

## Something to Think About



OAKWORTH  
CAPITAL BANK

# COMMON CENTS

Ordinarily, the Employment Situation report is the biggest piece of news the first Friday of each month. Today, it isn't, even though the Change in Nonfarm Payrolls was reasonable enough, some 226K net new jobs. So, something else, something big, must have happened, and it did.

This morning, President Trump signed an executive order basically reviewing the Dodd-Frank financial system regulatory legislation. Ostensibly, and on its face, this is the proverbial first step in rolling back or repealing it. However, since only the Congress can actually rewrite/repeal the legislation, well, the order itself isn't as powerful as its symbolism.

Since Dodd-Frank has exploded to over 20,000 pages of text, and still growing, any significant changes or line item repeals will take a month of Sundays. So, bankers can't rejoice just yet. Further, and I can't believe I am actually typing this, not all of Dodd-Frank is without merit. You know, it is kind of hard to argue with making our money center banks, the truly too big to fail, hold some additional capital, etc. You know? I mean the FDIC just doesn't have the ability to cover those guys, period.

But, as I wrote to a reporter friend of mine about an hour ago: "Over 20,000 pages of new banking rules? Think there might be some redundancy and nit-picking in there somewhere? I am not saying anything, I am just saying; if you know what I am saying." Let's just say the number of rules mandating redundancies are redundant.

Obviously, I helped start a bank, so the implication is I would be against bank regulation in all forms. Not so true. However, the kneejerk reaction against the banking system after the financial crisis of 2008-2009 was a bit alarming to me. Where were the regulators? Shouldn't they have cried foul earlier? Why did the Federal Reserve keep its foot on the gas for so long after the somewhat anemic recession at the start of the decade? Why did FNMA and FHLMC reduce credit standards in order to get more people into more homes? Why did the ratings organizations put AAA or other investment grade ratings on all those bundled mortgages? In essence, why did they keep insisting chicken [stuff] was chicken salad?

The list goes on and on, and a lot of people lost a lot of money. Heck, a lot of people lost their jobs. However, there were any number of headlines about bank executive X or investment banker Y who made a killing while Rome was burning, or something along those lines. Something had to be done to protect the public from the greedy banks! Right?

Well, I would submit the whole thing would have, could have, and should have been avoided IF only S&P and Moody's had refused to play ball with the investment bankers securitizing lousy looking mortgages. Done. Had they simply said "nope, we don't understand what you are doing; don't think your vectors are right, and know you know this stuff ain't AAA," the whole mess wouldn't have happened.

Big insurance companies, institutional money managers, and brokers gobbled up these packaged mortgages largely because they carried an investment grade rating from the ratings organizations...often AA and AAA. Trust me, they weren't doing the credit work themselves on each and every security, if any credit work at all the lower you went down the totem pole. Trust me, I had

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any number of folks trying to sell me the stuff back in the day. The pitch? “It’s AAA rating by both (implying S&P and Moody’s).” When I would counter I didn’t understand the structure and would need to see the underlying mortgage pools in any event, I would routinely get: “I guess I can get you that information, but its AAA rated by both.”

To make what is a long story kind of short, if these pooled/secured mortgages hadn’t carried investment grade ratings, there would not have been the same level of investor demand for them, or anywhere near it. As a result, banks/mortgage companies wouldn’t have made so many of them. Why? Because most banks don’t want to hold a whole bunch of residential real estate loans on the books, particularly if the numbers barely work.

However, back then, lenders could make a so-so loan and almost immediately sell it to someone who would package it with a whole bunch of other so-so loans. Slap an investment grade rating on most of the underlying tranches and a BB on the obvious garbage, and voila. In hindsight, the investor demand was hard to grasp. In fact, it was so great lenders had to devise new products in order to get more people to qualify for a mortgage...which they could, again, sell.

It was a money making machine until it wasn’t. I mean things got so out of whack I had a bank analyst basically call me a fool for daring to utter things like “interest rate risk,” “eventually, someone ultimately has to live in these houses everyone is buying,” and “duration” during a presentation. Duration? To that guy, duration was yesterday’s concept. He had, like so many others, bought into it.

Again, no AAA...no AA....no A...no BBB on some/most of that stuff, no housing bust, and, ergo, financial crisis. For my money, the ratings organizations have not gotten the reprimand, the black eyes, and the blame they should have gotten....nowhere near it. Even so, Dodd-Frank has already given us 20,000 pages of regulations with which to contend, and thousands more to come. That is until this morning.

Now, what is the likelihood “they” will repeal Dodd-Frank in its entirety? And I mean nothing from it stays on the books, nothing? The odds are probably as close to 0% as my winning the Powerball this Saturday. The best case scenario for the financial/banking system is “they” relax some of the proprietary trading rules, which could very seriously exacerbate the next financial system hiccup, and ‘line item veto’ a lot of the duplication of effort/paperwork that seems to accompany massive efforts such as this one. Then, somehow make it so the rules don’t keep evolving, growing, and changing every single year.

Contrary to popular belief, banks don’t want to make bad loans. In fact, that is the last thing we want to do. There are two happy days in a loan’s life: 1) the day we make it, and; 2) the day the borrower pays it back. Further, we typically don’t want to foreclose on property, seriously. Our collateral is underwater if ‘you’ can’t sell it for enough money to pay us back. All the talk at the time about banks only making loans so they could foreclose on the property and flip it for a quick buck? I suppose if you tell a lie long enough and say it loud enough people will believe it to be the truth. Sure, there might be the off instance, but, almost by definition, it would have been the exception rather than the rule.

Again, I helped start a bank, so it might seem I am biased. Perhaps, but I also know how the system actually operates, unlike many of our politicians/legislators. You know, the same people who draw up regulatory legislation. To that end, care to guess the number of days either Barney Frank or Chris Dodd (sponsors of the bill in question) had ever been actively employed in the banking industry at the time of the bill’s passage? From what I have read, a snake could count the days on its fingers. Maybe a summer job or something back in the day, but never as a career.

With that said, Signature Bank (SBNY) in NYC named Frank to its Board of Directors in 2015. Interestingly enough, according to what I can tell off Bloomberg, it appears as though SBNY has awarded Frank some 3,826 shares of stock over the two years he has served on the board. If history serves as a guide, he stands to get another 1,913 shares this calendar year. We shall see whether it keeps him on after his term expires IF the GOP maintains control of the Congress, and Frank’s remaining influence wanes as a result.

Who knows? Maybe he is the greatest director that company has ever had. I have no idea, and I wish them all well.

On top of the executive order regarding Dodd-Frank, President Trump also appears to be going after the so-called Fiduciary Rule the Obama Administration enacted to go into effect in a couple of months. The Fiduciary Rule? Yeah, here is the summary verbiage straight of the Department of Labor’s website:

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“The Department of Labor Fiduciary Rule is a new ruling, scheduled to be phased in April 10, 2017 – Jan. 1, 2018, that expands the “investment advice fiduciary” definition under the Employee Retirement Income Security Act of 1974 (ERISA). If this sweeping legislation (1,023 pages in length) is not delayed or stopped outright, it will automatically elevate all financial professionals who work with retirement plans or provide retirement planning advice to the level of a fiduciary, bound legally and ethically to meet the standards of that status. While the new rules are likely to have at least some impact on all financial advisors, it is expected that those who work on commission, such as brokers and insurance agents, will be impacted the most.”

Who can possibly argue with that? That sounds pretty good, doesn't it? If you didn't know the way the sausage is actually made in the investment industry, perhaps it would. In practice, it would mean, for all intents and purposes, brokers advising on retirement accounts would have to move to “managed money” or to lower cost I or A share mutual funds or reduce commission schedules or waiving loads, that sort of thing. That should be good, right?

Again, the devil is in the details. While great in theory, how many financial advisors are going to work for an account which doesn't generate enough money to meet the production grid? If it doesn't meet the production grid, how many firms are going to keep the account around? Production grid? Yeah, how much the advisor has to make per transaction/account in order to get “credit” for compensation purposes. These will vary by firm and often by advisor.

In so many ways, the Fiduciary Rule set a ceiling of sorts on retirement accounts at brokerage firms. If a ceiling is set ABOVE the market equilibrium price, no big deal. If it is BELOW the equilibrium, there will be a supply shortage. In this instance, you can think of the equilibrium as the minimum amount the advisor needs to make off the account before they see anything in their paycheck. If the account earns less than the minimum, they will not take it.

Assume Brokerage A mandates an account has to produce, say, \$500 in fees per annum in order for the advisor to receive credit for it against their grid. Also assume Brokerage A mandates a \$100K minimum account size for its managed money program AND the firm's compliance people think advisors can “get by” using A shares paying trailers of 0.25% on retirement assets. What is the minimum retirement account an advisor at Brokerage A will take? Well,  $\$500 / 0.25\% = \$200K$ ....so the answer is \$100K in the managed product.

Obviously, there are a lot of IRAs out there with less than \$100K in them. So, under the Fiduciary Rule, small investors were going to get the short-end of the stick, even if my example above might have been a little simplistic. Admittedly, advisors don't get rich on \$25K IRAs. However, those are the bread & butter for newbies in the industry. As a result, the Fiduciary Rule would have not only squeezed the small investor; it would have also limited options for young people looking to get into the industry, thereby reducing employment opportunities and long-term industry expertise. Whew, brother. I am not a broker, and actively compete against them, AND I thought it was a bad rule with extremely good intentions....but, as with banking, I kind of know how the sausage is made.

In the end, it is a weird day when the Employment Situation report takes the back burner to executive orders, but these were a couple of doozies. No one knows what the end outcome will be long-term, but these were probably steps in the right direction.....if only the pendulum doesn't swing back too far the other way.

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