AMERICAN BANKER®
THE FINANCIAL SERVICES DAILY

Monday March 4, 2013

SPECIAL REPORT : REGULATIONS & REFORM

Big Bank Breakups and Tech Disruptions: Predicting the Future of Reform

By Joe Adler

WASHINGTON — In eight years the leather wallet likely will be a relic, homes may be guaranteed by an entity other than Fannie Mae or Freddie Mac and a President Chris Christie or Hillary Clinton, if you prefer could sign the Financial Services Reform Act of 2021 into law.

Predicting exactly what the world will look like 11 years after the Dodd-Frank Act was signed into law is a stretch, but history shows that congressional updates to the regulatory structure are cyclical and occur roughly once a decade.

Dodd-Frank was enacted 11 years after Gramm-Leach-Bliley, also known as the Financial Services Modernization Act, was passed into law. A decade earlier Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, known as FIRREA, the first of two major bills responding to the thrift debacle.

"Over the course of the next decade, at some point there will be an event or an outcome of sufficient importance or poignancy that there will be action," said James Wilcox, a business professor at the University of California at Berkeley.

But prognostications of what kind of action run the gamut, including everything from a comprehensive housing finance reform plan to new attempts to eliminate "too big to fail" to answering the perennial question of what entities can or can't own a bank.

The next reform effort may well focus on addressing Dodd-Frank's flaws.

Almost everyone in Washington finds some fault with Dodd-Frank. But rather than making smaller, incremental corrections in the short term, Congress could attempt a more comprehensive fix further down the road. To many, Dodd-Frank, which is meant to apply more regulatory pressure on the largest financial companies, tried correcting problems with Gramm-Leach-Bliley, which made it easier for multiline financial conglomerates to operate.

"As time goes on and events happen, people will discover that various parts of the consumer credit rules passed by Dodd-Frank are having all kinds of consequences — some intended, and some recognized as more painful than first realized," Wilcox said. "And smart people will have figured out how to minimize or even evade the spirit of some other rules. So there is bound to be a lot of reworking."

Alternatively, the rush of technological change in financial services could serve as motivation to lawmakers to devise regulatory reforms that keep pace.

EUGENE A. LUDWIG
PROMONTORY FINANCIAL

"If you look forward in time, as the technology of communications continues to evolve, there is the potential for a whole raft of new structures that provide consumer financial services," said William Longbrake, a former Washington Mutual vice chairman who now teaches at the University of Maryland. "Regulation eventually is going to have to figure out how to respond to that."

Yet to some, Dodd-Frank may have broken the string of meaningful reform packages coming once every decade or so. Its scope far exceeded Gramm-Leach-

Bliley. The 2008 financial crisis, which gave rise to Dodd-Frank's, was wider in breadth than the savings and loan crisis that spurred FIRREA and its 1991 follow-up law: the Federal Deposit Insurance Corporation Improvement Act.

"Do I think there will be enough change in the marketplace and enough error that there will be some changes to the legislative landscape in the decade following Dodd-Frank? Yes. But I'm doubtful we will see anything as profound as Dodd-Frank," said Eugene Ludwig, the founder and chief executive of Promontory Financial and a former comptroller of the currency.

Some compared the 2010 overhaul more to the banking reforms that followed the Great Depression, which proved to have more staying power.

"It's worth thinking about whether this period is more akin to the 1930s," Ludwig said. "There was such profound change in the 1930s that it took a long time to digest."

And the slow pace of recovery following the 2008 meltdown may delay the type of booms that prompt broad pushes for deregulation.

"The financial sector will always argue for some deregulation, but I can't imagine it getting much traction for a while, until we've lived through a couple of decades and debated throughout that time, and my hope is that the effects of the combined memories in the financial system and the regulatory agencies will be enough to prevent a major breakdown that requires a major regulatory reorganization," said Donald Kohn, a former vice chairman of the Federal Reserve Board and now a senior fellow at the Brookings Institution.

Even if Congress does move to address innovations in the industry that lack a clear regulatory framework — such as mobile payments or prepaid cards — observers said those are more likely to be addressed in stand-alone laws rather than any broad overhaul.

"I don't see those as catalysts for a major regulatory overhaul, but rather as reforms that are more likely to come from one-off pieces of legislation," said former Federal Deposit Insurance Corp. Chairman Sheila Bair, who is now a senior advisor for the Pew Charitable Trusts.

Still, many see a fast-moving congregation of unresolved regulatory issues — both related and unrelated to the crisis — that at some point will demand legislation. The biggest gorilla in the room is the nation's housing finance system. Though the expansions of Fannie Mae and Freddie Mac are seen as one of the causes — and casualties — of the housing crash, Dodd-Frank did nothing to address the government-sponsored enterprises' future after their 2008 federal takeovers.

With a politically divided Congress, the housing market recovering and few signals from the administration about what it wants to do, some observers said GSE reform may have to wait for the next comprehensive shake-up of the regulatory system.

"It is not beyond the realm of possibility that a meaningful final answer takes that long. It wouldn't shock me," said Raj Date, the former deputy director of the Consumer Financial Protection Bureau. "When times are OK, the benefits of GSE reform are sufficiently theoretical and diffuse that it becomes difficult for people to get super-wound-up and excited about reform."

Longbrake said a statutory change to the housing finance system could end up following reforms that the market or the Federal Housing Finance Agency, the chief regulator of Fannie Mae and Freddie Mac, implement on their own.

"A lot of the details are going to get resolved by the work at the FHFA so that the legal structural entity will almost be an afterthought," he said. "Eventually, by 2021, you're going to have a new world. But the new world is in process right now, and by the time there is legislation it will be ratifying a consensus that's evolved."

To address the issue of "too big to fail," Dodd-Frank imposed tougher regulations on so-called systemically important companies, and set in place procedures designed to force companies to simplify their structure to assist in orderly wind-downs. The law also gave regulators authority to close firms in such a way that it did not disrupt the system. The updated Basel accord also requires stronger capital and liquidity maintenance by the big banks.

But one of the biggest question marks following the law is whether any of that will work.

"The 'too big to fail' issue is still hanging out there. The combination of Dodd-Frank and Basel III has done a lot, but some people see it as [it's] still a problem," Kohn said. "If one wanted to point to an area that is still very open in terms of public debate, it would be that."

A more severe solution — to simply break up the big banks and force them to come under a size cap — continues to gain steam, with notable voices in the policy sphere, including members of Congress, saying it is the only answer to ending "too big to fail."

Currently, such drastic prescriptions appear far from likely to pass Congress, but outside events could cause that to change relatively quickly. For example, the idea of creating a consumer protection agency dedicated to financial services was considered implausible only a few years before it was created by Dodd-Frank. Similarly, the Sept. 11, 2001, terrorist attacks generated rapid support for passage of the Patriot Act which, among other things, put in place new anti-money-laundering requirements on banks that had been viewed as dead-on-arrival only two months earlier.

Viewed in that light, many observers said more problems at the largest banks could potentially generate eventual passage of legislation to break up the banks.

“If you look at the ‘too big to fail’ debate right now, some of that same type of dialogue is going on, with strong opinions being voiced about what the future should look like with respect to large banks and prominent people speaking about the issue,” Longbrake said. “If the historical pattern holds true, that would suggest to me that indeed you would have some kind of legislation — probably not anytime soon — but by 2021 it is a good possibility.”

Major banking legislation typically only gains traction when some event forces Congress’ hand. Dodd-Frank, FIRREA and FDICIA would likely never have come about without crises. The same was true, in a different way, with Gramm-Leach-Bliley. Lawmakers finally acted when then-Citicorp and Travelers Insurance were attempting to merge, putting a bank and insurance provider under the same corporate parent.

Bair agreed that further reforms to address “too big to fail” will likely only materialize with a future big-bank failure that rocked the system.

“If you have another problem that’s big-bank driven, I think you’re going to have statutorily mandated breakups,” she said. “I hope we don’t have any more big bank failures for system stability reasons. Dodd-Frank gives the regulators the tools they need to end ‘too big to fail,’ but they need to use them. … My guess is Congress will have more debates about this and more hearings, and probably will not do anything in the near term. But all bets are off if there is another big bank problem. Then I think you will see strong bipartisan support to break them up.”

Yet more benign developments in the industry could also prompt reforms that no one today is seriously contemplating.

Date said new technologies demanding a legislative framework for financial services firms include everything from global positioning systems to social media. He used the example of GPS software that a car insurer could potentially use to assess one’s driving risk. If financial providers enhance their use of consumers’ digital footprint to make underwriting decisions, it brings into a play a whole host of fair lending and privacy issues, he said.

“It sounds Orwellian, but underwriting is nothing other than the harnessing of data to better make decisions, and there is a lot more data now than there used to be,” Date said. “Yet you don’t want abuses or inequitable results to crop up.”

In future reform efforts, lawmakers would likely have to consider new questions about what type of nontraditional providers should be given the benefits reserved for regulated banks, such as deposit insurance and access to the payments system.

That question today often focuses on the extent to which nonfinancial companies should be able to bank, and the extent of a bank’s nonfinancial enterprise. Most recently, before the crisis, banks tried to remove a longtime exception allowing retailers like Walmart to operate FDIC-insured industrial loan companies. Yet Dodd-Frank largely punted, calling for a study on the issue and a freeze on commercially owned ILCs that expires this year.

But with an even broader sphere of companies trying to provide financial products, that question could get even harder in a future overhaul.

“The concept of nontraditional providers of banking services to consumers is alive and well and is likely to be driven by technological developments,” Longbrake said. “To the extent that you have new mechanisms for delivering consumer financial services, definitely there will be a cry for regulation.

“The ILC issue morphs and changes, but it doesn’t go away. It expands into other ways of delivering consumer financial services.”