1Q 2017 Market Insights
The Big Fix
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"Dodd-Frank was passed. ... This is the biggest kiss that's been given to New York banks I've ever seen. This is an enormous boon for them. There've been 122 community and small banks have closed since Dodd- Frank." – Mitt Romney

The 2008 financial crisis was not your typical S&L crisis, rather it was a systematic failure that exposed numerous flaws in the U.S. banking system. Along comes the Federal Government, "recognizing" a need for reform. After all, isn't that what the Federal Government and its regulatory authorities do…close the proverbial barn door after the horses are out? Congress was going to fix the banking industry once and for all, and oh by the way, throw billions of dollars at this fix for good measure. What could go wrong?

The tricky part of finger-pointing in a systemic financial crisis is finding the "smoking gun." By definition, 'systemic' refers to the entire system, but legislators unfortunately can't simply say, "the system is broken." An attempt to correct, or prevent another occurrence will come with a legislative, economic and opportunity cost. Ultimately, the restriction of activity will come at the expense of lost profit, and as simple economics tell us, lost profits come at the cost of lost growth. Finding the perfect risk combination between regulation and free markets is challenging, if not impossible. Turning the dial on a $17 trillion economy means the slightest adjustment has the potential to deliver a meaningful result, intended or not.

Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was passed in 2010 as a legislative measure to prevent another financial crisis. The goal of the legislative act is to reduce various risks within the vast U.S. banking and financial system. While the Dodd-Frank Act is an 849 page document[1], there are three areas we will examine for purposes of its impact on the banking system. In short, the Dodd-Frank act did the following:

1. Created five major agencies or "offices" with existing agencies
2. Created the "Volcker Rule"
3. Reformed the credit rating agencies

Result #1 – New Agencies

For purposes of our discussion, we will discuss two of the five agencies. The first, the Financial Stability Oversight Council's (FSOC) primary objective is to identify financial institutions whose failure could pose a threat to the stability of the financial system. These are the companies that have been branded with the moniker, "too big to fail." The FSOC has the authority to break up banks that are too large or have too much concentration for the economic safety of the banking system. The FSOC was designed to oversee restructurings or liquidations that may occur via the Orderly Liquation Fund.

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[1] United States Government Publishing Office Public Law 111-203 – July 21, 2010

The second agency that we will discuss is the Consumer Financial Protection Bureau (CFPB). The CFPB monitors the financial products and services offered to consumers. The CFPB's primary goal is to add transparency to the financial marketplace on behalf of consumers. The perceived need for the CFPB is a result of the damage done to the economy via the subprime mortgage markets. Although much of the damage was done through the creation of exotic mortgage backed securities, these mortgages originated with individual consumers who were offered such incentives as "teaser rates" and "ARMs" (adjustable rate mortgages). With limited knowledge of what they were signing, those consumers made catastrophic decisions without proper disclosure or with flagrant misrepresentation by the loan originators. In certain cases, unassuming consumers would be offered a lower credit rating mortgage that carried higher fees and interest rates. This practice became known as predatory lending.

Result #2 – The Volcker Rule

Dodd-Frank also led to the creation of the "Volcker Rule", named after the former Federal Reserve Chairman, Paul Volcker. Chairman Volcker was the inspiration for this rule which prohibits short-term proprietary trading of financial instruments solely for the purpose of bank profits. Chairman Volcker believed that, "a stable commercial banking infrastructure is one of the foundations of a robust, developed economy." The idea that a bank could trade for profit, without the activity benefiting their banking clients, can lead to conflicts of interest between the bank and its clients. In certain cases, banks were trading or underwriting securities for clients while simultaneously taking the opposite side of the transaction. In cases like this, the banking client could lose and the bank itself would profit at the client's expense. The Volcker Rule is an attempt to return to many of the standards set by the Glass-Steagall Act, and the more comprehensive U.S. Banking Act of 1933. While banks may engage in many activities such as market making, hedging, and security underwriting, these activities may not be in conflict with the interest of their clients, or expose the bank to undue capital risk.

Result #3 – Credit Rating Reform

The last of the aforementioned three areas we will discuss is reforming the credit rating agencies. To that end, the Securities and Exchange Commission created the Office of Credit Rating Agencies. Credit Rating Agencies (CRAs) were accused of misrepresenting the level of risk to investors and, in numerous instances, not properly evaluating the nature of risk due to illiquid markets and contra-party risk. CRAs, since the financial crisis, have been subjected to a comprehensive review of policies, methodologies for establishing a credit rating, and internal conflicts of interest. Today, a CRA will have to disclose quantitative and qualitative methodologies and assumptions, historical ratings and changes to those ratings, and separate rating activities from sales and marketing activities, among numerous disclosures and segregated activities.

***"There is no such thing as free regulation"* –John Hutton**

The Dodd-Frank Act has attempted to close the door on potential or flagrant conflicts of interest in the financial system, increase disclosures to the general public, and increase the stability of the banking system through greater, more liquid, asset reserve requirements. While few will argue that a more stable banking system is bad for the U.S. economy, when has a one-size-fits-all approach ever worked?

The list of financial firms bankrupted or acquired during the "Great Recession" consisted of a diverse group of financial services providers. Mortgage lenders, S&Ls, retail banks, investment banks, insurance companies, and diversified financial service companies were all casualties, or on life support in the wake of a global liquidity crisis. This was not another story of some gun slinging, Nobel Prize winning hedge fund team that uncovered a temporary pricing imbalance and levered it to the hilt, resulting in billion dollar losses to Wall Street banks when the trades went bad. Most people shrug off those events and couldn't care less about another downed "fat cat." This crisis was different. This time it hit "main street" with a force as measurable, and losses beyond those felt on Wall Street.

There is a maxim in business which states, "know your client." The "client" in this case is the American consumer. Congress passed the Dodd-Frank Act and created the CFPB, attempting to prevent future occurrences that saw both real estate and stock market losses escalate into the trillions of dollars. Congress identified "too big to fail" institutions as the primary instigators, and constructed a legislative "Gordian Knot" that even Alexander can't undo. The question remains, "is the consumer better-off with Dodd-Frank?"

Regulation comes at a cost. Any company, regardless of the industry, will spend more as a percentage of revenue to increase staff, hire consultants, attorneys and industry experts to help navigate the increasingly complicated regulatory environment. According to the American Action Forum, as of July 2016, six years after Dodd- Frank was passed, the total cost of implementing the regulation to date has been $36 billion, and 73 million paperwork hours.[2] The final cost of the financial reform can't even begin to be calculated since only approximately 70 percent of the 390 total regulatory mandates have been created and implemented.

Unintended Impacts on Community Banking

Attacking "too big to fail" institutions, while well-intentioned, has had the unintended consequence of impacting communities serviced by community banks. The FDIC defines community banks as having less than $10 billion in assets. Community banks by definition exist in smaller, more rural areas, and service those communities in many ways. Small business lending, mortgages, financing for public school systems through TANs and other municipal funding, and agriculture are a few of the services provided by these smaller banking institutions. "About 1 in 4 counties rely exclusively on community banks for brick-and-mortar services within county lines. Almost half of rural counties have only community banks located within them under the broad definition (under $10B in assets) and about 5 percent of rural counties have only a single community bank office." [3]

Community banks, historically, have played a key role in providing access to capital for local communities and were the epitome of "relationship lending." Stricter regulations have taken much of the loan underwriting out of the hands of local lenders and standardized the criteria for the loan process. Proponents of greater regulation suggest that the risk characteristics of the loans, and the banks making the loans, have improved. Yet, there has been a noticeable shift in lending handled by community banks in favor of large banks. Federal Deposit Insurance Corporation Data suggests that community bank lending has fallen from 40 percent of total lending in 1994, to around 20 percent as of February, 2015. Community banks handle 77 percent of agricultural loans, and 50 percent of small business loans, and since the passage of Dodd-Frank, there has been an estimated 12 percent reduction in community banking assets.[4] With large banks fulfilling a greater portion of loan demands in small communities, how likely is

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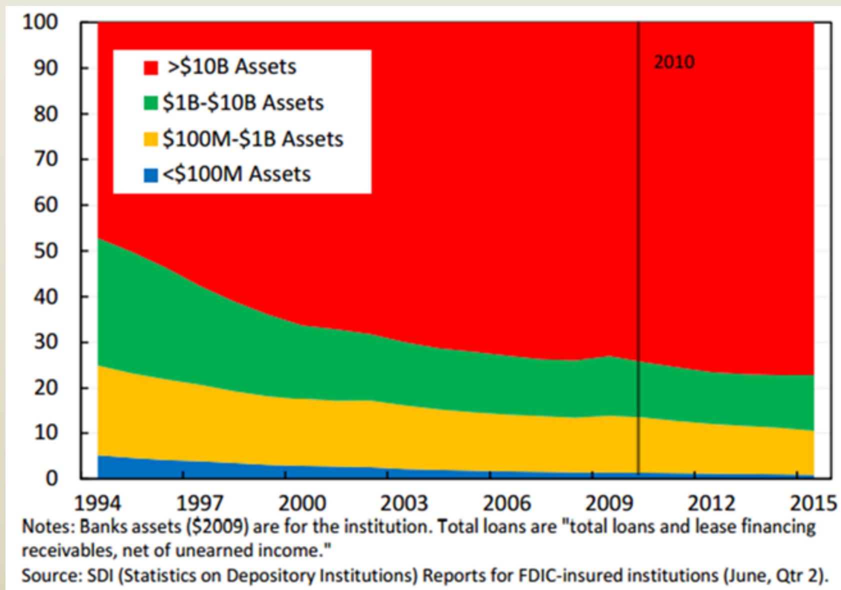
[2] "Six Years After Dodd-Frank: Higher Costs, Uncertain Benefits", Sam Batkins & Dan Goldbeck
[3] Council of Economic Advisers Issues Brief, August 2016.
[4] "The State and Fate of Community Banking" by Marshall Lux and Robert Greene, Mossavar-Rahmani Center for Business and Government, Harvard Kennedy School

it that they will accept the responsibility of extending new business loans to customers in rural America, or understand the nuances and challenges of agricultural financing?

The McFadden Act of 1927 was a federal act that gave states more authority to regulate bank branching, and most states responded by disallowing the practice of interstate bank branching. By 1994, the Riegle-Neale Interstate Banking and Branching Efficiency Act was passed allowing banks to expand their services by merging with banks in other states. The process of merging banking operations is a strategy employed to take advantage of economies of scale. The number of banking institutions has been on a steady decline as banks have merged to grow assets and mitigate duplication of administrative services. A 2014 FDIC study found that banks with less than $100m in assets from 1985-2013 saw an 85 percent decline in registrations, while the number and total asset size of banks with $100mm-$10B in assets increased.[5] The conclusion reached is that for the past two decades, there have been a declining number of entrants into the banking sector due to capital requirements, interest margins on balance sheets, and increased competition from larger banks that make the prospects of a small bank succeeding limited. Let the irony not be lost. Congress creates legislation to identify "too big to fail" banks, while simultaneously creating additional barriers to entry for small entrepreneurial banks focused on America's small businesses which employs over half of the American work force. Is this the regulatory complement to economic Crowding Out Theory?

Market Share of Loans for Banking Institutions by Asset Size



Data Source: Council of Economic Advisors

Smaller banks have seen their market share erode over the past 20 years due to a combination of higher capital requirements, shrinking net interest margins, and greater competition from larger banks.

Striking a Balance Between Growth & Responsibility

2017 begins with a new presidential administration professing to reduce the regulatory constraints imposed by previous congressional and presidential agendas. Finding a

[5] Council of Economic Advisers Issue Brief, August 2016.

compromise appropriate for removing moral hazard, yet promoting growth within the banking sector that does not require merging for survival will be a herculean task. The creation of “too big to fail” has had the unintended consequence of “too small to survive.” Much like the Anti-Trust laws of the 20th Century, the Government has struggled with the concept of redistribution. Deconcentration of power, profit and distribution in the name of fair competition has led to a vicious cycle of growth and consolidation, regulatory break-up, and companies merging again in the industrialized age of America. Nearly seven years after Dodd-Frank, it is clear that turning this dial on the $17 trillion economy has had several less than desirable, if not unintended consequences. The cumulative efforts by the banking industry to attain compliance with new regulations, billions of dollars in cost, and the millions of man hours spent implementing the edicts of Dodd-Frank in the end may do nothing more than posture the question: “Will the philosophy of ‘too big to fail’ be a natural extension to the legislation itself?”

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