DISTANT THUNDER - THE 2010 FINANCIAL REFORM IMPACT BEYOND WALL STREET: HOW SMALLER BANKS ON MAIN STREET DODGED MAJOR REFORMS AIMED AT WALL STREET

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For smaller banks beyond Wall Street, last summer's financial reform has produced more smoke than fire. While mega-banks lament the loss of lucrative and exotic stock and bond businesses, main street banks avoided regulation under the more onerous proposals. So far, the reform law — known as the *Dodd-Frank Wall Street Reform and Consumer Protection Act* — has not yet affected smaller non-money centers in ways anticipated before its passage.

Money Meltdown Triggers D.C. Smack Down

The 2008 financial crisis exposed some extraordinary weaknesses in the U.S. financial system, especially on Wall Street. After the worst of the financial crisis, and the pounding of the last gavel on the Congressional hearings, many regulators and money-center executives concluded that, fundamentally, the problem was the gigantic and inter-connected financial firms. Each of these financial battleships was tethered to others. If one sank, they all did.

Therefore, the focus on the law was two fold: First, identify the biggest financial ships, without which the entire system would sink. Second, disconnect institutions from each other — such as derivatives trading, insurance, lending, and certain securities dealing. Secondarily, Congress addressed a myriad of perceived smaller leaks in the financial vessel, with new laws addressing specific activities of banks, insurers, finance companies, and brokers. The heat of the financial crisis, combined with the simmering populist rage against big banks, fueled a combustible and high decibel legislative session that produced years of legislative tinkering in only a few months.

The Bottom Line for Smaller Banks

Amidst the hundreds of new laws and amendments to existing statutes are a few provisions that will directly affect independent banks throughout the country, regardless of size or location. Among the most significant are:

- **FDIC Insurance.** Locking in the increase of FDIC deposit insurance coverage of $250,000 per account. When individuals add other accounts, this limit is closer to $1 million.
- **Creation of a consumer watchdog for financial services.** This is one of the biggest changes in the law and will affect virtually every financial entity providing retail financial services. Like the Department of Homeland security after 9/11, this new uber-agency — the Consumer Financial Protection Bureau — combines the consumer financial regulatory staff of some of the largest agencies in Washington. No longer will a disparate group of federal agencies "get around" to consumer financial regulation. This agency has a mandate, a large budget, and now an aggressive leader. This agency will issue regulations regarding disclosures, collection practices, discrimination, processing, and pricing for credit cards, personal loans, bank deposits, and virtually all other services that relate to dollar bills. Bank regulators, not this new consumer super-cop, will enforce laws for banks with less than $10 billion in assets. This will be huge.
- **Another demotion for savings and loans.** Savings banks — the financial firms with the mission of financing home mortgages — suffered yet another regulatory demotion. Following the S&L crisis of the 1980s, this industry saw its primary regulator diminished and its independence severely restrained in the form of the Office of Thrift Supervision. Now, Congress has dissolved the Office of Thrift Supervision — shifting its activities to the Office of Comptroller of the Currency, which regulates all nationally-chartered banks. Many in the industry have proclaimed this as the beginning of the end for savings banks and their historical focus on mortgages. They fear that a generic bank regulator will view the savings bank focus as a liability, not a strength.
- **Second life for state regulation of banks.** Historically, banks have been either regulated by a national agency — the Office of the Comptroller of the Currency — or by the state in which the bank was headquartered. In addition, each state has been able to impose its own version of consumer or other banking laws on local branches of out-of-state banks. This was a system similar to our courts — cases may be filed in a state court or a federal court located across the street. In this case, many local banking groups fiercely — and successfully — defended these "states rights" in banking. Much to the dismay of the mega-banks centered in New York and North Carolina, Congress proclaimed the survival of many of the state powers to regulate banks and impose their laws.
- **Eliminating many benefits of "Trust Preferred Securities."** For the better part of 20 years, bank holding companies have issued stock with many elements similar to debt. However, unlike debt, bank holding companies were able to freely apply the amounts raised as capital — just as if it were regular stock, or earnings from operations. The trust preferred party, however, may be ending for all but the smallest bank holding companies. Some larger banks and thrifts get time to replace debt-like securities from counting as equity-like capital; smaller banks may retain this "magic capital" on the books through May 2010, but cannot use new trust preferred securities as capital. The smallest holding companies — those with less than $500 million in assets — may stay on the trust preferred wagon, to the extent that any market for these securities exists.

The Long Fuse of the Big Bomb

As dramatic as the passage of the law, some of the most significant aspects of the law are yet to come. The new law includes dozens of future trigger dates, including the following:

- Depending on who is keeping score, bank regulators must conduct several studies and adopt hundreds of new rules to apply the general principals of the legislation. These include regulations mandating more bank capital, restructured federal bank agencies, and processes to resolve failed banks.
- If the history of the savings and loan crisis is a guide, the large banks will lobby for additional changes to the laws as the structure of the industry changes. During good times, banks have successfully lobbied for laws permitting national expansion (the Neal-Riegle law) or addition of new lines of business (Gramm Leach Bliley). This time will not likely be any different.
- Given the incredibly open-ended nature of rule-making mandates for regulators, both lawmakers and lobbyists celebrating political victory may be rudely surprised by the unintended consequences of their work. An unknowing limit on a business line today might have disastrous consequences for a couple of critical companies in the future. Expect more laws to fix the unexpected problems of the new one.

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