Economic Insight

Banking deregulation in the US to boost growth – and risk

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Executive Summary

Deregulation has been firmly on Trump's agenda, with a recent bill easing rules for banks by watering down prudential standards and undoing some elements of the so-called Dodd-Frank law. However, while greater financial liberalization can contribute to higher long term growth, it can also encourage greater risk taking. We outline the main changes brought about by the new legislation, assess who benefits the most and identify the main sources of risk related to this new era of financial deregulation.

Our main findings include:

- **Regulatory burdens are set to lighten.** For bank holding companies (BHCs) to be subjected to enhanced prudential standards (EPS), their asset threshold has now increased from 50bn to 250bn. There will be fewer requirements on custodial banks, who now don't have to comply with supplementary leverage ratio (SLR) rules on funds placed with the Federal Reserve Bank (the Fed) or the European Central Bank (ECB). We estimate an increase in mortgage lending, with the bill introducing less stringent guidelines on what constitutes a "qualified mortgage", while exempting loans of less than USD 400k from appraisal requirements. These changes are supported by an increasingly pro-business atmosphere in the Fed, with latest stress tests suggesting a lighter interpretation of regulatory laws.

- **Small banking institutions are the big winners.** We estimate that over USD 60bn per year of additional credit will flow into the US economy as a result of this new bill. In terms of market shares, this reflects a comeback to the pre-Dodd-Frank era. Importantly, small banking institutions are no longer exempt from the Volcker Rule, which means they are now free to make certain speculative investments.

- **Less regulation, more risk.** Risky activities have benefitted from deregulation, most visibly in the 27 y/y increase in the issuing of collateralized loan obligations (CLOs), accounting for more than USD 66bn. And while small banks are the big winners, they are taking on more risk, notably community banks aggressively expanding their commercial real estate activity. Due to the recent regulatory atmosphere, economic policy uncertainty indices reflect complacency in the financial sector. Where there is low regulation uncertainty, there is potential for bubbles to inflate, leading to severe crises.

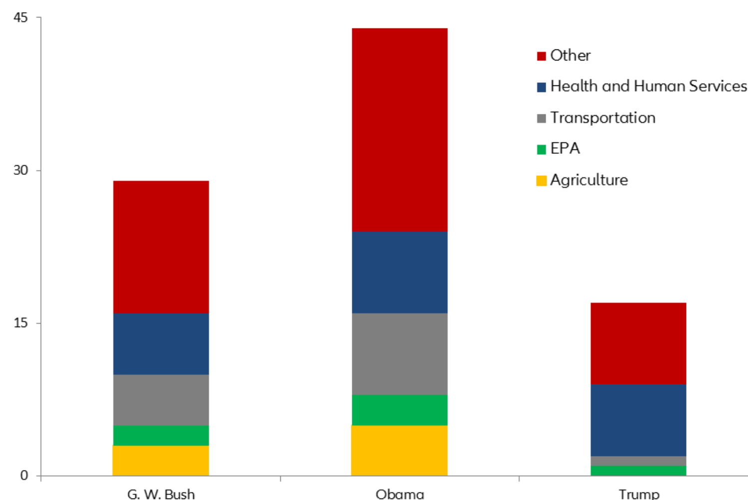
Trump's wave of deregulation

Since his election, President Trump has been determined to reduce the regulatory burden on the US economy. In 2017, the White House issued Executive Orders (EOs) directing federal agencies to repeal two regulations for every new regulation. On 23 May 2018, the *Economic Growth, Regulatory Relief, and Consumer Protection Act* was signed into law after a rare instance of bipartisanship in the US Congress. The bill aims to considerably reduce the regulatory burden on mid-size and smaller banks and BHCs. In the process, it undoes the so-called Dodd-Frank law, signed in the aftermath of the subprime crisis in order to put the US financial system on a stronger footing.

The bill specifically targets:

- the EPS, through provisions covering asset thresholds and stress tests;
- regulatory capital and liquidity requirements, including leverage and liquidity ratios;
- the Volcker rule;
- mortgage lending;
- consumer financial protection.

Figure 1: Published economically significant final rules within first year of a presidential term



Source: RegInfo, Office of Management and Budget

How is the banking industry going to change?

There will be a softening of enhanced prudential standards (EPS)

EPS include liquidity and risk management standards and heightened capital but also mandatory and frequent stress testing for large BHCs. The new bill will significantly increase the asset threshold for subjecting BHCs to EPS, from USD 50bn to 250bn, with staggered implementation dates depending on the institution's size. However, the "too big to fail" BHCs, also known as Global Systemically Important Banks (G-SIBs), will be exempted from such regulatory relief, regardless of their asset size.

Custodial banks should have fewer regulatory capital and liquidity requirements

The Bill aims to enforce various capital and liquidity requirements for most banking companies across the country. Nevertheless, the bill requires federal banking agencies to revise their SLR rules for custodial banks to exclude funds that are placed with the Fed or the ECB. This amendment intends to address recurrent criticisms that the Federal Reserve Board's enhanced SLR rule imposes an unnecessary burden on BHCs.

Mortgage lending is about to get easier

The Bill tries to encourage banks' capacity to lend money. This follows the same logic that underlies the amendments brought to the community banks regulation. The new regulation is likely to increase the number of mortgage loans deemed to satisfy the *Truth in Lending Act*'s "ability to repay" requirements so as to be treated as "qualified mortgages". "Qualified mortgages" follow stringent guidelines defined by Dodd-Frank, for example, a borrower's loan payment must represent less than 43% percent of their income. Moreover, it will allow certain mortgage loans of less than USD 400k to be exempted from appraisal requirements under the Financial Institutions Reform. The bill will also revisit recent measures taken by the Consumer Financial Protection Bureau under the *Home Mortgage Disclosure Act*, which requires many financial institutions to maintain, report and publicly disclose loan-level information about mortgages.

The Fed and regulatory agencies will be more lenient in their interpretation of the law

We're seeing a more pro-business atmosphere in the Fed and regulatory agencies, with recent proposals by the Fed to reform capital rules and some discretionary aspects of the latest stress tests suggesting a lighter interpretation of regulatory laws. Meanwhile, there have been significant new nominations of regulators at the top of the Federal Open Market Committee (FOMC), Consumer Financial Protection Bureau (CFPB) and the Federal Deposit Insurance Corporation (FDIC). The reshuffling is important, as it aims to water down the regulatory heritage of the subprime crisis. However, even prior to this new generation of regulators, the spirit of deregulation has continued to be at work.

Who are the winners in this round of financial deregulation?

Small banking institutions are set to benefit the most from this new bill, as they will now be exempt from the Volcker Rule if reporting USD 10bn or less in total consolidated assets (TCA), and liabilities of 5% or less of TCA. The main goal of the Volcker Rule is to restrict US banks from engaging in speculative trading behaviour that might disadvantage their customers, such as proprietary trading and owning or investing in a hedge fund or private equity fund.

In the wake of all these deregulation moves, we estimate the additional credit flowing into the US economy at slightly over USD 60bn per year, corresponding to a comeback to pre-Dodd-Frank era in terms of market shares.

With higher growth, there's higher risk

Derivatives coming back as a threat

Risky activities are being boosted by deregulation moves and are most visible in the CLO market after a US Appeal Court decided that these products no longer need to respect the retention rule, which states that issuers should hold 5% of their funds. More than USD 66bn of CLOs were issued in 1H18, representing a 27 y/y increase. Most customers who borrow money from non-bank channels (shadow banking) have a tendency to be less

creditworthy than conventional bank customers. For example, the use of bespoke tranche opportunities offered by banking institutions, which strongly resembles the notorious collateralized debt obligations – or CDOs – blamed for the last financial crisis, is a strong sign of possible credit quality deterioration.

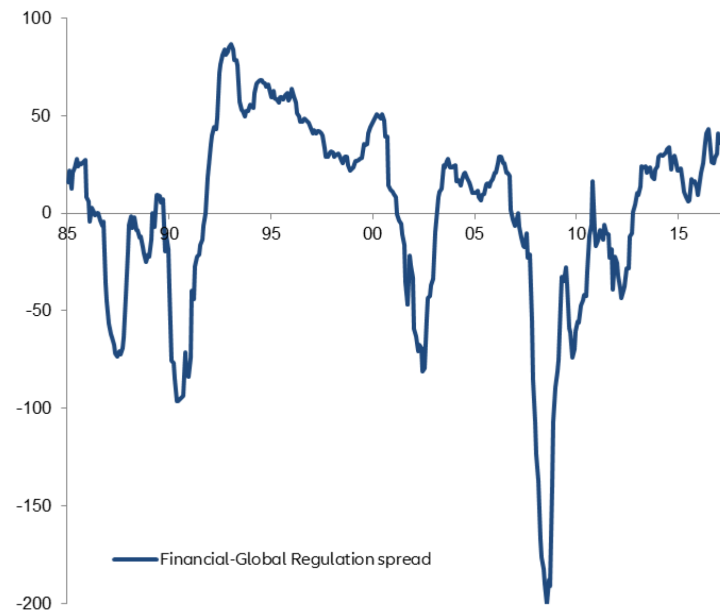
While small banks are the big winners, they take on more risks

There is a high level of risk concentration being present in community banks in relation to commercial real estate. The GAO (US Government Accountability Office) has estimated that while commercial real estate default rates are at record low, community banks have aggressively developed their activity in this area. In 2017, close to 500 community banks had assets in commercial real estate, representing more than 300% of their capital. In a context of stretched valuations, excessive credit in the corporate sector, and large transformations in the distribution sector, the risk of complacency is high.

Economic policy uncertainty indices reflect complacency

We also calculate the spread between US overall regulation uncertainty index and financial regulation uncertainty index[1] that we associate with a so-called financial regulation complacency index. The figure shows how the recent regulatory atmosphere has been rather less a concern for financial activities compared with all other types of sectors. We can see that times during which regulation uncertainty has been lower in the financial sector (positive spreads) correspond with periods during which bubbles have inflated leading thereafter to severe crises.

Figure 3: Financial regulation complacency index
(US financial regulation uncertainty – US global regulation uncertainty)



Source: Economic Policy Uncertainty Index

[1] More information is available on www.policyuncertainty.com

Conclusion

Deregulating undoubtedly has a positive influence on growth. However, this positive outcome is less evident when taking into account the additional level of risk generally accompanying any form of liberalization and leading sometimes to booms and busts. In the current US macroeconomic context, we identify four main sources of risk related to this new era of financial deregulation.

- US small banks will be the main beneficiaries of the so-called *Economic Growth, Regulatory Relief, and Consumer Protection Act*, with a potential of unleashing USD 60bn of new credit per year into the US economy. Yet injecting new waves of credit in a late phase of the cycle comports risks of overheating and complacency.
- Financial deregulation has already been at work for over a year, mainly via a laxer interpretation of the law by institutional bodies such as the Fed, the Consumer Financial Protection Bureau, the FDIC and the Financial Services Professional Board (FSPB). It has already encouraged risky behaviours, as reflected in our financial regulation complacency index.
- Deregulation can encourage risky financial activities; it means that hidden risks will significantly increase. US CLO market has clearly benefited from recent deregulation moves and is probably experiencing a sharp increase in new issuances.
- As the main beneficiaries of the law, small banks are already exposed to an exaggerated concentration of risk compared to commercial real estate.

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