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The Growing Regulatory State of Banking

By Alberto R. Gonzales, Doyle Rogers Distinguished Chair of Law, Belmont University • Counsel, Waller, Nashville

Our country has often struggled with finding the right balance between too little and too much regulation. Some believe there should be minimal government oversight of financial institutions, betting that the market will reward those who are honest and responsive and penalize those who are not so honest or who do not offer consumers the best services. The challenge, of course, is that some businesses will use any advantage in order to maximize profits, even if it means bending the rules to the point of breaching them.

For these reasons, some regulation and oversight is necessary—if for nothing more than to level the playing field. The danger, of course, is that government officials often do not fully appreciate how the heavy hand of regulation affects business, nor anticipate how legislation will affect the markets long term. Regulators often bootstrap on to existing rules and regulations additional safeguards and procedures that stifle ingenuity and imagination. Risk taking is penalized and thus discouraged.

In response to the 2008 financial crisis, Congress passed Dodd-Frank. The objective of the law was to prevent the excess risk taking that led to the financial crisis and to provide common-sense protections for American families by creating a new consumer watchdog, the Consumer Financial Protection Bureau (CFPB).

The CFPB is unique by virtue of its independence and scope of authority. It is supported by a percentage of the operating funds of the Federal Reserve, money that the Fed gets outside the normal appropriations process to assure its independence on monetary policy. Consequently, Congress is unable to exercise its traditional oversight role. Furthermore, while most regulatory agencies are led by multiple administrators, the CFPB is headed by a single administrator who alone decides policy. This person is appointed for a term of five years and cannot be removed by the President except for cause, making the agency virtually immune from presidential or congressional accountability.

The President nominated Richard Cordray to serve as the first director of the CFPB, but his nomination was blocked by Senate Republicans in part because of fears over the expansive power of this agency. Consequently, the President appointed Cordray in January 2012 under his constitutional power to make appointments while the Senate is in recess. Although, the CFPB operated for over two years without a Senate-confirmed director, the agency expanded its supervision over certain nonbank sectors, issued hefty enforcement penalties against large financial companies, and released rules to reshape the mortgage market.

The July 16 confirmation of Cordray, following a deal between Senate Democrats and Republicans, likely

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will result in an even more aggressive agenda. Not only do observers expect the CFPB to continue progress implementing provisions of Dodd-Frank, but many anticipate even greater public enforcement actions. The CFPB has already made clear its concerns about certain products, such as deposit advances and auto loans, and industry experts now expect enforcement actions against institutions in those sectors to increase.

Although the CFPB has broadened attention to multiple types of credit products, many believe the agency's top priority this year will continue to be mortgages. Following release of a slew of final mortgage rules—including requirements that lenders evaluate borrowers' "ability to repay" mortgages, the criteria for safe qualified mortgages that will be protected from borrower litigation, and a new set of servicing standards—observers expect the CFPB to focus on how the industry implements these new rules.

It is also expected that the CFPB will wrap up its examination of large banks that fall under its purview and will accelerate its supervision of more nonbank industries. Through authority under Dodd-Frank to examine certain larger participants in nonbank sectors, the CFPB has already officially added debt collections and consumer reporting agencies to its portfolio. It has been working on, but as yet has not finalized, a plan to include larger student loan service providers.

Through the authority of the CFPB under Dodd-Frank, we have seen the creation of a regulatory state, the likes of which we have not seen since FDR and the New Deal. Some would argue that extraordinary measures were needed to deal with extraordinary abuses. We can debate whether an agency with this much unsupervised power is necessary or whether it is even consistent with a constitutional system based on the idea of separation of powers. But what is not debatable is that the CFPB is here to stay for the foreseeable future, and financial institutions will have to deal with an ever growing regulatory entity until there is a change in the White House and a change in the control of the Senate.

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Some financial institutions have elected not to wait on the political process, choosing instead to seek relief in the courts against aggressive government oversight. A number of significant lawsuits are pending that have a bearing on the financial services industry. The Cordray recess appointment, plus others to the National Labor Relations Board, was successfully challenged and found illegal in the 3rd, 4th, and DC circuits. The courts held the appointment invalid because the Senate was not in recess. The US Supreme Court had already decided to hear the case of *Noel Canning v NLRB* to review the constitutionality of these recess appointments. Given the Cordray appointment, it remains to be seen whether the Supreme Court will reconsider. While this case raises important questions regarding the President's recess appointment powers, the court may wisely decline to involve itself in a legal issue with such a politically charged history.

In the case of *Mt Holly v Mt Holly Garden Citizens in Action*, the Supreme Court recently decided, over the government's objections, to consider the question whether the Fair Housing Act prohibits practices that are nondiscriminatory but, nevertheless, have a disparate impact. The outcome of this case is important to financial institutions because should the Supreme Court rule in favor of the Township of Mt Holly and against the government's position, the decision will provide lenders with a strong legal argument that may help defend against class-action cases brought under the Equal Credit Opportunity Act.

The Equal Credit Opportunity Act makes it unlawful for any creditor to discriminate on the basis of protected attributes, but the law contains no language providing for liability based on the "effects" of nondiscriminatory actions. The Supreme Court has required "effects" language—language not found in the FHA—in a statute before permitting disparate impact claims. The ECOA is much broader than the FHA and applies to nearly all extensions of credit to consumers and business-purpose credit transactions. In addition to possibly providing a defense to ECOA actions, the decision in this case may also be helpful against the CFPB, which has indicated that it will evaluate creditor's loan activities through a disparate-impact lens. Other regulatory and enforcement authorities similarly take the position that banks are subject to the dispa-

rate–impact standard. Consequently, the outcome of this case should be watched closely.

Finally, some banking experts anticipate that imaginative plaintiff lawyers soon will file lawsuits against financial institutions in state courts alleging negligence claims in areas where existing state laws would absolve the banks from liability, but where rules promulgated by the CFPB create a different, and most likely heightened, "standard of care." For example, the CFPB is considering imposing heightened requirements on banks that deal with fiduciaries such as holders of powers of attorney.

The CFPB has already begun flexing its muscles by filing amicus briefs on various federal issues and soon is likely do so in state courts, as well. While we await the outcome of all this litigation and watch the political process move forward, financial institutions should expect greater scrutiny.

There are a number of important decisions for leaders of a financial institution after learning of a government investigation into possible wrongdoing. One is whether the institution should conduct its own investigation. In September 2003, I faced the same decision as White House Counsel in connection with a Department of Justice investigation into the unauthorized leak of the covert identity of CIA operative Valerie Plame. Like the governing board of any financial institution, we at the White House had to weigh the pros and cons of initiating our own investigation.

Most leaders of financial institutions want to know immediately the facts following an allegation of wrongdoing. Without information, managers cannot deal effectively with a problem, and the institution is at the mercy of the working schedule of government investigators. Initiating an investigation allows business leaders to determine what happened, deal appropriately with any responsible parties, and implement corrective measures to prevent future misconduct. Furthermore, with the information from an internal investigation, the institution is in a better position to shape the narrative and limit, to the extent it can, any public relations damage.

In the Plame investigation, I recommended that the White House not do its own internal investigation. This was frustrating for the president's chief of staff, Andrew Card, because Andy, like any good manager, wanted to know as soon as possible of any wrongdoing by members of the staff. However, I anticipated that any White House investigation would become politicized and second-guessed by congressional critics. In essence, our investigation would be investigated. President George W. Bush had ordered full cooperation with the DOJ investigation, and I worried that any internal investigation might interfere with the Justice Department's work and subject the White House to charges of obstruction of justice.

The President of the United States, of course, does not have to answer to a governing body, and officials of financial institutions rarely have the luxury of sitting back while their institution is being investigated by the government. In most cases, therefore, it is wise to be proactive. By doing so, the institution is sending a clear message to multiple audiences. An investigation by the institution shows customers and clients, employees and staff, as well as the local community, that the institution takes the allegations seriously and is committed to accountability. Equally important, initiating an investigation sends a message to law enforcement and regulators that the business is serious about getting to the bottom of what happened.

Any internal investigation should be done in a way that does not interfere with the government investigation. In the Plame investigation, we made no contact with the White House staff as a group without first clearing it with the investigators. An internal investigation must be thorough, unbiased, and complete—one that will withstand possible public disclosure, as well as the scrutiny of the trained eye of government investigators. A sloppy or half-hearted internal investigation can do harm by signaling that the institution is not serious about discovering wrongdoing or is engaged in a cover-up.

Because of the evolving regulatory framework in which financial institutions operate, many are struggling with their economic forecasting. During difficult financial times, business leaders often feel pressure to be conservative and avoid the expense of a thorough internal investigation except in the most extreme situations of alleged wrongdoing. This is a mistake. In most cases it will be more cost-effective to implement appropriate training and preventive measures in order to discourage wrongdoing in the first place. However, when these measures fail, for the reasons stated above, an investigation is often a wise investment that may limit legal liability and protect the reputation of the institution.

In closing, these are uncertain times for banks. Lawmakers in several states have introduced resolutions this year calling on Congress to split up big banks by separating traditional banking services and investment banking. Five years after the financial crisis, these state resolutions show there is still public anger toward big banks. If these proposals gain enough traction in state legislatures, a growing number of members of Congress may feel pressure to support this effort.

The opponents to such measures say Dodd-Frank now provides consumers adequate protection against the abuses of the past, but banks need to watch this movement carefully. Many Americans are hurting and looking for someone to blame. ■

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