The Changing Regulatory Posture

Covid-19, the economy, racial equity and climate. These are what the Biden-Harris transition team initially identified as the priorities of its administration. Since President Biden took office, other pressing issues such as immigration, cyber defense, and the U.S.'s exit from Afghanistan have been added to the list. The financial services industry wasn't expected to, and does not, make the list, except to the extent that as part of corporate America it can advance the administration's higher priority initiatives.

From the beginning, the regulatory outlook for the U.S. financial services industry has hinged on two beliefs. One, the administration would appoint "tough" new prudential regulators to replace the appointees of the prior administration. Two, Congress, unlikely to garner bipartisan support for broad new legislation, would exercise its right in both chambers to invite financial services executives to testify on a wide range of issues. For some, that meant there would be many opportunities for Congress to excoriate the industry and its leaders. In summary, the message was:

- Plan for a rollback of some policies introduced by former agency leaders
- Be prepared for aggressive enforcement of existing regulations
- Expect new consumer and safety and soundness regulations that can be enacted under existing authorities
- Anticipate ongoing Congressional pressure

It didn't look good for a financial services industry that had enjoyed the benign regulatory, pro-business environment of the former administration.

So far, though, a detente of sorts has existed between the traditional financial services industry and Washington. There have been hearings where megabank CEOs were put on notice that they should expect rigorous oversight, but these hearings have not been as adversarial as feared. The industry has weathered the pandemic much better than might have been expected at its onset. Banking organizations played an important role in distributing government funding to businesses through the Paycheck Protection Program (PPP) and, for the most part, have

received high marks for their efforts. The public perception is also that consumer lenders and mortgage services generally have been appropriately accommodating to borrowers who have required temporary forbearance or other loan modification support, though this may be tested as the various foreclosure moratoria that have been imposed around the country and for certain categories of government-backed loans are eventually lifted. Banks and other traditional financial institutions, including broker-dealers and asset managers, are supporting, in words and actions, the administration's diversity, equity and inclusion, and climate goals.

Newer market entrants, by contrast, are not faring as well in Washington. Studies point to a much higher incidence of fraud in the PPP loans made by fintechs. Neither Congress nor those appointed or likely to be appointed to key regulatory posts support giving fintechs freer rein without leveling the legislative and regulatory playing fields. Similarly, the cryptocurrency sector, which has been described as the "Wild West" by one agency head[1] can expect much greater regulatory scrutiny. These newer players have taken some pressure off the traditional financial services industry – at least for the moment.

On the supervisory front, few key regulatory roles have been permanently filled to-date, and the timetable for filling the remaining ones is uncertain, although upcoming term expirations at the Federal Reserve will force some action. The signs are there, however, that the tougher regulatory environment many predicted is on its way.

The first indication that the financial industry would experience a harsher regulatory environment came two months before the inauguration of President Biden when the president-elect tapped Gary Gensler to lead the team responsible for reviewing the financial regulatory agencies. A Goldman Sachs executive early in his career and former chair of the Commodity Futures Trading Commission, Gensler has been described by the Washington Post as a "dogged advocate of stricter rules for the industry," a reputation earned for his aggressive enforcement of rules regulating swaps trading following the Great Financial Crisis. Soon after, Biden nominated Gensler as chair of the Securities and Exchange Commission (SEC) and Rohit Chopra as director of the Consumer Financial Protection Bureau (CFPB), eliciting groans from the industry and cheers from one of its sharpest critics, Senator Elizabeth Warren.[2]

Gensler was confirmed on April 14, 2021 and took the helm of an SEC with a 3-2 Democratic majority. His long list of priorities includes regulation of digital assets, the structure of the equity market following the GameStop trading frenzy, "gamification" of retail trading platforms, regulation of family offices following the collapse of Archegos Capital Management, competition among credit rating agencies, the desirability of a financial transaction tax, and environmental, social and governance (ESG) disclosure, examination and enforcement. Retail investor issues are also on the SEC's priority list. In late August, Gensler named long-time consumer advocate Barbara Roper as a senior adviser. Roper has been a director at the Consumer Federation of America, advocating stronger protections for retail investors. She has been a staunch critic of the

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[1] The "Wild West" landscape of the crypto market needs Congress to step up the SEC's regulatory authority, Gensler says, Business Insider, August 3, 2021.

[2] Wall Street should fear new Biden financial regulators, experts say, Marketwatch, January 19, 2021.

SEC's Regulation Best Interest, arguing that it was designed more toward minimum disruption of the broker-dealers' operating model and less toward protecting retail investors.[3]

Chopra, a former student-loan ombudsman at the CFPB, hasn't been confirmed yet. The prevailing view is that his confirmation will happen and has been delayed by the administration's desire to find a replacement for him on the Federal Trade Commission. In the interim, Both Chopra and Acting CFPB Director Dave Uejio were at the CFPB in its early days. Uejio has been busy rescinding Trump-era rules and advocating for consumer protections during the pandemic.

Senator Warren herself suggested a list of CFPB enforcement priorities in July to mark the 10-year anniversary of the CFPB. These include regulation of cryptocurrency, ongoing support to consumers affected by the pandemic and addressing racial inequity in lending, all priorities that Uejio has also mentioned.[4] Even if major rulemaking is stalled until Chopra is confirmed, there is little doubt that the philosophies of the acting director and the director-in-waiting are aligned. Going forward, we expect to see a more stringent supervisory posture, where seemingly isolated technical violations and/or compliance-management-system weaknesses identified during examinations are put on the path to formal supervisory action faster.

Jelena McWilliams, chair of the Federal Deposit Insurance Corporation (FDIC), is serving a five-year term that will expire in mid-2023. McWilliams has been a forward-looking regulator and strong proponent of innovation, which has gotten her industry support. She has consistently voiced her intent to stay until the end of her term,[5] and she may get that opportunity. The agency's five-person board currently has two Biden appointees (the acting CFPB head and the acting comptroller of the currency), an Obama holdover (former FDIC Chair Martin Gruenberg) and one vacant seat. This means that the agency's actions will be kept in check by the Democrats on its board and will align with the administration's policies. It also means the outlook for new industrial loan company charter applications is far less promising than it was during the former administration. McWilliams has laid out a number of supervisory priorities, including technology investments, cybersecurity, addressing climate risk and a continued response to those affected by the pandemic.[6]

And that brings us to the Office of the Comptroller of the Currency (OCC) and the Federal Reserve Board (FRB) – and the influence of Janet Yellen. Yellen, former chair of the FRB, was sworn in as the Secretary of Treasury on January 26, 2021. She appears to be wielding considerable influence on both OCC and FRB appointments.

[3] Consumer advocate Barbara Roper to join SEC, Marketwatch, August 25, 2021.

[4] Warren suggests potential CFPB enforcement priorities as agency marks 10-year anniversary, Troutman Pepper, JDSupra, July 27, 2021.

[5] The Chair of the FDIC cannot be fired by the administration, although it is common practice for regulatory agency heads of a different party to submit their resignations when a president comes into office.

[6] Statement of FDIC Chairman Jelena McWilliams on Oversight of Prudential Regulators: Ensuring the Safety, Soundness, Diversity, and Accountability of Depository Institutions, May 19, 2021.

On May 10, 2021, the Treasury announced that Michael Hsu would become acting comptroller, replacing Blake Paulson, who was also in an acting capacity. Hsu began his career as a staff attorney at the FRB, and his last position there was associate director in the Division of Supervision and Regulation. One of his responsibilities in that role was the Large Institution Supervision Coordinating Committee Program, which supervises the global systemically important banking companies operating in the U.S. He had previously served at the International Monetary Fund, the Treasury, and the SEC. Even though his qualifications appear significant and relevant for the job, tapping someone from the FRB to lead the OCC was not a traditional move and appears to be an early sign of Yellen's influence. The OCC is technically a division of the Treasury but historically has maintained its independence on bank regulatory and supervisory matters. Unlike the SEC, FDIC and FRB, the OCC does not have a board, so the comptroller's authority is unchecked. Hsu has said his focus will be on "solving urgent problems and addressing pressing issues until the 32nd comptroller is confirmed."[7] So far, those problems and pressing issues have included restructuring the agency to give Hsu direct oversight of bank supervision, pulling back the Fair Access rule promulgated in the waning days of the former administration, and tabling the OCC's recent changes to the Community Reinvestment Act in favor of trying to reach an interagency consensus. In Congressional testimony in May 2021, Hsu outlined four other "urgent problems"[8] on his mind:

- The U.S. regulatory community's fragmented approach to digitalization
- Large bank complacency leading to prudent risk management being set aside in pursuit of profit
- Reducing inequality
- Addressing climate change

How long Hsu will remain acting comptroller remains unclear. On Sept. 23, President Biden announced that he will nominate Cornell Law School professor Saule Omarova to lead the OCC. The news of Ms. Omarova's pending nomination has been met with enthusiasm by progressives and grave concern by the industry because of her extreme views on banking policy. The improbability that the Republicans will embrace Ms. Omarova's nomination, and the fact that the Senate Banking Committee is split with 12 members of each party on both sides, likely mean that the road to confirmation will be difficult.

Three important decisions regarding the FRB are forthcoming: whether Powell will be reappointed as chair when his term expires in February 2022 and who will replace Randy Quarles as vice chair for supervision and Vice Chair Richard Clarida when their terms end in October 2021 and January 2022, respectively. To put these decisions into perspective, it is important to remember that there are seven seats on the board, six of which are currently filled,

[7] OCC News Release, May 10, 2021.

[8] Acting comptroller outlines four ''urgent problems'' for banking, with emphasis on fragmented approach to digitalization, Regulatory Report, May 19, 2021.

and that all but one of the incumbents were appointed by former President Trump. The one exception is Lael Brainard, who was appointed by President Obama.

Yellen's views will likely weigh heavily on these decisions, as will the need to satisfy the progressive wing of the Democratic Party. Media reports have identified a number of potential contenders for these roles, including both FRB insiders and outsiders.[9] Recent opinion (with an emphasis on *recent* because Washington can change its mind quickly) has tilted in favor of Powell being nominated for reconfirmation and Brainard as the leading contender to replace Quarles, although recent controversy over the personal stock trading of two Federal Reserve Bank Presidents comes at an inopportune time for Powell.

All FRB appointments are important to the financial services industry because the FRB's decisions shape the economy, but the vice chair for supervision is the best indicator of what regulatory and supervisory posture to expect from the FRB. Brainard is favored by the progressives for her views on strict regulation. While not explicitly endorsing Brainard, Senator Warren has praised her "dissents in many of the deregulatory actions the Fed has taken" and is on record as saying Powell's FRB has been too protective of big financial institutions.[10]

Even though not all the roles have been filled and the heaviest regulatory burden may fall on the newcomers such as fintechs and crypto exchanges, the signs are clear. The regulatory environment will be more challenging for the traditional financial services industry in the current administration.

So what should financial institutions be doing to prepare for this changing regulatory environment? We have a few suggestions:

- **Revisit the organization's compliance risk appetite**. This has always been a challenging concept since organizations are understandably reluctant to suggest to regulators that they have *any* appetite to violate laws and regulations. We think there are more practical ways to address this issue, though, including by considering how relatively consumer-friendly the designs of the institution's product terms and features are.
    - For example, has the firm benchmarked considerations like its overdraft and late fee amounts, and/or the percentage of total revenue generated by fee income, to those of its competitors? Organizations that are on the far-right side of the spectrum for these attributes may want to think about moving back towards the middle of the pack to reduce their risk profile.
    - Similarly, firms should be sensitive to the particular products, services, and practices that have drawn the scrutiny of regulators or progressive lawmakers in the past, and either ensure they have extraordinarily effective compliance controls in place with respect to these products or consider reducing their exposures. Specific examples include overdraft and late fees as noted above, third

[9] Who's in line for Top Fed jobs? American Banker, August 19, 2021.

[10] Warren Praises Brainard, Slams Powell Ahead of Biden Fed Pick, Bloomberg, August 4, 2021.

party debt collection services, add-on insurance products, and private student lending (particularly when offered in conjunction with for-profit universities).

  - Firms should also pay close attention to potential ESG regulations and play an active role in their formulation, leveraging the lessons learned from their own ESG programs already in effect.[11]

- **Take a fresh look at the effectiveness of the organization's compliance management system ("CMS")**. In the decade since the last industry-wide regulatory enforcement action cycle started, we've observed that all of the agencies have consistently and significantly raised the bar in terms of their CMS expectations. Practices that used to be viewed as best in class and prevalent only among the largest institutions (for example, dedicated automated compliance monitoring and risk and control self-assessment reporting functions, predictive analytics in areas such as consumer complaints, and formalized issue management processes that require an independent credible challenge before issues can be closed) are increasingly expected for midsize and regional organizations as well. We're seeing that firms that were spared a formal regulatory action in the last cycle are often being caught off guard by just how far their examiners' CMS expectations have shifted.

- **Increase communication to senior leadership and the board of directors about the evolving regulatory environment.** Coming out of the last regulatory cycle, we saw many firms take headcount reductions and otherwise cut costs in risk, control and compliance functions. In many cases, these efforts were accelerated as the onset of the COVID-19 pandemic brought additional cost pressure. Whether intentionally or not, these changes had the effect of increasing organizations' risk profiles, which may have been a reasonable bet in a more permissive regulatory environment but poses greater risk today. Now that the level of inherent risk is increasing again, it would be prudent to make sure leadership is aware of these trends and can make informed decisions regarding what level of additional investment may be needed to get ahead of the curve and reduce the level of risk back down to the organization's intended appetite. Specifically for example, it's good practice to monitor public actions being taken against peer organizations and have a framework to consistently analyze and report out on your organization's exposure to those types of actions. That can be done by asking questions such as "Do we offer those same products and services?" or "How robust is our control environment relative to the deficiencies that were cited for our competitor?"

[11] Prepare for Changes as Biden Administration Sets Sight on ESG, Protiviti.

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