

2010 Legislative Outlook: Foggy, with a certainty of storms

Debate over financial reform pits House, Senate, Fed, and White House plans. What emerges will dictate the industry's future for years

By Steve Cocheo, executive editor, and Bill Streeter, editor-in-chief

What's 5%? In many situations, not much.

But sometimes, a small percentage can make a big difference. And the House approach to financial regulatory reform—H.R. 4173, "The Wall Street Reform and Consumer Protection Act of 2009"—contains a provision, minor in comparison to the legislation's overall scope, that is potentially industry-altering. It's a strong example, and not the only one, of the kind of change that the country could see in financial services, depending on how a final banking law emerges from Congress and the President's desk.

Assessing where things stand

The federal government has been considering legislation relating to the financial crisis for a bit more than a year.

When that journey began, "there was uncertainty as to whether some institutions would survive into the next quarter, in some instances," recalls ABA's Robert Davis, executive vice-president, mortgage finance, risk management, and public policy. "That is not the question now. But the uncertainty is just as great—and, in some ways, even greater—about the viability of certain lines of business that we've come to think of as traditional."

Davis says that the pending legislation—which passed the House in mid-December, and which remains pending in different form in the Senate—is on some levels actually "frightening, because you would think that there would be greater certainties regarding the nature of the federal solution; but we don't have that yet."

Which brings us back to 5%.

H.R. 4173 makes 5% a very meaningful number by dictating that institutions that sell loans to secondary markets must retain 5% of the credits sold. The intent is to ensure that lenders have "skin in the game," and thus pay closer attention to credit quality, rather than going for volume and unloading loans completely on an unsuspecting investor.

“The decision to be in a secondary market for any type of loan asset is really up in the air right now,” continued Davis, in an interview featuring himself and fellow ABA officials Floyd Stoner and Wayne Abernathy.

Adds Stoner, ABA executive vice-president for congressional relations: “How this turns out will affect all participants in the secondary market process, from loan originators, to securitizers, to investors. There will be broad implications.”

The broadest of all is that which dominates much congressional and presidential rhetoric: credit availability.

“Bank portfolios are showing the typical damage that comes from a deep, long recession,” said Wayne Abernathy, executive vice-president, financial institutions policy and regulatory affairs. “But the securities markets have been devastated. And, unfortunately, many of the possible new rules resulting from this legislation may make it very hard for those secondary markets to come back. And without them, banks can’t off-load their loans and turn around that capital to make new ones.”

Abernathy predicts that, unchecked, this will lead to a return to the type of smaller, more limited economy of 30-odd years ago.

“As a lot of the slack in the economy gets taken up again, the nation will need more financing, and at some point, banks will have to say, ‘We’re financed out,’” posits Abernathy. “And then, you’ll see some very serious constraints on the economy.”

Megapackage grinds on

Mind you, what these ABA lobbyists are discussing is still a bill, not law, but many aspects beyond the 5% issue loom as potentially game changing. Especially because they won’t occur in a vacuum. Going back to the “skin in the game” provision, federal banking capital rules designed long ago didn’t contemplate such an outcome. If there was any way a loan or package of them could come back to a bank, a sale hadn’t really taken place for capital purposes.

If that weren’t enough, pending accounting rule changes make the final outcome worrisome for lenders as well.

“Statements of Financial Accounting 166 and 167 are bringing things that were formerly off-balance-sheet back on balance sheet,” said Davis. “We’re arguing strenuously that capital rules can’t be applied as if sales would be done as an on-off switch. But the regulators and the accounting profession haven’t really synched up yet, to let bankers know clearly what the real capital requirements are going to be.”

One of the positives of H.R. 4173, in ABA's view, is that the House's proposed "Financial Stability Council" will be empowered to review accounting standards and policies as they impinge on systemic risk. Abernathy sees this as a critical counterbalance to the Financial Accounting Standards Board.

"The board has acted as if they believe, 'Our model is Truth,' said Abernathy, 'and that, 'If you're not in favor of the standards that we've come out with, you're in favor of deception and fraud.'"

Beyond the challenge individual sections of the legislation represent, the lobbyists warn of competitive impact. ABA worries that the implications loom especially large now. Banks constrained in lending will likely wind up watching providers of alternative forms of credit snatch up business. It has happened before. "And each time it happened," said Abernathy, "the banking industry has come out a smaller part of the economy." And yet, when the newcomers stumble and fall—think of mortgage brokers and subprime giants—the nation turns to banking to step in.

Mid-game, or thereabouts…

Stoner, Abernathy, and Davis spoke of the challenges of the current environment during a rare lull in the development of the legislation. Where in the bigger game does the industry stand?

"I can't say that we are definitely at half-time yet," said Stoner, "but the climate is incredibly difficult."

Stoner explains that the industry suffers from public perceptions of its relative health when many people are still hurting.

"In some ways, banks are coming back a little earlier than the rest of the economy," Stoner says, "and that makes for very difficult politics right now. When you have unemployment as high as it is, you have to have sectors of the economy coming back for jobs to be created. But until they are created, the public is very, very concerned about what they perceive as a disconnect between who is benefiting and who isn't."

Stoner, a Hill veteran, spoke both to the timing and the outlook for banking legislation in the Senate.

"The dynamic there is different," he said. "There are bipartisan groups working in the Senate Banking Committee on various parts of the proposal. And we believe that that bipartisan approach has the potential to work through a number of issues that still challenge. The recent announcement by Senate Banking Committee Chairman Chris Dodd that he is not seeking reelection will give him even more of an opportunity to pursue bipartisan legislation." [To read ABA's recent letter to Senate Banking Committee leaders, [click here](#).]

Indeed, the trio credits bankers' grassroots efforts—both in person and through more than 300,000 letters and emails—for improvements made in the House version. Such efforts will be critical, again, as the Senate

moves forward. [Visit ABA's Grassroots Center.]

Stoner sees the Senate's final legislation passing this spring. After that, reconciliation of the House and Senate versions will be a question mark, right down to how that resolution will be engineered.

MAJOR ISSUES REVIEWED

The trio discussed several major issues at length.

Future of the Federal Reserve

There's been a great deal of controversy about the Fed—its role, its powers, its special status—throughout this process. The House approach makes the Fed a super-regulator in some respects but would impose new limitations, as well. The Senate would strip away many traditional functions. How do you see this playing out?

Abernathy The Fed's role will never be the same, whatever the legislative outcome. It was changed through the course of last year. And right now I don't think anybody inside or outside the Fed is really sure of what the new role of the Fed will be. In some senses, it's going to be defined by legislation, but much of what has happened on an ad hoc basis for expediency's sake may also become permanent.

Many issues are evolving: What will be the Fed's role in regard to non-banks? What is its role with regard to holding companies that may have a little bit of a bank component but are mostly something else?

Stoner But there is a political sense now that the Fed should have more control from the outside. It is unfortunate in the manner in which it is coming out. We are very concerned about protecting the Fed's independence.

In H.R. 4173, there is an amendment—adopted over the opposition of Chairman [Barney] Frank (D.-Mass., House Financial Services Committee)—which would order the Government Accountability Office to audit much of the Fed's operations. That was pushed for years, but it hadn't received such broad political support before.

Abernathy Most of the criticism has been over the Fed's performance in the regulatory sphere. But in the efforts to address those regulatory concerns, Fed critics may also be compromising the monetary policy role.

Will that GAO provision survive the Senate?

Stoner That precise provision may not prevail. But some Fed-related provisions will.

Davis This reflects the financial crisis. Ed Yingling [ABA president and CEO] has said that the more things you give the Fed to do, the less political independence it will have. And that's turning out to be the case.

Through the 1990s the Fed lived in a comparative golden age, in terms of political pressure. It was allowed to focus on one thing that it could do well—maintain stable prices. And some argue that's really the only thing it should be doing. But if you add more targets and more objectives—and that's what's happening right now— independence becomes harder and harder to maintain.

Systemic Risk

This relates to the whole subject of systemic risk, a particularly complex part of H.R. 4173 and of the Senate's initial language. In both cases, the Fed would play a key role. Is that a good thing?

Stoner First, recognize that under both approaches systemic risk will be handled by a council of regulators, not just the Fed. That's something ABA has supported. But we also consider it absolutely essential that there be an effective mechanism for addressing institutions that are systemically important and potentially too big to fail. So you're going to have to have a fair amount of authority somewhere—and the Fed is very accomplished and has many of these authorities now.

Abernathy The Fed was created for systemic risk issues. Its evolution towards a larger role in the financial services industry more broadly is one of the more significant disagreements between the House and the initial Senate approach (which would strip away regulatory powers), so that issue is going to be pretty hotly debated.

Davis Regardless of the institutional mechanics, it is significant to have people agree that systemic risk is very important. And you will never again have a regulator be able to say, "I'm only worried about the safety and soundness of this institution on a narrow basis." There was an element of it being no one's job, beforehand.

The eventual mechanism that oversees systemic risk may not be perfect. Maybe it will be changed over time. Maybe it will evolve into something else.

But I don't think there's going to be a point where the regulators don't think systemic risk is

important. And that's a major step.

Abernathy For a long time the banking industry complained a little bit—but probably not loudly enough—about the risks building up outside of the industry. We felt comfortable that the existing regulatory apparatus would take care of any systemic risks in the banking world.

We had a good system. And bankers kind of felt that somehow, activity outside the banking world would take care of itself. We've learned over the past year and a half that it not only may not do so, but also that while officials are trying to take care of it, banking can get caught in the fallout.

Stoner While the House bill addressed some of the risks that come from the non-banking sector, we agree with those who say that it should be much stronger in that area.

Consumer Financial Protection Agency

The original Obama Administration approach to the CFPA was amended somewhat in H.R. 4173, whereas the Senate language more closely follows the original blueprint. Notable in the House version is that examination of banks and savings institutions under \$10 billion in assets would remain in the hands of their safety and soundness regulator.

ABA continues to oppose CFPA, in part because the proposed new agency would be writing the rules for everyone, without any duty to consider safety and soundness. Are there other factors?

Stoner We have been making the point throughout the debate that a case can be made for increasing the consumer focus of the prudential regulators, but that the problem remains that this new agency would have no effective way to get its hooks into the non-banks.

So, as far as we are concerned, you could have a robust consumer protection examination component of examinations for insured institutions—and these examinations already exist—but none for their competitors, who were the major cause of the economic problems we are now facing. That is not acceptable.

Bankers complain this is going to fall disproportionately on them because "everyone knows where to find a bank."

Abernathy That's been the experience over time. If you look just in the mortgage and housing area, new regulations were piled onto the banks. As a result, over two decades banks steadily lost share.

That was because they couldn't originate mortgages as quickly and as inexpensively as their non-bank competitors. Or they weren't willing to cut corners.

Backers of CFPA say it would go after the non-banks, too. I don't think it would. I think it pretends to. I think it would actually be very counter productive.

Davis There's going to be one regulation but whether you comply or not determines what your cost is. If you're not supervised, your level of compliance might be much lower.

Stoner Knowing that you're going to be examined every year to 18 months has an impact on behavior. And our concern is these other institutions won't have that potential examination, and, therefore, what's the point to their complying?

Impact on Credit Availability

A farm banker recently spoke about being ordered to stop making feedlot loans. The examiner insisted such credit was a commercial real estate loan and therefore the kind of loan the team wanted to see no more of. Will this type of situation get worse under new legislation?

Abernathy You see a lot of that. We've been warning Washington about a regulator-induced credit crunch for well over a year, and unfortunately, all of our warnings have come true.

Regulators like bright-line rules. But to the extent you have them, you take flexibility out of lending. And then you have some very odd consequences. You have good credit risks being denied because of the way the rule is written, and then you're going to have some people that you shake your head at, wondering why they get credit—but they fit the rules.

That's why we continually urge regulators to provide clear rules, but with flexibility.

Davis Funny mixed messages come out of government at times like this. Depending on the day of the week you're supposed to take more risk or less risk. You can't simultaneously take more risk and less risk. You can try to take smarter risks but then the regulators need to give you adequate leeway to make some judgments.

What will we see when Congress is done?

Stoner Our concern is that it will be boxes with hard lines. It's easier, legislatively, to do that, than to create a system that recognizes, as Bob said, that there's no lending without risk and that it takes judgment.

Charters and preemption debates

Two issues wrapped up in the pending legislation, virtually invisible to the public, yet of critical industry interest, are charter choice and federal preemption.

Davis said the level of interest, and grassroots response, on charter choice in the savings business has been “interesting and gratifying.” Bankers see “you are better off with choices, even if they hadn’t made that particular choice,” he said.

In H.R. 4173, the thrift charter survives, though the Office of Thrift Supervision would be absorbed into the Comptroller’s Office. Senate language, however, currently would bar any new federal thrift charters, and eliminate a federal thrift regulator.

Preemption for national banks and federal thrifts looked doomed as the House debated the legislation at the committee level. But Stoner said that the industry found allies that helped regain some of the lost ground in H.R. 4173 as passed.

“We worked closely with the state bankers associations on this, because it is something that affects banks of all sizes,” said Stoner. “We were pleased that as the House process evolved, members recognized this. There was a major push by the New Democrats, a group of moderates, particularly Rep. Melissa Bean (D.-Ill.), to make sure this was corrected before the bill went to the House floor.”

While what resulted was a significant improvement, Stoner notes that the situation in the Senate is still unclear. “We do know there is bipartisan concern about it,” he says, “because there are those who recognize the importance of having a national standard for a national market.”

“It’s not an accident that preemption for national banks has been a policy since the 1860s,” said Abernathy. BJ

ABA has published a comprehensive guide to its current policy positions. To read it, members may click [here](#).

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