blaydes for the counsel. He has since passed away, and the $1,000,000 of insurance he decided to keep, based on Blaydes' recommendation, has allowed his spouse to maintain her financial independence for the rest of her life, just as he wanted.

Blaydes believes that his industry has fundamentally changed for the better over the past 30 years, and is now focused not just on selling a financial product, but on compassionate caring for clients and acquiring the technical skills that are demanded by complex planning.

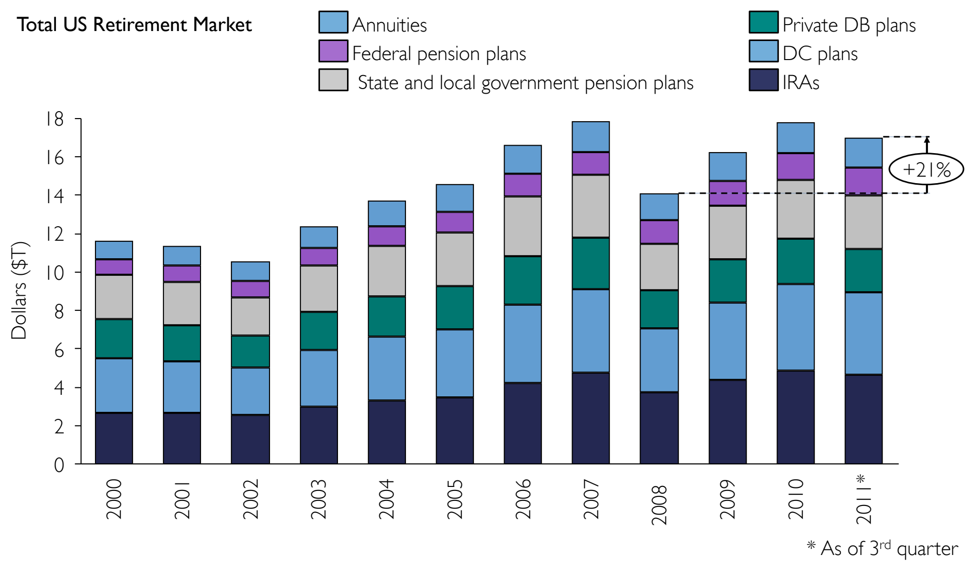
Saving for the Future

Having adequate retirement savings is vital to personal financial security and a big component of our financial services. According to the Investment Company Institute (ICI), as of the third quarter of 2011, retirement savings accounted for 36 percent of all household financial assets in the United States, equal to roughly $17 trillion (Exhibit 29). This level amounts to a 21 percent increase since 2008 with increases in all retirement financial vehicles.

Total retirement savings are aggregated using six plan types: Annuity Reserves, Federal pension plans, State and Local pension plans, Private Defined Benefit Plans, DC Plans and IRAs. All plan types fell from 2007 to 2008; however, IRAs took the largest hit, going from $4.7 trillion to $3.7 trillion, a 22 percent decrease. As of the third quarter of 2011, IRAs represent 4.6 trillion of the U.S. total retirement market, a 25 percent increase since 2008.

Exhibit 29

TOTAL RETIREMENT MARKET STANDS ABOVE 2006 LEVELS AT $17 TRILLION IN Q3'11



Source: Investment Company Institute

Much of the planning aspect behind retirement advisory involves the balancing of a portfolio. Known as "asset allocation," investors must make a choice of tradeoffs between risk and reward. Risk is determined by a variety of factors, but is most often associated with age of the account holder. As individuals near retirement and their personal risk aversion rises, the dollar proportion of bonds (fixed income) will replace holdings of equities.[12]

Value to the Economy Summary

The core functions of our financial institutions are critical to our economy. Deposits, while a simple service, provided a safe place for our finances during volatile times. Consumer loans increased to help our financing needs during the crisis and, more recently as our economic recovery has picked up, loans have increased to small businesses to finance job creation. Insurance is there to support us during the most difficult times, and the full range of our financial services support us as we plan for the future.

Regulatory Spotlight:
The Durbin Amendment

The least understood aspect of regulatory policymaking in Washington is unintended consequences. Unforeseen costs and unexpected outcomes are inevitable given the current scale and scope of new regulations.

In the midst of a slow recovery, these costs should be at the forefront of the debate. For example, higher capital requirements associated with Basel III may result in less credit growth, higher interest rates and slower economic growth in the short-run.

Congress and regulators do not develop rules with the intention of reducing economic growth or unnecessarily hurting American companies. However, by imposing overly burdensome costs and creating unintended consequences, poorly crafted regulatory policy can do just that. The poster child for this type of counterproductive regulation is the Durbin Amendment.

This section of the report will evaluate the merits and outcomes of the Durbin Amendment. We will evaluate the claims made by both sides of the debate based on what has been seen over the first four months of the law's enforcement. While the Durbin Amendment is unlikely to be changed in the near future, this analysis can inform future regulatory debates.

Key Findings:

- The enforcement of the Durbin Amendment in the fall of 2011 has resulted in a rollback of consumer benefits with no retail price reductions
- The percent of checking accounts that are free has dropped by 30 percent
- A study found that retail prices actually increased 1.7 percent after the Durbin Amendment took effect
- Small businesses specializing in small-ticket items have seen costs rise significantly due to the Durbin Amendment

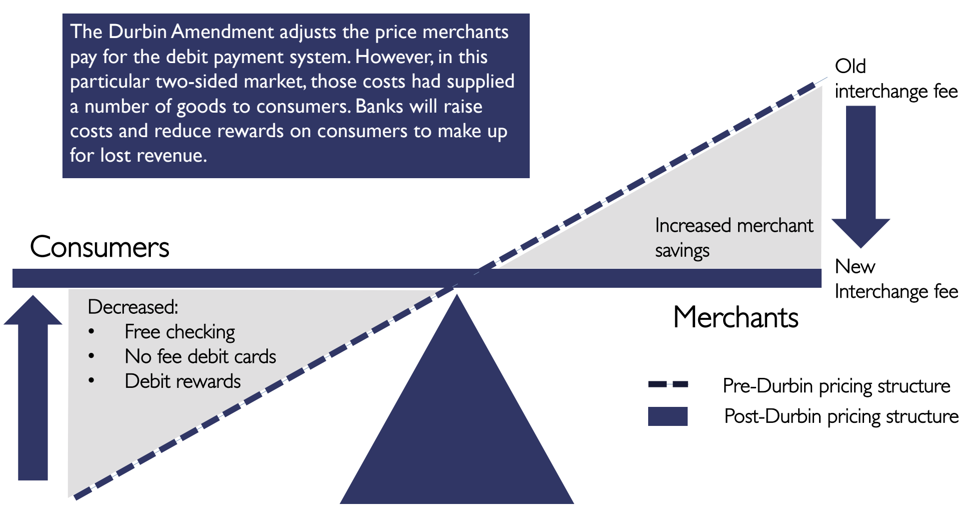
The Durbin Amendment pitted merchants against banks over approximately $17 billion in annual interchange fees, the cost merchants pay banks for processing debit card transactions. While the lobbying battle was business against business, consumers are impacted as well. Unfortunately, our analysis finds that the Durbin Amendment has made consumers worse off.

The Immediate Effects of the Durbin Amendment

In the first four months of its implementation, the Durbin Amendment has led to profound changes on the merchant and consumer side of the market. Just as increased interchange fees in the 2000s helped increase the availability of free checking, no-fee debit cards and rewards programs, reduced interchange fees will cause benefits to be scaled back. Meanwhile, there is no evidence that merchants, who received a major windfall, have lowered prices (Exhibit 30). The price controls in the Durbin Amendment completely ignore the economic incentives facing both banks and merchants.

Exhibit 30

REDUCING INTERCHANGE FEE SHIFTS COSTS TO CONSUMERS

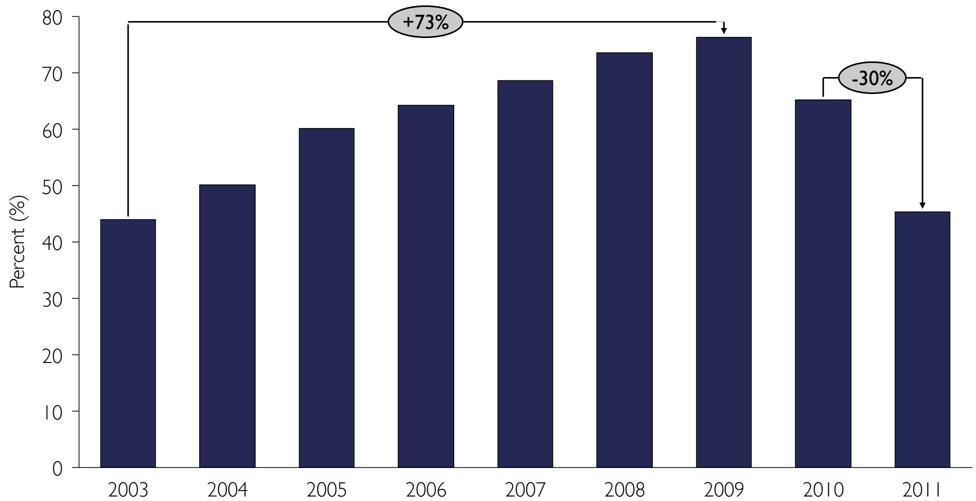


Bankrate data shows that the amount of free, non-interest bearing checking accounts peaked in 2009 at 76 percent, fell to 65 percent in 2010 due to the regulation of overdraft fees, and then fell even further to 45 percent due to the Durbin Amendment. (Exhibit 31). Free checking is less available now than it has been in the past six years. The cost in terms of access to traditional banking services is steep. One estimate found that approximately one million people may forego checking accounts at traditional banks.[13]

Exhibit 31

FREE CHECKING OFFERS HAVE DECREASED 30 PERCENT SINCE 2010

Percent of Non-Interest Checking Accounts that are Free



Source: Bankrate.com

While interchange fee revenues helped support no-fee debit cards, the Durbin Amendment has led to banks attempting to make up the lost revenue elsewhere. Consumers pushed back against banks that tried to charge debit card fees, but a reduction of previously free benefits on other services have not drawn such protest.

Increasingly, debit rewards programs are being terminated as the revenue used to support them evaporates. According to Pulse Network's 2011 Debit Issuance study, which took place prior to the Amendment's implementation, 54 percent of institutions were looking to re-structure or terminate rewards programs due to Durbin.[14] Bankrate's Fall 2011 Check Card survey found that 30 percent of banks surveyed the year before had terminated their debit rewards programs in 2011. The early results are clear; the Durbin Amendment has reversed the trend of lower consumer costs for debit cards and other bank services.

"The banks will charge you more, and I don't think the retailers are going to charge you less, which is why I didn't want to put it in the first place."

-Rep. Barney Frank

While banks have had to recoup lost revenue, merchants have not passed on savings to customers to offset their gains. A study by the Electronic Payments Coalition (EPC) surveyed the cost of a set basket of goods before and after the Durbin Amendment went into effect. The EPC study found that the cost of this basket of goods actually rose 1.7 percent.[15]

The result of this study is not surprising. International experience in Australia found no evidence of price reductions due to reduced interchange fees.[16]

The economics behind these results are simple. While the banking industry is highly competitive, merchants face various levels of competition. Prices tend to be sticky for merchants.[17] Merchants tend to price items around focal points such as $9.99 and face menu costs, the actual cost to changing prices. As a result, we have a situation where banks are reacting to price controls by cutting costs, while merchants have little incentive to reduce prices.

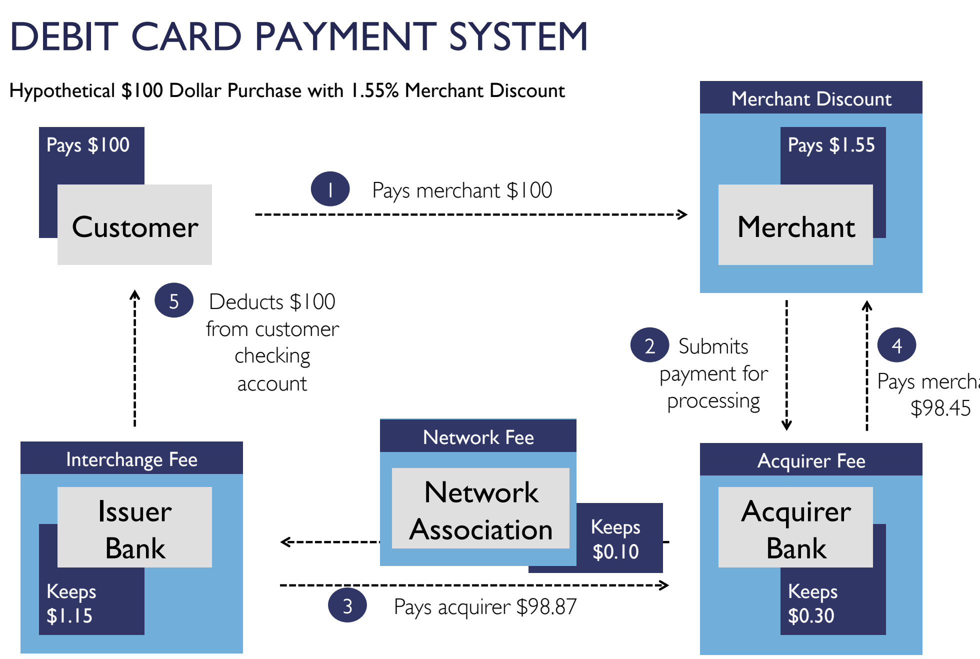
This situation was not lost on some legislators. Representative Barney Frank (D-MA-4) stated "The banks will charge you more, and I don't think the retailers are going to charge you less, which is why I didn't want to put it in the first place."[18]

The Durbin Amendment has led to a significant reduction in free checking, fewer rewards programs and consumers have not seen lower prices from merchants. Consumers are clearly worse off. This outcome should be no surprise if we consider the history of payment options and the economics of these systems.

Durbin Amendment 101

When a customer swipes a debit card to purchase an item, the merchant, two banks and the network association all process the transaction (Exhibit 32).

Exhibit 32



Source: GAO, Congressional Research Service

After the card swipe, the merchant submits the payment for processing by routing the card information through an acquirer bank to the card issuer bank. The merchant contracts with the acquirer bank, while the issuer bank is responsible for the card. After the process is approved, the money, minus the interchange fee and the acquirer fee, is transferred back to the merchant. The issuing bank deducts the full cost of the item purchased from the customer's account.[19]

The Durbin Amendment capped interchange fees at 21 cents to 24 cents per transaction, depending on anti-fraud investments by issuers. The cap was intended to keep fees at cost.

Prior to the Durbin Amendment, the average debit purchase was $38 with an interchange fee of 44 cents.[20] Therefore, banks will lose 45 to 52 percent of their potential revenue from reduced debit interchange fee if benefits, behaviors and purchase patterns hold constant.

Central to complaints made by merchants was that over the same time period of rising interchange fees, the cost of processing transactions and mitigating fraud fell. Merchants argued that the rise in fees above the cost of providing the service was an anticompetitive practice in need of price control. The merchants' argument was that due to Visa and MasterCard's market power, they could present "take it or leave it" offers that merchants had to go along with.[21]

While this argument might sound intuitively correct, it rests on the theories of one-sided markets where the seller is producing a good for one buyer. The payment card system, however, is a two-sided market where the seller is balancing the demands of both consumers and merchants. Evaluating what is a "fair" price in a two-sided market requires a different framework than that of a one-sided market.

Debit Card Payment as a Two-Sided Market

In the debit card payment system, there is a two-sided market, where network associations must balance the demands of consumers and merchants. Consumers enjoy the convenience, organization and rewards of paying with a debit card, while merchants benefit from increased sales due to these consumer incentives, as well as more efficient checkout and accounting processes.

Like the debit card payment system, news sources must balance the demands of both consumers and advertisers. Consumers want low-cost (if not free) news. Advertisers want to reach a large audience. The challenge for the news source is to price both sides accordingly to maximize the use of the product. In this instance, charging advertisers more and consumers less benefits both readers and advertisers. Readers get low-cost content and advertisers, while bearing most of the cost, reach a larger audience. These types of markets, where sellers balance the demands of two buyers, exist throughout the economy and in almost every situation where one buyer subsidizes the other.

When lobbying for regulatory action, merchants have highlighted the rising costs of the payment system on one side of the market. Very little attention, however, has been paid to the other side. As outlined above, one must examine the overall price of the payment structure to determine competitiveness, not just one side. We find three concrete cost reductions over the past decade: free checking, the introduction of no annual fee debit cards and debit rewards programs.

According to Bankrate's Fall Checking Studies, in 2003 only 44 percent of non-interest checking accounts were free. By 2009, 76 percent of non-interest checking accounts were free (Exhibit 33). This rise of free checking has helped lower consumer costs and brought more people into the formal banking system.

Beyond free checking, banks have reduced costs for holding debit cards. In the early 2000s it was common for debit cards, especially PIN debit cards, to carry a swipe fee for consumers. Now, according to a Bankrate Check Card study, 95 percent of the top 100 depository institutions offer debit cards with no usage fees.

In addition, card-issuing banks have instituted debit card rewards programs, such as airline miles and cash back incentives. According to Pulse Network data, the number of institutions offering debit rewards increased from 36 to 58 percent from 2005[22] to 2011.[23] Consumers have not just seen lower overall costs, but have many options to maximize their personal benefit from the card.

The Durbin Amendment Summary

The Durbin Amendment represents an attempt to legislate against economics and the loser has been the consumer. The Amendment's intrusion into the payment market through instituting price controls has led to distortions that have raised costs to consumers and small business while reducing innovation. As we look at future regulatory proposals, the experience of the Durbin Amendment should be a cautionary reminder to carefully weigh the costs and benefits of regulation and to be wary of unintended consequences.

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