Capturing Advantage Despite Uncertainty: U.S. Financial Policy under the Trump Administration

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Key Petrou Points

- M&A, product realignment, and asset/liability balances have largely been on hold since 2Q/16. Markets, though, are on the move, creating significant opportunity costs and risks as banks wait for regulatory certainty.
- Given the pace of nominations/confirmations and legislative action, uncertainty will continue on key questions until at least 1Q/18. Advocacy in this critical period will have significant impact on policy outcomes, but awaiting certain results from ongoing advocacy increases opportunity cost and strategic risk.
- U.S. financial regulation is likely to be substantively changed through a series of capital, liquidity, and governance revisions with strategic consequence varying by company size, charter, and business mix.
- Opportunity identification and incremental strategic planning will position U.S. financial institutions for first-mover opportunity and reduce realized exposure risk.

Thank you Mark [Olson] for that warm introduction. We have known each other for more decades than I think necessary to count, but I do want to mention how happy I am to speak to a group you have organized after years of public service, most recently on the Board of Governors at the Fed. Your leadership then and now have made a continuing difference to American banking.

Mark has asked that I describe the U.S. financial-policy framework as we meet together after a stunning election and tumultuous early going of the new Administration. With a new Congress, new President, and soon-to-be new roster of top regulators and monetary policy-makers, it's tempting to sit back and wait for the conclusion of all the debates now gripping Washington. I don't think any of us advising financial companies doing business in the U.S. have that luxury precisely because none of our clients does.

Policy moves slowly to certainty, but markets capture comparative advantage at every turn. If a financial company starts to think about its future during the first quarter of 2018 and then goes through the usual decision-making process, it's not going to be ready to do anything new of note until the third quarter of next year – and maybe not even then given the uncertain outlook now for the U.S. mid-term elections.

In short, waiting for policy certainty is like waiting for the absolutely most perfect day before venturing out for a walk. In practice, we all optimize externalities (that is, go out when it's nice without demanding it be perfect), take into account the best forecast we can get, double-check before we go out in case we need an umbrella, and then take that walk. I can't tell you what each financial company's uncertainty tolerance is because that's of course a matter for each board and management based on risk appetite, price sensitivity, and the like. I can, though, give you my best forecast for how several franchise-value critical issues may be decided as the new federal team gets down to the really hard work during the second half of 2017. I'll then suggest how to double-check initial plans and – most challenging of all – know when it's time to make the go/no-go call.

The Post Post-Crisis Rulebook

Ever since the 2008 financial crisis broke with almost-unprecedented fury, federal regulators have been making up for the lapses that led to the debacle. The new regulatory regime is called the Dodd-Frank one with or without a couple of cuss words in front of it, but the agencies in fact built it out well before the law was signed in 2010 and had plenty of authority under prior law to do much of what they've done since. Strategic thinking about the next U.S. policy framework thus requires careful analysis of where substantive change can come under current law, how current law might change with regard to critical prudential requirements, and then who wins and loses based on probability forecasts of key actions germane to strategic decisions presented by a client's objectives in the context of a fast-changing market.

Given this, let me turn to what we should be watching in the regulatory rewrite. Treasury's new report is a critical starting point for analysis. Yes, the OCC, FRB, and FDIC are independent agencies that can do what they like regardless of what Treasury wants. And, yes, even if agency heads make major changes, agency personnel – especially rank-and-file supervisors – can still demand much more than one might think from boards, senior management, and compliance personnel. Nonetheless, Treasury's report lays out a series of reforms that many within and outside of the federal agencies realize should be made not because they want to "deregulate" banks, but because they've been implementing the rules as is for at least five years and see how flawed some post-crisis standards are proving on their own or when the cumulative impact of all of the rules is considered altogether.

So, what is most likely to change? A few key items:

- Capital: Just days after he succeeded Dan Tarullo as head of supervision at the Fed, Jay Powell signaled his desire to make major changes in bank capital standards, especially with regard to smaller companies and to the leverage ratio (LR) as it applies to the largest banks. In the past, the Fed feared doing so not because it worried about the risk involved, but more due to fear of political backlash from top Democrats such as Sen. Warren. In the current political environment, that matters less – indeed not at all – at Treasury. Even more interestingly, Fed officials and others once opposed to LR changes that take certain assets out of the denominator now think this may well be necessary to enhance market liquidity. I expect soon to see proposed changes to the LR and, at the same time, rules that make the GSIB-surcharge still tougher in terms of risk-based capital thresholds. Push some changes, propose others so no one can say that anyone is being too gentle on the biggest banks – that's the political order of the day.
- Liquidity: That same push-pull will drive how the current liquidity framework is changed. Treasury calls for exempting all but internationally-active banks from the liquidity coverage ratio, and I think that could happen once the new agency heads are in place. The Fed may soon finalize the net stable funding ratio, but do so only for the very largest banks, advancing the LR changes at the same time to correct for some of the now-recognized problems with the NSFR.
- Foreign Banks: Treasury recommends a dramatic change for foreign banks that would regulate them not by the size of their banking group, but rather by their U.S. "footprint" independent of the parent bank's size or complexity. Gov. Powell has supported aspects of this, but it's going to be a harder sell. Large U.S. banks are not eager for rules that free up formidable competitors in their own back-yard, and "national treatment" provisions in law also makes it hard for agencies to waive rules for foreign banks that apply to U.S. firms. That said, there's a lot that can be done

to make it easier for foreign banks to expand their U.S. footprints if the $50 billion "drop-dead" threshold disappears, as I expect it will.

One more important issue: how U.S. and foreign banks are structured may well be materially changed, and largely under current law too. There's been a lot of talk about "Glass-Steagall 2.0," with rhetoric here about the 1933 Act largely distracting attention from what's really going on. What Treasury and the White House have in mind is using the current BHC framework to greater effect – indeed to the effect for which it was originally intended. That is, insured depositories would be governed by tough capital, liquidity, resolution, and activity restrictions such as much that's now in the Volcker Rule. As Treasury has said, this befits their status as beneficiaries of both FDIC insurance and FRB access. BHCs are not entitled to either of these privileges and thus should be considered shell companies atop an insured depository freed to take a lot more risk. Viewed this way, a BHC's non-bank subsidiaries could do a lot more than they are now allowed to do and that's the way the White House and Treasury think about the right structure for U.S. banking on a going-forward basis.

The outline I just gave about the new approach omits critical, critical details – is there going to be a capital requirement for the BHC and, if so what? How insulated is the insured depository going to be from the parent? Which non-traditional activities now housed in a bank are to be pushed out?

We don't know the answer to these questions, but advocating desired answers now as well as anticipating them for strategic planning is among the top priorities for effective strategic planning and M&A consideration in the new framework. There are of course others – stress testing and resolution planning for example. But in the interest of time I'll turn now to what should be done given how the new U.S. policy framework is shaping up.

Finding the Way Forward

Banks aren't exactly adventurous – the entire business of taking other people's money under tough regulatory constraints naturally inclines bank executives to caution, and rightly so. However, in a business in which "shadow banks" account for roughly seventy percent of U.S. financial assets and given the hot breath down bankers' necks from fintech, time also is not on our banking clients' side.

Let me outline five steps to capturing advantage despite all the uncertainties sparked by the Trump Administration in concert with changing market realities:

1) Define strategic goals with clearly-articulated best-case results. Don't start with "we'd like to," transition quickly to "but they won't let us" and then go back to business as usual for as long as that business is viable. Start instead with "ideally, we would be best positioned over the next three to five years if…." For purposes of this exercise, confine the "ifs" to those germane to regulatory and legislative policy, taking the impact of monetary policy also carefully into account.

2) Given the past pace of action, prepare a truly point-in-time assessment that looks ahead to next steps. I know this sounds parochial, but don't generally turn to lawyers to get this forward-looking point-in-time analysis. Lawyers are great at telling you what you can't do under current rules, but often not analytically or even temperamentally equipped to tell you what you could

do depending on what changes how. A mix between legal analysis and forward-looking policy analytics is critical here.

3) Match strategic goals with policy realities and forecasts to chart a course forward. If for example the strategic goal is to enter a new business line through acquisition and the policy forecast shows how this might profitably be done, identify targets. Once this is done, repeat step 2 to ensure that the policy forecast remains accurate before proceeding to step #4.

4) If the strategic objective is found viable under the revised policy assessment, proceed to identify how the strategic goal can best be structured, which policy actions are critical, when these decisions will be made, how you need to influence these decisions, and how best to make what you want match what you get. Compromise along the way may well be required – it so often is! – but a disciplined approach to identifying strategic opportunities and then exploiting them despite an incomplete rulebook is a lot easier than it seems.

5) One more step: in the case of activities, asset/liability mixes, or other current features that could be threatened by the new policy framework, repeat steps one through four but do them to identify and then unwind problematic positions before the rest of the market does too and any remaining value you can realize is lost in the shuffle.

All of this is of course easier said than done. Still, the most successful banking franchises do this every day – I'm not making this up, but rather distilling experience from our proprietary-advisory business.

I'd be happy now to answer questions to help you take your thinking from the "I wish" to the "how to."