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A Dodd-Frank Do-Over?

By: Nancy A. Bush, CFA
NAB Research, LLC
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Just when we thought we had Dodd-Frank—that massive, monstrous legislative by-product of the Financial Crisis—figured out, along comes a member of Congress who wants to chuck a large part of it and start over. Yes, we're speaking of Congressman Jeb Hensarling, Republican of Texas and chairman of the House Financial Services Committee, who has honed in on Dodd-Frank as one of the major growth-killers of our presently moribund economy.

This is not a new posture for the Congressman; indeed, his ideas for reforming Dodd-Frank have been on the table for several years now. Mr. Hensarling wrote an Op-Ed piece in the *Wall Street Journal* last year (titled "After Five Years, Dodd-Frank Is a Failure") in which he enumerated the ways that he saw Dodd-Frank as a major contributor to financial system instability and economic malaise. And in many of the areas that he named, he has a point. The virtual disappearance of free checking due to the impacts of the Durbin amendment; loss of liquidity in markets due (at least) partly to the Volcker Rule; and most emphatically, the authoritarian powers bestowed on the Consumer Financial Protection Bureau, with its endless avenues to oversee and to regulate the interactions between banks and their retail customers—all of these were engendered by Dodd-Frank and its add-ons.

We spoke with a number of financial industry observers and participants in preparation for this piece, and we were surprised to find little enthusiasm for Mr. Hensarling's proposed revisions. The overwhelming observation was that his proposals had two chances of becoming reality—slim and none—and that banking industry managements and observers would become more engaged with his ideas should it look like there was a serious chance that the political regime in Washington was about to change and that a major Dodd-Frank revision could indeed succeed. Even if the Republicans manage to keep control of the House and Senate, a Hillary Clinton presidency would see little possibility of banking reform of any type, and at this juncture no one knows the thoughts of Donald Trump as they pertain to banking regulation. So the assumption is that political stasis will prevail, and that banking oversight as it is presently constituted will survive largely intact.

We also wonder if there is not a bit of "regulatory fatigue" at present, and that many in the industry simply do not wish to see a major overhaul of the ground rules at this juncture. We have come to the end of the DFAST and CCAR cycle for this year, and the result has been very positive in spite of a "severely adverse" stress scenario for the largest banks that was stressful indeed. Add to that fact the additional uncertainties for the global economy that have just been introduced by the Brexit vote in the U.K., and now might not be the best time to be seen weakening the banking regulatory structure in the U.S., one which is widely conceded to be the world's most rigorous and effective.

The draft of Mr. Hensarling's potential legislation (called the Financial CHOICE Act) is over 500 pages, versus 2,300 for Dodd-Frank and thus it appears to be somewhat simpler. It's difficult at this juncture to judge the merits of all of his ideas, but they seem to break down mostly into a requirement for more capital in the banking system in exchange for an exit from some of the more invasive aspects of the regulatory regimen that exists presently. The most publicized requirement is that the nation's largest banks would maintain a 10% leverage ratio—that is, 10% common equity to assets—in exchange for leaving aside the Volcker Rule (which dictated the end of proprietary trading), avoiding designation as systemically important financial institutions (SIFIs), and escaping the clutches of the Basel regulatory regime (eliminating liquidity requirements, for example.)

There are benefits for smaller and mid-sized banks—like the moving of the goalposts for DFAST requirements from $10 billion in assets to $50 billion and for CCAR from $50 billion in assets to $250 billion—but Mr. Hensarling's other signature proposal (and the one that is receiving near-universal acclaim from bankers) would be the restructuring of the much-maligned CFPB. That agency would be renamed the Consumer Financial Opportunity Commission and would be headed up by a 5-member bipartisan commission, as would be brought under Congressional oversight and funding mechanisms. (The CFPB is presently funded by the Fed and is basically under the oversight of no one.) In addition, the new commission's mandate would be expanded to a dual one—not only that of protecting consumers, but also ensuring the existence of "competitive markets." (Whatever that may mean...)

Congressman's Hensarling's plans for the CFPB are obviously a non-starter in an election year and have lent themselves to accusations from the left that his bill is more about politics than it is about finance. But we have also found that one of his long-term campaigns is almost universally unpopular with bankers—who are generally a right-leaning bunch—and that is his effort to bring the Fed under greater purview of the Congress and subject it to a more stringent process of audit and appropriations. (Note—contrary to urban legend, the Fed is already audited by a number of different entities, including the GAO, the OIG, independent outside auditors, etc. There is an extensive report on the subject on the Fed website.) The managers with whom we spoke overwhelmingly do not want to see the independence of the Fed compromised any more than it has already been, and while they may disagree with the Fed's present posture on interest rates, they see this posture as a by-product of the extreme Keynesianism in vogue now among economists, rather than as a particular political bent on the part of Janet Yellen and the Fed's Board of Governors.

So—Congressman Hensarling has drafted a bill that is both DOA under any likely political scenario and is not universally beloved by the companies that it purports to help. What should the banking industry and others do with that? Since the CHOICE Act is the first really comprehensive effort to correct what are some widely agreed deficiencies in the Dodd-Frank behemoth, we regard it as a useful starting point from which to debate some of its more thought-provoking aspects. (Like the trade-off between capital and liquidity that it implies, and which we believe to be completely and utterly wrong.) But at this juncture, no matter which regulatory regime prevails, our industry contacts believe that the future path for capital levels in banking is upward, that returns will continue to be impacted as a result, and that more and more sectors of the economy will find themselves cut off from credit as a result. We hope that a less partisan and more thoughtful debate on banking regulation will forestall that reality—but we're not holding our breath.

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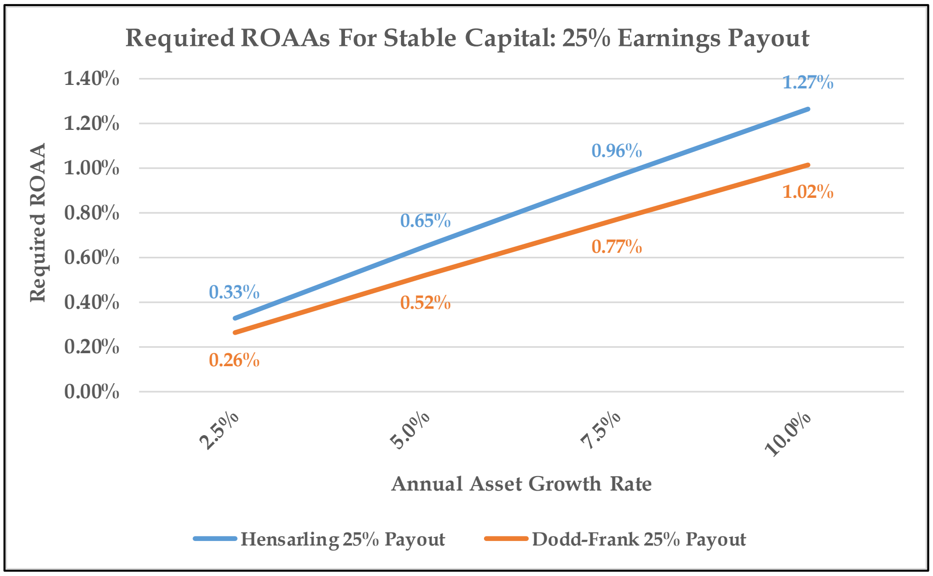
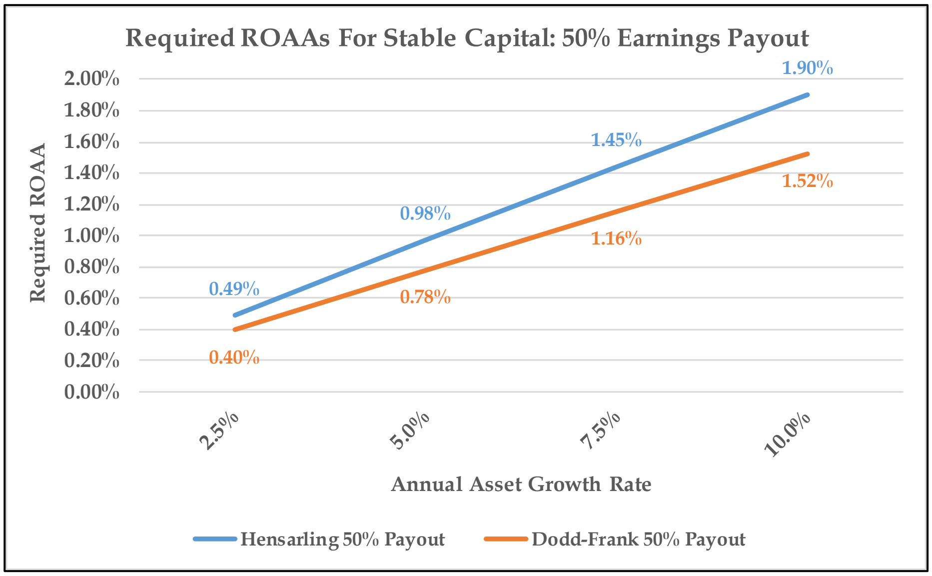
BSP Data Chart: Required ROAAs For Stable Capital

In order to maintain capital at the 10% proposed by Hensarling vs. the "new normal" 8% under Dodd-Frank (25% more required capital), a company has to produce increasingly higher returns on average assets annually depending on the level of asset growth and expected earnings payout in the form of dividends. For example, a company growing 7.5% annually and paying out 25% of earnings need only deliver a 77 bps ROAA to maintain its capital ratio under Dodd-Frank, but would need 96 bps ROAA minimum to maintain its capital ratio under Hensarling. A company wishing to pay out 50% of its earnings and grow 7.5% would need to produce a 1.45% ROAA at minimum under Hensarling's proposal, well above the typical ROAA produced by most banking companies.





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