

Perspective from
Franklin Equity Group

Deregulation in banking: A new paradigm and potential benefits for US equity income investors

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As regulatory oversight in the United States eases, bank stocks may offer an increasingly compelling opportunity for US equity income investors, according to Franklin Equity Group. These securities have historically offered higher dividend yields than the broader markets, and their capital bases and earnings have become more resilient in recent years.

Key takeaways:

- A shift in the regulatory environment in the United States could allow banks to accelerate earnings growth and return excess capital to shareholders.
- Bank dividends appear stable and poised to grow.
- Large banks should be better positioned than their smaller peers given larger excess capital bases, greater business mix diversification and their ability to invest in technology to reduce costs, enhance product delivery and deliver an improved customer experience.

Policy changes, deregulation improve bank outlook

The Trump administration is likely to create an improved environment for banks, potentially ushering in a new era of stronger earnings growth and higher returns on capital. After more than a decade of escalating regulation and increased capital requirements, we believe policy changes could create a more favorable regulatory backdrop and increase optimism within the industry, potentially increasing lending activity, while freeing up excess capital.

The global financial crisis (GFC) of 2007-2008 was partly due to aggressive bank behavior, which resulted in large losses, several bankruptcies and transformative mergers. In response, the US government moved to disincentivize banks from engaging in riskier activities and shore up both capital and liquidity. Although the banking system is undeniably stronger today, bank returns are also lower, with returns on equity averaging 10.2% over the last decade versus 13.7% over the 10 years before the GFC.¹ We now see a healthier balance between stability and returns, and an opportunity for banks to return more excess capital to shareholders.

Going forward, we anticipate increased regulatory clarity, less duplicative enforcement and lower compliance costs. If enacted, these changes could be supportive of a bank's lending capacity and ability to drive earnings, generate cash, build capital and pay healthy dividends. Further, many anticipate increased capital markets activity in 2025, potentially offering investors the prospect of continued lower earnings volatility with a faster growth outlook.

Bank stock dividends appear poised to grow

Increased capital levels and liquidity since the GFC have improved banks' financial footing, significantly reducing the risk of broader losses and systemic failures. Higher capital charges for holding risky assets have resulted in improved loan portfolios, reducing credit risk and volatility, making bank earnings more resilient now than they have been in years. In our view, this provides a solid foundation for bank stock dividends, which we expect to be stable and potentially able to increase more quickly.

Banks are also positioned to return more capital to shareholders. Having built up capital in anticipation of more stringent regulations, which now appear unlikely, banks have significant excess capital that could be returned to shareholders through buybacks and dividends, which would be positive for bank stocks.

Exhibit 1: The Common Equity Tier 1 Ratio

	Required (%)	Actual (%)	% Excess (Actual less Required)	Excess Capital (US\$ billions)
Bank of America	10.7	11.9	1.2	20.4
Bank of New York	8.5	11.2	2.7	4.5
Citigroup	12.1	14.6	1.5	17.2
Goldman Sachs	13.7	15.0	1.3	8.9
JPMorgan	12.3	15.7	3.4	59.8
Morgan Stanley	14.5	15.9	2.4	11.4
State Street	8.0	10.9	2.9	3.7
Wells Fargo	9.8	11.1	1.3	15.8

Sources: Bloomberg, Company Filings. Data as of December 2024. The Common Equity Tier 1 (CET1) ratio is a measure of a bank's capital strength and ability to withstand financial losses.

Note: These banks have been designated as systemically important by regulators (i.e. their failures could have a disruptive impact on the economy, and they are therefore more highly regulated than other banks).

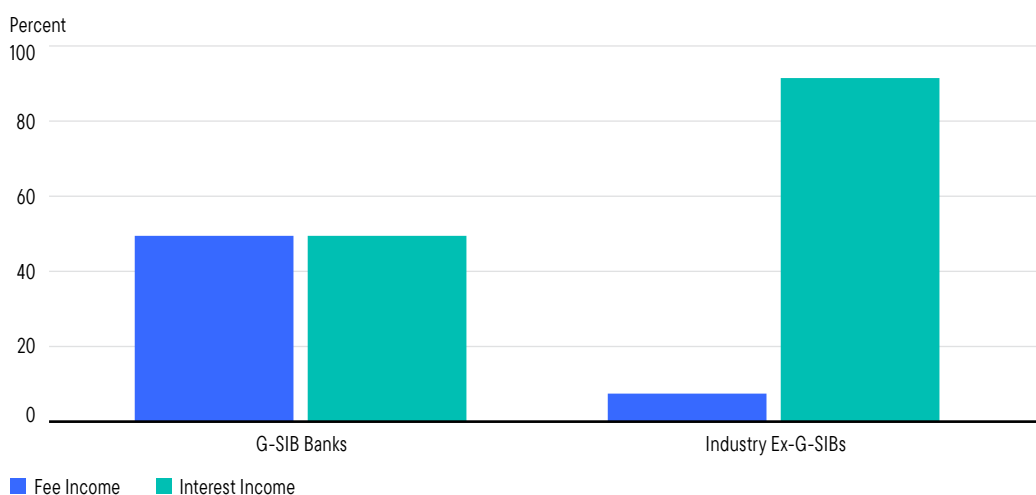
1. Source: FDIC. 10.2% reflects 10 years for the decade ending December 31, 2023, and 13.7% reflects returns for calendar years 1997-2006 10 years ending December 31, 2023 and December 31, 2007.

Larger banks have competitive advantages

While a more favorable backdrop benefits the entire industry, we believe the eight largest banks (the US-based globally systemically important banks referred to as the G-SIBs) are best positioned in several ways:

- Because they have had more restrictive capital requirements and been subject to mandated annual stress tests, the G-SIBs could be the biggest beneficiaries of relaxed regulatory requirements.
- As capital requirements are relaxed (and/or there is greater certainty that requirements will not increase), G-SIBs could see the largest increase in excess capital that can be returned to shareholders.
- US regulators removing requirements on the G-SIBs—that are more onerous than on their international counterparts—could create additional tailwinds.
- Large banks operate globally and have more diverse loan portfolios. They also have much less commercial real estate concentration and regional concentration than their smaller or regional bank peers.
- G-SIBs generate more fee income from investment banking, capital markets activity, wealth management and treasury management, which diversifies their income and reduces interest-rate risk.
- Larger banks can also invest significantly more capital in technology and automation initiatives (including AI). This enables them to create better tools for customers, while also improving operational efficiencies, which may result in better growth through share gains and potentially superior profitability.

Exhibit 2: G-SIB and Industry 2023 Revenue



Sources: FDIC, Company Filings. As of 2023.

Conclusion

We believe banks, particularly large banks, constitute an attractive investment option for equity income investors. Years of escalating capital and liquidity requirements have helped to reduce business risk and earnings volatility, which should make dividends more secure. An improved regulatory paradigm could free up excess capital, while simultaneously boosting earnings growth and supporting resilient dividend stability and growth.

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