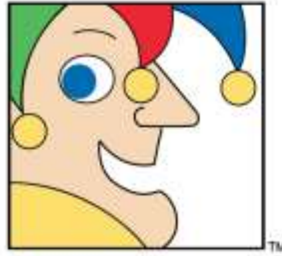

A Conversation With John Allison, the CEO Who Led BB&T Through the Financial Crisis

John Maxfield

Aug 4, 2017

There are a handful of banks in the United States that have separated themselves from the competition over the past decade. One of them is **BB&T** (NYSE:BBT), a $221 billion bank based in Winston-Salem, North Carolina.

BB&T's performance through the financial crisis leaves no doubt about this. Even through the depths of the crisis, BB&T didn't record a single quarterly loss. That puts it in an exclusive club, joined by banks such as **U.S. Bancorp** (NYSE:USB) and **M&T Bank** (NYSE:MTB), both of which have similarly proven over long periods of time to be exceptional institutions.

The person most responsible for BB&T's success over the past three decades is John Allison, who joined the bank in 1971 and served as its CEO from 1989 through 2008; he remained on the board for five more years before retiring to lead the Cato Institute.

I reached out to Allison recently for his thoughts on the industry today. What follows is a transcript of select portions of our conversation, edited for organization and flow.

The Fool: How has banking changed since the financial crisis?

John Allison: The big shift was a radical increase in regulation and micromanagement of the industry by regulators, including down to the loan level, telling you what kind of loans you could make. That was particularly discouraging for companies like BB&T that had come through the crisis and done very well.

The somewhat encouraging news is that there is some effort by the current administration to roll back the regulatory attack on the industry, and we're seeing some evidence of that in terms of seeing banks regain the ability to increase dividends, as an example.

If I were running a bank today, I'd like to go back to taking care of my customers and do what we were doing before the crisis. Given that our company went through the crisis without a

quarterly loss, it's clear that what we were doing was fundamentally sound. Healthy companies like ours should have been allowed to continue doing what we were doing, but the regulatory environment isn't allowing that to happen.

The Fool: What's the biggest problem with the current regulatory environment?

Allison: I started my career as a small business lender, and the kind of loans that I made then couldn't be made today. Those are the kind of loans where you did a financial analysis, but you primarily made a judgment of the individual, their character, and their idea. We had great success doing that kind of lending. But the banking examiners have clamped down on that even though there's no evidence it contributed to the crisis.

What had happened was that the regulators had gutted their practices around safety and soundness in the long period of time before the crisis when losses in the industry were low. They built up their compliance side instead. Then when the crisis came, they hired a bunch of young people who had no idea what banks ought to be doing in terms of lending and told them that all banks were making bad loans. This led them to clamp down on lending practices in markets that weren't causes of the crisis.

If you have a business that doesn't need to borrow money, it's fine. But if you want to start a small business today, it is much harder to get financing from a bank. This is especially true in the real estate market. If you own a small shopping center and you want to use the equity in it to buy another one, you can't do that anymore. You have to come up with cash, which is difficult for the small guy, the guy starting up.

The lending standards have become much tighter, imposed by the regulators, than they were in my 40-something-year career in banking. And it kills small business start-ups. A lot of people get confused when they look at total loan growth, which isn't that bad. But that's because big companies are borrowing a lot of money at low interest rates. But that distorts what's happening with the entrepreneurial small business owners, who are huge job creators. And many of those are good jobs, innovative jobs.

The Fool: Why are regulators coming down so hard on small business loans?

Allison: There's an obsession with mathematical modeling. Small business loans don't fit well into mathematical models because there's an element of character that's huge. A number of loans that I was able to make early in my career that created thousands of jobs, you simply couldn't make today. You have to make a judgment about an individual, their idea, and their commitment to getting the job done. You can't do that anymore.

The mortgage market is a particularly interesting case because the approval standards for small mortgage loans are not tight at all. In fact, at least in theory, they're probably too loose. But in practice, if you get the paperwork wrong, then the borrower doesn't owe you any money. They can choose not to pay their mortgage.

So what you've done is you've shifted the burden of judging whether the person can pay you back to judging whether you've crossed all the *t*'s and dotted all the *i*'s.

The Fool: What are your thoughts on consolidation in the industry since the crisis, especially after the Dodd-Frank Act of 2010?

Allison: Dodd-Frank has distorted consolidation and competition in the industry in an odd way. We've seen very few start-ups since the crisis because the entry costs are much higher now. We've also seen a lot of smaller banks that have merged away because they couldn't absorb the regulatory costs. And then you get to these arbitrary barriers [at $10 billion, $50 billion, and $250 billion in assets], which are ironically helping the very large banks. They've been penalized in a certain sense, of course, with a huge regulatory burden, but relatively they're penalized less.

When I started at BB&T we were a small bank. The impact of regulatory costs on a small bank is more dramatic than on a big bank because the CEO has to be involved personally on the regulatory side. The CEO of a large bank is involved as well, but he can hire people who are good at handling that stuff. The intellectual talent of people in a small bank is critical, and when they're focused on regulations as opposed to growing their business, that distorts their ability to run their bank and do what they're supposed to do in the community.

I would argue that the big banks have an implicit guarantee from the federal government, and I'm just talking about five or six banks. They let Washington Mutual fail, but they saved **Citigroup** (NYSE:C). They failed Wachovia, but saved Citigroup. The market is not stupid, and no matter what people claim Dodd-Frank says, what it practically says is that we're going to bail out a handful of very large institutions.

I'd let big companies fail, and I'd let the market understand that. At that point, I don't think you'd have the consolidation problem. I think the consolidation problem has largely been driven not by economics, but instead by government policy. It's created an unfair playing field for a handful of organizations that should have failed, like Citigroup, which would have been broken up by the market, and we wouldn't have the concentration today.

The Fool: What are your thoughts on profitability in the industry since the crisis?

Allison: From the beginning of the crisis until just recently, returns in the industry have been below the cost of capital, with a number of large banks trading below book value. An industry can't be healthy over the long term if they're earning less than their cost of capital. It has happened in the past in certain industries, and when it does, something dramatic happens to those industries. The returns are improving, but they're still low relative to what they need to be to have a really viable banking industry.

If you look, there's a high correlation between economic growth and healthy banks. You can't name a country with a healthy economy that hasn't also had healthy banks. So the fact that banks are struggling to make satisfactory returns means that it has a negative impact on economic growth, which is partly reflected in the inability to make small business loans that spur job creation.

Dodd-Frank is structured in a way that could kill the industry long term. What they're asking for is more capital and at the same time imposing massive new regulatory costs. The banks can have more capital and reduce risk, but they can't have more capital and incur these regulatory costs.

I'm a big advocate of the Financial CHOICE Act, which would require banks to hold more capital but in return allow them to opt out of Dodd-Frank. I think banks can have strong capital positions, but they can't have that and at the same time be micromanaged and have this huge burden of regulatory costs. Banks can't afford both.

The Fool: In your opinion, what caused the crisis?

Allison: I view the crisis differently than a lot of people. I was a long-serving CEO when the crisis struck and I think the whole thing was caused by regulatory policy.

Yes, some big banks made mistakes. But it was a combination of government housing policy, Fannie Mae and Freddie Mac in particular, which had $5 trillion in liabilities and $2 trillion in subprime mortgages when they failed, and the Federal Reserve, which held interest rates below inflation, that contributed to the bubble in the housing market, along with bubbles in other markets.

I don't believe the whole industry was failing. I think that's ridiculous. It was a relatively small number of large institutions that were in trouble. Banks like Citigroup. I think they should have been allowed to fail and the world would be a better place today.

The whole idea that everybody would have gone broke if one of the big banks failed was absurd. We had been doing business with investment banks like Bear Stearns and **Goldman Sachs** (NYSE:GS), but we controlled our risk with those companies just like we did with any borrower. If they had gone broke, we would have lost money, but not nearly as much as we lost to residential builders in the marketplace.

It was a relatively small number of large banks and a handful of small banks that were in trouble. It was not an industrywide crisis, except to the degree that the regulators created a crisis by choosing to fail Wachovia, save Citigroup, fail Lehman Brothers, save Bear Stearns. The uncertainty caused by that response took what was going to be a normal correction and transformed it into a crisis, making everything worse than it had to be.

The Fool: How did regulators' response to the financial crisis differ from their responses in past crises that you witnessed?

Allison: I went through the financial correction in the early 1980s, which should have been more severe because we were in bad trouble economically after the inflation of the 1970s. I also went through the correction in the early 1990s. In neither case did we have a panic. And the reason we didn't have a panic was because at least you knew what to expect.

Thousands of banks and thrifts failed in the 1980s and 1990s. The unwillingness to let banks fail in the latest crisis -- they were effectively bailing out everybody -- prevented the natural correction process from happening.

We had rule of law in the past. In this crisis, we had no rule of law. When Washington Mutual failed, instead of taking the losses out of the FDIC fund, they took it from bondholders. That crashed the capital markets, which then caused Wachovia to fail. That was a regulatory decision.

What was actually going on at the time was a huge flight to quality. BB&T and companies like **Wells Fargo** (NYSE:WFC) were buried with cash. This idea that there was a liquidity crisis was absurd. The healthy banks were buried with cash, it was just a flight to quality. Bank deposits went up in the crisis, they just went to good banks like us, U.S. Bancorp, and M&T Bank.

So allowing the market to work would have been bad in the short term but good in the long term because it would have cleaned up irrational institutions and redirected capital to where it should have been.

We needed a correction. I think corrections are healthy because we get overly optimistic. But the response to the crisis has had much bigger implications than the actual correction itself because it led to bad legislation. All those things made the crisis worse than it needed to be.

The Fool: What was the impact from Dodd-Frank on well-run banks like BB&T, U.S. Bancorp, and M&T Bank?

Allison: Because our bank stayed healthy through the crises in the 1980s and 1990s, the examiners let us grow. We continued to take care of our customers. We didn't change our lending standards one iota. And we took on a lot of customers from failed institutions. Even bad banks have a lot of good customers. So we were able to grow through those crises and actually help the economy.

This time, because of ignorance on the regulatory side, the regulators tightened down on healthy banks so that we had to put thousands of customers out of business that didn't have to go out of business and that would still be creating jobs today.

One of the roles of a bank is helping well-run businesses through difficult times. If a problem is cyclical, where you're confident that a business will be healthy in the future, then you should help them through the cycle. And we did that. But this time, regulators came in and on a loan-by-loan basis told us which borrowers we could help and which loans we could modify. That ruined many businesses and had a huge impact on the economy.

10 stocks we like better than BB&T
When investing geniuses David and Tom Gardner have a stock tip, it can pay to listen. After all, the newsletter they have run for over a decade, *Motley Fool Stock Advisor*, has tripled the market.*

David and Tom just revealed what they believe are the ten best stocks for investors to buy right now... and BB&T wasn't one of them! That's right -- they think these 10 stocks are even better buys.