Bauerle's Bank Notes

Hotel California

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A bank director wryly told me last week that reinstatement of the Glass-Steagall Act is the only political party plank adopted by Republicans and Democrats alike at their just-concluded national conventions. When it comes to our financial system, both parties have made nostalgia their strategy.

Meanwhile, House Financial Services Committee Chair Jeb Hensarling (R-Tex.) has announced plans to rewrite large swaths of the Dodd-Frank Act. The proposed title of the law is the Financial CHOICE Act, an acronym for "Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs" (here called FCA or the Bill).

FCA is a potpourri of would-be changes in financial regulation. Big banks are both pilloried (sharp increases in penalties for executives' misdeeds) and pandered to (neutering of the Consumer Financial Protection Bureau). Community banks are given the ability to opt out of many Dodd-Frank requirements. And long-money lobbyists' fingerprints are everywhere, such as in the proposed repeal of section 117(b) of Dodd-Frank.

That section requires continuing Federal Reserve oversight of companies protected from insolvency by the Fed in 2009 even though the Financial Stability Oversight Council never declared them Systemically Important Financial Institutions. Companies like General Electric chafe at being reminded they owe their continued existence to U.S. taxpayers. So their lobbyists tagged section 117(b) as the Hotel California provision of Dodd-Frank and seek its repeal. The moniker comes from the Eagles' eponymous 1976 pop music hit, whose double-entendre-laden last line says, "You can check out any time you like, but you can never leave!" Characterizing section 117(b) as a financial Hotel California could only be conceived by Tiffany-twisted lobbyists in their Mercedes Benz, pretty, pretty boys who call themselves the public's friends.

The most meritorious part of the Bill is its exemption of community banks from parts of the Dodd-Frank regime. These banks view as burdensome and unnecessary Dodd-Frank-prompted requirements like Current Expected Credit Loss standards that were the subject of the last installment of this column. Under the FCA, the trade off for exemption from Dodd-Frank requirements is that community banks must maintain unusually high levels of capital as a cushion against potential loan losses. Because the Bill is still being drafted, the proposed minimum capital levels are not identified.

Many community banks already keep higher levels of capital than their money center counterparts. For those banks that do not, the challenge will be how to raise the capital necessary to qualify for the exemption from Dodd-Frank requirements. Higher capital levels by definition depress earnings per share, making bank shares less attractive compared to investments in other industries. That reality makes it difficult to sell bank shares to investors. Some way to bridge the gap is needed.

One possibility is to permit community banks to raise specially designated series of stock that enjoy preferential treatment (e.g., dividends exempt from federal income taxation) in return for stock sale proceeds being used to fund projects or enterprises that confer identifiable community benefits. Challenges of adopting such a tactic include preventing abusive use of the program and getting banks to take advantage of it. In 2009-2012, many banks shunned special funding available under the American Recovery and Reinvestment Act of 2009 because of the strings Congress attached to its availability.

Another approach would be to permit community banks to follow the example of Silicon Valley Bancshares (NASDAQ: SIVB). This company does what many community banks once did: serve as a one stop shop for both junior and senior capital. In many smaller communities, the local bank is the sole source for capital formation. The challenge, of course, is not to sacrifice banking safety and soundness on the altar of business development. But Silicon Valley Bancshares as well as Citibank (Citicorp Venture Capital) and JP Morgan (One Equity Partners) have shown that safety and soundness, and sponsoring sub-senior business capital formation are not mutually exclusive.

In all events, developing a workable framework to capitalize middle-market and small businesses is correctly identified by the sponsors of the FCA as an important priority in the current economic moment.

The weakness of FCA is its retrospective focus. Silicon Valley's growing disruptive effect on the financial services industry and the broader economy is where Congress's energy should be concentrated. Established financial companies have everything to lose via the vulnerabilities being created by rising tech-enabled financial companies. Earnings streams are at risk; so is operational functionality. Tech companies know the stakes are high and have amped up their political lobbying accordingly. Jeff Bezos did not buy the Washington Post because he likes to read the newspaper or expects outsized profits from the investment. His ability to influence the nation's politics and its lawmakers via the Post protects his Amazon investment. If JP Morgan or Wells Fargo had bought the Post, Rep. Maxine Waters (D-Calif.) and Republican Rep. Hensarling would both be up in arms.

Given election year politics and the lateness of the hour in the 114th Congress, the Financial Choice Act is unlikely to receive serious consideration. It is a trial balloon whose measure will be taken by those elected to federal office in November. Sensible reappraisal of the benefits and burdens of Dodd-Frank is a worthwhile exercise. To be avoided, in our view, is retreat into a miasma of the past as well as failure to adapt our legal regime to the emerging future of the financial services economy.

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