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

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A Few Unresolved Issues*

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One thing can be counted upon — there always are issues left unresolved. That remains true as 2013 comes to a close, notwithstanding the fact that most of the major financial services rules generated by the Dodd-Frank Act have now been finalized. The landscape is changing in financial services, however, and those rules, as is always the case, address issues that surfaced a decade ago. Here are a half dozen that await us as we move into 2014.

1. The growth of global financial services regulation. This has been mentioned so often that it seems as though it can hardly be listed, but times are changing. In the early 1970s, Peter Cook of the Bank of England visited central banks and other U.S. regulators proposing that the G10 countries consider closer communication on regulatory matters. He was courteously received, but it required the failure of a private bank in Germany[1] and of a New York Clearing House bank[2] to establish a special committee of the G10 to begin systematic cooperation among nations in the regulation of banks. The failure of BCCI increased the need for such cooperation, and the collapse in the 2000s of the U.S. housing market, and with it the sudden significant risk to the U.S. financial system, was contagious and effected countries around the world. The concept of cooperation among nations has increased, and we must now recognize that we have partners (albeit junior and usually silent) in the regulation of our financial system.

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1] Herstatt Bank failed on June 26, 1974 after Deutsche Marks had been released to Herstatt by foreign banks, but before U.S. dollars had been delivered by Herstatt to those banks, and the central bank of Germany did not require delivery to be made.

[2] Franklin National Bank failed in October of 1974. It was a tangled web of foreign exchange fraudulent practices, a mafia-connected Italian owner, a foreign branch bleeding deposits, and a variety of other issues effecting foreigners. This was the stuff of movies, with the owner ultimately dying in prison of cyanide poisoning, the Italian prosecutor that provided the evidence by which U.S. prosecutors could convict that owner being assassinated by the mafia, links to the U.S. Administration, etc. At the time, Franklin was the largest U.S. bank failure.

2. The regulator-regulated relationship — trust. The regulator-regulated relationship has turned full hard to distrust, suspicion, and documented supervisory action. One of the foundation stones of regulated financial services in the U.S. for most of the 20th century was an assumption that regulators knew the business, had an overriding interest to see that the business was run fairly and within the bounds of the regulations, and were devoted to getting results beneficial to consumers, businesses, and the financial services institution. That led to examiners that were on the lookout for insider dealing and embezzlement or fraud of all kinds (those kinds of individuals should not be in banking), but did not use a cease and desist order or memorandum of understanding when a strong meeting with the CEO and the Board, or a severe letter of reprimand would do the job.

   That approach has changed, and, in particular, with the coming of age of consumer regulation in the form of the CFPB, there appears to be much less interest in correcting the problem than there is in punishing the institution. The assumption, of course, is that the punishment will force the changes. Even if changes have already been made, punishment will follow since the assumption is that without the threat of punishment the changes would not have been made.

   This is a dilution of the basic glue that holds economies together — trust. We have already had that demonstrated in the Too Big To Fail debate, and the extraordinary conclusion that Congress drew that providing assistance to the banking system was a poor choice by the government in that time of severe risk to the financial system. How else would Congress suggest to take us out of the problems so quickly at what ended up being only a very modest cost to the taxpayers? Nevertheless, assisting the financial system in this way was seen as the wrong thing to do. That led to mandatory living wills, the elimination of assistance even when assistance is the best thing to do in the circumstances, and to resolutions such as the globally inspired single point of contact. It is impossible to say at this time that this change in attitude will be beneficial (that probably will not be the case), but it is a clear signal by Congress and the regulators that they no longer trust the financial services industry.

3. Technology. This is a real bear for management that is a bit long in the teeth. It is even a problem for the younger crew of managers. We have cutting edge technology in use on a regular basis by consumers and businesses of all types. One of the characteristics of that technology is

real time response. For example, someone sees a pair of shoes on sale in a shop window, they take a picture with their iPhone, compare the shoes immediately with other similar shoes available on-line, and decide to buy or not buy immediately. It is instant information that persuades sales to be made or not made.

Consumers now expect that a similar real time reaction is available from lenders, and lenders will have to decide how to provide that while still acting within the constraints of regulations that have been created with a manual system and hard mail in mind.

4. Privacy. This is becoming confusing. Various revelations about the ubiquity of electronic eavesdropping, security procedures, hacking successes, security cameras on street corners, etc., have caused a large segment of the population to rage against the absence of privacy in their lives. At the same time, a perhaps different segment has found it reasonable to have TV cameras follow them around 24/7 telecasting to millions of people anything and everything about their daily lives, and others have calmly placed on electronic devices the most intimate of material that will sit in cyber space forever. It appears as though there is no one view of privacy, and businesses will have to wend their ways through the thicket of conflicting points of view.

5. Certainty versus flexibility. In some ways, this issue arises because of the ability technology provides to accelerate decision making and decrease the cost while increasing the value to consumers and businesses. Systems permit decisions to be made on complicated questions (say a mortgage loan application) if the standards of the lender and the regulations governing the decision are clear and unequivocal. Yet, at the same time, some applications simply don't fit cleanly within the general parameters. Even though the DTI ratio may be poor, the wealth of the individual and the long standing relationship with the lender militate toward granting the loan, even if it fails to become a Qualified Mortgage.

   These kinds of decisions create exceptions to the systems, and retard the decision making process in that case. The trick is to ensure that the greatest number of cases can avoid manual underwriting and run through the system. For that, certainty is necessary and exceptions, rather in the regulations or in the standards set by the lender, add to congestion.

6. Desire for uniformity in rules. Uniform rules are nearly an impossibility in a dispersed government structure such as the one we have in the U.S. Our citizens mistrust government deeply, and fervently disapprove

of the concept of the government running our lives. That has led to a structure of layers of government that sometimes seem endless — Federal Government, state government, county and city government, district government regional compacts, village boards, homeowners associations, etc. The theory seems to be that breaking government up into small segments will prevent any one segment from controlling our lives.

But there are obvious drawbacks to that. The most obvious is the desire for each of those levels of government to have some authority over more and more areas.[3] That leads to situations in which consumers and lenders are conflicted in trying to comply with rules of the various layers. In addition, the fragmented government leads to situations in which a consumer will be treated differently on business matters depending upon where he or she lives, or works, or has a residence. In addition, they may be treated differently in a financial transaction depending upon the size of the bank with which the consumer does business, since in some cases protections which the Federal Government believes are essential to protect consumers are not enforced against smaller lenders.

Uniformity makes so much sense from the perspective of simple fairness to consumers. Whether they live in one state or another, they should be able to get comparable products at comparable prices and with comparable protections against illegal activity. Do we really need multiple chartering authorities for banking entities in our technology-driven economy, one that really ignores state or regional boundaries?

Uniformity of regulations, or the lack of it, remains an issue.

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[3] Paraphrasing Robert Kaplan in Balkan Ghosts — the natural borders are seen by each state as those of their greatest historical expansion.