FedFin Client Report

Friday, March 17, 2017

FedFin Assessment: The Strategic Impact, Political Consequences of an FHC-Heavy Regulatory Rewrite

Client Report: **FHC24**

Executive Summary

In this report, we assess how a plan to ring-fence U.S. banks by line of business might be implemented. Comments from the White House last week and FDIC Vice Chair Hoenig's Monday release (see Client Report **FHC23**) reinforce our initial forecast that a Vickers-style realignment will have significant traction in the U.S. with both populists and progressives. This approach – which we call FHC-heavy – provides cover for other actions that could be characterized as "unduly favorable to Wall Street" while at the same time getting strong support from community banks and – depending on critical details – much of the rest of the U.S. financial-services industry other than large, diversified banks and foreign financial institutions. This report thus addresses how the strategic landscape would be reshaped by an FHC-heavy policy with or without a ten percent leverage standard and other make-or-break provisions.

We here describe how FHC-heavy fits into the U.S. framework and how variations on it will affect different types of financial-services firms and the broader global regulatory framework. We also note aspects of this approach that could be adopted without change in law. FRB agreement to this approach would, however, be necessary were this attempted.

Critical analytical and advocacy questions that must be answered include:

- Winners and Losers: Which activity is allowed where under which rules drives competitiveness for banks and non-banks across the range of financial-services, fintech, payment, and even commercial services. Companies will thus wish to determine in advance of specific proposals whether an FHC-heavy framework works for or against them and how.
- How the Framework Fits with the Fed: Prior FedFin work has addressed challenges created by the changing structure of U.S. finance to effective

Federal Financial Analytics, Inc.
1140 Nineteenth Street, N.W., Washington, D.C. 20036
Phone (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com www.fedfin.com

monetary-policy transmission and macroprudential regulation. FHC-heavy would further complicate these policy challenges as well as require action on issues such as the ability of a bank within a financial holding company (FHC) to obtain liquidity from the Fed or hold excess reserves in concert with use of the reverse-repo facility and for the scope of central-bank authority.

- The Role of Foreign Banks: Any FHC-heavy approach would not only apply to the IHCs established for foreign banking organizations (FBOs), but also increase challenges to branch and agency operations. M&A would need to be considered in light of potential ring-fencing, with opportunities created for integrating U.S. activities with securities and related parent or affiliate ventures.
- Capital: As with many regulatory questions, how much capital is required where is the crux of strategic impact. Companies will therefore wish to consider how a leverage requirement would affect the costs and benefits of their preferred approach to FHC-heavy. They will also want to review the Hoenig approach to redesigning the leverage ratio that would incorporate an array of risks – could this work, how much would it cost, how does it affect stress testing and risk weighting?
- What Happens to Global Regulation: Already in fragile condition, global negotiations could be dealt a fatal blow if the U.S. departs from global capital and liquidity regulation. Ring-fencing *per se* would not have this impact, but a broader structural change will. How will this affect the future of U.S. and cross-border finance, taking into account ongoing trade and regulatory challenges?

Analysis

Because of the critical importance of an FHC-heavy policy, this FedFin report provides more background than usual in this client service.

1. Background

In sharp contrast to most nations, the U.S. has a strong preference for limiting the activities of banks due to longstanding populist fears dating back in law at least to the Glass-Steagall Act of 1933. The Bank Holding Company Act of 1956 has also strictly limited non-banking activities, with Section 4(c) (8) remaining remarkably unchanged for decades. And, when “non-bank banks” began in the 1980s following bank acquisitions by non-bank financial companies and retailers, Congress shut this down in 1987 for all but certain savings associations and limited-purpose banks.

The Gramm-Leach-Bliley Act (GLBA) of 1999 is often seen as opening up banking to securities through “repeal” of Glass-Steagall, but in fact GLBA respected both that law and the tradition of separating banking by allowing securities, insurance, and very limited commercial services only in separate subsidiaries of the financial holding company and, in still more limited circumstances, of national banks. Each non-traditional activity must be housed in a separate subsidiary of the FHC and is regulated by its "functional" federal agency (e.g., the SEC for securities). The FRB has limited authority over FHCs as a whole, power somewhat strengthened in the Dodd-Frank Act.

Although GLBA expanded the scope of activities that could be affiliated with a bank holding company through a parent financial holding company, it preserves the often-porous boundaries between traditional banking and affiliates that permitted a great deal of *de facto* integration of banking with other financial services and even commerce. The FRB, OCC, and FDIC have recently made it clear (see Client Report **CHARTER23**) that they would like to roll back some of their own actions as well as the few provisions in U.S. law still allowing the integration of banking and commerce.

Aspects of the framework established by prior law, GLBA, and Dodd-Frank now under attack in the FHC-heavy proposal include:

- the authority of an insured depository institution (IDI) to support affiliated non-bank activities with its own funding and/or that received from the Federal Reserve. Critics assert that this access poses risk to the IDI and affords undue competitiveness to their affiliates despite the limits now embodied in Sections 23A and 23B of the Federal Reserve Act;
- authority for IDIs and/or their subsidiaries to engage in securities and insurance activities that can be structured as shadows of activities directly regulated by the SEC, the CFTC, and state insurance regulators. Housing these activities in IDIs under authority such as the OCC's expansive definition of the "business of banking" gives them significant funding advantages due to exemptions from the inter-affiliate restrictions cited above and, critics argue, implicit guarantees based on counterparty confidence in FDIC coverage and other hoped-for federal support;
- remaining authority for affiliations between banking and commerce, most notably through the merchant-banking authority conferred in GLBA and regulatory decisions (now being rolled back) authorizing physical-commodity operations. The law also permits continued chartering of non-bank banks by entities that are not BHCs or FHCs, as well as potential special-purpose fintech charters. Private-equity firm ownership (permitted to a limited extent before the crisis) is another avenue to mixing banking and commerce;
- limitations on the Federal Reserve's authority across an FHC. This was expanded in Dodd-Frank, which also clarified a parent company's source-of-

strength obligations (i.e., need to support a subsidiary IDI as addressed in see FSM Report **FHC19**). Congress has recently limited the FRB's source-of-strength authority for holding companies with insurance subsidiaries (see FSM Report **INSURANCE45**). Other holding-company parents will surely seek comparable protection; and

- the ability of a company that elects to become a BHC (as was done during the crisis) to return to non-BHC status after markets stabilize and central-bank support is repaid. The Dodd-Frank Act includes a "Hotel California" provision that now bars return to non-BHC status (see FSM Report **SYSTEMIC29**).

2. Key Aspects of FHC-Heavy

There is nothing from Mr. Mnuchin as to what the Administration's plan would be beyond suggestions that there would be:

- ring-fencing of non-traditional activities (e.g., investment banking);
- prohibitions on proprietary trading in the IDI;
- an end to Dodd-Frank's orderly liquidation authority (OLA) because IDIs could be resolved by the FDIC and non-banks would be handled under bankruptcy; and
- significant community-bank reform.

We doubt the Trump Administration would support a key plank in the Hoenig plan – the ten percent leverage ratio – and there will also be significant differences between him and Congressional Republicans on other make-or-break strategic factors. These include:

- the scope of inter-affiliate transactions;
- the extent to which an IDI in an FHC may hold excess reserves with the FRB or, should this be restricted, engage in reverse repurchases through the over-night RRP;
- the treatment of foreign banks, including the extent to which U.S. branch and agency operations now under home-country capital and activity authority could continue to operate as is. We would assume that any FHC restrictions for BHCs would apply in like-kind to IHCs controlled by FBOs, with strategic impact depending on the applicable U.S. capital regime;
- the continuation of the GSIB regime and related surcharges. These would likely end;
- the extent of regulatory relief afforded FHCs from Dodd-Frank demands. We would expect this to be extensive, but Democrats will only agree if the offsetting capital charge is high (i.e., at least the Hoenig ten percent leverage ratio); and

- the extent to which commercial activities and affiliations would be permitted. This is unlikely to be directly addressed, leaving open the possibility of future non-bank banks and private-equity parents unless Democrats demand constraints supported by enough community banks to gain GOP agreement.

3. Strategic Considerations

It is clear from the issues described above that community banks are likely to be significant winners even if a high leverage ratio applies to them. This is because:

- community banks believe an FHC-heavy framework advantages them if only because it weakens big banks;
- most can meet even a ten percent LR; and
- few have non-traditional activities.

For regional BHCs, the balance between winners and losers will depend on the terms of the FHC-heavy framework. This is because:

- some can meet a high leverage requirement and some cannot. The composition of the rule also determines strategic impact. For example, a ratio recalibrated as Mr. Hoenig has suggested to capture operational risk could be punitive to regionals with large credit-card, securitization, and/or payments businesses. Those focused on partnerships with fintech would also absorb higher capital requirements even as non-bank fintechs over time gain strength;
- due to size, even some traditional, non-complex regional BHCs would transgress activity limits such as those in the Hoenig plan. This would result in significant additional restructuring and funding costs; and
- many smaller regionals are increasingly under less costly FRB rules that diminish the benefits of FHC-heavy relief.

Non-banks active in businesses that compete with banks are clear winners because areas in which banks gained competitive advantage under GLBA and/or retained it despite Dodd-Frank would be reduced, if not eliminated. The big risk to them, as to community banks, is contagion from any crisis sparked by the lack of OLA or risks left unaddressed in the new framework, but near-term franchise value likely will not be affected by this.

The most complex strategic implications affect the largest banks doing business in the U.S. Key considerations include:

- the treatment of FBOs, which affects not only FBO franchise value given the importance of the U.S. to most business models, but also internationally-active U.S. banks due to the potential for retaliation;
- custody banks. If not granted the exemption proposed by Mr. Hoenig, ring-fencing and/or a ten percent leverage ratio would be a far-reaching strategic challenge;
- BHCs with a principal focus on non-traditional activities. With an exit from "Hotel California" and in the absence of a punitive leverage ratio, these BHCs could gain significant strategic advantage. They generally could keep activities developed since the crisis (e.g., FDIC-insured funding sources, retail-lending platforms) with limited cost add-on or simply return to their pre-crisis business model; and
- Diversified U.S. BHCs, especially those now designated as GSIBs. Aspects of FHC-heavy have different costs and benefits depending directly on each company's business model, the regulatory-relief afforded FHCs, and each firm's forward-looking objectives.

4. Political Outlook

A key consideration for all of the financial institutions described above and most especially for the largest U.S. banks is the extent to which the variations in FHC-heavy define success or failure for each company and thus the configuration of political alliances. Already fragile regardless of charter or size, industry consensus could break down into smaller sub-groups creating still more formidable political risk. Coalitions such as those speaking for community banks and non-banks will thus have particular influence, especially in areas of FHC-heavy that may be accomplished without statutory change. Efforts to do this may of course face court challenge and/or inter-agency disputes that curtail implementation, but some of the most critical to FHC-heavy that could proceed without statutory rewrites include:

- a higher leverage ratio perhaps with a different denominator for targeted FHCs;
- more stringent inter-affiliate restriction in areas of clear FRB discretion (e.g., the definition of an arm's-length transaction);
- decisions by the FRB to redesign access to its liquidity, reserve, and/or repo facilities;
- more stringent risk-based pricing requirements for FDIC coverage;
- activity-targeted risk-based capital requirements (e.g., those proposed by the FRB for merchant banking analyzed in FSM Report **COMTRADE8**);
- a far more "tailored" stress-testing, resolution-planning, and broader regulatory framework for BHCs based on an FHC's business model; and
- IDI ownership conditions.

Federal Financial Analytics, Inc.
1140 Nineteenth Street, N.W., Washington, D.C. 20036
Phone (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com www.fedfin.com

FHC-heavy factors requiring statutory change include:

- Hotel California;
- the Volcker rule;
- express exemptions from systemic regulation; and
- coverage of non-banks.

Federal Financial Analytics, Inc.
1140 Nineteenth Street, N.W., Washington, D.C. 20036
Phone (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com www.fedfin.com