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# NABE Special Report: Regulatory Enforcement in the Trump Era

Relaxed enforcement and reduced compliance hurdles for smaller banks are likely to be the hallmarks of Trump administration regulatory policy.

Cutting regulatory burdens on businesses and financial institutions is one of the chief goals of President Trump, whose first acts included signing an executive order directing federal agencies to reduce the number of regulations. Slashing regulations already on the books, however, is complicated because it requires Congressional action with a divided House and Senate, or a lengthy rule-rewriting process by regulatory agencies that can take years.

Given these challenges, the administration's immediate solution will be to install leaders in the regulatory agencies that will be less zealous about enforcement, said Mark Calabria, chief economist for Vice President Mike Pence, speaking on a panel at the recent National Association of Business Economics conference in Washington, D.C.

"Personnel is policy," Calabria said, noting that enforcement is one "part of the Obama era that can easily be replaced."

Calabria, who joined the administration from the Cato Institute, contended that "our financial and regulatory system is deeply flawed … in many cases, straightforward deregulation is the answer, but I recognize that the financial system is complicated."

Panelist Brian Gardner, a senior vice president of bank research at investment bank Keefe,


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“The first thing (the administration) can do is to instruct supervisors and examiners to change their behavior.”

*–Brian Gardner, Keefe, Bruyette & Woods*

Bruyette & Woods, said that the prospect of legislative changes is not good, given the ideological differences between the House and Senate.

For example, Texas Congressman Jeb Hensarling, chairman of the House Financial Services Committee, has introduced the Choice Act, which would gut the Consumer Financial Protection Bureau (CFPB), eliminate the Volker Rule that bars banks from making speculative trades and give banks the ability to opt out of Dodd-Frank regulations in exchange for raising more capital. Some form of Hensarling’s bill is likely to pass the House, but Senate Republicans do not support the bill and it would likely face a filibuster from Senate Democrats in any event.

## No Second Guessing?

The best hope for reducing the regulatory burden is likely to come from instructions that the new agency leadership provides to staff. “The first thing (the administration) can do is to instruct supervisors and examiners to change their behavior,” Gardner said.

How would that work in practice? One of the chief objections to banking regulations implemented in the wake of the last financial crisis is that the rules as written leave a lot of room for interpretation, and banks’ actions are subject to second-guessing from regulators.

To take some examples from the commercial real estate market:

- Risk-retention rules. The recent rules from Dodd-Frank that took effect in December require CMBS issuers to hold 5 percent of the securities they sell. A handful of compliant deals that have been issued to date used a “vertical” structure in which the banks that contributed loans to the pool retained a 5 percent portion of each class.

To make the deals work from a profit standpoint, the issuing banks classified the retained bonds as whole loans, which allowed them to claim the most favorable accounting treatment and set aside less capital. A stringent regulatory regime might nix the decision and require the issuers to count the retained bonds as securities, which would make the structure less economical. However, agencies under Trump appointees are more likely to give deference to the banks.

- Proprietary trading. Investment banks must set aside more capital for the securities they buy for their own trading purposes than they do for securities bought as part of the function of supporting markets (such as CMBS) in which they operate. Market-making supports liquidity and is a critical factor in the value of securities, since investors are not likely to pay up for bonds they can’t easily sell. However, the line between what investment banks buy to trade as opposed to make markets is a thin one that involves interpretation. A more lenient regulatory process would enable banks to do what they think is right for the market without the fear of being overruled.

- High Volatility Commercial Real Estate (HVCRE) loans. The regulation took effect in 2015, requiring banks to set aside more capital for construction and redevelopment loans. Banks have complained that what constitutes a redevelopment loan is open to interpretation, so in some cases they have cut back on lending to transitional properties. Again, under Trump’s appointees banks would have more leeway to classify loans in a fashion more favorable to their bottom line.

“The easy way to change the regulatory environment is to give banks the benefit of the doubt, where examiners are not second-guessing every decision they make,” Gardner said.

“There has been a healthy lending recovery for large corporations, but not a healthy lending recovery for small businesses.”

*–Mark Calabria, chief economist to Vice President Mike Pence*

It will take time to replace the heads of the agencies, though. For example, Federal Reserve Chair Janet Yellen's term expires at the end of January 2018, and Richard Cordray's term as director of the CFPB ends in July 2018. Trump is trying to fire Cordray, whose agency has drawn the ire of Republicans, but that effort is being challenged in court.

## Emphasis on Small Banks

Calabria said the pillars of the Trump regulatory policy are to prevent bailouts, give consumers choice, restore public accountability to regulators and foster long-term economic growth. Among the areas that the administration is expected to review include bank stress tests, the Volker Rule, the Bank Secrecy Act, which involves anti-money laundering efforts, and how the U.S. adopts international banking standards set by the Basel Committee. The administration will be more inclined than its predecessors to look at new Basel rules in the light of their effect on American institutions.

One of the administration's main concerns is how regulations affect small banks outside of major metropolitan areas. The cost of stress tests and new regulations might not be an impediment to large money-center institutions, but the relative cost of compliance is crushing to smaller institutions in rural communities and could result in less loan activity in those areas.

“There has been a healthy lending recovery for large corporations,” Calabria said, “but not a healthy lending recovery for small businesses.”

—**Paul Fiorilla**, *Associate Director of Research*