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INSIGHTS & PERSPECTIVES
GLOBAL FIXED INCOME
MARCH 2025

US Banks: Could Regulation Roll Back Go Too Far?

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Key Points

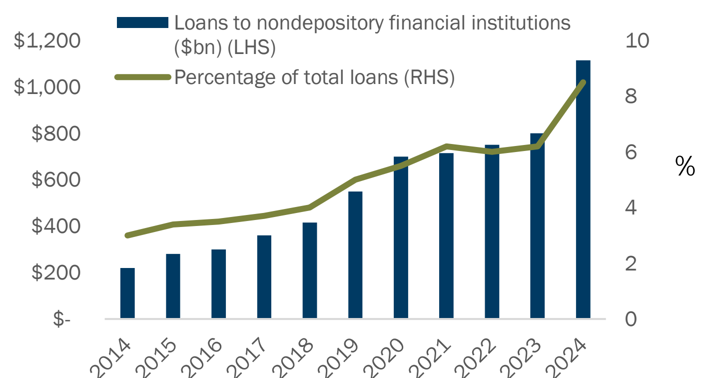
- Bank regulation moves in cycles, with the pendulum now swinging back toward deregulation under the Trump administration.
- Bank investors benefited greatly from strengthening regulations over the last 15 years. The greater concern would be a dismantling of the existing regulatory and legislative banking frameworks.
- Regulatory rollback is ultimately likely to be more modest and likely involve the cancelling of proposed rules. Basel III Endgame implementation is likely to be significantly modified or abandoned entirely, benefiting larger banks.
- One area to watch is possible revisions to regulations that currently require banks' holdings of central bank reserves and treasuries to be backed by capital as part of complying with the Supplement Leverage Ratio (SLR). Easing of these rules has the potential to substantially reduce the larger US banks' long-debt needs. If enacted, this event could potentially tighten credit spreads.
- The US Treasury is motivated to see a modification of the SLR to reduce long-term Treasury yields by encouraging banks to be larger buyers and holders of Treasuries.
- The growing bank vs. non-bank nexus creates additional systemic risk considerations as deregulation proceeds, and changes here should be monitored especially in the repo market.
- Bank M&A activity is likely to increase as regulatory barriers to consolidation are reduced, with transaction values having already risen in 2024.
- Despite deregulation, banks maintain strong capital positions with average TCE (tangible common equity) ratios of 7.15%, more than double the levels seen pre-GFC (global financial crisis).

The Regulatory Pendulum: Historical Context and Current Shift

Bank regulation moves in cycles. Following the GFC, where financial losses from the banking sector cost the global economy $2 trillion, the regulatory pendulum swung sharply toward stricter oversight. Politicians and bank regulators implemented comprehensive reforms that doubled the capital held by US banks. The Code of Federal Regulation (CFR) Title 12 on Banks and Banking expanded from approximately 5,000 pages in 2009 to almost 10,000 in 2010. Under the Biden Administration, this trend continued with proposed regulations totaling over 1,000 additional pages.

A notable result of heightened regulation has been the migration of risk outside the traditional banking system. Nonbank financial institutions' share of lending climbed to 8% of total bank loans in 2024 from low single digits in 2014, as banks became less willing to lend partly due to more stringent regulatory requirements

FIGURE 1: BANK HAVE LOST LENDING MARKET SHARE TO NONBANK FINANCIAL INSTITUTIONS



Source: S&P Global, Federal Reserve, Federal Financial Institutions Examination Council

NOTHING HEREIN SHOULD BE CONSTRUED AS A GUARANTEE OF PROFITABILITY OR THAT INVESTORS WILL BE ABLE TO AVOID LOSSES, INCLUDING A TOTAL LOSS OF THEIR INVESTMENT

The regulatory pendulum now appears to be swinging in the opposite direction. The Trump administration has frozen many of the former administration's proposed rules and is reconsidering how regulators enforce existing regulations. There are mounting calls for simplification of the regulatory framework, with many banks and policymakers advocating for streamlining the comprehensive Basel framework, which represents the current state of standards for bank oversight and regulation.

Key Questions for Credit Investors

This regulatory shift raises three critical questions for fixed income investors:

1. Is there a point where deregulation goes too far?
2. Will reduced regulation increase vulnerabilities within the banking system?
3. Are current valuations sufficiently pricing in bank reform?

The answers depend largely on how banks respond to this regulatory reprieve and how different aspects of the regulatory framework are modified.

There's an important distinction between regulatory simplification and broad rollback. We anticipate renewed efforts to cut red tape, which can be neutral to bank ratings if they don't hinder effective supervision or reduce banks' incentives to pursue sound risk management.

Mechanisms for Regulatory Change

Without comprehensive legislative change, which we do not anticipate, regulatory evolution will likely follow two paths:

1. REASSESSMENT OF PROPOSED REGULATIONS

The most probable course of action involves halting regulations proposed by the previous administration. This should represent a short-term positive for the industry by eliminating potentially complex rules that in our view would have increased costs without effectively reducing systemic risk.

The Biden Administration had proposed several major regulatory changes, including Basel III Endgame, which would have increased capital requirements for residential mortgages. Another proposal would have required larger regional banks to issue $70-100 billion in additional holding company debt. While these measures might have protected taxpayers from bank failures, they would have likely impacted profitability without substantially reducing industry risk.

We do not expect a comprehensive review of existing regulations which would be more impactful to bank investors as the desire for quick regulatory fixes is likely prioritized over a broad and lengthy overhaul of existing regulations.

2. PERSONNEL CHANGES AT REGULATORY AGENCIES

The second avenue for change involves appointing new leadership at key regulatory agencies. These appointees will have nearly four years to implement regulatory changes outside the legislative channel.

Several agencies are expected to see leadership changes, including the Federal Reserve's vice chair for supervision, SEC Chair and FDIC leadership. These transitions will substantially influence how existing regulations are interpreted and enforced.

Staff reductions at regulatory agencies could function as de facto deregulation, with banks facing less day-to-day oversight. However, insufficient regulatory staffing could also impede the development of new, more balanced rules.

It's worth noting that Fed Chair Jerome Powell would likely resist any attempt to remove him before his term expires in 2026, providing some continuity in monetary policy and financial system stability despite regulatory shifts.

The Basel III Endgame: Likely Dead or Significantly Modified

To make the banking sector more resilient to economic shocks and in response to the banking failures in March 2023, Federal Reserve Board supervision chief Michael Barr issued a draft rule for Basel III Endgame. The draft rule would have required larger US banks to hold more capital against credit, operational and market risks. Industry players estimated the rules would have pushed up capital requirements for the largest institutions by 19%. After vocal industry protest, the Federal Reserve scaled this back to an estimated 9% increase in capital requirements last September.

While the Basel III Endgame would require endorsement by the OCC and FDIC as well as the Fed, most analysts believe the

rule will be significantly modified or potentially abandoned entirely. New agency leaders will likely table rulemaking that hasn't been finalized before they take over, sending the Basel III Endgame "back to the drawing board for further relief. (PWC November 8, 2024)

One Rule to Watch: Treasury Market Impact

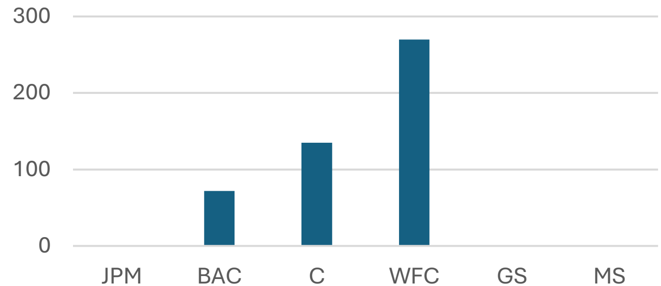
The enhanced supplementary leverage ratio (eSLR) requires larger banks to hold long-term debt of at least 5% of their leverage assets (includes on and off balance sheet assets). This ratio is indifferent to asset type, treating one dollar of Treasury securities the same as one dollar of risky subprime auto loans.

As of Q3 2024, three of the six larger banks are constrained by the eSLR. Consequently, banks are less willing to own safer but lower-returning assets, notably US Treasury securities. This is problematic since outstanding Treasury securities have grown nearly fourfold relative to primary dealer balance sheets since 2007 (see Figure 2 below).

FIGURE 2: PRIMARY DEALER SHARE OF AUCTION AWARDS OF LONGER-TERM TREASURIES

Source: Bank of Policy Institute

FIGURE 3: MONEY-CENTER BANK'S BALANCE SHEET CAPACITY TO HOLD US TREASURIES, $BN



Source: Morgan, Bank of America, Citibank, Wells Fargo, Goldman Sachs and Morgan Stanley, Bank Policy Institute

The Impact on Bank Capital and Debt Requirements

Recent speeches by Federal Reserve Governors have mentioned excluding Treasury securities from the eSLR calculation. Such a change temporarily occurred during the COVID period.

The impact of SLR (Supplementary Leverage Ratio) changes could be substantial. For US Global Systemically Important Banks (GSIBs), the potential benefits vary based on which assets are excluded from leverage exposure calculations. A narrower amendment to the rule could see central bank deposits excluded from the denominator of the SLR. A broader revision of the rule could see central bank deposits and Treasuries held as trading securities being excluded. The greatest revision would see the above exclusions as well as the exclusion of Treasuries held in the "available for sale" and "held to maturity" accounts.

Under these scenarios, the US GSIBs could experience reduced long-term debt needs due to a decrease in leverage assets as long-term debt requirements are determined by a minimum percentage of leverage assets.

Using estimates from JP Morgan, the reduction in amount of long-term debt varies from $54 billion on the narrower revision of the rule to $161 billion on the greatest revision of the rule. In terms of annual debt issuance, that range is equal to 36% of the amount long-term debt issued in 2024 all the way to 108%.

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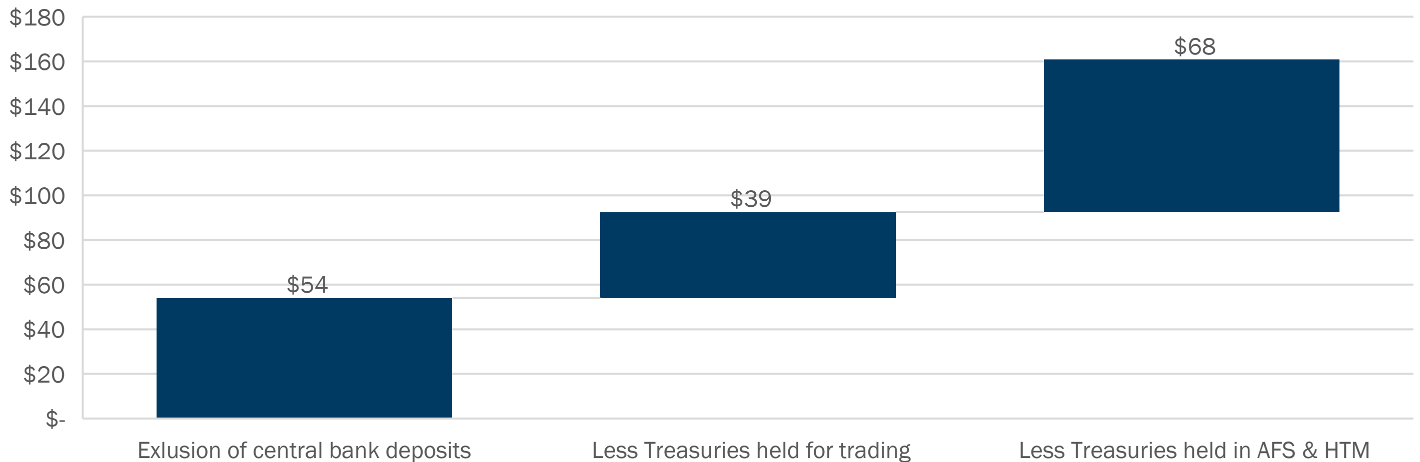
FIGURE 4: REDUCED LONG-TERM DEBT ISSUANCE OF MONEY-CENTER BANK'S UNDER ESLR REVISION SCENARIOS



Source: JP Morgan Research

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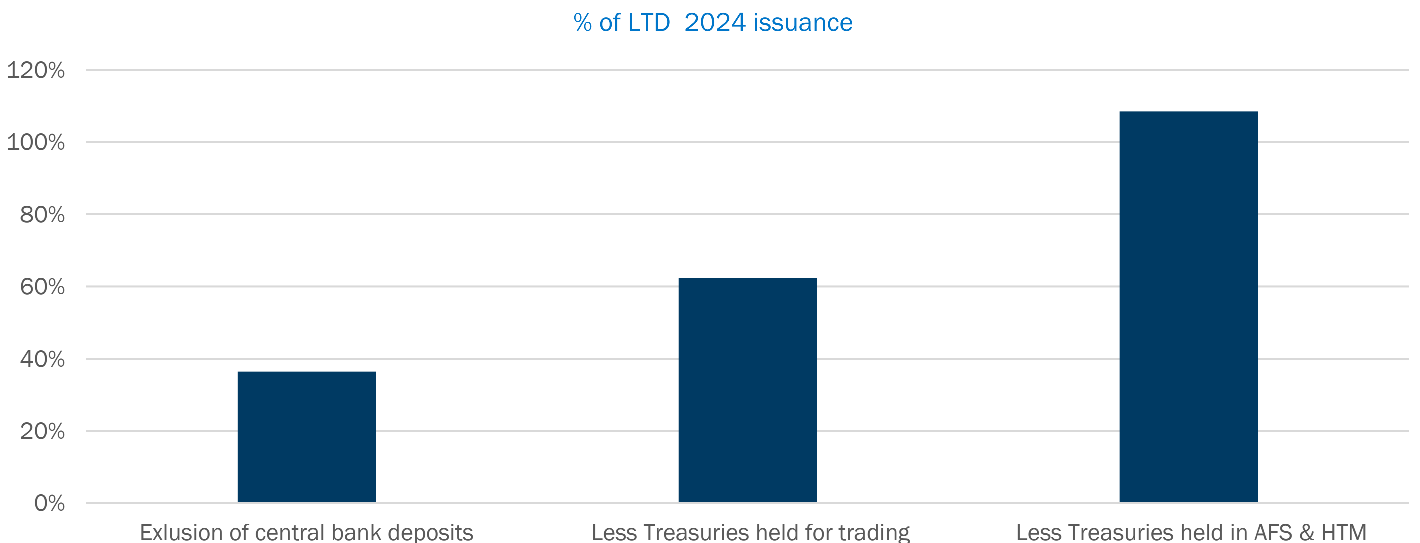
FIGURE 5: GAUGING LONG-TERM DEBT REDUCTIONS AS A % OF 2024 LONG-TERM DEBT ISSUANCE

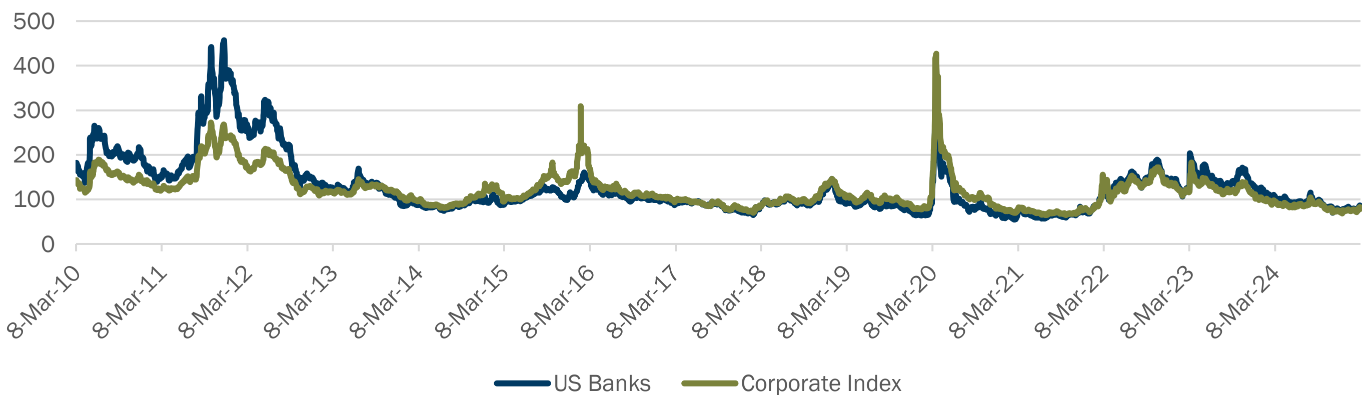


Source: JP Morgan Research, Bloomberg

The potential impact is especially significant at the Insured Depository Institution (IDI) level, where approximately 64% of GSIBs' Treasury holdings reside. The IDI is often more constrained by SLR requirements than the holding company, making regulatory relief particularly impactful at this level.

Credit spreads could benefit from these changes. One way to gauge the possible effect on the large bank credit spreads is to look at where credit spreads were before the rules were changed in 2016. Using research from JP Morgan, GSIBs traded on average about 25 basis points through the JP Morgan JULI index, with a tight spread of 55 basis points. Since the rule change, the sector has traded only 8 basis points through the index on average. Put together, a meaningful reduction in long term debt needs could drive spreads tighter once again. A further notable effect of a rule change could see the freeing up significant capacity for larger banks to own Treasury securities and extend more repos to clients. Barclays estimates repo volumes of $9 trillion could be added to the market. However, additional repo capacity creates possible risk outside the banking sector—the top 10 hedge funds account for 40% of total repo borrowing with leverage ratios of 18 to 1 as of Q3 2024, according to the Office of Financial Research.

FIGURE 6: US BANKS' CREDIT SPREADS HAVE BEEN BENEFICIARIES OF GREATER REGULATION OVER THE LAST 15 YEARS: 5-YEAR CREDIT SPREADS (BP)



Source: JP Morga Research

Regulators have also recently mentioned revising the GSIB surcharges to which the largest banks must adhere. A consequence of this rule change could be the larger US banks seeing a lowering of required capital ratios. This could translate into freed up capital between $160 billion to $200 billion, according to Jefferies Research. Some of this freed up capital will likely support more bank lending, M&A activity and return of capital to shareholders, especially as bank equity prices have recently declined.

The Bank-Nonbank Nexus: A New Systemic Risk Factor

As regulatory focus on traditional banks potentially eases, one area deserving closer attention is the growing interconnection between banks and nonbank financial institutions (NBFIs), which creates potential for amplification and propagation of systemic risks.

Our analysis and research from the Federal Reserve suggests banks are net recipients of funding from nonbank credit providers, while also providing significant lending to NBFIs. The growth in private credit and nonbank intermediation represents both an opportunity and a risk for banks. Collateral and good diversification by borrower type have helped mitigate risks for banks so far.

In a potentially less regulated environment, monitoring these interconnections becomes even more critical for credit investors to assess systemic risk.

Insured Depository Institution (IDI) Considerations

The failure of some smaller regional banks in 2023 highlighted the importance of how regulation affects bank operating entities. Members of the FDIC board, including Vice Chair Travis Hill, have criticized the agency's handling of these failures (see FDIC Speech, July 24, 2024)

With new leadership, the FDIC may take a different approach to bank resolutions and possibly revise certain policies related to bank failures, contingency funding plans and the Deposit Insurance Fund.

Our research suggests authorities will continue to deploy loan forbearance measures to mitigate shocks. Regulators have increasingly stepped in with support measures for bank borrowers affected by various shocks since the GFC. This may result in fewer surges in non-performing loans but potentially larger increases in other adverse asset quality metrics, along with negative pressure on bank profits.

Areas to Watch: M&A and Regional Banks

MERGERS AND ACQUISITIONS

Banks are likely to see a more favorable regulatory environment for mergers and acquisitions under the new administration. The Justice Department issued stricter guidelines on banking mergers in 2023, which may have discouraged potential deals. As S&P noted observer noted, "There has definitely been a muted aspect to M&A. Managements considered whether it was worth starting if the acquisition could be denied in the end." (source Global Finance)

A reversal of these merger restrictions could accelerate consolidation in what many consider an over-banked industry. The FDIC has already signaled this shift by reversing its 2024 rule applying "heightened financial stability analysis" to mergers creating banks with at least $100 billion in assets.

After falling to just 102 deals in 2023, bank mergers increased to 129 deals in 2024, with significantly higher transaction values. Total assets acquired in 2024 reached over $600 billion, compared to under $200 billion in 2023. This trend appears poised to accelerate further in 2025 as regulatory barriers continue to ease.

REGIONAL BANKS

Second-tier banks (those holding between $100 billion and $250 billion in assets) may avoid a suite of new regulations that were proposed following the collapse of Silicon Valley Bank, Signature Bank, and First Republic Bank in 2023. These initiatives have stalled amid industry pushback and disagreements about the causes of the regional bank failures.

As one industry expert noted, "After the 2023 failures, regulators were pushing oversight with a fine-tooth comb rather than on a risk basis. All that is going to be reviewed, then most of it unwound." (source: Global Finance)

Commercial real estate (CRE) exposure represents a particular area of vulnerability for regional banks. CRE loans that are at least 30 days past due or on nonaccrual have gradually climbed and should increase further. Banks with CRE loans exceeding 200% of Tier 1 capital face particular scrutiny (with office exposure as a percentage of Tier 1 capital ranging up to 60% for the most exposed banks).

Risk Assessment: Does Deregulation Increase Vulnerability?

While banks and investors generally welcome regulatory relief, we must consider whether deregulation could increase systemic risk. Bank investors and creditors have benefited from robust legislation governing the banking sector since the GFC. Financial risk experts have expressed measured concern about the deregulatory agenda, noting that careful consideration must be given to preserving the elements of the regulatory framework that have strengthened the financial system's resilience over the past decade.

From our credit analysis perspective, several factors mitigate potential risks:

1. Targeted relief: The expected SLR changes focus primarily on low-risk assets like central bank reserves and Treasury securities.
2. Tier 1 leverage ratio remains: Even if SLR is modified, banks would still be subject to the Tier 1 leverage ratio, ensuring some capital is held against all assets, including Treasuries.
3. Tangible capital strength: Current tangible common equity ratios at major banks average 6.71%%. For context, during

the GFC, the weakest banks had ratios of 2-3%, while stronger banks were around 4-5%. Even adding $1 trillion of leverage assets would only drop the average TCE ratio to 6.34%, using Bloomberg data.

4. Stress testing continues: While changes may increase transparency and reduce volatility in resulting capital buffers, the annual stress testing framework remains in place, providing a backstop against excessive risk-taking.

5. Unrealized losses declining: Unrealized losses on securities are down sharply from their peak and should continue to decline as long-term securities move closer to maturity, easing some capital pressure. However, should rules that currently require unrealized losses on "available for sale" securities be included in capital levels be rolled-back, this creates the risk that the quality and quantity of banks' capital bases are undermined.

Outlook for Bank Credit

For fixed income investors, US banks should continue operating within a robust regulatory framework despite potential changes. Banks' first line of defense is their profitability, and the likely cancellation of proposed regulations should benefit their bottom lines.

We expect banks to proceed cautiously in response to regulatory changes, particularly given the possibility of Congressional shifts in the midterm elections. The worst scenario would be for banks to disregard rules only to face penalties when a new administration reinstates stricter enforcement.

The prospect of making US banks more internationally competitive while enabling organic and acquisition-driven growth will likely strengthen the outlook for bank credit. At the same time, investors should remain vigilant about how banks deploy any regulatory relief they receive and monitor the growing interconnections between banks and nonbank financial institutions.

A substantial regulatory rollback is not our base case, but we remain mindful that this risk always exists, as experience has shown. The key for credit investors will be distinguishing between beneficial simplification and potentially destabilizing deregulation.

Areas of Bank Regulation We're Watching for Change

Regulation	Description	Potential Changes
BASEL III ENDGAME	Comprehensive set of international banking regulations intended to strengthen bank capital requirements	Likely to be substantially modified or abandoned
FDIC BANK MERGER GUIDELINES	Guidance on bank mergers with emphasis on competition and financial stability	Already relaxed with removal of financial stability analysis for mergers creating banks with $100 billion+ in assets
ENHANCED SUPPLEMENTARY LEVERAGE RATIO (ESLR)	Requires largest banks to hold 5% equity against all assets regardless of risk	Potential exclusion of Treasury securities and central bank reserves from calculation
STRESS TESTING	Annual Federal Reserve assessment of banks' capital adequacy under stressed scenarios	Greater transparency on capital expectations with potentially less severe scenarios
BANK CAPITAL RULES	Rules governing minimum capital levels banks must maintain	Unlikely to see substantial changes to existing requirements
BANK HOLDING COMPANY DEBT REQUIREMENTS	Requirements for larger banks to issue debt at the holding company level	Likely to be less onerous than Biden administration proposals
CLIMATE RISK DISCLOSURES	SEC rules requiring climate-related risk disclosures	Likely to be scaled back significantly
NONBANK OVERSIGHT	Regulatory framework for monitoring interconnections between banks and nonbanks	Potential focus on better understanding risk transmission channels

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