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REGULATORY REFORM: IT'S TIME FOR THE PENDULUM TO SWING BACK

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President Donald Trump's recent executive order directing the Treasury and the financial regulatory agencies to reevaluate the banking laws and regulations has encouraged much speculation about a potential rollback of Dodd-Frank. We believe that the new Administration can have a swift, positive and profound impact on the regulatory environment. However, the key to this is not only rolling back Dodd-Frank, but instead countering the prevailing regulatory philosophy through the President's ability to appoint the senior-most bank regulators. Taken together, the senior policy-makers at the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Consumer Financial Protection Bureau have been far more impactful on the regulatory environment than Dodd-Frank.

Post-crisis, the regulatory environment for banks has seemingly grown more severe each year. While the regulations required by Dodd-Frank have been a contributing factor, Dodd-Frank's impact is often over-stated—it is more a symptom than a cause of the current regulatory environment. The environment is far more a function of a populist regulatory philosophy that took root following the financial crisis and has not abated. During the financial crisis, the government wisely resisted calls to formally nationalize the banking industry and yet, in many ways, that is what has been happening informally. Over the past several years, the regulators have effectively been wresting control away from bank boards of directors and management of many important decisions. Mergers and acquisitions, dividend policies, stock buybacks, corporate reorganizations and compensation are all areas over which the bank regulators now exercise an unprecedented level of control. Moreover, when a bank makes an error, it is often punished by the regulators far in excess of any proportionality to the perceived misconduct.

Time and again banks have been subject to unfair and capricious regulatory decisions in the post-crisis era which do not square with precedent. Rather these decisions are frequently based on new unwritten policies adopted without prior notice, public comment or other elements of proper administrative procedure. Banks rarely appeal these decisions or comment publicly on them because of fear of retribution by the regulators.

Correcting this imbalance does not require legislation. Indeed, rolling back Dodd-Frank without changing the current regulatory philosophy would be a hollow victory for the industry, because other banking laws, such as the Bank Holding Company Act, the Federal Deposit Insurance and the National Bank Act, grant the regulators nearly limitless power. Instead, a change in the tenor of the leadership at each of the regulatory agencies would make an enormous difference. The regulatory agencies have the ability to implement substantial regulatory reform without the need for Congress to act.

In order to identify what needs to be changed, it is helpful to revisit the major changes in regulatory policy post-crisis. In our view, the regulators have relied primarily on four tools to assert greater control over the banking industry—none of which are based on Dodd-Frank.

- **First**, the regulators downgraded the supervisory ratings for a large number of banks. Banks and their parent bank holding companies receive confidential numerical ratings from their regulators on a scale of 1 to 5 (with 5 being the worst) relating to capital, asset quality, management and other categories. The ratings process is effectively non-appealable. Banks that were rated 1 were downgraded to 2 and many 2-rated banks became 3-rated. Pre-crisis, it was not unusual for a well-run bank to receive a 1 rating. Today, a 1 rating is extremely rare. Importantly, the regulators also changed the implications for receiving a 3 rating. A rating of 3 essentially puts a bank in the penalty box—it is unable to acquire or branch and is limited in its ability to pay dividends. That was not the case pre-crisis.
- **Second**, the regulators unleashed a battery of enforcement actions—the number and severity of which is absolutely without precedent. The topics ranged from increasing capital to strengthening Bank Secrecy Act/anti-money laundering (BSA/AML) compliance, consumer compliance and risk management. Many of the enforcement actions have remained in place for years. By some estimates, financial institutions have paid in excess of $200 billion in governmental fines since 2009—an amount of capital that could have supported trillions in new loans.
- **Third**, the regulators have been exerting an enormous amount of pressure on the boards of directors of banks to strengthen capital, liquidity, risk management, compliance and internal audit. Effectively the regulators have turned corporate governance into a supervisory tool by frequently criticizing boards for providing insufficient challenge to management, questioning independent board members to see whether they have a firm grasp of the issues and criticizing board packets and minutes for not being sufficiently detailed. Over the past several years, corporate governance across industries has received intense focus from activist shareholders, boards of directors and academia and substantial reforms have been adopted. Adding a heavy layer of regulation to the corporate governance of banks unnecessarily risks micro-managing them—second-guessing decisions such as

strategic direction and personnel selection that are provinces of the boards of directors.

- **Fourth**, the Federal Reserve instituted annual stress tests in 2009 (before Dodd-Frank was enacted) for the banks with assets of $50 billion or more. These annual stress tests—which have evolved into the Comprehensive Capital Analysis and Review (CCAR)—are perhaps the Federal Reserve's most powerful tool for influencing the size and risk profile of a bank. Through CCAR, the Federal Reserve can reshape the risk profile of a bank, block acquisitions or force divestitures. Stress tests are an important supervisory tool. However, CCAR is conducted in an overly opaque and unpredictable way, leading to widely held industry sentiments that the process is capricious—a way for the regulators to reward and punish. Greater transparency would reduce the industry anxiety and uncertainty that surrounds the process.

Rolling back these changes in policy would have an enormously beneficial effect on the banking industry. Other changes that would be impactful include:

- ***Doing away with regulation by enforcement of BSA/AML compliance and establishing clear and objective standards.*** Perhaps no other area has been the subject of regulatory overreach as BSA/AML compliance. Regulatory requirements are not clearly communicated or uniformly applied. Instead, the regulators communicate their expectations through harsh and extensive enforcement actions that come with little warning and remain in place for years at a time. Until these actions are formally lifted, mergers and acquisitions and other corporate actions are nearly impossible. Some of the strongest, best run banks in the country are currently subject to them, including JP Morgan, U.S. Bancorp, Capital One, State Street, BB&T, M&T, Discover, Ameris Bank and many others. Strong internal controls to combat money laundering and terrorist financing are vital and necessary and we are not suggesting otherwise. Instead, there are other more effective, less punitive means by which to accomplish these important objectives.

- ***Taking politics out of implementing the Community Reinvestment Act (CRA) and decreasing the leverage of community groups in the merger application process.*** Enacted during the Carter Administration, the CRA was intended to enlist the aid of the banking industry in combatting urban decline. The act accomplishes this by encouraging banks to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods, consistent with safe and sound operations. To ensure compliance, the regulators are required to take into consideration a bank's record of performance under the CRA in evaluating an application requesting permission to merge or acquire. Importantly, the CRA was not intended as a punitive statute and does not prescribe any penalties beyond the foregoing. Although the statute has remained fundamentally unchanged, its implementation has varied, often depending on each Administration's political agenda. Under the Obama Administration, the standards for CRA compliance were raised sharply, without prior notice or proper administrative procedure. As in the case of BSA/AML, we believe that the CRA is vital and necessary. However, the CRA should be implemented in a clear, consistent and apolitical manner and not as a lever to effect socioeconomic change. An unsatisfactory CRA rating typically bars a bank from mergers and acquisitions. Because CRA exams are not given every year and the interval of time between the completion of a CRA exam and the receipt of a final rating can take a year or more, a bank can be in the penalty box for several years.

- ***Moreover, the regulators have interpreted the CRA to grant community groups unprecedented leverage in the regulatory approval process for mergers and acquisitions.*** A protest from a community group or an individual, regardless of whether it is frivolous or substantive, can derail a transaction for many months. This practice by the regulators of delaying mergers when there is a protest, regardless of whether the protest has merit, has given community groups free license to extort contributions and pledges from banks in the midst of acquisitions.

- ***Shortening and simplifying the regulatory approval process for bank mergers.*** Post-crisis, the regulatory approval process for bank mergers has gotten longer and more complicated. However, it is still possible to get approval quickly. Less than two years ago, BB&T received regulatory approval for four acquisitions over a 10-month period. Huntington received Federal Reserve approval to acquire First-Merit within less than four months from the date the application was filed. However, recently, the regulatory approval process has taken a step backwards. Two well-constructed proposed mergers by experienced acquirers—New York Community Bancorp's bid for Astoria Financial and Investors Bancorp's bid for The Bank of Princeton—were both terminated because of the failure to obtain regulatory approval. Incidents such as these greatly undermine confidence in the regulatory approval process.

The financial crisis did enormous harm to the world economy. There is no debate that the regulators and the industry needed to rethink risk management, capital, liquidity and other safeguards. The resulting improvements in the regulatory architecture have been dramatic. However, they have been accompanied by regulatory overreach stemming from a populist philosophy and thoughtfully rethinking that philosophy can deliver swift and immediate benefits.