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FINANCIAL SERVICES REGULATORY REFORM UPDATE

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As expected, the House failed to pass a "clean" bill on Tuesday that would have raised the debt ceiling by $2.4 trillion, by a vote of 97-318. In a rare occurrence, but one that perfectly encapsulated the theatrics of this debate, the sponsor of the measure, House Ways and Means Chairman Dave Camp (R-MI) introduced the bill *and simultaneously announced his opposition to it,* because it failed to include spending cuts to accompany the debt ceiling increase. Notwithstanding the illogical result of an author of a piece of legislation complaining that it lacked certain provisions, the vote was pure political theater intended to provide conservative freshman cover for a later vote to raise the debt ceiling. That said, it is entirely probable that many of these freshman will not be willing to take a "Kerry-esque" "against it, before they were for it" vote, and it is also unclear how many Democrats will be willing to resist the political appeal of letting the vote go down on the lack of tea party support. As we draw closer to the August 2nd date, we should expect more gamesmanship as both sides attempt to extract as much political "juice" from the issue while simultaneously engaging in a game of chicken with dramatic ramifications for the nation.

Evidence of this could be seen in the fact that despite efforts by Camp and others in the Republican leadership to assuage markets that this vote was not indicative of Congressional intent to fail to raise the ceiling, the Dow dropped 280 points the day following the vote. Then on Thursday, Moody's Investors Service warned that the country will lose its top credit rating (from Aaa to Aa) if the U.S. defaults on its debt. Even if default wasn't to occur, Moody's indicated that still might lower its "outlook" rating to negative unless substantial steps are taken in reducing the deficit. While Republicans viewed this announcement as affirmation for spending cuts, Moody's analysis was primarily focused on the short-terms risks of failure. Noting that, "the degree of entrenchment into conflicting positions has exceeded expectations" and "heightened polarization over the debt limit has increased the odds of a short-lived default." Standard & Poor's previously downgraded its outlook on the U.S. credit rating to negative in April.

Meanwhile, Vice President's closed-door working group of legislators is "making progress," according to House Speaker John Boehner (R-OH), though it appears that Boehner is now attempting to insert himself directly into the conversation. In a statement on Thursday, Boehner said that "Eric Cantor is doing an excellent job representing us in those talks, but the White House needs to step up." He called on President Obama to meet with him and other congressional leaders in order to reach an agreement within a month. With the Speaker and the President announcing late on Friday that they will be hitting the links on the 18th of June, perhaps "a 19th hole agreement" can be reached that will put this issue to bed before July.

In other news this past week, while many groups and organizations in the US are criticizing federal financial regulators for their great haste in implementing the Dodd-Frank rules, a European official came out this past week in favor of a *speedier* execution, so that the U.S. might catch up to its EU counterparts. In doing so, European Commission Michel Barnier also questioned the United States' commitment to Basel II, which was passed back in 2006. He believes the U.S. "leaves too much latitude for financial institutions" and allows them to "circumvent globally-agreed principles."

This past week was relatively light with the Senate in recess but the House in session. Although that schedule flip-flops next week, we continue to anticipate another relatively light week on the Hill and the Administration.

FED GOVERNOR PROVIDES INSIGHT INTO FSOC'S THINKING ON SIFIS APPEARS THAT REGS WILL BE SET UP TO DISCOURAGE MERGERS OF SIFIs

In a speech Friday in Washington, D.C., Federal Reserve Governor Daniel Tarullo stated that federal regulators should mandate capital surcharges as a means of disincentivizing mergers by systemically important financial institutions ("SIFIs"), in cases that would increase risk without yielding substantial public benefits. Specifically, he stated that "There is little evidence that the size, complexity, and reach of some of today's SIFIs are necessary in order to realize achievable economies of scale… The regulatory structure for SIFIs should discourage systemically consequential growth or mergers unless the benefits to society are clearly significant." Tarullo is the Fed governor in charge of supervision and regulation, and he added that the Fed is currently working on a metric that would apply to banks with more than $50 billion in assets, and would gradually increase capital standards according to measures of systemic importance including size.

In his speech, Tarullo also contested the idea that these heightened capital requirements are a form of punishment for large firms, or that identifying the largest firms would increase moral hazard. Tarullo stated that there is "little if any research" showing that the biggest banks need their magnitude in order to achieve economies of scope and scale. He added that "moral hazard is already undermining market discipline on firms that are perceived too-big-to-fail."

He also provided some insight into the FSOC's thinking on the different approaches under consideration for identifying the additional capital levels SIFIs will be responsible for meeting. Based on the speech it appears that one of them, dubbed by Tarullo as the "expected impact" approach, is having the most influence on Fed staff so far. This approach seeks to impose capital requirements based on assumptions about the costs to the economy of the failure of both a designated mega-bank and a smaller bank. As Tarullo said, "if the loss to the financial system from the failure of a SIFI would be five times that resulting from failure of the non-systemic firm, then the SIFI would have to hold additional capital sufficient to make the expected probability of failure one-fifth that of the non-SIFI." It was unclear from his remarks if Tarullo, the Fed, or the FSOC intend to apply this rule across the board on all SIFI's or just certain institutions. Obviously applying this type of capital requirement on the non-bank financial institutions that receive SIFI designations would be a game changing event to their business models.

Finally, in a direct attack on a concept that is gaining strength in Europe, he stated that international financial regulators should not allow contingent convertible bonds to meet additional capital requirements.

SENATE ON THE VERGE OF ADDRESSING AMENDMENT TO DELAY IMPLEMENTATION OF INTERCHANGE RULE

Sen. Jon Tester's (D-MT) amendment to delay implementation of the Federal Reserve rule on debit interchange fees by 15 months could be addressed as soon as this coming week. Reportedly, Tester will offer the amendment this Wednesday, June 8th during a debate over a bill to fund the Economic Development Administration. Tester's amendment, which has been modified since it was first drafted in an effort to gain more support, would delay the rule's implementation by 15 months, and require federal financial regulators to perform an additional study on how to best implement an interchange fee. Despite these changes, it is unclear whether Tester has enough votes to pass the 60 vote threshold necessary for passage.

As has been widely reported, the "Durbin Amendment" required the Fed to issue a rulemaking on this subject, and in December the Fed released a draft rule, which is scheduled to go into effect in July. That rule would limit interchange fees to no more than the issuer's allowable costs divided by the number of electronic debit transactions on which the issuer received or charged an interchange fee in the calendar year. Alternatively, the issuer could receive debit interchange fees capped at 12 cents per transaction.

If the vote were to come up and fail, it is unclear what immediate next steps the banks would be able to take in their fight against this rule.

CFTC ANNOUNCES MEASURE TO PROIDE LEGAL CERTAINITY TO REGULATED INSTITUTIONS IN LIEU OF FINALIZED RULES BY THE JULY DEADLINE

On June 2nd, CFTC Chairman Gary Gensler announced that the agency will be issuing a preventative measure to protect derivatives users from legal issues and uncertainty before the July 16th deadline to enforce certain Dodd-Frank requirements. This measure will apply to "harmless" regulated institutions subject to derivatives rules. Gensler said the CFTC is "looking at how to, in essence, give the market certainty. It might be even considered as interim relief."

Gensler announced the preventative measures at the National Association of Corporate Treasurers' 2011 National Conference, where he also rejected the congressional plan to delay implementation of portions of the Dodd-Frank derivatives regulations. Both the House Financial Services and House Agriculture committees have passed legislation to delay the Dodd-Frank rulemakings at the CFTC, but the measure is not expected to move in the Senate. Gensler also said that legislative action is not necessary and that regulators have "have ample latitude within the statute to address any July 16 issues" that may arise. For example, the CFTC is working to determine which portions of the statute require rulemaking and which portions are "self-effectuating." Gensler implied that the self-effectuating portions of the statute would not require CFTC action in order to have the power of final rules. Finally, Gensler said that the CFTC has consulted with the SEC on the possible options the agencies can take to provide relief to those affected by derivatives rules.

CFPB PUBLISHES LIST OF RULES FROM OTHER AGENCIES THAT WILL NOW BE THE RESPONSIBILITY OF THE CFPB

On May 31st, the Consumer Financial Protection Bureau (CFPB) published for public comment a list of rules, currently under the purview of other agencies, for which the CFPB will be responsible effective July 21st. Although the CFPB was not required by statute to release the list for comment, it noted that it was doing so in favor of transparency. The final list of rules and orders will be published on or before the transfer date. The CFPB has consulted with all the agencies from which it will be taking over regulatory authority, including the Fed, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), NCUA, Federal Trade Commission (FTC) and the Department of Housing and Urban Development (HUD). The full list is available in the Federal Register, but includes rules on: adjustable rate mortgages, truth in lending activities, home mortgage disclosure and, what we anticipate to be an area of heavy lobbying, regulations related to the privacy of consumer financial information.

LAWMAKERS CONTINUE TO PRESS URGE REGULATORS TO LESSEN POTENTIAL REGULATORY BURDENS ON SECURITIZERS OF HOME LOANS

On May 31st, one hundred and sixty-eight members of the House signed on a letter urging financial regulators to exempt home loans with lower down payments from new risk retention requirements if the loans are backed by private mortgage insurance. The letter was addressed to the SEC, the Fed, FDIC, FHFA, the OCC and HUD.

The letter marks the most recent effort by Congress to persuade regulators to reassess a March proposed rule that requires sponsors of mortgage backed securities to retain credit risk on their balance sheets while exempting qualified rate mortgages ("QRM") from the risk retention requirements. Lawmakers, facing substantial lobbying efforts by those impacted by this rule, which includes such strange bedfellows as civil rights groups and banking interests, used this letter to urge regulators to broaden the definition of a QRM to include loans with lower down payments that are privately insured. Members argue that the current proposal, while it provides for FHA insurance, crowds out private insurers.

Previous efforts by Congress also included strong suggestions that the intent of the risk retention provision of Dodd-Frank does not require a QRM to maintain a 20 percent down payment by the borrower, a point which was also addressed in this most recent letter.

HEAD OF EU BANKING REGULATION CRITICIZES U.S. REFORM AGENDA

Ahead of a visit to Washington to meet with Treasury Secretary Geithner, Michel Barnier, the EU Commissioner in charge of financial markets, sent a letter to the Secretary expressing concerns over the pace of U.S. banking regulation. As the Financial Times splashed across a headline above the fold, Barnier said that Brussels was moving faster than the U.S. in several key areas and that the U.S. must work quickly to tighten its banking rules. Barnier specifically mentioned capital requirements for banks and executive pay limits as areas where the EU will see a competitive disadvantage if the U.S. does not act soon. The letter said that "'bankers' bonuses' is a matter that continues to cause public outrage" and that "getting this matter right is key to restoring our citizens' confidence in the financial system—and ultimately their confidence in the public authorities regulating the financial institutions."

The letter also highlighted concerns that the U.S. is uncommitted to Basel Commission implementation. While the EU implemented Basel II in 2006, the U.S. has yet to fully implement the standards. In regards to Basel implementation, Barnier said that the notion of a "level playing field must be a reality, not an empty slogan." Barnier was expected to push Geithner on implementation and compliance with Basel III at their meetings this week.

In response, the U.S. Treasury released guidance on Secretary Geithner's schedule of meetings with Mr. Barnier. The guidance says that the two officials will "discuss the United States' intense focus on making certain that all key financial centers live up to the G-20's commitments on central clearing and trading of derivatives." As the U.S. is farther along in implementing derivatives rules than the EU, the Financial Times reported this guidance as a "veiled counterattack" against the concerns in Mr. Barnier's letter. The guidance also said that Geithner will "underscore the U.S.'s continued commitment to implementing our Basel agreements rigorously and on the agreed timelines, and our firm expectation that others do the same."

UPCOMING HEARINGS

During the week of June 6th, the Senate will be back in session, but the House of Representatives will be in recess until the week of June 13th. Very few financial services hearings are schedule in the meantime.

On Tuesday, June 14th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Institutions will convene a hearing on "too big to fail."

On Tuesday, June 14th at 2pm, in 2128 Rayburn, the House Financial Services Subcommittee on International Monetary Policy and Trade will hold an oversight hearing of the World Bank and multilateral development banks.

On Wednesday, June 15th at 10am, in 2128 Rayburn, the House Financial Services Committee will hold a hearing to receive the Treasury's annual report on the state of the international financial system. Treasury Secretary Timothy Geithner is expected to testify.

On Thursday, June 16th at 10am, in 2128 Rayburn, the House Financial Services Committee will meet for a hearing on international financial regulatory coordination.

On Thursday, June 16th at a time TBD, in a location TBD, the House Appropriations Subcommittee on Financial Services and General Government will mark up draft legislation that would make fiscal 2012 appropriations for departments, agencies and programs under its jurisdiction.

On Thursday, June 23rd at a time TBD, in 2359 Rayburn, the House Appropriations Committee will mark up draft legislation that would make fiscal 2012 appropriations for programs related to financial services.

On a date TBD, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit will hold a hearing on the Small Business Lending Fund (originally scheduled for April 6th).

On a date TBD, in 2128 Rayburn, the House Financial Services Committee will hold a hearing on an independent study conducted by the Boston Consulting Group on a proposal to overhaul the Securities and Exchange Commission. (Originally scheduled for June 3rd).