Bauerle's Bank Notes

Of Roll Calls and Capital Calls
May 23, 2017

As President Trump met with community bankers earlier this month, the U.S. House Financial Services Committee reported out to the full House H.R. 10, the Financial CHOICE Act. [i]

The bill is the Republican majority's bid to re-trade the Dodd-Frank Act. That law stripped big banks of profit centers like proprietary trading and debit card interchange fees. Dodd-Frank also imposed new rules and costs on large and small banks alike, such as the requirement of contingency funding plans and additional restrictions on high-cost consumer loans.

Fissures in banks' relationship with their regulators since 2008 have been slow to heal. At the moment of crisis, a pitched battle raged. In an emergency meeting between federal authorities and big bank CEOs to outline Federal Reserve plans to supply liquidity to the banking system, Wells Fargo's then CEO vehemently rejected the funding, saying his bank did not need it and would not take it. Federal officials shot back that they would have the bank under a regulatory order overnight if Wells refused the funding. The CEO relented, Wells took the money and later paid it back ahead of schedule.[ii] The crisis passed, but big banks especially remain committed to winning political payback.

H.R. 10 would again permit proprietary trading, allow federal bankruptcy law resolution of distressed bank holding companies, and repeal other portions of Dodd-Frank the industry considers burdensome. The bill would stunt the growth of the Consumer Financial Protection Bureau. Federal bank regulatory agencies would be subject to federal fiscal appropriation for their budgets, rather than being able to assess banks examination fees without Congressional oversight. Banks would gain an appeal process by which to contest institution-specific adverse regulatory actions. And regulators would have to conduct a cost-benefit analysis before implementing new regulations.

Our issue with H.R. 10 is not what it says or does, but what it does not say or do. By focusing single mindedly on Dodd-Frank, the bill neglects issues that are at least as important, and urgent, to the future of banking. Most banks today are running a rear guard action against non-bank product and service innovation. That innovation is funded by tech companies' access to torrents of private equity capital. Closing brick and mortar branches, reducing head count and automating credit decisions are banks' defensive measures. They do nothing, however, to grow the franchise.

Dodd-Frank and its intended antidote, H.R. 10, both reveal Congress to be treating symptoms rather than causes of banking industry dyspepsia. Congress must take both a short term and a long term view. To illustrate, consider the Bank Holding Company Act of 1956 (BHCA). The law exerts an outsized influence on the structure and function of the banking industry. That influence is invisible to the public and taken for granted by Congress, the industry and its regulators. The public's inattention can be excused; not so the others'.

Congress enacted BHCA to prevent big banks from dominating the nation's financial markets.[iii] The act requires the Federal Reserve Board of Governors to approve bank acquisitions and says owning 25% or more of a bank automatically subjects the owner to regulation by the Federal Reserve System as a bank holding company. The Fed also deems a rebuttable presumption of control to exist at a 10% ownership level. When a single person or entity owns 5% or more of three or more banks, that too gives rise to a presumption of control and Fed regulatory oversight. The last rule is not codified anywhere. It is simply the Federal Reserve Board staff's position, but it enforced as policy.[iv]

Today, unlike 1956, the practical effect of these limitations is to undermine, rather than advance, the BHCA's anti-oligopoly goal. De novo banks and community banks struggle to raise capital because they cannot under BHCA sell large equity stakes. So they use registered offerings of securities sold to retail investors, a costly and inefficient process, at least when compared to private equity investment. The practical effect is community banks are limited to the capital they have already accumulated. Shareholders' expectation of dividends prevents reinvestment of earnings in organic growth. The only option left is to acquire other banks or be acquired.

Meanwhile, industry consolidation has caused 2/3 of bank deposits to be held by four banks: JP Morgan, Citibank, Wells Fargo and Bank of America. If they were alive, authors of the BHCA would wonder how that could happen in the face of BHCA.

Before BHCA became law, private equity was the foundation of American banks. In our view, it should be again, at least for community and regional institutions. Men and women named Morgan, Rockefeller, Mellon, Girard, Crocker, Ford[v], DuPont[vi] and others less well known capitalized the banks that funded America's rise in the 20th Century.

Several generations later, much of the $1 trillion of private equity currently available for investment is managed by family offices of those whose wealth has been accumulated in our own time. Many of these people are in their late middle age and share three attributes. They can afford to be patient investors. They can afford to accept good rather than great returns on their capital. And they are growing mindful of their mortality and desire to leave the world a better place than they found it. Because banks foster sound economic growth and are unlikely to lose value in the long run, bank equity investments are a natural outlet for persons so motivated. But BHCA stands in the way.

Financial restructuring of distressed banks also suffers from BHCA limits on concentrated ownership. Over the last 20 years, we have personal experience restructuring several banks that faced capital or liquidity deficits. When a bank is troubled, speedy execution of the restructuring plan is essential. Again, public securities offerings are a suboptimal strategy for raising capital. H.R. 10 would substitute bankruptcy reorganization for government agency-directed resolution in certain circumstances. Unless the control provisions of BHCA are revised, however, the H.R. 10 bankruptcy restructuring option is likely to be a dead letter.

In the words of one of H.R. 10's sponsors whom we know, the bill was formulated to show the Republican majority in Congress stands for and with Main Street. "Main St." is emblazoned on the center of the House Financial Services Committee's official seal shown on its website. To fully serve that mission, Congress must do more than battle over the ways and means of bank regulation. It must make it easier for community and regional banks to raise capital to keep up with changes roiling the industry and the rest of our economy. That truly would be a shot in the arm for middle America and the best solution yet to the problems that come from depending on a few too-big-to-fail Wall Street banks.

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[i]http://www.cnbc.com/2017/03/09/trump-to-meet-with-us-community-bankers-on-regulatory-costs.html; https://www.govtrack.us/congress/bills/115/hr10.

[ii]Multiple accounts of the meeting have been published. They reflect divergent perspectives about the wisdom of the emergency liquidity effort. The accounts all agree on the essential facts of the confrontation between Wells' CEO Richard Kovacevich and top federal officials. For example, see former Treasury Secretary Henry Paulson, Jr.'s memoir, On the Brink: Inside the Race to Stop the Collapse of the Global Financial System (2010).

[iii]See The Bank Holding Company Act of 1956, 7 *Duke Law Journal* 1-24 (1957) Available at: http://scholarship.law.duke.edu/dlj/vol7/iss1/1

[iv]That sort of regulation by fiat is one cause of the industry's anger at what it considers regulatory overreaching.

[v]Comerica Bank's antecedents include especially Manufacturers National Bank of Detroit, capitalized by Henry and Edsel Ford in 1933 to help stem the banking crisis then gripping the nation.

[vi]General Motors capitalized the National Bank of Detroit, also in 1933. DuPont interests owned effective control of GM from 1917 to 1961.