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Financial Services Legislative and Regulatory Update

Leading the Past Week

If Congress is acting like children, as some have opined, then last week had all the roller coaster moments from adolescence, as the potential for a deal went from unlikely to probable to broken down. Last week closed with slight optimism for a resolution of the uncertainty that Congress would pass a debt limit increase before the 'x-date' of government default. On Thursday, President Obama had a meeting with Republicans, during which he neither accepted nor rejected a House plan to increase the debt limit for six weeks. With both sides describing the meeting as "constructive," though inconclusive, stocks rallied with the Dow, Nasdaq, and S&P all rising by the end of the day Thursday. On Friday, House Republican leaders offered a plan which would reopen the government and raise the debt ceiling for six weeks. Despite hopes that the offer could address the looming default and the shutdown, Senate Majority Leader Reid (D-NV) disparaged the plan, saying that he does not believe a "six-week delay of a catastrophic default is enough time to give the economy the confidence it needs." By the weekend, the potential consensus around a plan floated by Senator Collins had melted and it looked like Senators Reid and McConnell were back trying to reach a deal, but success was alluding them at the writing of this note.

Even as lawmakers may be inching toward an agreement, large banks have begun to prepare contingency plans, given the ever increasing likelihood that there could be some type of default. These plans primarily focus on the potential effect of a default on the repo market, which banks use for financing through posting Treasury securities as collateral for short-term loans from money market funds, insurers, and other investors. For example, Fidelity Investments and JPMorgan Investment Management, two large money-fund managers, have reported to have sold all of their holdings of Treasury bills that would have matured at the end of October and early November as a "precautionary measure."

Banks are not the only ones preparing for a potential default; international groups and global stakeholders have begun to take precautions. The International Monetary Fund (IMF) has begun to

assist member countries on preparations to mitigate the effects of the US government shutdown and potential debt ceiling crisis. IMF Managing Director Christine Lagarde has said that the international organization is "engaging with other countries that feel the spillover effects and we are helping them devise a set of policies that will be helpful for them." The IMF also warned in its World Economic Outlook analysis released last week, which cut global growth forecast, that "failure to promptly raise the debt ceiling could also adversely affect financial markets and economic activity, with spillovers to the rest of the world."

Domestic officials have also become increasingly vocal against the danger of breaching the debt ceiling as October 17th approaches. On October 8th, in advance of an appearance before the Senate Finance Committee to discuss the debt limit, Treasury Secretary Lew held a conference call with the Financial Stability Oversight Council (FSOC) to discuss the consequences of Congress failing to raise the debt limit. On the call, the regulators shared comments from the industries they oversee with the CFTC and SEC particularly focused on the lack of government funding impacting their ability to monitor markets troubled by a potential default.

While attention has shifted to the looming debt limit, concerns continue over the government shutdown. According to Gallup polling released last week, confidence in the economy deteriorated more in the days since the government shutdown than in any week since the Lehman Brothers collapse which spurred the financial crisis. Gallup warned that the economic brinkmanship could "negatively affect U.S. stock prices, America's credit rating, and, ultimately, the nation's economic recovery."

Like so much of the shutdown, the impact on the financial regulators appears to be mixed. For some, like the Commodity Futures Trading Commission (CFTC), the lack of funding is creating difficulties for the Commission to carry on its implementation of the Dodd-Frank Act. Despite saying he would try hard not to allow certain rulemaking deadlines to slip, CFTC Chairman Gary Gensler said in interviews last week that the shutdown could delay votes planned for October 24th on rules which would restrict commodities speculation and strengthen futures customer protections. On October 9th, five banking regulators which remain in operation, including the Federal Reserve (Fed), Consumer Financial Protection Bureau (CFPB), Federal Deposit Insurance Corporation (FDIC), National Credit Union Association (NCUA), and the Office of the Comptroller of the Currency (OCC), issued a statement urging financial institutions to work cooperatively with borrowers affected by the government shutdown. The agencies advised that affected customers may face temporary hardship in making payments on debts and that financial institutions should consider prudent workout arrangements that increase the potential for creditworthy borrowers to meet their obligations.

<u>Legislative Branch</u>

Senate

Chairman Johnson Agrees to Delay of Iran Sanctions Legislation

At the request of the Obama Administration, Chairman of the Senate Banking Committee Tim Johnson (D-SD) said he would delay the legislation which the Committee has drafted to impose new sanctions on Iran. Johnson said that he is "inclined to support the White House" in waiting to introduce legislation until after the multilateral talks in Geneva this week.

Treasury Secretary Lew Warns Senate Finance Committee of Fallout from Default

On October 10th, Treasury Secretary Jack Lew appeared before the Senate Finance Committee to provide testimony on the debt limit and the potential impacts a Congressional failure to increase the

debt ceiling. In his testimony, Lew warned that a default would be "catastrophic" and even a last minute resolution would be "very dangerous." Lew also noted that prioritization, in which the government would pay bondholders and other debts before other obligations such as Social Security, is not an option, saying government payments are "not designed to be turned off selectively" and prioritization is "default by any other name." Republican Senators pushed back against Lew. Ranking Member Orrin Hatch (R-UT) pressed Lew for what the Administration would specifically want to see from a debt limit increase and Senator Mike Crapo (R-ID), who is also the top Republican on the Senate Banking Committee, questioned Lew on the benefits of raising the debt ceiling to the nation's long-term debt crisis.

Executive Branch

Federal Reserve

Yellen Nominated to be Fed Chairman – Republicans Announce their Objections

On October 9th, President Obama announced his nomination of Janet Yellen to serve as the next Chairman of the Federal Reserve. Yellen, current Vice Chair of the central bank, was seen as a front runner, especially liberal factions in the Senate made it clear that they wouldn't support the nomination of Larry Summers. Yellen, perceived by some, as a "dove," based on her support for the accommodative monetary policies (*i.e.,* QE) begun by Chairman Bernanke, will likely calm market fears that the tapering of these polices would be accelerated. While Yellen will receive strong support from Senate Democrats, such as Banking Committee Chairman Tim Johnson (D-SD), who commended the President and noted that Yellen "has a depth of experience that is second to none," and from Senator Elizabeth Warren (D-MA), who also praised the decision, saying with "great confidence" that Yellen's track record would further the work left that the Fed must do to accelerate the U.S. economic recovery, similar accolades from Senate Republicans may be a bit sparser.

For example, the Ranking Member of the Banking Committee Mike Crapo (R-ID), citing his opposition to continued quantitative easing, said he would "carefully" examine Yellen's nomination, while Senator Bob Corker (R-TN), a Banking Committee member, has said he would vote against her. Also, Senator Rand Paul (R-KY) has hinted at a filibuster of the nomination, but is certainly opposed given his, and his father's long entrenched opposition to the Federal Reserve. Despite potential Republican opposition, Senate Majority leader Reid (D-NV) predicted Yellen's "nomination will receive the speedy consideration and confirmation it deserves."

FOMC Releases Minutes from September Meeting

On October 9th, the Federal Reserve released the minutes from the September Federal Open Markets Committee (FOMC) meeting. Perhaps the most interesting fact to be gleaned from these notes is the observance that, "most of the participants leaning toward a downward adjustment in the pace of asset purchases also indicated that they favored a relatively small reduction to signal the Committee's intention to proceed cautiously."

Regulators Examine Credit Risk in the National Portfolio

On October 10th, the Federal Reserve, FDIC, and OCC released an annual review of credit quality of large loan commitments owned by U.S. banking organizations, foreign banking organizations, and nonbanks. The review found that the national credit portfolio was largely unchanged in 2013 from prior years but cautioned that leveraged loans exceed industry norms and the volume of criticized assets remains high

Benjamin Franklin Gets a Makeover
On October 8th, a redesigned $100 bill made its debut. The Federal Reserve has worked for several months developing new designs and features for the $100 bill with the goal of making it more difficult to counterfeit. Changes to the currency include a holographic bell, a new 3-D security ribbon, and a textured collar on Benjamin Franklin, among other new security measures. The Fed has coordinated with the State Department to ensure that foreign officials are ready for the new bill, an important step as up to two-thirds of all American $100 bills are circulating abroad at any time. A new website, newmoney.gov, will inform trading partners in 23 different languages of the changes.

ABA's Keating Calls on Regulators to Consider Community Bank Relief
On October 7th, American Bankers Association (ABA) President Frank Keating wrote to regulators asking for regulatory relief for community banks. Keating, addressing himself to Fed Chairman Ben Bernanke, Comptroller of Currency Thomas Curry, FDIC Chairman Martin Gruenberg, and CFPB Director Richard Cordray, warned that the number of community banks chartered has sunk to the lowest in over a century and we are witnessing an "erosion of community banking." To remedy this, Keating called on regulators to: address the "punitive" regulation of mortgage servicing assets; ensure the Volcker rule does not contain burdensome compliance requirements; strengthen regulators' ombudsman programs; simplify the call report; revise Basel III rules as they relate to S-Corp Banks; and consider the current tax advantage credit unions receive due to the Farm Credit System.

SEC
SEC Launches Market Data Website
On October 9th, the SEC launched its new market data website built to showcase the agency's Market Information Data Analytics System (MIDAS) which collects trading activity daily. Chairman Mary Jo White called the website a "game changer" in the market structure debate and expressed hope that the new tools would provide the public with insight into dark pools, and high-frequency and algorithmic trading. The SEC also published a staff paper on alternative trading systems, which used MIDAS data to explore trade sizes on off-exchange trading venues.

Industry Asks for CEO Pay Rule Extension
On October 9th, a group of business stakeholders, led by the Chamber of Commerce Center for Capital Markets, wrote to the SEC asking it to extend the comment period for its proposed rule to require public companies to disclose the ratio of CEO to employee pay. The comment period ends on December 2nd but the groups are asking for a 60 day extension in order to fully respond to "the intricate nature of this rule and the diverse array of complex issues on which the SEC is specifically requesting comments."

SEC Official Outlines Priorities Following CEO Pay Rule Finalization
Speaking at the Practicing Law Institute executive compensation conference, SEC Division of Corporation Finance Office special senior counsel Anna Krauskopf said that the SEC will move forward on other executive compensation requirements under Dodd-Frank now that the CEO pay ratio rulemaking is close to final. According to Krauskopf, the SEC is "hard at work" on additional proposals, including clawbacks and employee hedging but that it is "premature to suggest dates or the order" that the SEC will issue the proposals.

FHA
Stakeholders from MBA to Congress Ask for Loan Limit Adjustment Delay

On October 4th, Mortgage Bankers Association (MBA) CEO David Stevens wrote to Federal Housing Finance Agency (FHFA) Acting Director Edward DeMarco requesting that the agency delay lowering the size of home loans that Fannie Mae and Freddie Mac may finance. Stevens argues that the loan limit should not be lowered until at least six months after the new CFPB lending rules go into effect in January 2014 to allow lenders to adjust to new requirements. A coalition of 15 housing industry groups also sent a letter to DeMarco on October 8th, echoing the call to delay the loan limit changes and arguing that the government does not have the authority to lower loan limits. The FHFA has been weighing lowering the cap on the size of mortgages that the government sponsored entities (GSEs) can guarantee from $417,000 in most areas and up to $625,500 in wealthier neighborhoods. It is not just industry stakeholders asking the FHA for this delay, as 66 House lawmakers wrote to the FHFA on October 7th, to ask for the loan limits to be maintained.

Supreme Court Will Not Hear Challenge to FHFA's Lawsuits
On October 7th, the Supreme Court announced that it will not hear a challenge by large banks to the lawsuits brought by the FHFA alleging the banks sold billions in faulty mortgage bonds to Fannie Mae and Freddie Mac. Banks bringing the case included JPMorgan Chase, Bank of America and Goldman Sachs, who filed with the Court after UBS lost an appeal in April that argued the FHFA had let too much time pass and thus lost standing to bring the lawsuits.

GSEs Form Mortgage Securitization Subsidiary
On October 7th, the FHFA announced that Fannie Mae and Freddie Mac have established a joint venture to build a new common securitization platform that will operate and design a system to package and sell mortgage bonds. Common Securitization Solutions (CSS) is an effort by the FHFA to save taxpayer funds from pricing irregularities that have surfaced between Fannie and Freddie. When complete, CSS would allow the two GSEs to consolidate how the loans purchased from lenders are packaged.

FDIC

Regulators Issue Proposed Rule on Flood Insurance Lender Requirements
On October 8th, the FDIC voted to issue a proposed rule to implement requirements for lenders regarding the mandatory purchase of flood insurance. The regulations, established by the Biggert-Waters Flood Insurance Reform Act, directs regulators to enact rules that would require lenders accept the private flood insurance purchased by homeowners, so long as it meets certain conditions. The proposed rule would also ensure lenders place insurance fees and premiums in escrow accounts at the same rate it collects loan payments and would allow lenders to charge borrowers for forced place insurance. On October 10th, regulators, including the Fed, OCC, NCUA, and Farm Credit Administration, jointly issued the proposed rule.

CFPB

Bureau Will No Longer Bring Enforcement Lawyers to Exams
Speaking on a conference call with CFPB examiners, Director Cordray noted that the Bureau will stop brining enforcement lawyers to routine examinations. The policy change is a result of criticism from industry lawyers, trade groups, and other stakeholders who argued that the presence of enforcement attorneys bred a hostile environment that disincentivizes executives from being open about potential issues within their institutions. The Chamber of Commerce wrote to the agency in February urging the policy change and the Federal Reserve Office of Inspector General recently said it would review the

approach taken by the Bureau. According to CFPB spokesperson Jennifer Howard, enforcement lawyers will still play a role in supervision and will work closely with examiners offsite.

CFPB Fines Firms, Offers Guidance on HMDA Compliance

On October 9th, the CFPB announced two enforcement actions under the Home Mortgage Disclosure Act (HMDA), which requires certain mortgage lenders to accurately collect and report data about home mortgage loans. The Bureau relies on HMDA data to assess compliance programs and guard against discrimination in home mortgage lending. Mortgage Master will pay $425,000 and Washington Federal will pay $34,000 in civil penalties. Mortgage Master was found to have has "significant data errors in the 21,015 mortgage loan applications it reported for 2011" and Washington Federal was found to have had "significant errors in the 5,785 mortgage loan applications it reported for 2011." The same day, the Bureau also released a bulletin which gave industry additional guidance about the importance of accurate HMDA data and effective HMDA compliance management systems. The bulletin discusses appropriate HMDA compliance management and outlines factors the agency would consider when evaluating financial institutions for HMDA violations.

Upcoming Hearings

The Federal Government Remains Shutdown and Hearing Schedules in Flux