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ANALYST INTERVIEW

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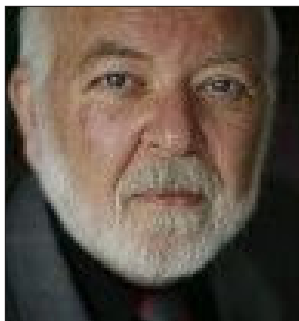
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Banking Sector Offers Attractive Investments Despite State of Regulations

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SECTOR — BANKING

(AGT800) TWST: In previous interviews with us, you have spoken critically of the degree to which the government was regulating the banks. Could you give us an update on your thoughts in that area? What, if anything, has changed in the last six to eight months?

Mr. Bove: The Financial Stability Board — FSB — is composed of 24 countries like the United States, the large European nations, China and Japan, and 12 agencies such as the World Bank, the IMF and the OECD. It regulates the banking industry, and it sets capital standards for banks globally. A decision made three weeks ago states that the big banks in the United States are the riskiest in the world and that they should be penalized by having higher capital requirements than any other large global banking institutions. At the same time the FSB concluded that the Chinese banks are the safest in the world and that there were fewer problems in the European banks. In fact, it lowered the capital requirements for two of the British banks.

Now that decision comes at a time when for the last three to five months there have been numerous stories in the press concerning the problems at **Deutsche Bank** (NYSE:DB) and **Commerzbank** (OTCMKTS:CRZBY), and that European banks had not properly reserved for their loan losses. There is an Italian banking crisis. There have been significant statements concerning the health of **Barclays Bank** (NYSE:BCS) and **HSBC** (NYSE:HSBC). The Chinese banks are supposedly

hiding \$2 trillion in loans. Most observers, whether investors in the equity markets, the financial markets or in the media, have all concluded that there are significant problems with the loans of the European banks and the Chinese banks.

At the same time, these same articles were mentioning that these problems didn't exist in the United States banks. So in contrast to the conventional wisdom concerning where safety in banking lies in the world, the FSB states that the U.S. banks are the riskiest in the world and the Chinese banks are the safest in the world. It is beyond outrageous.

I will give you one other example. **Bank of America** (NYSE:BAC) is believed to have spent \$49 billion in legal fees, fines and litigation related to the acquisition of Countrywide Credit. A U.S. appeals court, which had an opportunity to take a look at one of these fines concerning a sales program called the "Hustle," concluded that **Bank of America** had done nothing wrong. The U.S. government has the right to appeal "Hustle" decision by going to the Supreme Court. Instead, the U.S. dropped the case. It took its \$49 billion, put it in its pocket and walked away.

These are two pieces of evidence in the last few weeks that indicate that the regulation of banking has been punitive for United States banks and that maybe the justification for the regulation is not merited. If you will allow me, I will give you one additional example. In the **Fannie Mae** (OTCMKTS:FNMA)/**Freddie Mac** (OTCMKTS:FMCC) situation, the United States government

Highlights

Richard Bove talks in-depth about the state of regulations on U.S. banks. Mr. Bove points to evidence that the regulation of banking has been punitive for banks and that the justification for the regulation may not be merited. Mr. Bove says an increase in interest rates would be very beneficial to banks, and right now the sector is perhaps the most attractive investment one can find.

Companies discussed: Deutsche Bank AG (USA) (NYSE:DB); Commerzbank AG (ADR) (OTCMKTS:CRZBY); Barclays PLC (ADR) (NYSE:BCS); HSBC Holdings plc (ADR) (NYSE:HSBC); Bank of America Corp (NYSE:BAC); Federal National Mortgage Assctn Fnni Me (OTCMKTS:FNMA); Federal Home Loan Mortgage Corp (OTCMKTS:FMCC); JPMorgan Chase & Co. (NYSE:JPM); Industrial and Coml Bank of China Ltd (HKG:1398); UniCredit SpA (BIT:UCG); State Street Corp (NYSE:STT); Bank of New York Mellon Corp (NYSE:BK); Northern Trust Corporation (NASDAQ:NTRS) and Citigroup (NYSE:C).

the decisions it made in August of 2012 to take away all of the profits of these companies and give the profits to the United States Treasury. There have been numerous lawsuits concerning this action, and the Federal Claims Court in Washington has concluded that the government must provide certain documents to the plaintiffs, which the government continues to refuse to do.

There is now going to be a change in Treasury Secretary. When that change occurs, all of the data that the current administration refused to provide to the courts could be made public. I think. If it is made public, there is a very, very good chance that it will indicate that there was a willful desire by the administration to ignore the Housing and Economic Recovery Act of 2008.

In addition to which, it could be shown that the Treasury Department lied to the public concerning the rationale for its takeover of **Fannie Mae** and **Freddie Mac**. If that happens, I think that all the banking regulation will be called into question because all of the verbiage around the formation of the Dodd-Frank Act in 2010 will now be called into question. To use a cliché, the **Fannie** and **Freddie** are a tiny tip of the iceberg of what is wrong with banking regulation.

TWST: How do you think the election results will affect the banking industry?

Mr. Bove: It would appear that it will have a fairly significant effect on the industry. There is a lot of talk about repealing Dodd-Frank, which in my view is simply ridiculous. In Dodd-Frank, by 2013, there was determined to be 15,000 pages of regulations. There have been hundreds of rules already put into effect. By 2017, there may actually be 30,000 pages of regulations and hundreds more rules.

If the government were to attempt to repeal Dodd-Frank, I am guessing it would take a decade to figure out where all these regulations and rules exist. It makes no sense to waste time to do this. It will only result in more populist screaming against the banking industry and an agitated press seeking to pillory the industry one more time. More importantly, the primary reason why it makes no sense is because, even if one gets rid of Dodd-Frank, all of the rules that the Federal Reserve, the SEC, the CFTC and others have put in place will still be in place. Who can go and find all these regulations and say they no longer exist because Dodd-Frank was repealed?

The only way to get rid of these regulations in an effective fashion is to get rid of the people who are on the Federal Reserve. Right now the Federal Reserve is supposed to have seven members. It only has five. The new president has the ability in days, so to speak, to put the two people who are missing on to the Federal Reserve and bring it back from five to seven. The chairperson of the Federal Reserve has a term that runs out in February of 2018, and the vice chair has a term that runs out in June of 2018. If those two people are replaced, then four of the seven people on the Federal Reserve would be removed and replaced.

The most important person to replace is a fellow named Daniel Tarullo, who is the Federal Reserve governor in charge of banking

regulation. I would assume that if the president put enough pressure on this guy, similar to the way President Reagan and Treasury Secretary

Baker put pressure on Paul Volcker, they could get him to resign. There is a chance that the new president could completely change the membership of the board of the Federal Reserve. If that were done, then there is no need to get rid of Dodd-Frank. The new Fed board could eliminate the most onerous rules.

Now people would argue the Federal Reserve is sacrosanct, and you cannot touch it. It is supposed to be an independent agency. It is supposed to be immune to political pressure, but that is totally untrue. Liaquat Ahamed wrote the award-winning book *Lords*

of Finance, which argues that in the 1920s, political pressure shaped the decisions being made by the Federal Reserve. In the Nixon administration, Arthur Burns and G. William Miller were taking their marching orders from the Nixon White House. Allan Greenspan was believed to be totally politically motivated.

So the Federal Reserve has often given way to political pressure. That is the first reason that it is not inappropriate to do something about the board. The second reason is that the Federal Reserve has gone way beyond anything that the Dodd-Frank Act has required. The Dodd-Frank Act was not telling the Federal Reserve to tell banks that they should not be involved in global finance. There is nothing in the Dodd-Frank Act that states that, every year, the Federal Reserve should increase capital requirements for the banking system.

In other words, the Federal Reserve has made the decision that it will mandate laws and rules that Congress never intended. It is totally out of control. The regulatory branch of the organization is not doing anything to assist banking or the U.S. economy. It is only hyperfocused on penalizing the banking system. When I say that the Fed regulators are doing nothing to assist the U.S. economy, you have to understand that 99.999% of the people who talk about the Federal Reserve do not understand that what it does in the regulatory area is totally contrary to what it is doing in the monetary policy area.

For example, if you were to ask the average person what is money, he or she doesn't have a clue. They have no idea what money is. Money is the cash in your pocket. It is the funds in your checking account, and it is whatever investment you may have made in some type of retail money market fund. In the United States, 83% of the money supply is bank deposits. Therefore, if you deleverage the banking industry, which has been done and is continuing to be done, you shrink the deposits in the banking system. If you shrink the deposits in the banking system, you are shrinking the growth in money supply. If, on the one hand the Fed introduces a monetary policy that states that it wants to increase the money supply, and it initiates programs like QE-1 to QE-3, in theory, the goal is to stimulate the growth of money. However, if on the other side of the Federal Reserve building, it is shrinking the banking system, it is shrinking the growth in the money supply.

If the Fed tells the banks they must use their deposits to buy government securities, it reduces the funds they have to make

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loans. Repeating it reduces the growth in money supply by reducing the velocity of money. The Federal Reserve doesn't seem to understand what it is doing, and it is contradicting itself through its own actions. Therefore, I think getting rid of Dodd-Frank is useless, but getting rid of the Federal Reserve Board is critical.

TWST: So there is a kind of push/pull, a chaotic aspect, if you will, to how the banking system is being manipulated? Has there not been right-thinking appointees regarding those positions, or has there been perhaps misguided political pressure from the last eight years or so?

Mr. Bove: This goes to the core of how one should be approaching the functions of the Federal Reserve. The Federal Reserve should have in place concepts developed over what is now literally a hundred years as to how to react to a variety of monetary and financial conditions, because nothing that we have seen in the past eight to 10 years is different in any way from what has occurred in prior periods. The point is that one would have thought that, over 100-plus years, the Federal Reserve would now know how to react to a variety of economic and financial developments. What is evident in the speeches being made by all these Federal Reserve governors is that they don't have a strategy or a position built on a hundred years of history. That is one problem.

1-Year Daily Chart of JPMorgan Chase & Co



Chart provided by www.BigCharts.com

The second problem is that Janet Yellen has no control over this organization. She is not William McChesney Martin, Paul Volcker or even Alan Greenspan. None of these chairpersons would have allowed all of these Federal Reserve governors to be running all over the country on a weekly basis spouting some theory with one guy disagreeing with another and none of them referring to any recent academic study as a basis of they are saying. In other words, every time the Federal Reserve comes up with a ruling, one would think that someone had done some serious academic study to determine what the impact of the ruling would be. This ruling would also take into account the lessons of history. Not only is this not done, but the Fed argues that in many cases this should not be done.

"If the Fed tells the banks they must use their deposits to buy government securities, it reduces the funds they have to make loans. Repeating it reduces the growth in money supply by reducing the velocity of money."

The Fed wants to know how the market is going to react once the rule is put in place as opposed to saying: We are putting this rule in place because we have studied it, and we understand what the impacts are likely to be given a certain range of probability. They don't look, and they don't care to look. Going back to the very first thing that I said when we began this conversation, the FSB and the Federal Reserve are requiring U.S. banks to hold more capital than foreign banks. **J.P. Morgan** (NYSE:JPM) has a capital requirement of 10.5% of assets. The average bank in China has a capital requirement of 8% of assets.

Based on these requirements, if both companies started out with exactly the same amount of capital — by the way, all of the four biggest banks in China are much bigger than **J.P. Morgan** — but if both of those entities started out with exactly the same amount of capital, **J.P. Morgan** would be required to put up 3.5% in a capital buffer, and the average Chinese bank 1%.

Work through the numbers and you find that **J.P. Morgan's** lending capacity would be 30% below that of the average Chinese bank. That is not a hypothetical. That is today's environment. **J.P. Morgan** has 30% less lending capacity than the average Chinese bank on the same amount of capital.

This has a big impact on the U.S. economy. It has a big impact on who is going to dominate the world economy. Right now, the biggest bank in the world is the **Industrial and Commercial Bank of China** (HKG:1398). It has \$3.5 trillion in assets. **J.P. Morgan** has \$2.5 trillion in assets. **The Industrial and Commercial Bank of China** is facing massive real estate loan losses. **J.P. Morgan** has probably got the strongest balance sheet that it has seen in 50 years. The capital requirement on the Chinese bank is 8.5%. The capital requirement on **J.P. Morgan** is 10.5%.

TWST: You are saying that they need to be loosened up to be able to do more, given the health of their balance sheets? They should be more productive as a bank and not stifled so that they aren't actually looking less competitive than the Chinese bank who's actually facing a harsher climate internally?

Mr. Bove: Correct. The balance sheets indicate that the bank with the stronger balance sheet is getting hit with higher capital penalties. The bank with the stronger balance sheet is being told that it cannot lend as much money as the bank with a weaker balance sheet. I want to give you one more example. **UniCredit** (BIT:UCG) is the biggest bank in Italy. **UniCredit** has roughly \$1 trillion in assets. It is sitting on top of an Italian banking industry, which is facing significant challenges due to loan losses, mismanagement, etc.

State Street Corporation (NYSE:STT) is an American bank with a third of a trillion in assets, so it has one-third as much money as **UniCredit** does. **State Street** has 70% of its assets in Treasuries and cash deposited at the Federal Reserve and other government-related securities. The banking regulators believe that the risk in **State Street** is the same as the risk in **UniCredit**, and they have given **State Street** the same capital rating as **UniCredit**. This

goes well beyond the fact that you have now crimped **State Street's** ability to lend as much as **UniCredit**, and you have taken the bank, which has got vastly superior balance sheet, and rated it as being as risky as a bank with tremendous weaknesses.

It goes to the politics of the situation. It tells you that the politics are such that the U.S. banks are being penalized on a political basis. They are being penalized not just by the FSB, but by the Federal Reserve, the SEC and the Treasury Department. All of these agencies have agreed that **State Street** is as risky as **UniCredit**.

All of these domestic agencies have agreed that even though the **Industrial and Commercial Bank of China** has \$3.5 trillion in assets and **J.P. Morgan** has \$2.5 trillion, that **J.P. Morgan** is riskier than the **Industrial and Commercial Bank of China** on a too-big-to-fail basis. It is absurd. It is so wrong that one can hardly believe that this situation exists.

TWST: Can you talk a little bit about rising interest rates and what you see happening there, and then also how that's affecting your perception of which stocks in this industry you like or don't like?

Mr. Bove: At the current time, all banks would benefit by an increase in interest rates. Now that is not always true, right? In other words, people tend to think that it is some sort of truism that banks benefit if interest rates go up. The assumption is correct that when interest rates rise, bank earnings go up. This is not the end of the story, however. What is forgotten is that when interest rates go up, the value of bank assets go down because 92.5% of bank assets are financial instruments.

If you raise interest rates, the value of those financial instruments are declining and lowering the real capital of a bank is going down. History argues that whenever this has been done, it has resulted in weaker bank stock prices. However, right now interest rates are very low. The Federal Reserve and market forces have put them at record lows. They are so low that bank earnings are being unusually penalized. Therefore, at this point if interest rates rise, earnings are more likely to go up than assets will go down.

So an increase in interest rates at this time would be very beneficial to banks. There are no banks that will be harmed by an increase in interest rates; all banks will benefit. The banks that will benefit the most are the banks that have the greatest amount of fixed-rate assets. They would be **State Street**, **BNY Mellon** (NYSE:BK) and **Northern Trust** (NASDAQ:NTRS), all of whom have sizable amounts of Treasuries and Federal Reserve deposits on their balance sheets. Next the **JPMorgan Chase** and **Citigroup** (NYSE:C) are likely to do well given the liquidity on their balance sheets. They will see an immediate increase in the return on these liquid assets with no offsetting costs — unless they raise rates on deposits, which is unlikely.

The average regional bank has a lot of loans that are variable

rate in nature. So as interest rates go up, they will increase the yield on their assets. They will not increase what they pay to the consumer, and their margins will expand, and they will basically have higher earnings.

TWST: I want to close with just your overall advice to investors regarding the banking sector.

Mr. Bove: Right now the banking sector is perhaps the most attractive investment that you can find and, in fact, the stock market has begun to understand this. In other words, bank stocks, if you take it from July 4 of this year to the present, have outperformed the market by I think about five-to-one. If you take bank stock prices going back two years, despite the absolute disasters that occurred in 2015, bank stocks have outperformed the market.

Banking companies in 2015 had the biggest profits in the history of the American banking industry. Banking companies, if the economy grows well say at 2% in 2017, and interest rates are raised by 25 basis points to 50 basis points, will have 2017 earnings which will far exceed anything that the industry's produced ever. So the earnings are there.

What is fascinating is that the valuation of bank stocks is not above average. If you take the 15-year price to book, tangible book or earnings, bank stocks are not selling at valuations, which are above the 15-year average. So the stocks are cheap on a valuation basis, the earnings outlook is good, and the stocks should be bought.

TWST: Is there anything else you wanted to add before we end?

Mr. Bove: Our focus is so much on regulation that I haven't talked at all about the fundamentals of the industry. The fundamentals of the industry relate back to the structure of the balance sheet. Right now banks have too much equity and too much liquidity according to any historic measurement that you want to look at. If you would bring those ratios as in common equity to assets or liquid assets to assets back to normal, you would see an enormous increase in bank earnings. Everything right now is going in the direction of the industry. Again, I focused too much perhaps on the Fed and regulation as opposed to the fundamentals of the industry, which are actually very strong.

TWST: Thank you. (KJL)

Note: Opinions and recommendations are as of 11/25/16.

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