Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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Regulatory Consistency Is Lacking[†*]

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November, 2014

It is axiomatic that regulatory certainty is conducive to economic efficiency and grow. Inconsistent regulatory mandates can lead to paralysis, and irrational regulatory requirements create waste and unnecessary costs.

No regulator is perfect, and no regulatory framework will always result in the best and most logical rules. However, in the rush to issue hundreds of new rules under the Dodd-Frank Act, the Basel Accord and other policy initiatives, an avalanche of new, often inconsistent regulatory requirements, have been forced upon the financial services industry.

The Consumer Financial Protection Bureau, for example, has issued regulations designed to ensure that mortgages are only given to those with the ability to repay the loan, at least at the time of loan origination. Banks complied by tightening lending standards to conform to the regulatory requirements for a "qualified mortgage." Now, government officials are blaming these same banks for providing insufficient credit to homebuyers. Some senior officials, including Federal Reserve Chair Janet Yellen, have publicly stated that banks are holding back the housing recovery by refusing to make mortgage loans to riskier borrowers.

The mortgage servicing business has also been subject to seemingly inconsistent regulatory goals. In the past, many banking institutions provided mortgage servicing services, and these banks made expensive investments in the computer systems and personnel training necessary for this specialized field. Then the banking agencies issued regulations that imposed punitive capital requirements on mortgage servicing assets under the Basel III capital standards. As a result, banking companies divested their mortgage servicing businesses. Less-regulated non-bank companies have become the primary mortgage servicing providers.

Now federal agencies are concerned that mortgage servicing functions are being transferred to so-called shadow banking firms that do not have to follow the same capital rules and risk-management requirements as banks. But this was the obvious result of subjecting this asset to stiff capital requirements.

The recently adopted Basel III liquidity rule provides another example of contradictory regulation. The rule is intended to enhance safety and soundness by requiring banking companies to hold high-quality

[*]This article is based on a Bank Think piece written by the author and published in the American Banker on October 15, 2014.

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liquid assets to meet the cash needs of a 30-day run during stressed economic conditions. High-quality liquid assets are limited to such items as U.S. Treasury bonds and debt instruments issued by European Union countries and other foreign nations, as well as very limited amounts of certain high-quality corporate bonds and equity securities.

The regulatory message is clear: Banks should hold more Treasury and foreign sovereign debt. The policy ignores the fact that these instruments have significant risks, including interest rate risk and, in the case of foreign debt, credit risk. So these measures will not necessarily result in safer banks. They will, however, result in less funding for housing, small business loans, and consumer loans. The reason is simple, the total amount of loans and assets a bank can hold is limited. The more Treasury and foreign debt the bank is required to hold, the less capacity the bank has to make loans to private businesses or to consumers.

Ironically, just as a policy requiring banks to load up on government securities is being implemented, a regulatory proposal from the Federal Housing Finance Agency seeks to cut off access to Federal Home Loan Bank advances to financial companies that do not maintain a sufficient portfolio of housing assets. Thus, for liquidity purposes, one arm of the government is telling banking companies that mortgage assets do not count as liquid assets and that they should hold government securities. Meanwhile, another arm is telling financial companies that unless they maintain a mortgage portfolio they will be cut off from the liquidity that is offered by the FHLB system.

In yet another area, the State Department and the United States Agency for International Development have issued multiple studies and reports extolling the benefits of remittance payments sent by U.S. residents back to their home countries. There is no question that these remittance payments provide a very significant source of capital to developing countries, thereby enhancing stability and growth. On the other hand, the government clampdown on anti-money laundering and anti-fraud compliance, including suits by the Department of Justice, has made it more difficult and costly for licensed financial institutions to provide these services. As a result, banks are rethinking whether they want to be in the remittance business at all, and the underground and unregulated remittance providers that actually pose far greater risk are more than eager to provide an alternative to the regulated sector.

These are just a few examples of a broader problem facing the financial industry. The problem comes down to the fact that there is not one overriding goal or agency capable of reconciling the competing objectives of various new regulations. Without such coordination, regulatory policy will continue to be inconsistent, and the cost will be paid by the American public.

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