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Industry Note
Industry Update

FINANCIALS RESEARCH

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Prospects for Reform of Dodd Frank

Ratings

Industry View:	Positive

KEY TAKEAWAYS

- For more than a century, prudential banking rules have evolved to promote systemic safety and soundness, access, competition and consumer protection. Furtherance of these principles is a crucial policy questions for proponents of amending or repealing the Dodd Frank Act.
- Political risk tolerance for the potential unintended consequences will inform the congressional process for re-drafting and eventually considering Chairman Hensarling's revised 2017 version of the Financial Choice Act (FCA). Hearings are likely in the first quarter of next year; timing for floor consideration in the House or Senate depends most on agreements among the White House, Senate Democrats and financial services trade associations.
- FCA's foundation is a trade-off for institutions willing to agree to a standard capital ratio (10% in the 2016 draft) for relief from many DFA and longer-standing regulations including risk-weighted capital requirements. In addition, the bill deregulates much of DFA's systemic risk rules, meaningfully changes the Consumer Financial Protection Bureau, and appends several targeted financial and capital market deregulatory efforts introduced in the House of Representatives during this Congress.
- Not all banking organizations support the bill. Many have complained it was drafted and introduced without detailed private sector input. Democrats on relevant committees of jurisdiction generally deride the bill as putting systemic health in the hands of institutions responsible for some excesses which contributed to financial and economic stresses of last decade.
- These and other factors complicate our ability to guess timelines and final substance of an expected FCA re-write. Our sense remains DFA is very likely to be amended before 2018 midterm elections and that the process will move more slowly than built into current expectations.

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Prospects for Reform of Dodd Frank

Introduction

The 2010 financial services reform law known as Dodd-Frank Act (DFA) certainly has been due for an upgrade, as is usually true of laws enacted in response to extreme circumstances. **Conceptually and politically, this law and the 1999 deregulation embodied in the Gramm-Leach-Bliley Act (GLB) which define the range of pendular changes in little more than a decade of US financial services policy.**

Our sense is that the next bank law update ultimately will end up between DFA and GLB, leaning a bit toward the latter as would reflect the result of 2016 campaigns strengthening Republicans' hands at the federal and state levels of government. **Despite conflicting or even contradictory statements from candidates during the past campaign, we agree DFA will be amended this year or next.** It remains impossible to discern just yet which individuals or ideas will drive the process and result.

Factors likely to help define outcomes include the Senate 60-vote threshold on filibusters; President-elect Trump's pick to run the Treasury Department; and, public perceptions of banks especially among people whose income derives strictly from labor. The last point covers many in supporters 'will of the people' populists. **Most likely, the next iteration of banking law will be shaped by a right-leaning coalition willing or forced to negotiate systemic risk and consumer protection arrangements.**

We are less sure that a resurrection of Glass-Steagall is necessary, practical, desirable or possible. **Activities of financial intermediaries no longer fall neatly into simple buckets like commercial or investment functions.** Balance sheet capacity, reduced dependence on wholesale funding, and operational risk mitigation are more important in a world of banking defined by a range including universal and community institutions. Attempting to arbitrarily limit institutions' activities based on size of their consolidated financials is one approach but not the only one. **Systemic soundness (including non-bank activities), consumer protection and access matter to most customers and taxpayers.**

Prospects for Dodd Frank Act (DFA)

For more than a century, prudential banking rules have evolved to promote systemic safety and soundness, access, competition and consumer protection. Furtherance of these principles is a crucial policy questions for proponents of amending or repealing DFA.

Political risk tolerance for the potential unintended consequences will inform the congressional process for re-drafting and eventually considering Chairman Hensarling's revised 2017 version of the Financial Choice Act (FCA). Hearings are likely in the first quarter of next year; timing for floor consideration in the House or Senate depends most on agreements among the White House, Senate Democrats and financial services trade associations.

FCA's foundation is a trade-off for institutions willing to agree to a standard capital ratio (10% in the 2016 draft) for relief from many DFA and longer-standing regulations. Conceptually, this offer is likely to appeal both to some market participants as well as some policy makers.

Section One of the existing draft describes an exemption available to eligible banking organizations willing to meet and maintain a capital ratio which entitles an institution to regulatory relief. Interestingly, this provision also shields exempt organizations from all financial stability considerations contained in Dodd-Frank.

The remaining sections of the bill deregulate much of DFA's systemic risk rules, meaningfully changes the Consumer Financial Protection Bureau, and appends several targeted financial and capital market deregulatory efforts introduced in the House of Representatives during this Congress (see Appendix).

Not all banking organizations support the bill. Many have complained it was drafted and introduced without detailed private sector input. Democrats on relevant committees of jurisdiction generally deride the bill as putting systemic health in the hands of institutions responsible for some excesses which contributed to financial and economic stresses of last decade.

These and other factors complicate our ability to guess timelines and final substance of an expected FCA re-write. Our sense remains DFA is very likely to be amended before 2018 midterm elections and that the process will move more slowly than built into current expectations.

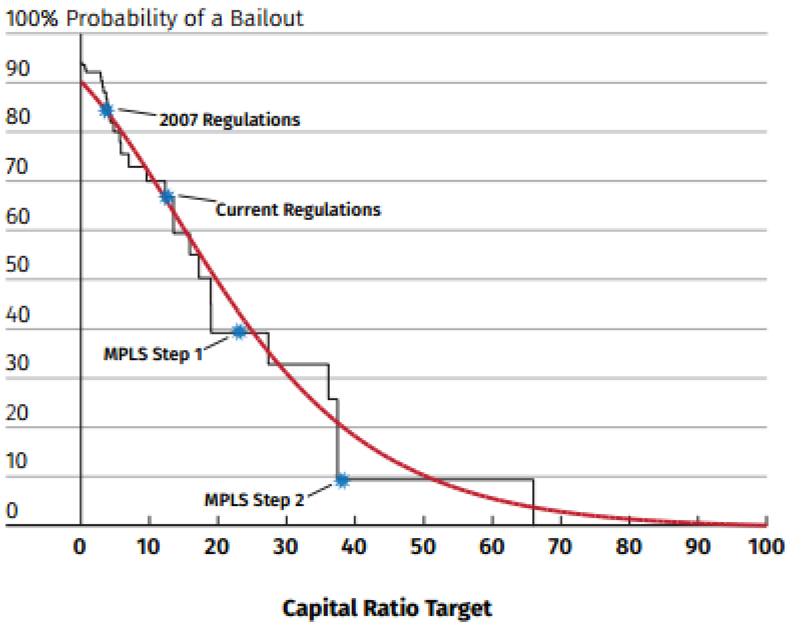
APPENDIX: The Minneapolis Plan and Financial Choice Act

How Much Bank Capital is Enough?

The public policy trade-off underlying bank regulation is that between financial stability on the one hand and the cost of financial intermediation, and its near-run impact on economic growth through the supply of bank services such as lending, on the other.

The balance-point is most easily affected by changing the minimum regulatory requirement for bank capital (a liability available to absorb losses and thereby reduce the chance of bailout using taxpayer funds). For example, in its "Minneapolis Plan", the Minneapolis Fed proposes reducing the probability of a bailout, which it estimates at 67% over the next century under current regulation, to below 10% through increasing the equity capital of large banks from the current 13% of risk-weighted assets to as much as nearly 40% for some institutions to the extent necessary for Treasury to certify that they cease to pose a systemic risk (Figure 1).

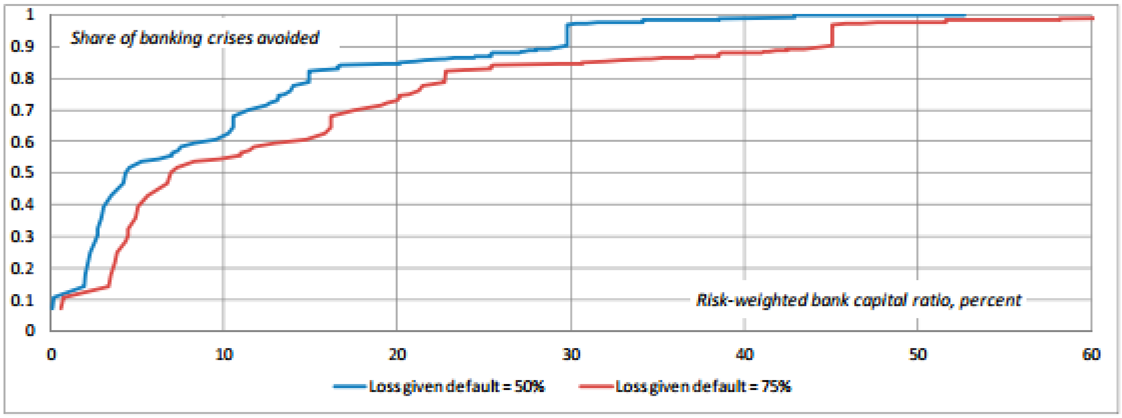
Figure 1: Probability of a Bailout in the Next 100 Years



Source: Federal Reserve Bank of Minneapolis

In a similarly-framed analysis, based on data from 28 banking crises in OECD countries, the IMF concludes that loss-absorbing capital (so, unlike the Minneapolis Fed analysis, including debt as well as equity capital) in-line with today's Federal Reserve requirement of 18% of risk-weighted assets for systemically important financial institutions or "SIFI's" would reduce the chance of bailout to 15-25% (depending on the assumption used for loss given default on loans), and that the marginal benefit of additional capital for risk-reduction declines quite sharply thereafter (Figure 2). The different estimates for the probability of a bailout under current regulation (67% by the Minneapolis Fed and up to 25% by the IMF) illustrate the danger of false precision in these studies: the IMF concludes the exercise requires "several simplifying and perhaps undesirable assumptions and its results are necessarily too model-, bank-, and sample-specific to provide convincing policy guidance".

Figure 2: Share of Banking Crises Without Losses Beyond Different Levels of Total Loss Absorbing Capital



Source: IMF

Indeed, the IMF goes further to argue that "estimating the optimal level of bank capital is likely an impossible task ex ante [since] it requires defining a social welfare function and estimating the effect of bank capital on the cost and availability of credit, the probability and severity of banking crises, and the impact of credit availability and banking crises on output and output volatility". Given the inability to compile a compelling analysis for policy guidance, along with a political climate shaped by the President-elect's pledge to "reduce anti-growth regulations" in general and specific complaint that banks are "unable to lend" because of regulation, we do not expect any transformational change in the current risk-based capital regime.

However, it may be complemented in the US by an approach consistent with that advocated in the Financial Choice Act (FCA), sponsored by Jeb Hensarling as Chairman of the House Financial Services Committee: that well-managed banks choosing to maintain a simple leverage ratio based on accounting, rather than risk-weighted assets whose computation involves regulatory judgements around riskiness, of 10% (versus the current regulatory requirement for US SIFI's of 6%) can find relief from the capital and liquidity requirements of the Basel 3-based regime. Exempt banks would not face regulatory limits on capital distributions or on mergers and acquisitions, but would still be required to participate in the agency stress-testing examinations.

Volcker Reform and Other Regulatory Relief Proposed in FCA

The Financial Choice Act (FCA) proposes broader regulatory relief to the banking industry beyond an off-ramp from the adequacy standards of the risk-based capital regime for well-capitalized and well-managed institutions including: a repeal of the Volcker Rule and Durbin Amendment; reform of the Consumer Financial Protection Bureau (CFPB) and Financial Stability Oversight Council (FSOC); and roll-back of Title II of DFA (which deals with the orderly liquidation of a non-viable financial institution). We briefly address these proposals before turning to the likelihood that elements of the FCA become law:

Volcker Rule: The Volcker Rule prohibits those banks with access to the safety net features of the banking system, such as FDIC deposit insurance and the Fed discount window, from engaging in proprietary trading and from sponsoring hedge funds and private equity funds. It exempts market-making, where banks buy and sell securities on behalf of customers, arguing that this activity is less risky than proprietary trading, where banks buy and sell securities for their own account, and is necessary for the smooth functioning of capital markets. The FCA would repeal the Volcker Rule on the grounds: (i) that it cannot be sensibly implemented given the line between proprietary trading and managing inventory for client transactions cannot be policed, and is in many cases is a matter of intention rather than observable behavior; and (ii) that the stability benefits of risk-reduction are not outweighed by the economic costs of reduced market liquidity most notably as banks cut the inventories supporting liquidity in the corporate bond market.

Durbin Amendment: The Durbin Amendment sets a cap on the "interchange" fee paid by card-accepting merchants to card-issuing banks on debit transactions, and establishes a framework for processing or "routing" transactions that allows merchants more ability to select a card network on a transaction-by-transaction basis. The FCA would repeal the Durbin Amendment on the grounds: (i) that merchants are provided adequate protection by the ability to take legal action under anti-trust law so that the Durbin Amendment is a case of Congressional over-reach; and (ii) that, in any event, its practical impact has been to restrict the availability of free checking accounts (with 37% of banks offering free checking in 2015 versus 75% before the interchange caps of the Durbin Amendment were implemented in October 2011), and to increase the minimum balance required to avoid account maintenance fees.

Consumer Financial Protection Bureau (CFPB): The DFA mandate of the CFPB is to enforce federal consumer financial law, to ensure consumers have access to financial products and services offered in fair, transparent, and competitive markets. The FCA notes that, uniquely among regulatory agencies, the CFPB is funded by the Federal Reserve in an amount deemed necessary by a sole Director serving a 5-year term, and therefore falls outside budgetary oversight by Congress. The FCA's concern is that, given these freedoms, the CFPB has abused or exceeded its statutory authority (for example by limiting the ability of consumers to contract to resolve disputes through arbitration) and, in the process, harmed consumers by restricting access to financial services particularly among the under-banked and those seeking mortgages; it proposes to increase accountability by making the CFPB subject to the usual congressional appropriations procedures, and replacing the sole Director with a bipartisan commission,

Financial Stability Oversight Council: The FSOC is charged with identifying risks to financial stability and promoting market discipline through eliminating the moral hazard created by an expectation of government bailouts. As heads of the federal financial regulatory agencies, the voting members of the FSOC are presidential appointees, and the FCA complains that as a result the ability of the FSOC to designate non-bank financial institutions (a.k.a. "shadow" banks), including financial "utilities" such as payment systems and central clearing counterparties, as systemically-important (which has been legally challenged by MetLife) introduces political risk into the financial system that is outside the normal checks and balances applying to the regulatory agencies themselves, and can distort competition by endowing the liabilities of those institutions designated as systemically-important with an implicit government guarantee. The FCA would maintain the FSOC as an inter-agency forum for information-sharing and coordination, but repeal its authority to designate shadow banks as systemically important and to restrict or outright prohibit certain activities of these shadow banks.

Orderly Liquidation: The orderly liquidation authority (OLA) of Title II allows the FDIC to place systemically-important financial institutions that are at risk of failure into receivership under Federal control and, if deemed necessary for financial stability, provide a bailout through the Exchange Stabilization Fund. The FCA argues that, beyond the moral hazard of an implicit guarantee, this introduces uncertainty into investors in distressed financial institutions since they will have no advance assurance as to whether resolution will be through the Bankruptcy Code (either Chapter 7 or Chapter 11) or through Federal receivership under Title II. The FCA would prohibit the use of the Exchange Stabilization Fund to bail out a financial firm or its creditors, and repeal the authority of the FDIC to seize a firm whose imminent failure is viewed as jeopardizing financial stability and add an additional chapter to the bankruptcy code designed to accommodate the failure of a large, complex financial institution.

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