Just When You Thought It was Safe to Go Back into the Water: The 2017 Policy Outlook

Karen Shaw Petrou
Managing Partner

Federal Financial Analytics, Inc.
www.fedfin.com
info@fedfin.com

Remarks Prepared for the
Conference of Counsel
Washington, D. C.

October 6, 2016

About six months ago, the general counsel of a good-sized bank told me that he thought all the major post-crisis standards were just about done, giving him and his bank the peace and quiet with which to contemplate the future of their franchise without any more Washington annoyances. In his view, Basel III's transmogrification into Basel IV wouldn't change much, his bank had stress testing and resolution planning pretty much down, and he knew who would win the election. Of course, this policy forecast is far off the mark. And, regardless of rights and wrongs, policy drivers still determine the future of U.S. banking organizations. Even if all the rules stay the same – which they won't – the asymmetric application of costly new rules continues to define the competitive landscape.

What I would like to do this morning is lay out the 2017 policy outlook we forecast, differentiating conclusions by charter (i.e., GSIB, BHC, SLHC, DIHC, FBO, and non-bank). Importantly, I will try to restrain myself from views on which policy drivers are necessary prudential improvements and which are just costly rules with little marginal prudential benefit. I will say, though, that I think advocacy on this outcome question is critical because several current standards are combining with monetary-policy and market forces with what we have found to be unintended, often-perverse result. I am grateful to The Clearing House for funding some FedFin research on these issues – we've recently completed an in-depth assessment of the overall framework on FRB monetary-policy transmission, operational risk, and one paper I feel particularly strongly about that lays out how new rules combine with unprecedented FRB policy to increase U.S. income inequality. We will also shortly be releasing papers on the leverage capital rules and, sponsored by the American Bankers Association, a look at why the FRB pays interest on excess reserves.

I would be happy to discuss these policy consequences with you, but let me focus on the hard news of what's to come and what it means for shareholder return regardless of policy impact. The national election of course has more than a little impact on these outcomes, but I will focus on broad trends that will drive the next Administration and Congress regardless of who wins. I'll also prioritize policies we believe will emerge regardless of continuing Congressional stalemate, noting where underlying trends lead to bipartisan consensus that supports administrative and regulatory action. I'll leave for another day the structural changes in the U.S. financial-policy landscape that clearly require statutory change partly because here the election matters a lot and it takes so long to enact legislation that you will have ample opportunity to adjust strategy should any viable legislative initiatives emerge in 2017.

Big-Bank Fear and Loathing

I saw a fascinating poll last week finding that registered voters aged 18-34 who are otherwise strongly anti-Trump in this survey felt Donald Trump would handle Wall Street and bank regulation better than Hillary Clinton on a 51-44 margin. The overall poll regardless of age also picks Trump over Clinton on this question by about the same margin, but younger voters favor Clinton over Trump on everything but financial policy.

This poll came about a week after the Wells Fargo cross-selling case broke. That surely didn't endear banks to the electorate, but I think the fundamental reputational challenge evident in these numbers was there before and will be potent even as this case fades from the headlines. This means at the least that any near-term transgressions or perceived transgressions by large banks will be mercilessly enforced by federal regulators and law-enforcement officials under either a Clinton or Trump administration. I suspect a Clinton one would be governed more by the rule of law, but perceptions that it's over-cozy with Wall Street will make it at least as punitive. Practically speaking, this suggests another internal review of any possible risk-management and compliance problems, dealing with them in a proactive fashion before regulators come in to defend their own turf against politicians already doubtful of the agencies' objectivity and vigor.

Strategically, this anti-bank sentiment also means that a transaction that breaks any type of new ground will have a very hard row to hoe. This isn't, though, to say that M&A isn't possible. Three recent developments are important to note:

- First, the federal banking agencies recently laid out which activities are consistent with a bank charter and which are off limits. Attention has been focused on the FRB's new and very dim view of merchant banking, but the entire report is very much worth a read as a guide to non-traditional activities that one or another of the agencies think suitable within a bank or BHC charter. Insurance activities in particular warrant another look, as I recently laid out in an *American Banker* article, but brokerage and investment-advisory services are not only favored by the agencies, but also preferred under current capital rules. I know that Donald Trump has talked up Glass-Steagall reinstatement and that is also favored by populist Senate Democrats. This adds political risk to banking/securities transactions, but I think these are still relatively low-level ones as long as no activity is non-traditional and no bank involved in M&A is very big.
- Secondly, the FRB's newly-proposed CCAR framework should significantly reduce the burden of entering the stress-test red zone or combining above the $250 billion threshold. Importantly, even a relatively large amount of non-traditional assets in a BHC with assets under $250 billion doesn't increase stress-test cost.
- Finally, there's fintech. Absent a rapid, politically-driven shift to the wild side on prudential regulation, the tentative, safety-and-soundness focused approach to fintech will continue. The Wells Fargo case makes this even more so because regulators are fearful that "sandboxes" will turn into jungle gyms. That said, look again at what is possible from an M&A perspective because the new inter-agency policy does provide considerable room for innovative transactions. One warning: the Wells Fargo case will make it not only more difficult for big banks to innovate, but also for non-banks to arbitrage away.

Tectonic Forces

I've so far talked about immediate risks and opportunities – the volcanos ready to blow in 2017. Beneath this active, dangerous surface are tectonic forces moving the assumptions on which most bank franchise assumptions now rest. On one side of these giant moving plates is the Federal Reserve, increasingly certain that its own fundamental assumptions about how to make monetary policy are no longer working in the wake of all the economic and financial-system changes since 2008. The other seismic plate grinding its inexorable way along the FRB is the political fear-and-loathing I've already discussed. It not only means an array of near-term strategic challenges for larger banks, but also creates an implacable obstacle to any regulatory changes that anyone might come to characterize as relaxation.

Stuck in between the forces driving the FRB to change the way it functions and the post-crisis political reality demanding still greater big-bank vengeance are U.S. banks, especially those above $250 billion and foreign banks of almost any size and shape. I strongly suggest that each of you thus take the decisions the FRB will make about itself in 2017 as matters of utmost strategic priority instead of referring them over to academics and monetary-policy economists. Here's why.

Chair Yellen has already made it clear that she and the rest of the Federal Reserve are unpersuaded by new research from Larry Summers and his Harvard colleague arguing that big banks are weaker than they were before the crisis because market capitalization has shrunk to such a pittance. I will leave for another day who's right and wrong here, but for strategic-forecasting purposes, it doesn't matter. What matters is that the FRB dismisses this conclusion and believes big banks can be far more regulated without prudential risk. This policy conclusion will extend through any new President for the political reasons noted above despite how the Dodd-Frank "repeal" debate advances.

Point two about the FRB: it is also convinced that two Jackson Hole major research papers have it right about the real dangers of Treasury-repo market illiquidity. Each of these papers – one from Stanford and one again from Harvard – acknowledges that new rules – principally the SLR and LCR – are the principal reasons why this critical market has broken down and why other, equally-systemic financial ones could follow. Each paper then takes it as axiomatic that these rules cannot change. The Harvard paper in fact also concludes that the new big-bank rules should not change and might need to be made even tougher so that GSIBs are forced to become utilities.

To solve for market infrastructure while holding the new rules at least constant, each paper posits solutions that warrant careful consideration. The Stanford paper takes a relatively modest path, urging creation of repo CCPs along with a lot more Treasury issuance of short-term notes. New CCPs might arise, although many problems we can discuss later impede this as a near-term practical option. Lots more short-term Treasury notes are a fiscal non-starter due to taxpayer cost considerations.

So, on to the Harvard paper. What does it recommend beyond putting big banks into a straightjacket? Reliance on a far bigger FRB portfolio and non-banks through the FRB's reverse-repo program (RRP) for monetary policy purposes and recognition that non-bank money instruments are the future of finance. Along the way, interest on excess reserves for banks should either be reduced to eliminate what the paper believes is a subsidy edge over non-banks or eliminated altogether. Could this pose new risks? Maybe, says the Harvard paper, but not compared to big banks and in fact nicely controlled by the new rules that should keep big banks firmly in their grip.

The FRB has already decided that it needs a bigger, differently-constructed portfolio – see Chair Yellen's comments at Jackson Hole and just last week to a group of community bankers. Statutory authority isn't coming any time soon, if at all, but the FRB doesn't need this to build a far bigger portfolio of assets, especially if it is persuaded that the RRP can solve for short-term market liquidity problems even as the new window effectively transmits monetary policy.

I fear that this reconfiguration of FRB policy would have profound income-inequality impact unless it proves an immediate, magic elixir for economic recovery and rising rates. I know that it would reconstruct U.S. finance into a system in which community banks scavenge for what they can in under-served markets, big banks operate with implicit TBTF protection akin – hard to believe, but true – to Fannie and Freddie before 2008, and large asset managers have all the fun.

Is this redesigned post-crisis financial framework well understood and clearly intended? Of course not, just as the income-inequality impact of the standards already in place with current accommodative policy are not meant to make the poor poorer – very much the contrary. But, just as the poor are getting poorer, I think the financial system is restructuring by virtue of incremental decisions each of which is made in isolation from others with no understanding of correlation and cumulative impact.

In 2017 the tectonic forces of politics and policy could collide with Richter-scale magnitude because politicians and the FRB will each pursue what they think best for themselves convinced that the only possible damage they could do would be to big banks which deserve it anyway. They're wrong – there will be a lot of collateral damage if big banks are *de facto* turned into new-style GSEs, but we may again only learn this the very, very hard way.