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Reg Reform Debate Pulls Fed into Unfamiliar Fight

By Steven Sloan, American Banker

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WASHINGTON — Congress has opened a new front in the battle over federal preemption — just as lawmakers reached a compromise on the original question.

A little-noticed provision offered by House Financial Services Committee Chairman Barney Frank would prevent the Federal Reserve Board or a systemic-risk council from overriding state or federal consumer protection standards — a move some said could have punishing consequences in the future.

The proposal is buried in a nearly 250-page manager's amendment the Massachusetts Democrat attached to the regulatory reform legislation being considered by the House this week.

"This is very much entwined with the larger debate" over preemption, said Karen Shaw Petrou, the managing director of Federal Financial Analytics Inc. "It seems to be an effort to close a potential back door for federal preemption."

Because of procedural rules, it is often difficult to fight individual provisions in a manager's amendment, but industry representatives said they will oppose the measure.

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The compromise on the Fed's powers "is anti-preemption on steroids," said Scott Talbott, the top lobbyist at the Financial Services Roundtable. "It means that the certainty and efficiencies created by one uniform national standard is gone."

In an interview, Frank said regulators could work any potential issues out. "They all work for the same administration," he said. "If all the bank regulators thought something was a problem, they could step in. But I don't think the consumer protection agency has that kind of power to tell them what to do."

The Fed would not comment on the provision, which consumer advocates said would force banking regulators to work more closely with the proposed Consumer Financial Protection Agency that would be established under the legislation.

Lawmakers are "looking to see greater collaboration between the Fed and other players and the CFPA," said David Berenbaum, executive vice president of the National Community Reinvestment Coalition.

Debate over regulatory reform began in the House late Wednesday after lawmakers agreed to a compromise on the broader preemption question put forth by Rep. Melissa Bean, D-Ill. Under the deal, the Office of the Comptroller of the Currency could preempt state consumer protection laws by simply issuing a letter or ruling

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Receiving far less attention is the ability of the Fed or a systemic-risk council to overturn consumer protection rules that are deemed to pose systemic risk. In part, that is because there is debate over whether a consumer issue can present a risk that threatens the broader economy.

"It can certainly result in the failure of an institution," said Gil Schwartz, a former Fed lawyer now working in private practice. "But it's hard to imagine a consumer regulation that rises to the level of a systemic risk."

Others disagree, and point to a 1989 California law that allowed homeowners to purchase a home and pay the same mortgage rate as the previous owners.

"They overrode contracts," Talbott said. "Banks had losses and they piled up until it was overturned."

Critics have also cited affordable housing criteria for the government-sponsored enterprises that required Fannie Mae and Freddie Mac to make loans to low- and moderate-income consumers. When the housing crisis hit, many of those loans added to losses at the enterprises, which eventually had to be seized by the government.

The provision underscores the friction that could result if the Fed has to work in close quarters with the CFPA. The Fed would likely have the weaker hand if it is unable to block CFPA moves that the central bank thinks could cause broader economic turmoil, observers said.

"What this says is the CFPA should ignore the Fed," said Mark Calabria, a former Republican Senate aide who is now the director of financial regulation studies at the Cato Institute. "If you have these systemic-risk issues, why would you be telling the regulator not to care?"

Other industry representatives also expressed concern that Frank's provision could embolden states to enact laws that would prevent banks from discriminating against unemployed borrowers or those with low credit scores. In those instances, however, Schwartz said the Fed might be able to use its power as a safety and soundness regulator to order a stop to such lending.

"What the banking agencies would do is tell the banks to just not make those loans," he said. "They can suggest to the institution that it would be improper to take that risk and make that loan."

Berenbaum downplayed such a scenario, and said there should not be a conflict between consumer lending and a bank's safety and soundness.

"Central to all lending is that it be safe and sound and be done in a way that's sustainable," he said. "Strong consumer protection equals safe and sound lending."

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