Manulife Asset Management

Investment Note

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Deregulation in the US and the coming boom in regional bank M&A

Will 2018 be remembered as the start of a new cycle of profit building or rising systemic risk in the financials sector? Lisa Welch, lead portfolio manager of the Bank Opportunities' strategy, believes that the recent wave of financial market deregulation is less a cause for alarm than celebration, particularly given deregulation's likely effects on small and midsize banks and the prospects for accretive merger and acquisition (M&A) activity.

A decade after the financial crisis, banks are finally seeing some light at the end of the regulatory tunnel.

Among the latest changes to make headlines, the US Federal Reserve (Fed) has proposed to relax certain aspects of the Volcker rule, which will likely reduce compliance costs and enhance trading profits at large US banks.

Key moments in current deregulation

The Volcker rule, named for former Fed Chairman Paul Volcker, was passed as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which has governed key aspects of the US banking system since 2010.[1] Designed to rein in proprietary trading by banks, the Volcker rule was a watershed effort to reduce the proliferation of systemic risk. Its target was the bigger banks' then largely hidden and poorly regulated practices of making markets in excessively risky financial instruments.

However, despite Wall Street's fanfare around the Volcker rule's approaching revision, relaxing elements of this rule is not as significant—whether in terms of creating new risks for markets or in terms of creating stimulative benefits for the economy—as other deregulatory changes recently signed into law. In the first place, the Fed has not proposed to totally abandon the Volcker rule, but instead has proposed to make it less complex. Notably, financial institutions will continue to face strict regulatory oversight when it comes to aggressive market-making activities.

In our view, the more important deregulatory move—and one that has far greater upside than downside potential—can be found in new legislation that eases rules affecting small banks. The bipartisan passage of the Economic Growth, Regulatory Relief and Consumer Protection Act—better known as the Crapo

[1] US Congress. Dodd-Frank Wall Street Reform and Consumer Protection Act.

bill, named for Senate Banking Chairman Mike Crapo of Idaho—which the president signed into law on May 24,[2] may have far-reaching stimulative effects on the entire banking industry.

Redefining "systemically important financial institutions"

What did the Crapo bill accomplish? Among a variety of regulatory amendments—some of them momentous and others less so—it crucially raised the threshold at which banks are labelled as systemically important financial institutions (SIFI) from US$50 billion to US$250 billion in total assets.[3] This redefinition removes some of the burden on smaller banks by eventually eliminating the Comprehensive Capital Analysis and Review (CCAR) process, the stress test framework introduced by the Fed to assess, regulate, and supervise large banks and financial institutions.

This change will allow small and midsize banks to become more profitable enterprises, and it could result in higher capital returns and lower expenses for this segment of the industry. In our view, this change is bound to lead to more autonomy in banks' capital decision-making and, potentially, more M&A activity. The opportunity is broad, moreover, because many small and midsize banks could today combine their assets and still be below the US$250 billion threshold.

How to position for deregulation

Deregulation is likely to be a boon to the financials sector's earnings profile. And for investors, being able to focus on the primary beneficiaries of current deregulation efforts is the perhaps the single best way to make the most of this secular tailwind. That means focusing on regional banks, which stand at the fulcrum of the aforementioned changes to the SIFI level. These are banks that will either be directly impacted by this new legislation or banks smaller than US$50 billion in total assets that may indirectly benefit by becoming more attractive targets of M&A transactions.

The debate over deregulation has hinged on accusations of government overreach versus a broad-based call for robust safeguards against systemic risk in the US financial system. No one wants a repeat of the 2007–2009 mortgage market meltdown that led to massive bank bailouts and helped trigger an intractable global recession. But there is a worthwhile argument for loosening financial market regulations when we focus on the growth-inhibiting effects that certain regulations exert. We believe that an improving regulatory environment may benefit the financials sector in healthy ways over a substantial timeframe, leading to positive changes in compliance cost structures, improving operating leverage, and potentially more M&A activity.

[2] US Senate Banking Committee. https://www.banking.senate.gov/newsroom/majority/president-signs-crapo-banking-bill-into-law
[3] US Congress. Economic Growth, Regulatory Relief and Consumer Protection Act.

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