Perspectives

Presidential election and financial services outlook: Regulation reflation not expected

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Key Takeaways

- If President Trump is reelected, we would not expect much change for the financial services sector as his administration has already completed significant financial sector de-regulation
- In a Biden presidency, there is the potential for transformative financial sector legislation and re-regulation, especially under a "clean sweep" – control of the executive branch and both houses of Congress
- We will carefully track Senator Warren's chances of being appointed Treasury Secretary, as she has been a proponent of legislation to split up the larger U.S. banks' investment banking and commercial/retail banking arms

We do not expect much change for the financial services sector if President Trump is reelected. President Trump achieved significant financial sector de-regulation in his first term. In fact, in his first week in office, President Trump issued an executive order that required for every new regulation issued, at least two prior regulations be identified for elimination. His administration largely delivered on that order when it comes to the financial sector. As such, financial sector policy is unlikely to feature prominently during a second Trump term.

Under a Biden presidency, there is the potential for transformative financial sector legislation and re-regulation that could reshape the financial landscape for decades. However, when one reads Biden's *Bold Ideas* platform, banking reform is not one of them. Simply put, it is not clear how much of a priority financial sector policy will be; it is possible the priorities of a Biden administration will lie elsewhere.

The greatest scope for change would likely occur in a "clean sweep" election; where Democrats win the White House and Senate while maintaining control of the House. In such a scenario, the Democrats could push through larger changes to banking regulation through the legislative process. A motivating factor for invigorated financial sector policies is a view held by left-of-center Democrats that banks and other financial institutions are inherent sources of economic and societal risk and need to be de-risked.

The choice of Kamala Harris as the Democratic vice-presidential candidate likely means policies will be more centrist. Similarly, as Biden's home state is Delaware – home of the U.S. credit card industry – any proposed banking regulatory policies will likely reflect his appreciation of the role the financial sector plays in terms of facilitating economic growth and consumer choices.

A unifying feature of Democratic policy and regulatory initiatives pursued will be an ESG component. This is evident from Biden's July 2020 comments that "It's way past time to put the end to the era of shareholder capitalism. The idea the only responsibility a corporation has is its shareholders — that is simply not true, it's an absolute farce. They have a responsibility to their workers, their community, to their country."

Banks could be pressured by regulators to become agents of change in tackling climate risk. We could see bank regulatory stress tests incorporate a component that assesses banks' resilience to climate risks. This August, Senate Democrats released a detailed climate report that included the comment that, "...Our financial regulators' job is to ensure a stable and efficient financial system, which means they need to start assessing and managing climate risks. Financial regulators will be key in getting market participants to start this process, but they themselves are unprepared. Our regulatory agencies must take concrete steps to incorporate climate risk into their financial stability and supervisory responsibilities."

The prospect of a $1 trillion stimulus targeted at infrastructure spending would be a positive for the banking sector. It would boost the long-term productivity of the economy, increase the number of jobs, and lead to an expanded economy into which banks can profitably lend.

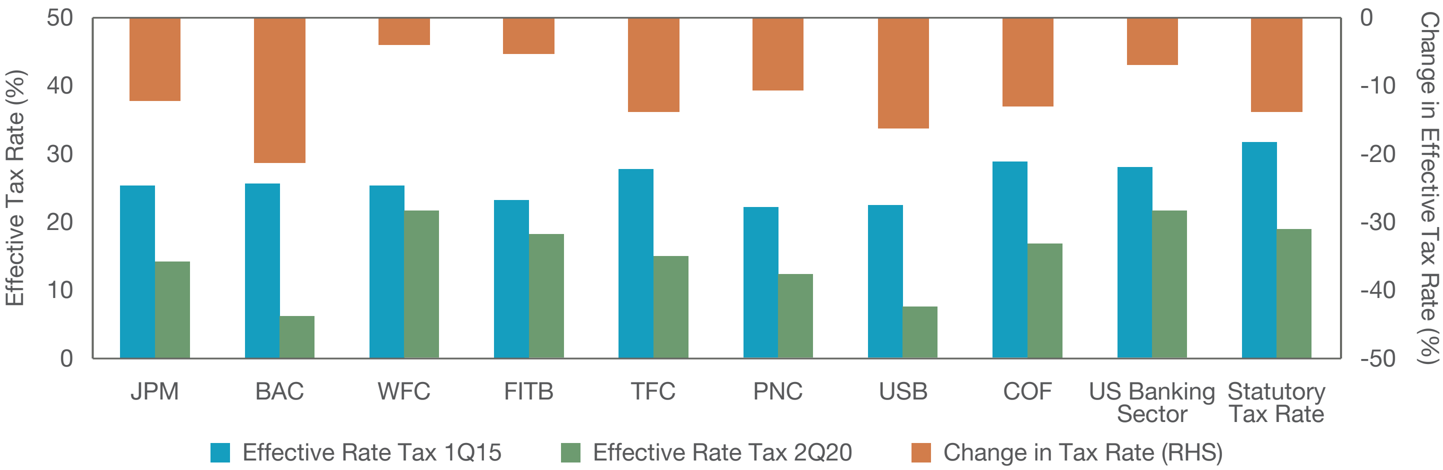
At the same time, partial reversal of the 2017 corporate tax cuts – as the Biden campaign has proposed to pay for these spending initiatives – would increase effective tax rates for the banking sector.

Figure 1: Key financial sector policy proposals of the two campaigns

Name	Biden	Trump
Taxes	• Raise the corporate tax rate from 21% to 28%, which is estimated to raise $1.3 trillion in taxes over the next decade. This is important for the U.S. banking sector as the bulk of its earnings are domestically earned. The top six U.S. banks saw their effective tax rate fall to 18% in 2019 from a rate of 30%, on average, before the Trump tax reforms took effect • Tax on the liabilities of the ultra large banks to promote financial stability – the consequence could be the large banks shed lower yielding assets such as repurchase agreements (repo) which could have an adverse impact on market financing conditions • Financial transaction tax (FTT). If enacted, this policy could hurt banks with large trading and asset-management divisions as well as exchanges	Could look to reduce capital gains tax
Postal Banking	• Creation of a postal bank to help provide banking services to the under-banked. Unclear how this could work and whether the larger banks could be coerced to pitch in	N/A
Fintech	• Creation of a Federal Reserve run real-time payment system. This could help make real-time payments to households and small businesses. The system would likely spur fintech payment technology, but also threaten the larger banks that have invested in legacy payment systems	Further rule easing to encourage banks to partner with fintech firms
Cannabis	• Move to further prevent federal regulators from targeting a financial institution for opening an account for a cannabis business that is compliant with state law	N/A
Consumer Lending	• Possible changes to the 2005 bankruptcy code to make it easier for individuals to discharge personal debt (e.g. credit cards and auto loans) • Interest rate caps could also be applied to credit card loans	Potential to scale back role of the Consumer Financial Protection Bureau (CFPB)
Financial Stability Oversight Committee (FSOC)	• Strengthening of the Financial Stability Oversight Council (FSOC) and oversight of larger banks as well as non-bank financial entities, such as insurance companies, asset managers, and private equity firms	Further de-emphasize FSOC's role
Housing Reform GSE	• Further expansion of affordable housing. Could see expanded role for government sponsored enterprises (GSEs)	Could look to privatize the GSEs and end current conservatorship
Other	• A Biden-Sanders plan mentioned that Democrats will push to create a new government credit reporting agency housed within the CFPB. The public credit reporting agency is an attempt "to provide a non-discriminatory credit reporting alternative to the private agencies," the policy announcement said. This could threaten the businesses of credit reporting agencies	Further easing of community reinvestment act requirements

Sources: MacKay Shields, Donaldjtrump.com, Whitehouse.gov, Joebiden.com, 2020.

Figure 2: U.S. Banks' effective tax rates have fallen under Trump — Biden could reverse this trend



Sources: Bloomberg, FDIC, 2020.

Personnel appointments can greatly shape policy outcomes

In a split Congress that limits the scope for legislative change, cabinet appointments take on added importance. Executive branch officials are bestowed with significant authority from day one. The policies and approaches these officials make can shape almost every aspect of the economy and society. The key is whether and how they exercise those powers. We saw this play out across the Trump presidency, for example, the appointment of a former coal industry lobbyist as head of the Environmental Protection Agency who subsequently weakened environmental protections to clean up coal ash ponds that contaminate groundwater.

For the financial services sector, there are a few presidential appointments that should be carefully monitored. The Treasury Secretary is an important appointment for shaping financial regulation. Several names have been mentioned in the press as potential Treasury nominees should Biden be elected. One name to watch is Senator Elizabeth Warren, who brings a strong understanding of the banking sector. She is a proponent of re-instating Glass Steagall and splitting up the larger U.S. banks' investment banking and commercial banking activities. Reinstating Glass Steagall would require an act of Congress and presidential signing into law, and hence is a potential outcome only under the Democratic clean sweep scenario. Implementing such a law could create significant volatility in bank bonds' credit spreads as bond holders could see their bonds transferred to support the more levered wholesale funded operations of the then split-up banks (notably the investment banking arms), while the retail and commercial banking operations would be funded through more stable deposits.

Senator Warren has also criticized the issuer-pays models of the credit rating agencies as she believes there are incentives for rating agencies to award better ratings to issuers, regardless of risk to win business.

A financial transaction tax – which is a tax on buying and selling equities, bonds, or other financial contracts including derivatives – has also been mentioned in Biden's campaign documents. The Treasury Secretary would be the point person for pushing this through. Such a tax could be harmful to the likes of asset managers and stock exchanges as it could decrease trading volumes and drive trading to overseas exchanges. Campaign documents also mention a tax on larger bank liabilities. An area where the large banks take on significant liabilities to earn thin profit margins is repo lending. Any measures that would reduce already small margins could mean banks pull away from repo lending facilities. This would likely have an adverse impact on market trading conditions.

At the Federal Reserve, Jerome Powell completes his four-year term as Chair of the Board of Governors in February 2022. His term is expected to be renewed under a Biden Presidency, though there is some speculation that Neel Kashkari, the current President of the Federal Reserve Bank of Minneapolis, could vie for the position. This would be a worrying development for bank equity investors as President Kashkari has previously advocated for banks with assets of more than $250 billion to issue equity up to 23.5% of risk-weighted assets – a near doubling of current levels. We recognize banks are safer with more capital, but from a credit perspective, banks also need to be profitable and remain going concerns as the first line of defense for credit investors is profitability. Measures that overly threaten bank profitably could lead banks to assume more risk as a means to earn sufficient returns. Hence, we think a workable balance is needed between profitability and capital.

Much of the recent roll-back of financial legislation was driven by Randy Quarles, the current Vice Chair for Supervision at the Federal Reserve. His term as Vice Chair for Supervision ends in October 2021. We would not expect a President Biden to reaffirm him in this role. A democratic-appointed replacement has the potential to reverse his efforts and strengthen financial regulation.

Similarly, the heads of the Securities Exchange Commission (SEC), Office of the Comptroller of the Currency (OCC), Federal Housing Administration (FHA), and Consumer Financial Protection Bureau (CFPB), could all be replaced with democratic appointees. Each agency could look to reverse practices adopted under the Trump administration and pursue a re-regulatory agenda as Federal agencies have the ability to make, interpret, and enforce rules and regulations.

Figure 3: Deregulatory tracker: notable financial deregulatory items under Trump

Name	Agency	Current Status	Last Updated
Community Reinvestment Act Reform	OCC	In effect	7/30/2020
Supplemental Leverage Ratio Relaxation	Fed	In effect	6/15/2020
Protection for Payday, Vehicle Title, and Certain High-Cost Installment Loans	CFPB	Delayed	6/20/2019
Fiduciary Rule	DoL	Repealed	6/12/2019
Risk-Based Capital Rule	NCUA	Delayed	11/6/2018
Dealer Markups Guidance	CFPB	Repealed	5/22/2018
Regulatory Capital Rule for Small Banks: Transitions	Treasury, Fed, FDIC	In effect	5/11/2018
Arbitration Rule	CFPB	Repealed	10/25/2017

Source: Brookings Institution, 2020. DoL stands for the Department of Labor. NCUA stands for the National Credit Union Administration. FDIC stands for the Federal Deposit Insurance Corporation.

Finally, the House Services Financial Committee under Chairwoman Maxine Waters could bring attention to the workings of the private equity, investment banking, and asset management industries, particularly in the areas of diversity and inclusion.

So, putting this all together, a Biden presidency would likely bring change to the financial services sector, but just how much depends on how far the president moves on regulations, and in our view, whether he realizes a strong banking sector is a key ingredient to a recovering economy. The appointment of vice president candidate Harris likely grounds policy in the center. The key for a Biden administration will be to balance adding regulation that ensures the safety and soundness of the financial services sector without jeopardizing the economic recovery the financial services sector can help facilitate.

Definitions

A credit spread is the difference in yield between two bonds of similar maturity but different credit quality. **The effective tax rate** is the average tax rate paid by an individual or a corporation. **A statutory tax rate** is the legally imposed rate. **The Glass-Steagall Act** is a 1933 law that separated investment banking from retail banking. **A repurchase agreement,** also known as a repo, is a form of short-term borrowing, mainly in government securities. **Financial transaction tax (FTT)** is a tax on buying and selling a stock, bond, or other financial contract like options and derivatives.

Important Disclosures

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