The 2014 Election: A Critical Juncture in Financial Services Legislation, Regulation, and Oversight

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As November draws closer, the financial services industry is staking out a front row seat in tracking the outcomes of the 2014 midterm elections. The 114th Congress’ legislative agenda in this area will be shaped in large part by the Senate Banking Committee’s willingness to work with their counterparts on the House Financial Services Committee. The extent of that willingness, of course, will turn on which party controls the Senate when the next legislative session begins.

113th Congress: First Steps in Housing Finance Reform

Both the House and the Senate have focused their activities in the financial services space on long-awaited housing finance reform of late, a trend that is expected to continue in the lame duck session and as the 114th Congress begins.

a. Senate: Bipartisan Proposals Lead the Way

In June 2013, Senators Mark Warner (D-VA) and Bob Corker (R-TN) introduced the first major bipartisan government-sponsored enterprise (“GSE”) reform proposal, S. 1217, which would have replaced Fannie Mae and Freddie Mac with a system of first-loss private capital and government-sponsored backstop insurance. Building on the momentum generated by this initial draft proposal, Senate Banking Committee Chairman Tim Johnson (D-SD) and Ranking Member Mike Crapo (R-ID) held nearly a dozen additional hearings on the topic and re-introduced a modified S. 1217 to considerable fanfare in April 2014.

The Johnson-Crapo proposal, which added more flexible standards for private capital eligible for the proposed private capital buffer requirement, was voted out of the Senate Banking Committee to the full chamber in May and placed on the Senate floor for possible consideration in the coming lame duck session. While the rapidly shrinking congressional calendar and criticism from prominent Democrats together mean that Johnson-Crapo stands little chance of actually being brought to a floor vote, its progress indicates that lawmakers on both side of the aisle are increasingly serious about enacting fundamental reforms to the GSE system. If industry support is any indication, this Senate version of housing finance reform will be the baseline text for likely future legislation reforming the housing finance system.

b. House: Ready and Waiting on the Senate Dust to Settle

Meanwhile, House Financial Services Committee Chairman Jeb Hensarling (R-TX) has ensured that the House Financial Services Committee also remains active in the GSE reform debate. During his second term at the helm of the Committee, Chairman Hensarling championed the Protect Taxpayers and Homeowners Act (“PATH Act”), which proposed to eliminate the government guarantee in the mortgage market and dissolve the GSEs within
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five years of enactment. The PATH Act also proposed key changes to the Federal Housing Administration, including the reduction of its mortgage insurance coverage to only 50 percent. The PATH Act was voted out of committee in June 2013 along party lines. However, in the case the legislation advances to the House floor, further amendments are possible.

Chairman Hensarling is among a number of Committee colleagues in pushing for housing finance reform. Democrats showed significant interest in the issue and some, including Ranking Member Maxine Waters (D-CA), introduced their own GSE reform bills as alternatives to the PATH Act. Although these proposals gained little traction in the Republican-controlled House, they do indicate that members of the House Financial Services Committee are prepared to take action on the subject once the Senate is able to proceed with its reform initiatives.

Legislative Outlook for the 114th Congress

Another key area of action in the 114th Congress may be Dodd-Frank corrections. Until recently, Democratic lawmakers have resisted efforts to modify Dodd-Frank. However, new leadership will not be so constrained, particularly as the president contemplates his legacy and the opportunity to improve this significant legislative achievement. Even former House Financial Services Committee Chairman Barney Frank (D-MA) has publicly conceded that the Dodd-Frank Act is imperfect and that some of its unintended consequences require correction.

Among the areas of bipartisan agreement are four proposals that passed the House in the form of H.R. 5461, which would make modest improvements to the Qualified Mortgage Rule to remove advantages to unaffiliated ownership structures for title insurers; allow the Federal Reserve to take the unique situation of insurance companies under advisement when creating the leverage and risk-based capital rules for the largest and most significant insurance companies; provide relief from margin requirements for derivative transactions for certain “end users”; and create an important exception from the Volcker Rule related to collateralized loan obligations. While President Obama is unlikely to sign bills that would result in a significant overhaul of Dodd-Frank, proposals like H.R. 5461 that enact technical modifications, clarify the law’s meaning, or that otherwise enjoy significant bipartisan support are more likely to make it past the president’s desk in the 114th Congress.

What future GSE reform efforts and other financial services initiatives will look like will remain unclear until the balance of power in the Senate is finally resolved. A mere four Republican victories in competitive Senate races would give control of the Senate Banking Committee over to the GOP for the first time since early 2007. Furthermore, Committee leadership will change even if the Democrats retain control of the Senate, as the party will have to replace retiring Chairman Johnson, who is not seeking re-election. The resolution of these question marks in the coming months will have significant implications for the next two years of financial services reform.

a. Democratic Senate: A New Leader’s Priorities

If the Democrats retain control of the Senate, the most likely candidate to replace Chairman Johnson is Senator Sherrod Brown (D-OH). Other possible candidates for the chairmanship include Senator Jack Reed (D-RI), Senator Robert Menendez (D-NJ), and Senator Chuck Schumer (D-NY); however, it appears that each of these lawmakers are more interested in
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seeking leadership positions on other committees or, in the case of Senator Schumer, within the Democratic Party, and are therefore unlikely to seek a Senate Banking Committee leadership position.

A staunch supporter of the Dodd-Frank Act, Senator Brown has historically focused his legislative activities on imposing additional reforms governing “too big to fail” institutions. However, as chairman, Senator Brown would most likely find himself in the difficult position of brokering compromise between factions of senators that hold drastically different ideological views, such as Senators Elizabeth Warren (D-MA) and Patrick Toomey (R-PA), which may impact Senator Brown’s ability to successfully spearhead major regulatory reform. However, Senator Brown may find some bipartisan support for reducing the regulatory burden imposed by the Dodd-Frank Act on smaller institutions. Senator Brown has also recently demonstrated an interest in strengthening consumer protection measures. For example, in June, Senator Brown publicly urged the Consumer Financial Protection Bureau (“CFPB”) to create rules to more closely regulate the payday lending industry, and it is expected that this will be a potential agenda item for a Senate Banking Committee chaired by Senator Brown.

The outlook for housing reform under a potential Brown leadership is less certain, as he was one of the Democrats that ultimately voted against the Johnson-Crapo proposal. Should he choose to pick up where Johnson-Crapo left off, Senator Brown’s principal criticisms of that bill—that it constituted an unnecessary total overhaul of system, failed to require sufficient private capital, and provided insufficient funding for affordable housing—may provide a preview of his view of the market. The complexity of the issue and the intense debate surrounding Johnson-Crapo may lead a prospective Chairman Brown to focus his reform efforts elsewhere. However, if he does so, the risk that the already-tenuous financial status of the GSEs will continue to deteriorate over the next two years means that Senator Brown may be able to only temporarily delay consideration of GSE reform.

b. Republican Senate: A Familiar Face Returns

If the Republicans gain control of the Senate, Senator Richard Shelby (R-AL) is expected to be the next chairman. In doing so, Senator Shelby would resume a position that he held from 2003 through 2007, an experience that may buoy his ability to quickly initiate legislative action once he takes the gavel.

Senator Shelby and Chairman Hensarling share a desire to roll back the Dodd-Frank Act regulatory burden, as Senator Shelby has been a vocal proponent of reforming major provisions. For example, the Insurance Capital Standards Clarification Act (S. 2270), which clarifies that the Federal Reserve Board should not apply bank capital standards to insurance companies designated as systemically important financial institutions (“SIFIs”), has already been approved by the full Senate. However, while a prospective Chairman Shelby would generally agree with the deregulatory agenda of his Republican colleagues, he may depart from their priorities in key areas. For example, Senator Shelby currently supports enacting stricter capital standards for the largest banks and shares a desire for more careful regulation of “too big to fail” institutions with his potential Democratic counterpart in the Committee, Senator Brown. Due to Senator Shelby’s leadership experience on the Committee, this common ground may allow him to more quickly and effectively garner support from Democratic lawmakers and broker compromises between the parties in order to push legislation forward.
On balance, the fact that a Chairman Shelby would enjoy only a narrow Republican majority may lead him to eschew more controversial housing finance reform in favor of providing incremental relief from some aspects of the Dodd-Frank Act regulatory burden, a cause that already enjoys more bipartisan support. Should he choose to proceed with GSE reform, we believe that Senator Shelby is likely to be a supporter of PATH Act-type reform, as he has not expressed support for Johnson-Crapo due, in large part, to his desire to significantly reduce the government’s role in the housing market. The looming 2016 presidential election may also play a role in organizing Senator Shelby’s agenda, as he will likely face a tighter timeline in which meaningful legislating will be possible.

c. House: Chairman Hensarling Pushes Ahead

Across the Hill, Chairman Hensarling is expected to retain his position and will likely continue to push for Dodd-Frank Act regulatory relief, particularly for smaller financial institutions. Chairman Hensarling has also historically taken a strong interest in capital markets reform, as evidenced by his leadership in the 2012 enactment of the Jumpstart Our Business Startups Act, and we expect such efforts to continue in the next Congress. Finally, note that the Financial Services Committee has explored possible capital markets and banking reform packages under Chairman Hensarling’s leadership; though such proposals have not advanced thus far due to the lack of corresponding interest in the Senate, look for him to revive these efforts if given the opportunity.

We also expect Chairman Hensarling’s Financial Services Committee to continue to target the CFPB in the 114th Congress. In recent months, Committee members have heavily scrutinized not only the Bureau’s regulatory agenda but also its internal activities, including high-profile human resources issues and the cost of renovations to the Bureau’s facilities. The coming Congress will continue to closely monitor the Bureau’s examination practices and enforcement actions, particularly those related to auto lenders, mortgage servicing, overdraft fees, and other financial services products offered to economically vulnerable individuals.

Regulatory Leadership and Oversight

Regardless of the outcome of the elections, the federal financial regulators will continue to work on completing implementation of the Dodd-Frank Act and other initiatives, such as improving access to credit and liquidity in the mortgage market.

a. Leadership: Lineups are (Mostly) Set

Notably, the leaders of most federal financial regulators were only recently confirmed to their positions by the Senate: Securities and Exchange Commission Chair Mary Jo White, in April 2013; CFPB Director Richard Cordray, in July 2013; Federal Housing Finance Agency Chair Mel Watt, in December 2013; Federal Reserve Chair Janet Yellen, in January 2014; and Commodity Futures Trading Commission Chair Timothy Massad, in June 2014. Thus, the next Congress is unlikely to feature many contentious confirmation battles in the Senate, at least in the financial services regulation sphere.

The notable exception is at the Department of the Treasury, where there will be new appointees to fill recent vacancies in Domestic Finance. Those nominees may face contentious confirmation hearings, particularly on the topic of the designation of SIFIs; as discussed above, this is likely to be the case regardless of whether it is Senator Brown or
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Senator Shelby that holds the gavel in the Senate Banking Committee, as both lawmakers have expressed concern over the SIFI designation process in recent months.

b. Oversight: Likely Agendas and Likelier Republican Scrutiny

In any case, key priorities of the federal financial regulators would include completion of several bank regulatory reforms, including the SIFI capital surcharge; position limits in the derivatives market; the implementation of cross-border regulation of derivatives; and further oversight and reform of SIFIs, including enhanced prudential standards and the examination of asset manager activity for systemic risk. On the consumer protection side, we can expect the CFPB to continue to chart new territory in consumer transactions with continued action relating to small-dollar, short-term lending, credit card disclosures, student loans, mortgage servicing, non-bank auto lending, and others. In addition, the FHFA and other housing regulators and the Department of Justice continue a steady stream of enforcement activity related to the mortgage market meltdown and the enforcement of new underwriting rules and mortgage servicer guidelines. Also, in the next two years, the financial position of the GSEs is likely to deteriorate fairly dramatically which will draw new attention to their conservatorship status.

Generally speaking, if the Republicans regain control of the Senate, regulators would likely find their actions and agendas subject to increased Congressional oversight and scrutiny. Chairman Hensarling has repeatedly criticized the federal financial regulators in oversight hearings, particularly with respect to the perceived lack of transparency in the SIFI designation process and mismanagement at the CFPB. Senator Shelby would be likely to take a similar tack and hold more frequent oversight hearings, particularly with respect to the activities of the CFPB, should he assume the chairmanship of the Senate Banking Committee. If Senator Brown becomes chairman of the Senate Banking Committee, he would also be expected to closely exercise oversight of the federal financial regulators, although he would be inclined to support their efforts while urging more enforcement actions against “too big to fail” institutions.

Conclusion

Most presidents tend to focus on legacy issues in their final two years in office, and the Dodd-Frank Act is certainly a signature achievement of the current Administration. Therefore, we expect that President Obama may be willing to consider legislative corrections and improvements to Dodd-Frank, particularly those that pass Congress with bipartisan support. The House passed at least 15 such bipartisan measures in the 113th Congress, and with new leadership at the Senate Banking Committee, these and similar provisions may be positioned to reach the President’s desk.

Moreover, Congress will continue to exercise oversight with respect to the ongoing regulatory implementation of Dodd-Frank. In addition, capital markets regulators are coordinating across borders to an unprecedented extent. This emerging international dimension to domestic policymaking, particularly the ongoing dialogue between regulators in Washington and those in Basel, Brussels, and Frankfurt, cannot be ignored. We expect Congress’ oversight of federal regulators to increasingly focus on the Administration’s interactions with global regulators.
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