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POINT OF VIEW

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IMPLICATIONS OF THE TRUMP ADMINISTRATION FOR FINANCIAL REGULATION

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How will the Trump Administration affect financial regulation? This crucial question cannot be answered definitively, since the election of a true outsider brings considerably more uncertainty than we have seen in many years. However, an appropriate analytical framework will allow us to form initial hypotheses about what actions are nearly certain, what are fairly likely, and what are improbable or even impossible. Further, it can focus us on the key questions to bear in mind as events unfold.

This Point of View presents my own personal views of the key considerations and how they may play out in the next few years, which I hope will help readers to form their own points of view.

Evaluating the likelihood of various scenarios requires considering:

- The key personnel and the balance of power between them.
- Their intentions.
- The obstacles and constraints they will face.
- The political and economic conditions under which they will operate.
- Their managerial and political effectiveness.

The remainder of this note is organized in the following sections:

- Summary of my expectations.
- Overall direction of change.
- The key underlying uncertainties.
- The constraints on change.
- Changes that are highly likely.
- Changes that are reasonably likely, but not certain.
- Changes that are conceivable, but not probable.
- Senate filibuster dynamics.

SUMMARY OF MY EXPECTATIONS

The very short version of my current views is:

- We will see a rollback of some financial regulation, although not nearly as much as advertised.
- Community and regional banks will get much of what they wish for.
- The picture will be more mixed for the largest banks, which remain unpopular.
- Insurers will see a lessened federal role.
- Asset managers may see less effect from global policy concerns on “fire sale” risk.
- The DOL Fiduciary Rule will be rolled back, but some rule may take its place.
- Senate Democrats will be able to block the big legislative initiatives, such as the Republican promise to repeal Dodd-Frank.

- The most significant changes will come from new Trump regulatory appointees.
- The Volcker Rule may remain, protected by Senate Democrats, but regulators will simplify and loosen its application.
- There is a real risk for the big banks that leverage ratios will be forced higher.
- There is even a chance that "Glass-Steagall" returns in full force, possibly in a form that is really "narrow banking" rather than the old Glass-Steagall.
- My guess is that the "Congressional wing" of the Republican party will be in the driver's seat on key issues, led by Jeb Hensarling.

Although I have distinct views on the most likely path, based on ten years as a policy analyst in Washington, mostly at the Brookings Institution, and two decades before that as a financial institutions investment banker, it is critical to bear in mind that there is a truly unusual degree of uncertainty associated with the outsider status of the President-elect. He has only a very short record of detailed views on public policy and we have never seen him govern. Further, his approach is intentionally different from conventional politicians and we do not know how that will play out.

OVERALL DIRECTION OF CHANGE

The pendulum of regulation is reversing direction sooner than seemed likely a few months ago, towards less binding and less detailed regulation. The President-elect and the Congressional majority are clearly calling for a reduction in regulatory burdens across the economy, explicitly including in Finance. As a result, financial institutions will be given more room to make their own decisions with less micro-management through highly prescriptive rules.

A significant amount of this change will result from the replacement of Obama appointees at the regulatory bodies with Trump appointees as vacancies occur (including some important unfilled slots already available.) There is considerable uncertainty about personnel and the situation changes rapidly, so I do not want to speculate here about the unfilled slots.

Regulators have a great deal of discretion in overseeing the U.S. financial sector, so the switch to a set of leaders with a very different world view from those appointed by Obama will matter a great deal. The remainder of this note will focus on some key regulatory issues, but there are a host of others that collectively are quite important even if they do not rise individually to the level where they merit discussion here. In other words, the total impact of the switchover will be large, regardless of exactly what happens with the major initiatives discussed here.

The biggest potential changes, such as the proposed "repeal" of Dodd-Frank, would require legislation and are considerably less likely as a result. The Republican wish list will be cut back in practice, as Senate rules provide the Democrats a great deal of power to stop legislation that they feel strongly about.

The "Financial Choice Act" gives a fair sense of the direction of legislative change. This was proposed by House Financial Services Committee Chairman Jeb Hensarling, who will have a powerful influence on what Congress does. The core idea is that banks would receive an exemption from most of the burdens of Dodd-Frank if they maintain a 10% leverage ratio and are sufficiently well managed (a “Camels” rating of 1 or 2). The large banks are very unlikely to voluntarily make this choice and would therefore continue to be covered by the full rigor of Dodd-Frank. (There is the possibility that banks might eventually be required to switch over, rather than given a choice.)

Many key Republicans favor substantially higher leverage ratios and want much less reliance on complex models. In this they are backed by many Progressive Democrats and some people in the regulatory community, especially Thomas Hoenig, Vice Chair of the FDIC. New regulatory chiefs could move a substantial way in this direction without new legislation.

Structural reform of the mega-banks is on the table, possibly through a “Modern Glass-Steagall”. This was put into the Republican Party platform at the suggestion of Trump’s campaign and he sometimes mentioned it during the campaign. This, however, would require legislation. If it were done as stand-alone legislation, it would probably have enough Democratic support to pass. If, on the other hand, it is wrapped into larger changes to Dodd-Frank it would likely be halted by the Democrats.

The Federal Reserve will lose some power and discretionary authority. Republicans harbor considerable antipathy towards a Fed that they see as too powerful and too interventionist.

Insurers, asset managers, and other non-bank financial institutions face considerably less risk of new regulation, especially that based on financial stability concerns. In line with this, the Financial Choice Act would eliminate the ability of the Financial Stability Oversight Council to designate non-banks as systemically important and would retroactively de-designate those that have been designated. This provision might not survive the legislative process, but the Chair of the FSOC is the Treasury Secretary and it would be very unlikely that a new firm would be designated as systemically important under a Trump Administration. As described below, the DOL Fiduciary Rule will also be changed.

Republicans believe that the Consumer Financial Protection Bureau has been excessively aggressive and want to rein it back considerably. Part of this would be done through the regulatory process and part through legislation.

Republicans want to abolish Title II of Dodd-Frank, which sets up a special resolution mechanism that can be used when a systemically important financial institution is failing. New provisions would be added to the bankruptcy code to handle the special public policy needs related to systemic failures. It happens that there is a budgetary cost to parts of Title II, as scored by the Congressional Budget Office, so such a change could potentially be included in a budget reconciliation act, eliminating the ability for a filibuster to halt action. In practice, elimination of Title II may not affect banks in a big way, outside of a major crisis, as there will still be just as much need for resolution and recovery planning and banks are already focused much more heavily on the required planning to allow a bankruptcy filing to be feasible than on any consideration of Title II. There would, however, be direct and indirect implications for the government’s response to a major crisis and the perception of foreign policymakers as to what those responses would be.

The system of housing finance in the US may change very substantially under President Trump. The Treasury Secretary-designate has already indicated in an interview that he is attracted to the idea of ending the government’s effective ownership of Fannie Mae and Freddie Mac. Housing finance is a very complex subject that is not primarily about financial regulation, so I will leave it to future notes. My one observation now is simply that there are strongly opposed and roughly equally powerful forces pushing in opposite directions, so do not be surprised if nothing changes in a major way for a year or two or even through Trump's entire presidency, as was true for most of Obama's two terms. (If federal credit programs interest you, I recommend my book – *Uncle Sam in Pinstripes: Evaluating US Federal Credit Programs.)*

THE KEY UNDERLYING UNCERTAINTIES

How much influence will Senate Democrats have?
This principally depends on whether Republicans make the aggressive and unlikely decision to gut the filibuster mechanism. (See Senate Filibuster Dynamics, below.) If they do, then Democrats in the Senate become fairly unimportant unless several Republicans oppose the majority of their party. If the filibuster remains, it gives Democrats a powerful mechanism to halt legislation they oppose. Their influence also depends on Trump's popularity. If it becomes fairly high, then they will likely feel constrained to be circumspect about taking him on, especially as many Senate Democrats are vulnerable in the 2018 elections. If his popularity falls back down, they may be very aggressive.

How involved will President Trump and his key White House staff be with financial regulation?
My working theory is that the President-elect will not focus on financial regulation and will leave it to the "Congressional Wing" of the Republican Party. Letting them have their way on issues that are not of personal importance helps keep them in line on issues where he cares and his views diverge from theirs, such as may be the case on running up a budget deficit to support infrastructure spending combined with a tax cut. If I am right, then Hensarling's views will be very important as will, I believe, those of Hoenig, who is the favorite financial regulator of the Congressional Republicans. That would be bad news for the big banks, since the two of them push higher leverage ratios and less reliance on models. Both are fairly unfavorable to the mega-banks more generally. Smaller banks would likely be very happy with the trend of regulatory policy, however.

It is possible that Stephen Bannon, who has been named as the Chief Strategist in the White House, will decide to push on financial regulation. If so, it is likely to be even more populist in tone and therefore even worse for the largest banks, including the potential for a restoration of the anti-affiliation provisions of Glass-Steagall. On the other side, it is possible that Steven Mnuchin, the new Treasury Secretary, will choose to play a major role in financial policy. We do not know much about his views, but some have privately expressed hope that he is more pragmatic, although this may be wishful thinking on their part as we simply do not know what he will choose to do.

In addition, Gary Cohn, number two at Goldman Sachs, is set to head the National Economic Council. This presumably adds another voice that would push back against raising the leverage ratio by a large amount or breaking up the largest banks. He would not necessarily be heavily involved in decisions on bank regulation, but he would have a voice on major legislative moves in this area, based on their effects on the economy. He may also have a major voice on appointments to financial regulatory bodies, but that depends heavily on internal politics within the Administration that are impossible to judge yet. It may also be in his best interests to keep a low profile on financial regulation issues, given perceived conflicts of interest involving his former firm.

Finally, the new president may choose to get more directly involved. It seems unlikely he would do this on a sustained basis, but he could certainly step in at key points. It is essentially impossible at this point to know where he would come out on the details of financial regulation or even on relative priorities. For this reason, I consider his potential for greater involvement to be a random factor at this point rather than a force pushing in one direction or another.

Who will Trump appoint to key regulatory positions and what will their agendas be?
I will not speculate on specifics here, but the personnel choices will matter a great deal.

How popular will Trump be after six months or a year?
This will affect his ability to hold the support of Republicans in Congress and will influence how aggressively Democrats oppose him.

What further banking scandals, if any, will arise?
One of the industry's biggest political risks is that one or more scandals make it politically impossible to de-regulate, at least in certain areas, or increase the political need to impose more burdens on the largest banks.

What will economic conditions be like during Trump's term?
This will affect the ability and desire of the new Administration to de-regulate or to push for higher capital levels, as well as having a host of other indirect effects.

How will the Trump Administration and the regulators it appoints operate in the international arena?
There are a number of indications that the new Administration may pull back from America's previous very active involvement with the global standard setting bodies for financial regulation, such as the Basel Committee on Banking Supervision and the Financial Stability Board. Republicans have been quite skeptical of these organizations and the overall deregulatory mood is consistent with less interest in advancing new global standards. At the same time, these bodies have been an effective way for the US to achieve its interests at the global level, such as pushing for higher capital levels at European banks. Further, Trump seems to have bonded with the post-Cameron Tories in the UK on the issue of Brexit and might be open to closer cooperation with London, the other dominant global financial center alongside New York.

Specifically, how will the new Administration affect negotiations on "Basel IV"?
The Basel Committee intended by early January to finalize its Basel III capital and liquidity standards with a set of additional measures that the industry has dubbed "Basel IV". These measures have proven controversial, with the U.S. leading a push for higher capital standards and most of Continental Europe and Japan pushing back hard. The dispute has delayed final agreement until at least March and therefore potentially given the reins on the American side to appointees of Trump's.

It is tempting to assume that Trump appointees would be more favorable to the European position, as a result of a less aggressive regulatory mindset and an Administration attitude that places less emphasis on global agreements. However, I view it as more likely that Trump appointees would continue to push for higher global capital standards. Many of the likely appointees, and their allies in Congress, want to de-emphasize model-based capital standards and focus on other measures. They usually prefer leverage ratios, but the introduction in Basel IV of "output floors" and limitations on the permitted use of models has a similar impact. In addition, it is broadly believed in Washington, whether true or not, that some major European banks are substantially undercapitalized and collectively represent a systemic risk that could eventually harm America. The Basel negotiations are the most effective way to push for higher European capital levels. To add to the uncertainty, it is also possible that the new appointees will take an even harder line position and the whole negotiations will fall apart, which might actually be viewed as preferable by some of the European players.

THE CONSTRAINTS ON CHANGE

Senate Democrats have considerable power to halt legislation. Regulatory frameworks embedded in law, such as Dodd-Frank, will remain in force unless and until Senate Democratic opposition to change can be overcome. Senate rules give a large minority party substantial influence. See the section below on Senate Filibuster Dynamics.

Washington can only focus on a few big things at a time. Presidents can generally only push through perhaps three major initiatives in their first two years, otherwise their efforts become too diluted to succeed against determined opposition. It is not at all clear that a repeal of Dodd-Frank, or "restoration" of Glass-Steagall, is a high enough personal priority for Trump to get the concerted push from him it might need. Alternatively, action could be driven by Congress, where Republicans have called for Dodd-Frank's repeal for years. However, there are also real limits on how much Congressional leaders can push through in one term, such as the serious limits on time for legislative action on the Senate floor. Congressional attention will be dominated by Trump's key initiatives, leaving less time for other controversial matters.

Voters continue to hate "Wall Street", although they favor smaller banks. This gives Democrats considerable leverage in pushing back against any changes that they can successfully portray as caving in to Wall Street and could also fuel the passage of a "Modern Glass-Steagall" Act as many in both parties have proposed.

Major regulatory bodies have substantial independence, which they are likely to defend while still recognizing that the political winds have shifted. If past precedent holds, this will somewhat limit the influence of the Administration. However, there is the possibility that Trump will reduce the actual independence of these regulators, much of which comes from precedent and a long-standing political consensus and not from Constitutional protections. These factors should not be under-estimated, though, and any Congress, even the current Republican-led one, is likely to push back against efforts by a president to seize more control of these important institutions.

Regulatory bodies will continue to have their own institutional interests and core constituencies. They will show more continuity than might be expected, including turf wars among regulators and with Treasury. This would be unlikely to change even if Trump chooses to rein in regulatory bodies and is successful in doing so. Administrations themselves are not unitary and fights often flare up between different Cabinet departments even though they are all creatures of the President in a way that regulators are not.

Global peer pressure on regulators will continue to matter to some extent and there will also be the practical need to reach agreement on how to treat issues that cross borders. The importance of these points will depend heavily on personnel decisions, as well as political developments.

Individual supervisors will continue to have incentives to be risk averse and be tough supervisors. Supervisors do care what their bosses think, but they also know that if an institution they are overseeing blows up, it will reflect very badly on them personally. The negative effects for them are disproportionate to the small positives they will receive from being perceived as appropriately reflecting on a day to day basis a larger policy approach of balancing safety against economic growth.

However, supervisory bodies could be starved of resources, reducing their impact. Even if individual supervisors retain a conservative bias, there is the possibility that they will be fewer and over-worked, making their views less critical.

Future scandals will lead to more regulation in specific areas. It is politically very difficult to see a financial scandal and not then act through legislation or regulation. It is hard to predict what scandals may arise, but easy to see that they will occur. This risk always exists, but remains heightened with all the investigations still ongoing into the actions of financial institutions. The large pots of money received by states and the federal government from enforcement actions provide further incentive to continue this. For that matter, private litigation could uncover damaging information as well.

CHANGES THAT ARE HIGHLY LIKELY

Trump appointees will dominate financial regulation, even at the Fed, but it will take a number of months to get them in place and then for them to start having an effect on decisions. Governor Tarullo is likely to resign once a Fed Vice Chair for Supervision is appointed, which could be in the first three months of 2017, although there is a chance he could stay to fight until clearly outnumbered later in the year. He would, in any event, be considerably less influential once a Vice Chair for Supervision is appointed. Further, the Chairs of the SEC and CFTC will soon be Trump appointees and the current terms of the Comptroller of the Currency and the Chair of the FDIC end in the Spring and Fall of this year, respectively.

There is a good chance that the new appointees will favor higher leverage ratios and will de-emphasize advanced models and complex stress tests. This is particularly true if Hoenig is named as the Fed Vice Chair for Supervision. Hoenig is an outspoken and aggressive advocate of replacing risk-based calculations with reliance on a high leverage ratio. John Allison, another contender, is also a strong believer in the leverage ratio. Hensarling is also a major advocate, lending crucial Congressional support.

The $50 billion test for systemic importance of banks will be raised substantially, perhaps into the $150 to $250 billion range. This will require amending Dodd-Frank, which may limit the ability to raise it to as high as $500 billion, as some have advocated. Democratic votes will likely be needed in the Senate if a filibuster is threatened, forcing some compromise.

It is unclear if this increase would apply to Foreign Banking Organizations. Under the current regulatory logic of equal treatment it would, but the politics are different for the foreign banks. Hensarling has indicated that his proposal would include FBOs, however one does not know if this would remain true in the new political environment.

The FSOC will not name any new non-bank SIFIs and those already named will eventually be de-designated.

Trump will replace Richard Cordray as the director of the CFPB and Congress will gain authority over its budget, giving Republicans further influence. As a consequence, it will become considerably less activist. The timing of this depends on whether a court ruling is upheld that gives the president the power to fire the director without cause. (There is also an outside chance that the new president will act on a principle advocated by some Republicans, which is that the Executive has the same right as the Judiciary to declare something unconstitutional.) Otherwise, Cordray's term runs until mid-2018. The budgetary change could be made as part of a budget reconciliation bill, which cannot be filibustered.

The Department of Labor (DOL) Fiduciary Rule will be withdrawn or very substantially modified. Politically, this rule was seen as pushing the limits of regulatory activism and will certainly not survive intact. However, there are underlying real world concerns and political perceptions that led to this rule that will not go away. A scandal in this area would do serious political damage if it occurs after killing the Obama Administration rule. Therefore, the likelihood is that some form of Fiduciary Rule, whether led out of the SEC or DOL, will be created to take its place. Any such rule should be easier for the industry to adapt to, however, and may take years to put into place.

The threat to asset managers of aggressive action against systemic risk from "fire sales" will recede. The Financial Stability Board, IMF, and other global bodies have become quite focused on the systemic risk from potential fire sales by asset managers during a crisis period. Had Clinton won, there was a real possibility that this would translate into new regulation, as was already partially the case under Obama with the SEC's proposed new liquidity rules for mutual fund managers. This risk will not vanish, but it recedes considerably under the less activist Trump approach to financial regulation.

The growing federal role in insurance regulation is likely to halt. Republicans have been more open to the demands of insurers for circumspection in the federal role, are generally less activist, and are more respectful of states' rights issues. The modest growth of the federal role in insurance is therefore likely to halt or reverse. That said, scandals have a way of changing politics and voters often demand action by the federal government when something goes wrong, so developments could put this trend back in gear.

Cyber security regulation will continue to increase in importance. This is something both parties agree on, in broad concept.

CHANGES THAT ARE REASONABLY LIKELY, BUT NOT CERTAIN

The Supplementary Leverage Ratio may increase and possibly the core leverage ratio along with it. As noted, there are very important advocates of higher leverage ratios. A hike would also provide political cover for deregulatory actions, such as the core of the Financial Choice Act, which might otherwise be perceived as favoring Wall Street. However, the degree of impact might be somewhat lessened by changes to the calculation of the ratio, such as potentially excluding cash held at the Fed from the denominator. Technical changes such as this might allow a 10% target to be kept while reducing the capital burden on the largest banks. Nonetheless, the point is that capital requirements could rise significantly for the biggest banks.

The Volcker Rule will be repealed or simplified/weakened. Outright repeal would have to survive a Democratic filibuster threat, so may not happen. However, regulators could simplify its application and choose not to be aggressive in their interpretations and enforcement. It was clear that, behind the scenes, the Fed never liked the Volcker Rule, adding to the likelihood of a pullback on the aspects that the industry finds onerous. That said, Dodd-Frank is specific enough that there are limits on simplification unless new legislation allows it.

CHANGES THAT ARE CONCEIVABLE, BUT NOT PROBABLE

A "Modern Glass-Steagall" could be created, as discussed above. If there are major further scandals involving the mega-banks, there is even the possibility that law or regulation would be used to break them up. There likely would be significant support from Progressive Democrats in the Senate, led by Elizabeth Warren. Although listed here as "not probable", there might be as much as a one in three chance, depending on how the politics of financial regulation develop.

Dodd-Frank could be changed substantially more than expected if Republicans decide to be much more aggressive about changing Senate rules or re-interpreting them to reduce the ability to use filibusters. This is unlikely, as discussed under Senate Filibuster Dynamics below, because there are a number of Senate Republicans who would oppose this for institutional and personal reasons. However, political circumstances change and it cannot be ruled out, particularly if Senate Democrats use the filibuster mechanism frequently and aggressively.

SENATE FILIBUSTER DYNAMICS

Current Senate rules allow a minority to block action on a proposed bill or Supreme Court appointment by continuing to debate it forever. Such a "filibuster" can be ended by a vote of 60 out of the 100 senators on a "cloture" motion. Republicans only have 52 seats, so if the Democrats stick together they can easily defeat cloture. They would almost certainly stay united on major financial regulatory issues, especially Dodd-Frank, which is a political winner for them.

However, the filibuster mechanism is a Senate rule, solely under its control, and not a constitutional provision. Democrats changed these rules in 2013 on a simple majority vote (an approach dubbed the "nuclear option") and Republicans might choose to do the same. Use of the nuclear option is highly controversial and a number of Republican senators have indicated that they would oppose its use to abolish filibusters of legislation, as would all Democrats.

However, Democrats do risk creating unanimous Republican support for such a change if they are overly aggressive in their use of the filibuster, especially if Trump is popular over time. This risk may cause them to be somewhat cautious in deploying filibusters.

Further, "budget reconciliation" bills are not subject to filibuster. This was agreed in order to ensure that budgets could be passed even in a very partisan climate. The rules about such bills are complex and interpretations are debated, but the core idea is that each item in such a bill should primarily be about spending, taxes, or debt limits.

A budget reconciliation bill could easily be used by Republicans to avoid filibuster of items that are clearly budget-related, such as bringing the CFPB under the control of Congressional budgets.

It would be much more controversial to game the system by putting in items, such as the repeal of Dodd-Frank, that have budget effects but are principally about other matters. However, it is up to the Senate to interpret its own rules, so a determined Republican majority could use this approach aggressively.

The practical limitation is that some Republican senators would be unwilling to effectively gut the filibuster mechanism through budget reconciliation gimmicks. This could, however, change if political dynamics make it compelling to support party unity.

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