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Washington Policy Flash Note

Top Five Financial Policy Takeaways from Client Meetings

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We spent the bulk of last week on the road meeting with clients to discuss political risk trends, the state of legislative efforts on Capitol Hill, and regulatory priorities in 2013. We have included our top 5 takeaways from these meetings. In almost every single meeting, the mood was positive and the conversations were decidedly more issue-specific than the macro-focused discussion we had throughout 2011 and 2012. While this was an encouraging trend, we left this trip concerned that the market was discounting the likelihood of political risk reemerging in Q1 2013.

Our top 5 takeaways from these meetings were: (1) Consensus expectations are that D.C. will broker a last minute deal on the sequester and government shutdown; (2) Bank-focused investors had markedly less regulatory concerns than they did last year; (3) Every single client asked about how the recent NLRB ruling could impact the CFPB; (4) Student loan dischargeability in bankruptcy is still one of the top concerns for education lending investors; (5) Our mortgage-focused discussions were largely optimistic and forward-looking, not macro-focused as they were in prior meetings. Please see below for a more detailed accounting of these issues.

Wall Street Expects D.C. to Avoid Sequester and Shutdown...We Disagree

In these meetings, we focused attention on the upcoming calendar (see below) in order to highlight potential political potholes ahead. Specifically, we noted that the fiscal cliff deal and the debt ceiling punt have allowed markets to enjoy a well-deserved break from needing to focus on political brinkmanship. That, we believe, will change shortly after the State of the Union Address. The State of the Union is followed, in short order, by the budget sequester deadline on March 1 and the end of the most recent continuing resolution (CR) on March 27. We believe that the budget sequester will go into effect and that a government shutdown is likely at the end of March. The budget sequester - $85 billion in automatic budget cuts – is truly a microcosm of the larger budget wars that have been waging in D.C. in recent years. Neither side wants the sequester to go into effect but there are core differences in how to handle it. Democrats want to raise more revenue (e.g. higher taxes and close loopholes) while Republicans want to slash government spending (e.g. cuts to entitlement programs). Instead of seeking compromise, the two sides spend day after day trying to pin the negative repercussions of inaction on the other side. This is governing in the modern age. When detailing our thoughts about the upcoming political risk calendar, we found that about half of our clients believed the budget sequester would be avoided with a last minute deal. More surprisingly, only one of the clients believed there would be a government shutdown.

To be sure, these risks are not as impactful as triggering the fiscal cliff or the debt ceiling could have been. Still, we found it incredibly noteworthy that the consensus remains that D.C. will continue to broker last minute deals to avert financial calamity. We disagree with consensus at this juncture because, by punting the debt ceiling, House Republicans choose the sequester and the government shutdown as their battleground. We have yet to see any indication that there will be a compromise on these issues in advance of their respective deadlines.

Upcoming Political and Economic Calendar		
February 12, 2013	State of the Union Address	
March 1, 2013	Budget sequester starts (new date set by fiscal cliff deal)	⬅ Spending Fight
March 19-20, 2013	FOMC meeting (includes Bernanke press conference)	
March 27, 2013	Federal government's stop-gap spending measure expires	⬅
April 15, 2013	Budget resolution deadline; Congressional pay suspension without action	
April 30 - May 1, 2013	FOMC meeting	
May 19, 2013	Debt ceiling suspension ends	
June 18-19, 2013	FOMC meeting (includes Bernanke press conference)	
Late July - Early August 2013	Extraordinary debt ceiling measures exhausted	

Source: Federal Reserve, BLS, Reuters, CQ, GPO, Compass Point

Bank-Focused Investors Had Very Few Regulatory Concerns vs. 2012

Our initial financial policy marketing trip of 2012 was also in early February and coincided with the announcement of the AG/Servicer settlement. A number of the same clients we met both in February 2012 and February 2013 made a point of noting how different the regulatory landscape is for the banking industry one year later. In 2012, the industry faced the introduction of new capital rules, the full authority of the CFPB with a Director, continued mortgage repurchase requests, the implementation of living wills, the stress test, the aforementioned AG/Servicer settlement, and continued mortgage policy uncertainty.

Let there be no doubt, bank investors did not feel out of the regulatory woods but seemed to feel far more comfortable quantifying and compartmentalizing regulatory risk. For example, proposed rules were released last summer to implement Basel III. While there are still questions to be answered (e.g. will there be a community bank carve out?), the bulk of the rule will be consistent with the proposal and will be finalized in 2013 for implementation to begin in 2014. Another example of this trend is in regards to mortgage putback claims. Consistently throughout our meetings, bank investors noted their belief that GSE putback claims were no longer a primary concern while private-label putbacks were admittedly still a tail risk (but not nearly as amorphous a concern as they were over the past few years). This shift was detailed in our August 2012 mortgage putback note.

We were posed questions about the upcoming stress test, efforts to curb Too-Big-to-Fail, the Volcker Rule, and the CFPB's efforts to standardize overdraft protections. The stress test was the most asked about among these questions. We noted our belief that the Federal Reserve is committed to ensuring that the stress test fulfills its primary goal: foster systemic confidence in the nation's largest banks. This belief was reinforced by the Fed's change in the stress test process for 2013. As the Fed explains: "In a change from prior years, following the Federal Reserve's assessment of the initial capital plans, CCAR firms will have one opportunity to make a downward adjustment to their planned capital distributions from their initial submissions before a final Federal Reserve decision is made." This change to allow for downward adjustments to proposed capital distributions should result in fewer stress test failures and, more broadly, demonstrates that the Fed wants to give as many banks as possible a passing grade.

Every Client Asked If the CFPB Would Be Impacted by the NLRB Ruling

It is no exaggeration to say that the NLRB ruling was mentioned in every single meeting we had last week. In late January, a lower court ruled that President Obama's recess appointments to the National Labor Relations Board (NLRB) in January 2012 were unconstitutional. The immediate read-through from this ruling relates to the Consumer Financial Protection Bureau (CFPB) and the recess appointment of Richard Cordray as Director (see here for a summary). President Obama used his recess authority to install Cordray as CFPB Director on January 4, 2012 – the same day as the NLRB recess appointments which were invalidated.

Most investors are focused on this issue because if Cordray's recess appointment is invalidated, the CFPB would likely cease to have the authority to supervise covered non-bank industries such as payday lenders, non-bank mortgage servicers, debt collectors, credit reporting bureaus, and private student lenders. We caution, however, that this issue by no means spells the end for the CFPB as some might have thought. We believe that a higher court will need to decide the issue. If the higher court reverses the decision then Cordray's recess appointment will stand and he will be able to hold the seat through 2013. If the higher court affirms the lower court's ruling, however, then Senate Democrats and the White House will simply allow the Republicans to make a number of the structural reforms to the CFPB they have been demanding (e.g. implement a commission structure; put the agency on the budget appropriations process). Either way, there should be no functional changes to firm's compliance implementation planning in the near-term.

For more information, please listen to a playback of a Ballard Spahr/Compass Point webinar titled: "The Impact of the D.C. Circuit Court NLRB Ruling on the CFPB." (Slides; Recording)

Student Loan Dischargeability in Bankruptcy Was a Hot Topic

Investors remain cognizant of Sen. Dick Durbin's (D-IL) legislative priorities. Ever since he secured passage of a debit interchange limit as part of the Dodd-Frank Act, Wall Street has focused extra attention on his efforts. This is most apparent in the focus education investors place on the issue of private student loan dischargeability in bankruptcy. Durbin has been the primary advocate for this issue since 2005 when the bankruptcy reform law made private student loans nondischargeable in bankruptcy. During our meetings, we detailed our belief that this effort was likely to garner more attention than ever before for a number of reasons: (1) The Higher Education Act must be reauthorized by the end of 2013 which refocuses Congressional attention on the issue; (2) The fact that there is now over $1 trillion in student debt outstanding means this subject will garner increased media attention; and (3) Senate Democrats have been bolstered by the addition of Sen. Elizabeth Warren (D-MA) who we expect to bring more awareness to this debate.

At this point in time, we believe it is highly unlikely to expect sweeping changes to the treatment of private student debt in bankruptcy. We simply see no path to passage in the House and Senate Democrats appear unwilling to deviate from their demands for complete dischargeability. Still, it is early in the legislative calendar and education issues will not truly garner Congressional attention until the debate over the Stafford Loan rate doubling begins in the spring.

Mortgage Discussions Were Positive and Forward-Looking

Our previous marketing trips have been dominated by client concerns regarding housing policy uncertainty and the perceived heavy-handedness of regulators. This trip was different. While we did focus on outstanding concerns such as the QRM Rule and private-label putbacks, we were encouraged to find a decidedly more optimistic discussion of the policy-related issues at hand. This was clearest in our discussions regarding the state of mortgage rulemaking. One year ago, the CFPB had just gone fully online and there was no clarity as to how they would finalize the Qualified Mortgage (QM) rule, federal and state regulators continued investigating mortgage servicers, and investors were deeply concerned that the proposed QRM rule would effectively end the private-label MBS market.

One year later, our conversations focused on specific elements of the final QM Rule (e.g. how does the 3% cap on point and fees work?) rather than debates about the legality of the CFPB itself. The majority of investors we met with found the rule less burdensome than expected (although there was some concern as to why loans underwritten to GSE or FHA standards will be considered QMs). In terms of mortgage servicing, both federal and state settlements have been completed in the past year and the CFPB's new rules are fully finalized. On the QRM front, we highlighted our view that the 20% down payment set in the proposed rule was likely to be lessened to 5% or 10% at most (a view shared by the majority of clients in our meetings).

As we expressed in our meetings, we are encouraged about the state of mortgage regulations at this point in time. The QRM Rule will be finalized in the first half of this year. Once this is done, the core elements of the Dodd-Frank Act's mortgage-related rules will be complete. For the first time since the law was signed in 2010, there will be regulatory clarity on the entire mortgage pipeline – origination, securitization, and servicing.

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