New Rules of the Road are Becoming Fixed*

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This session of the 114th Congress is heading into its latter stages with no significant financial services legislative changes easily predictable, notwithstanding efforts by various sectors of the industry and, in many cases, efforts by a large number of elected representatives, to make changes. Consumer activists groups seem relatively content both with the way things have been legislated in the near past and in the way that the Obama appointed regulators are implementing the legislation. They are not advocating major changes. With progressives and ultra conservatives by and large capable of blocking most any matter on the legislative agenda on issues they choose to engage, no significant changes are likely to occur the remainder of this session. Much of the progressive agenda found its way into the Dodd-Frank Act and has now been incorporated in regulations, and the ultra conservatives cannot mount a sustainable positive legislative effort.[1]

The conclusions, therefore, is that the rules will not change much between now and the end of the year when Congress will adjourn sine die. If that is the case, we can probably now see the structure and rough outlines of the kind of regulation the financial services industry will see going forward. Fundamental changes in the system during next year, a year shaping up as a volatile election year, will be difficult because of the carryover of the distrust of financial services entities by the media and the general public. In fact, financial services firms will be fortunate to avoid additional restrictions during the next session next year.

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[1]This demonstrates the power of the presidency in our governmental structure, when aided by a determined minority block in Congress willing to vote in lock step, even when both Houses of Congress are strongly in the hands of the opposition party. As an example of that, the change that has the best opportunity to occur is a modest change in rules governing regulatory requirements for small banks, and even that, challenged by the icon of the progressives, is uncertain.

In summary, it is likely that what we have now is basically what we will have for a number of years. At some point, systems and procedures, as well as expectations of the industry and its customers, become embedded. Too many interests become vested for major changes to occur. So what are some of the new rules of the road?

Some rules that are becoming fixed

The FDIC has walked back from its earlier list of risky merchant activity after the existence of the list itself began to encourage lending institutions to withdraw funding from them, but Operation Chokepoint continues as an attempt to discourage funding to those of the third party payment processors that exhibited more than normal risk in the management of their activities. The scar remains, as does the intention to ensure that lenders look carefully at their customers and, in particular, third party payment processors. Rule: Regulators will continue to pressure lenders (whom they regulate) to force changes on their customers (whom regulators don't regulate).

The increase in cyber security breakdowns in many industries and governments goes far beyond the Congressional squabble about sharing information or who should be responsible for losses caused by hacking. It covers real time problems like zero day exploitation and its use by governments, coordinated attacks based on accumulated data inventoried in earlier hacks, weaknesses in our laws that prevent some kinds of counterattacks against hackers, etc. This issue will be with us always.[2] Rule: Significant cyber issues that are difficult to resolve will be ignored in favor of elevating and arguing about less significant issues that are easier to understand.

While the bubble in the housing market recedes further into history, the National Mortgage Settlement continues with annual reports from the monitor, the last of which is scheduled for April of 2016 but may be extended now that HAMP has been extended.

Under that settlement, a number of individuals have received small payments as outlined in the consent order, and lenders who signed the order have assisted many homeowners in restructuring their loans. That will soon fade away along with HAMP. Whether the procedures designed to deal with default mortgages under which the mortgage lenders have been operating under HAMP and the Settlement will fade away is less certain, since processes and systems have now been established that carry a patina of correctness; it might be foolish to abandon them and then explain later how what was substituted was as good as the government approved HAMP and Settlement systems and procedures. It is unclear how many homeowners have been assisted, although some reports place it as low as one million persons, considerably less that the 4 to 8 million once thought to be expected under the program. It is somewhat of a truism, however, that a government program once put in place is very hard to eliminate. Rule: Modifications of defaulted residential mortgages will be seen as standard procedure.

[2]There are many ways to view the risks. Here is one systematic way: ***Economic and Policy Frameworks for Cybersecurity Risks***, Friedman Brookings, July, 2011

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TARP has ended at a profit for the government; according to TARP calculations, of about $15 billion, notwithstanding a loss of over $9 billion in assistance to the auto industry. Nevertheless, it is viewed as a waste of money, a bailout of big banks, and a policy failure in the press and among active politicians. Rule: Even if a government action prevents a catastrophe, use of it in the future may be prohibited if its use creates a catchy slogan that can be used by those who oppose it.

Reliable markers in our markets are becoming harder to find. LIBOR was rigged, for goodness sakes. The FX market appears to have been rigged. Now investors are claiming that the U.S. Treasury market is rigged. Where does one turn to find a highly functioning market that is not rigged? Dark pools contribute to the paranoia. Rule: Fundamental assumptions about transparency in financial service markets will continue to be questioned.

Social media transactions by marketplace lenders are increasing in size and soon will reach a meaningful share of the financial services market. What would have been seen by your father to have been a highly unreliable market may experience for a while the benefits that flow from millennials and others who are comfortable with new forms of finance and communication (particularly when they are tech based) and who have been treated to a decade worth of stories by media commentators and government spokespersons on how the traditional forms of the industry have been anti-consumer. After that moment passes, however, they will have to show they can produce value as demanded by their customers. Rule: Techies will be the "new good thing" in financial services for a while.

Explanations for why the AIG officers allegedly responsible for many of the bad decisions that led to the massive expenditure of TARP funds managed to get large bonuses after the funds had been placed in the company were never persuasive. As ex-Federal Reserve Chairman is reported to have said in an interview, more individuals should have gone to jail.[3] There are many that believe if more individuals at large financial firms had gone to jail, the reputation of the big institutions would not have been so damaged and the general attitude of the population concerning the methods used to avoid a catastrophe would have been more benign. If there ever was a time when individuals should have gone to jail, it was in the aftermath of the Great Recession. Not many did. Rule: Corporations will be treated harshly for breaking rules; individuals not so much.

The agency tasked with taking the perspective of the consumer in financial transactions has attempted to move into currently popular social media channels to convey their messages. Blogs, for example, are now accepted methods for conveying agency information to the public. The determination of the priority schedule for supervision and enforcement is, in great part, influenced by the system it has devised to receive "complaints" from the public. Yet, those messages on the open portal of the Bureau are not filtered sufficiently to determine if a company or an issue truly needs the attention of the Bureau. Gross non-normalized data are the foundation of the data used

[3] ***Ben Bernanke: More execs should have gone to jail for causing Great Recession***.

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for review. Rule: CFPB will continue to use and be guided by relatively unfiltered social media forms of communication.

Some old issues have been resolved by the Courts, at least in part. Disparate impact theory can be used to determine if discretionary lending has taken place under the Fair Housing Act. Left undetermined are questions such as whether ECOA will support such a theory, whether the HUD rules for determining questions and shifting burdens of proof in the determination are acceptable in the courts, and how to reconcile the guidance of the U.S. Supreme Court with practical case facts that will arise.[4] There will be further reviews of the details of disparate impact theory in the next few years because the decided case left much to be determined. Rule: Financial regulatory issues will be frequent visitors to the U.S. Supreme Court.

In the PHH administrative review, now in the courts, the Director speaking for the Bureau announced that there would be no adjudicatory value in agency guidance that had not been published in the Federal Register, a major change in the importance of informal guidance from (in this case) HUD. In the same case, he interpreted statutory language in RESPA to change the meaning of that language in conflict with both the understanding of the government and the private sector. We'll see what the courts say about that case.[5] Rule: CFPB (and perhaps DOJ) will continue to blaze new intellectual trails and be willing to ignore what the community has seen as established law.

To reach some of its decisions, the Bureau has applied a statistical analysis technique that takes into account, on a dynamic basis, models that determine racial identity of individuals based upon last names and upon geographic locations. Using that tool, it and DOJ have charged companies with violations of ECOA and Fair Lending in the indirect auto lending sector, and have entered into consent agreements with them. Similar techniques were used in a ECOA case involving alleged redlining.[6] Defendants have not yet directly challenged the statistical system directly which the allegations of violations have been shown.[7] In part that might have to do with the fact that a number of the companies charged have been in the process of trying to obtain approval from federal regulators on other important applications before them. Rule: Defendants who are leveraged by pending applications will not challenge the basis of the statistical analysis in disparate impact cases.

If there is one cry that has persisted since the downturn and its resolution, it is that large banks should be made smaller, even if in doing so the economy is put at unknown risks. It is encapsulated in the phrase, Too Big To Fail. It has its intellectual foundation in a belief that the largest institutions feel immune to economic principles and will regularly act contrary to their

[4] Read the opinions in the ***Texas Department of Housing case.***

[5] See discussion in ***Brief Comments on Disparate Impact and Kick-backs***.

[6] Consent agreement in CFPB and DOJ v. Hudson City Savings Bank, F.S.B.

[7] In a similar case in which, among other things, Quicken Loans argues that the statistical sampling method used in its discussions with the Bureau and DOJ was flawed, the courts have also been asked to decide the issue of proof of discrimination. See discussion in ***Quicken sues HUD, Justice departments over investigation into FHA loans***.

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interests, all for short term gain, thus creating risks to the entire financial system. This has led to stress tests which are based on assumptions by government employees that are not explained to those being tested; a requirement under the living wills sections that banks spend considerable time and resources describing in great detail and in advance how any problems created by the failure of those institutions could be resolved by FDIC (only to find that they failed to consider all of the kinds of problems that the FDIC could predict); laws and regulations are being passed that punish institutions simply for being large whatever their conduct might be; and considerable pressure will remain on the large institutions to hold more capital, almost to the point that there will be little, if any, economic or policy protection provided by the marginal increases.

In the meantime, the larger institutions are those that are driving the economic engines of the country and providing the bulk of the jobs and taxes in the financial services sector. Smaller banks are finding it hard to develop succession plans, and they cannot meet the competition from online financial services. We have become an urban country and rural and small town community banks are not the future of banking for those living in the cities. Certainly, they are not the funding resource for the host of major global companies that have access to lenders worldwide. Rule: Large banks will be with us always, and that is a good thing.

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