



U.S. Congressional Midterm Elections: Implications for Financial Services

November 8, 2010

Midterm Elections Offer Breathing Room for Financial Services Industry

Economic recovery will undoubtedly be the primary focus of both the U.S. Congress and the Obama Administration in 2011. As financial services issues are inextricably tied to stability and growth, they likewise will remain the subject of much debate. Yet, as is normally the case with divided government in America, debate does not equal action.

The Dodd-Frank financial reform law calls for approximately 200 new regulations and 100 reports to Congress. However sweeping that legislation was, it did not address reform of the two major government-sponsored enterprises, mortgage giants Freddie Mac and Fannie Mae. Underlying their conspicuous absence are the substantive and political challenges surrounding any debate over their futures. Nevertheless, their immense importance to both consumers and the financial markets virtually ensures that they will be at the top of the legislative agenda.

The remaining items on the legislative docket will vary widely from the House to the Senate. While the Senate remains in Democrats' hands, Senator Tim Johnson of South Dakota is slated to ascend to the chair of the Banking Committee. Because of his friendlier relationship with the financial industries, it is possible that at least some of the many new regulations will receive closer scrutiny. In the House, however, future leadership of the Financial Services Committee is yet unclear. It is entirely possible that current ranking minority member Spencer Bachus will be passed over in favor of Ed Royce, or even Scott Garrett, to head the panel. Whoever wields the gavel is likely to preside over countless oversight hearings and investigations into the Dodd-Frank law.

Absent new events, the above-mentioned political realities will most likely yield little in the way of major concrete advances or reversals. Of course, many corporations will find that an issue that is of relatively minor importance to the economy is an enormous concern to its own well-being. For those who seek to maintain the status quo, the key will be to stay actively engaged and watchful. And for those who seek legislative action, it will be critical to navigate the shoals of gridlock carefully to achieve their aims.



Trish Wexler
Senior Vice President, VOX Global

LEGISLATIVE AGENDA

Oversight of the Dodd-Frank Wall Street Reform and Consumer Protection Act

“I don’t think that major changes will take place on Dodd-Frank... It’s a matter of minor changes taking place. There is not only resistance from the Senate, but the veto is possible, too. So we should focus on realistic solutions to our problems.”

--Sen. Tim Johnson (D-SD)

After the midterm victories, Republicans have vowed “vigorous” oversight of the Dodd-Frank law, though prospects for repeal or any major revisions are considered to be low. First, oversight hearings are anticipated for all key players involved in writing the hundreds of rules mandated by Dodd-Frank. It is expected that individuals from the Treasury, the Federal Reserve Board, the Commodities Futures Trading Commission, the Federal Deposit Insurance Commission, the Securities Exchange Commission

and others will be called to Capitol Hill for questioning – a process which in and of itself can shape the rulemaking process.

The first lawsuit related to the bill has already been filed, challenging provisions governing debit card interchange fees. Many more lawsuits can be expected. Outside the Financial Services Committee, members may also seek to affect Dodd-Frank by restricting funds required for implementation, a fairly common tactic for halting regulations.

Finally, some Republicans on the House Financial Services and Senate Banking committees have also indicated their intent to introduce a “technical corrections” bill, or a series of smaller bills that repeal or amend specific sections of the law.

The following are likely focal points for attempts at legislative action related to the Dodd Frank law:

Volcker Rule

The “Volcker Rule” restricts larger insured banks from trading on their own accounts, and from owning or investing in a hedge fund or private equity fund. It also limits the liabilities that the largest banks can hold. Republican leaders are concerned that this rule undermines U.S. competitiveness and will cut profits of the largest banks – further stifling the economic recovery. The speed with which these new leverage limits would be implemented – years ahead of the 2019 deadline outlined in Basel III, the global financial regulatory reform guidelines – is also a concern of Republicans due to the prospect of capital flight to foreign companies with more lenient leverage limits. We expect Republicans to encourage the Federal Reserve to make changes to the Volcker Rule.

Derivatives Provisions

The derivatives reform provisions of Dodd-Frank lost a key ally in the elections, Democratic Senator Blanche Lincoln. The provisions, which will require most routine swaps to be traded on exchanges and routed through clearing houses, are expected to be an early target of Republicans looking to rewrite Dodd-Frank – particularly now with Lincoln no longer in the Senate. Representative Spencer Bachus, considered the front runner candidate for chairing the House Financial Services Committee, has been highly vocal in his desire to rewrite these rules. Bachus may look to carve out exemptions to the rules so they better mirror the Volcker rule, allowing banks to carry on derivatives trading outside of the exchange and clearing requirements, so long as the financial services firms have customers that use derivatives in their businesses.

LEGISLATIVE AGENDA

Resolution of Systemically Important Financial Institutions (SIFIs)

“With a business background I understand the importance of a limited, functional federal government that allows business to thrive. It is time to change the message coming from Washington and provide business with a modicum of certainty.

--Rep. Ed Royce (R-CA)

Dodd-Frank sets forth “resolution” plans – a new way for the government to dismantle large nonbank financial firms considered systemically important, or “too big to fail,” that are on the brink of collapse. Many Republicans, including Bachus and fellow committee member Representative Ed Royce, would like to repeal this provision as they believe it provides preferential treatment for larger financial institutions and their creditors. Specifically, they believe that creditors of large institutions will perceive a lower risk of investing

here, placing smaller institutions at a distinct competitive disadvantage.

Royce has proposed that, rather than a traditional bankruptcy model, the FDIC should be forced to estimate at the outset of a resolution what a creditor would have gotten in bankruptcy, then impose an additional haircut of 20% as a form of insurance against writedowns. After a resolution is complete, the FDIC would have leeway to pay back all or part of the 20% premium.

Consumer Financial Protection Bureau (CFPB)

This new independent agency has drawn significant fire from the GOP and was often used as a key example of government overreach in rhetoric leading up to the midterm elections. In practice, however, even the most conservative of Republicans on the Financial Services and Banking committees agree that this agency has a role in protecting consumers and should not be dissolved altogether.

Representative Jeb Hensarling, considered one of the more conservative leaders of the House Financial Services Committee, has argued for significantly reducing the power of the CFPB, and removing any authority that “smacks of wage and price controls.” He is, however, not opposed to the consumer communication role of the agency, should these communications take the form of increased disclosures, transparency and information for consumers to help them make more informed decisions.

Royce’s concerns with the CFPB centers around the bifurcated nature of the regulators. He argues that the CFPB does not have to take institutions’ safety or soundness into consideration when writing their consumer “protection” rules. Representative Darrell Issa (R-CA) is expected to take over the House Oversight Committee. Issa has vowed to hold hearings on the CFPB — and specifically, on the appointment of Elizabeth Warren to set up the new agency.

“We don’t need a CFPB. That would be a great first step for this administration if they want to start showing how they are willing to work with us, to say that, ‘We recognize the failure that this doesn’t do anything to address the problems so let’s start unwinding that.’”

--Rep. Scott Garrett (R-NJ)

LEGISLATIVE AGENDA

Interchange Fees

The so-called “Durbin amendment” in the Dodd-Frank Act puts the Federal Reserve in the position of determining a “reasonable and proportional” rate for interchange fees charged on debit card acceptance by merchants. Last month, the first law suit against Dodd-Frank was filed on the subject of the Durbin amendment, calling it unconstitutional and anticompetitive – something Capitol Hill is likely to watch closely. Like all other provisions in Dodd-Frank that put the federal government in the role of setting prices for the free market, the GOP is expected to look to amend this provision.

Government-Sponsored Housing Finance Reform

“I have legislation that over a five-year period would transition Fannie and Freddie back into a competitive market. It is certainly a bill that I will be pushing even harder in the next Congress and working with other like-minded individuals in trying to get that done.”

--Rep. Jeb Hensarling (R-TX)

Reforming mortgage finance and determining the future of government-sponsored entities Fannie Mae and Freddie Mac is one of the most significant issues not addressed in the Dodd-Frank law, and one where there exist broad differences between and within. Because broad economic recovery will likely not occur until housing and finance issues are addressed, it is expected that House and Senate banking committees will focus a good deal of time in addressing this unresolved issue. Both parties are in agreement that reform is necessary – but have different policy prescriptions for solving the

same issue. Consensus will be required to be successful on this front, but highly challenging in a divided Congress.

As mandated by Dodd-Frank, the Obama Administration is required to put forward a plan for the future of housing finance, and has promised to roll out its plan for proceeding with an overhaul of Fannie Mae and Freddie Mac in January 2011. To date, the Treasury Department has remained relatively silent on its plans. But recently, even outgoing House Financial Services Committee Chairman Barney Frank agrees that Fannie and Freddie should be eliminated and replaced with another structure. Other current and former administration officials have also hinted that an explicit guarantee of private mortgages may not be the most appropriate approach.

In the Senate, presumptive Senate Banking Committee Chairman Tim Johnson has indicated that he wants to take the issue slowly so as not to destabilize housing markets further or make homeownership unaffordable while doing so. A deliberate process is anticipated in this chamber.

In the Republican-controlled House, the GSE Bailout Elimination and Taxpayer Protection Act of 2010 is expected to be the Republican starting point next year. The bill, sponsored by Representative Jeb Hensarling and co-sponsored by many Republican leaders on the House Financial Services Committee, would result in elimination of the GSEs by winding down their portfolios over time and slowly increasing their capital requirements to have the private market take over this function over the next five years. There is also a desire to strengthen the Federal Housing Administration to ensure it is financially and actuarially sound enough to serve as a social safety net for elderly, disabled, and young homebuyers. In the end, however, it is unclear if all Republicans would support a complete separation of the government from the mortgage market, so the more conservative Republicans may need to compromise on this principle.

LEGISLATIVE AGENDA

Foreclosure Prevention

“I would like to see some greater oversight into the foreclosure programs...The effectiveness, the money, where it is and what it’s being used for – that to me is a big issue.”

-- Shelley Moore Capito (D-WV)

Republicans want to take a closer look at the Obama Administration’s foreclosure prevention policies. The Congressional Oversight Panel, commissioned in 2008 to oversee the administration’s financial rescue-related programs, has been highly critical of Treasury’s efforts to date. We expect Republican members of the House Financial Services Committee to hold hearings to influence and shape these policies.

Bank Tax

Earlier this year, the Obama administration had proposed a “crisis responsibility fee” on banks with assets exceeding \$50 billion to collect around \$90 billion over 10 years in order to recoup taxpayer losses from the Troubled Asset Relief Program (TARP) payments of 2008. The provision was ultimately not included in Dodd-Frank and discussions of late have diminished significantly, even prior to the election, as estimates of the costs of the 2008 TARP program have declined. Key members of both committees – including Senator Tim Johnson – have said publicly that they think it is “highly unlikely” that this tax on banks will be considered in the next Congress.

Repealing Ban on Internet Gambling

The changing of the guard in the House reduces the prospect of repealing the ban on internet gambling, which had been gaining momentum under the leadership of Chairman Frank, a champion of legalizing online gambling. This is a measure that has traditionally been supported by Democrats, looking to tax, register and license internet gambling. The prospects also had support from libertarians and free market Republicans. But traditionally, Republicans have supported a ban with Representative Bachus one of the most vocal opponents of internet gambling. While the next Speaker of the House, John Boehner, has indicated that while he wants to stop the spread of illegal gambling, he does believe gambling for entertainment in moderation is acceptable and that he generally opposes government interference on the internet.

U.S. HOUSE 2010

Financial Services Committee

The week of November 15-19, Republicans and Democrats will meet in their respective caucuses to elect their leadership and committee chairmen, and possibly even make member appointments. Once the committees are assigned, the House Financial Services Committee will have a very different composition as a result of the midterms. Of the 42 Democrats on the committee, 11 lost their seats, while each of panel's 29 Republicans who sought reelection won handily. Two other committee Democrat races remain undecided – and are expected to remain undecided for some time. With the new Republican majority, the party ratio will essentially reverse. As a result, there will be approximately a dozen newly-elected Republicans on the panel. Conversely, there will be very few, if any, new Democratic members. Below are the leading candidates for chairman of the House Financial Services Committee and its subcommittees:

Spencer Bachus (R-AL)



- As the senior Republican since 2006, Bachus is the presumptive frontrunner to lead the Financial Services Committee.
- He has been a harsh and vocal critic of bailouts, economic stimulus bills and current housing finance policy.
- More recently, he promised to “shut down” mortgage finance giants Fannie Mae and Freddie Mac, launch investigations and end the bailouts that are keeping them afloat.
- Bachus has also indicated his desire to repeal the provision in the Dodd-Frank law that calls on the government to seize and liquidate systemically important financial firms outside of bankruptcy.
- Bachus is also focused on derivatives provisions in the new law that carry new capital requirements estimated to take as much as \$1 trillion out of the U.S. economy. Calling it a “job killer,” he has stated, “Not all derivatives need to be traded on the exchanges... It’s not good for manufacturing or other Main Street industries.”
- He has voiced concerns with the governance and leadership of the Consumer Financial Protection Bureau (CFPB). While not advocating for total repeal, he believes a commission rather than a single person should manage it. He may also seek budget cuts for the CFPB.
- Bachus ultimately voted against the Dodd-Frank Act – but some Republicans feel he did not go far enough in his efforts to halt this legislation. This may present a challenge to his candidacy.

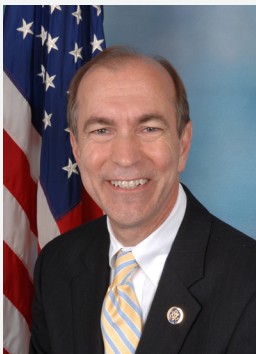
Ed Royce (R-CA)



- Post-election, Royce announced his intent to challenge Representative Bachus for the committee chair.
- He is widely considered a rising star on the committee and expected to play a leading role, as either chairman of the committee or a key subcommittee.
- He is a longtime credit union industry champion, and a chief advocate of legislation to create an optional federal insurance charter.
- Royce’s focus for 2011-2012 will be addressing perceived problems with the Dodd-Frank Act including rules affecting “systemically important” entities, the competitive impact of the Volcker rule and the overreach of the Consumer Financial Protection Bureau.

U.S. HOUSE 2010

Scott Garrett (R-NJ)



- Garrett serves as the senior Republican on the House Financial Services Capital Markets Subcommittee, which oversees GSEs Fannie and Freddie. This experience will be critical in the 2011-2012 session, because mortgage reform is a legislative priority for both parties.
- Garrett has proposed establishing a legal framework for a covered bond market in the United States as an alternative to securitization, which would provide mortgages and other forms of credit. Last year, he fought unsuccessfully to include his legislation in the Dodd-Frank law.
- Garrett wants to repeal the Consumer Financial Protection Bureau, and disagrees with how Dodd-Frank handles systemic risk.
- Garrett's close relationship to the next Speaker of the House, John Boehner, is expected to enhance his chances.

Jeb Hensarling (R-TX)



- Hensarling is one of the committee's most outspoken and conservative members.
- Hensarling's goals for the committee include full privatization of the government sponsored mortgage finance system, and overhauling the Dodd-Frank law.
- Currently he is the senior Republican on the committee's Financial Institutions Subcommittee.
- Hensarling is running to become chairman of the House Republican Conference which would make him the fourth ranking Republican leader in the House and likely impact his actions on the Financial Services Committee.

Ranking Member

Outgoing Chairman Barney Frank (D-MA) will lose control of the Financial Services Committee but remain the senior Democrat on the panel. Number two Democrat Paul Kanjorski (D-PA) lost his reelection battle, paving the way for Maxine Waters (D-CA) to have her pick of subcommittee on which to serve as ranking Democrat.

U.S. SENATE 2010

U.S. Senate Committee on Banking, Housing and Urban Affairs

Tim Johnson (D-SD)



- Since Senator Chris Dodd (D-CT) announced his retirement intentions last fall, Johnson has been groomed to take over the chairmanship of the Senate Banking Committee, and remains the heir apparent.
- Johnson is more conservative than Dodd and represents a state with a significant number of financial services jobs – community banks, credit unions, and a large financial institution employ tens of thousands of South Dakotans.
- Johnson has indicated that his key priority for this Congress is oversight of the Dodd-Frank law, and to expect “minor tweaks.”
- Johnson has vowed to take housing finance reform slowly and cautiously so as not to destabilize the housing or mortgage markets.

Charles Schumer (D-NY)



- While several media reports have suggested that Schumer may lead the panel, it is highly unlikely that Johnson will be passed over. Regardless, the outspoken Schumer will undoubtedly continue to play a leadership role on this Committee.
- Schumer represents a significant financial services employee base in his state. While he is a liberal Democrat who enjoys ample media attention, he notably did not take a leadership role – and remained relatively silent – during the Dodd-Frank law’s debates.
- Schumer has pushed legislation that would force China to devalue its currency, and may seek a vote on this legislation during the lame duck session. Should time expire, it is expected that this will be a priority for Schumer in 2011.

Ranking Member

Senator Richard Shelby (R-AL) is expected to continue as the senior Republican on the Committee.