2023 Preview

Biden's Financial Services Push

Why 2023 is Set To Be a Landmark Year for Financial Services Regulation

CAPSTONE

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Introduction

Capstone expects 2023 will be a landmark year for US financial services regulation, as the Biden administration looks to cement scores of high-profile regulatory initiatives before the uncertainties of the 2024 election. In this US 2023 Financial Services Preview, we offer 10 predictions on looming, underappreciated policy changes that will impact the sector.

The Fed will increase capital requirements for large banks. In early 2023, we expect the Federal Reserve (Fed) to propose raising capital requirements for large US banks. We believe the risk of large increases is underappreciated and see downside for equities.

The SEC will finalize its market structure rulemakings. As early as 2H 2023, we expect the Securities and Exchange Commission (SEC) will finalize its recently proposed market structure rules, posing risks to wholesalers and retail broker-dealers.

Policymakers will ratchet up their scrutiny of fintech. The tighter focus from regulators may lead the Consumer Financial Protection Bureau (CFPB) to designate the buy now, pay later (BNPL) industry for supervision, and policymakers will increasingly scrutinize bank partnerships.

Pressures on "junk fees" will increase. In 2023, we expect the CFPB to propose a rule reducing the credit card late fee safe harbor, posing headwinds to subprime and private-label card issuers. This would follow the recent Federal Trade Commission (FTC) announcement of a similar effort on what it calls "junk fees" which will likely lead the commission to propose a rule in 2023.

Congress will jumpstart retirement savings. Congress looks poised to pass a package of bills called "the SECURE Act 2.0," which will jumpstart retirement accounts and savings in the coming years.

Regulators will ramp up scrutiny of auto dealers. We expect the FTC to proceed with enforcement actions against auto dealers for misleading sales practices, while it moves toward finalizing its recently proposed Motor Vehicle Dealers Trade Regulation Rule in 2024.

The CFPB will ramp up its scrutiny of the credit reporting industry. We expect credit reporting to rise to the forefront of CFPB scrutiny in 2023, which could lead to proposed rulemaking and enforcement activity.

The card networks (Visa and Mastercard) will remain in the crosshairs. The Fed's recently finalized changes to its rules implementing the Durbin Amendment will become effective in 2023, creating a revenue drag for Visa Inc. (V) and Mastercard Inc. (MA), while the card issuers continue to fight proposed legislation that would go even further in promoting competition.

Real estate brokerages will face continued risk from antitrust investigations. Realtors will be on the defensive as the US Department of Justice (DOJ) and a pair of class action lawsuits delve into allegedly anticompetitive behavior in the residential real estate industry.

Insurance regulators will roll out reforms aimed at addressing PE investment. In 2023, we expect working groups at the National Association of Insurance Commissioners (NAIC) to release policy recommendations aimed at addressing the growth of private equity (PE) investment in insurance carriers.

A Deeper Look

The Fed Will Increase Capital Requirements for Large Banks

Winners and Losers of Increased Capital Requirements	
Winners	N/A
Losers	JPMorgan Chase & Co. (JPM), Bank of America Corp. (BAC), Wells Fargo & Co. (WFC), Citigroup Inc. (C)

In early 2023, we expect the Fed will propose increasing capital requirements for large US banks. We believe the market does not fully appreciate the risk of large increases and see downside for equities.

In July 2022, Michael Barr was confirmed as Vice Chair for Supervision at the Fed, becoming, in effect, the regulatory czar for large banks. Early in his tenure, consensus in the industry was that Barr would modestly raise bank capital requirements. Indeed, several times since his confirmation, Barr has signaled that the Fed is engaged in a holistic review of bank capital requirements.

> We believe investors underappreciate the magnitude of possible changes.

We believe investors underappreciate the magnitude of the possible changes. In a December speech (and subsequent Q&A), Barr suggested potential changes to the regulatory framework include:

1) implementation of the Basel III "endgame" reforms in the US;

2) changes to stress testing (including the possibility of multiple scenarios); and

3) reconsideration of the countercyclical capital buffer.

Barr also argued that capital requirements in the US are currently "toward the low end of the range" envisioned in most academic research, and overlayed his comments endorsing the philosophy that robust capital is needed due to inherent economic uncertainties, best exemplified by the 2020 pandemic. While details remain to be seen – and Barr said he'll have more to say in early 2023 – we believe the combination of these changes (in part offset by tweaks to the supplementary leverage ratio) could have an unexpected impact on required capital for large US banks.

The SEC Will Finalize its Market Structure Rulemakings

Winners and Losers of SEC Market Structure Rulemakings	
Winners	Intercontinental Exchange Inc. (ICE), Cboe Global Markets Inc. (CBOE), Nasdaq Inc. (NDAQ)
Losers	Virtu Financial, Inc. (VIRT), Robinhood Markets, Inc. (HOOD)

As early as 2H 2023, we expect the SEC to finalize its recently proposed market structure rules, posing risks to wholesalers and retail broker-dealers.

On December 14th the SEC proposed a series of four rulemakings that together would rewrite the rules underlying US equity market structure. The four proposals cover the following:

1. disclosure around order execution
2. minimum pricing increments, exchange access fees, and odd lot order transparency
3. order-by-order competition
4. best execution requirements

We at Capstone are still digesting the proposals, but we believe proposals #3 and #4 are highly impactful, and likely to damage market makers and broker-dealers that receive payment for order flow (PFOF). We expect the rules to be finalized as early as 2H 2023 (potentially slipping into 2024). When this happens the rule's opponents, including Virtu, which has already signaled a willingness to litigate, will consider legal challenges.

Policymaking Will Enhance Their Scrutiny of Fintech

Winners and Losers of Enhanced Fintech Scrutiny	
Winners	N/A
Losers	Affirm Holdings Inc. (AFRM), Afterpay (acquired earlier this year by Block Inc. [SQ]), Klarna Bank AB, Zip (ZIP on the Sydney exchange), and PayPal Holdings Inc. (PYPL)

Among other developments, the Consumer Financial Protection Bureau (CFPB) may designate the buy now, pay later (BNPL) industry for supervision, and policymakers will increasingly scrutinize bank partnerships.

The CFPB in September issued a long-awaited report following an inquiry into the business practices of five of the largest BNPL companies – Affirm, Block, PayPal, Zip and Klarna. The bureau in its report alleges that use of the industry's flagship "pay-in-4" product may increase the risk for consumers of financial overextension. The report also claims that several common industry practices related to disclosures, dispute resolution, autopay requirements, late fees, and payment representations may harm consumers.

> Capstone believes the report and the critical remarks from Director Rohit Chopra that accompanied it indicate the risk of near-term enforcement action

Capstone believes the report and the critical remarks from Director Rohit Chopra that accompanied it indicate the risk of near-term enforcement action against the industry has risen. Additionally, Capstone believes that the bureau will try to bring BNPL under its supervisory authority in 2023, either through a "larger participant" rulemaking or by using its dormant authority to examine non-bank entities that pose a risk to consumers.

Acting Comptroller of the Currency Michael Hsu expressed concern that the rise of fintech-bank partnerships, if left unchecked, could create systemic risk leading to a financial crisis. In October, the OCC announced it will open an Office of Financial Technology in 2023 to improve the agency's ability to oversee relationships between fintechs and banks. A recent report from the Department of Treasury expressed concern that fintechs operate outside the banking regulatory perimeter and recommended developing a consistent supervisory framework for fintech-bank partnerships. This would include the finalization of third-party risk management guidelines initially published in 2021.

The Select Subcommittee on the Coronavirus Crisis further amplified concerns among regulators about fintech compliance regimes in a recent release. The committee found that fintechs that facilitated loans through the Paycheck Protection Program lacked institutional controls that were present at traditional financial institutions and were also more likely than traditional banks to approve fraudulent loans. We expect that the OCC and other federal regulators to monitor fintech-bank partnerships more closely in 2023, which may limit growth opportunities for certain fintechs and common bank partners and increasing the risk of enforcement.

Pressures on “Junk Fees” Will Increase

Winners and Losers of Increased Pressure on “Junk Fees”	
Winners	N/A
Losers	Synchrony Financial (SYF), Bread Financial Holdings Inc. (BFH)

In 2023, we expect the CFPB to propose a rule reducing the credit card late fee safe harbor, posing headwinds to subprime and private-label card issuers. This follows the FTC’s recent announcement of a similar effort on what it calls “junk fees” and the likely proposal of a rule in 2023.

> We expect the CFPB to propose a rule reducing the credit card late fee safe harbor, posing headwinds to subprime and private-label card issuers

In 2023, we expect the CFPB and FTC to increase their scrutiny of what they have called “junk fees.” These are fees which regulators argue are misleading or which do not correspond to an action that provided value to consumers. The “junk fee” emphasis has attracted substantial pushback from the consumer finance industry, which has argued that most consumer finance products are already subject to a robust regulatory regime, which is in part predicated on disclosure. Nonetheless, we expect several important developments in 2023:

- **The CFPB will likely propose reducing the credit card late fee safe harbor.** In June 2022, the CFPB published an advanced notice of proposed rulemaking (ANPRM) on credit card late fees, setting the stage for a potential rulemaking. We believe the CFPB is likely to propose a rule reducing the safe harbor (currently set at $30 for first violations and $41 for subsequent violations) in the first half of 2023.

- **The FTC will likely propose a rule on “junk fees.”** In October 2022, the FTC published an ANPRM on “junk fees,” setting the stage for a proposed rule as early as 2023. Whereas the CFPB only has jurisdiction over consumer financial products or services, the FTC’s jurisdiction covers most of the economy, highlighting potential risks for businesses across the economy.

Congress Will Jumpstart Retirement Savings

Winners and Losers of Jumpstarting Retirement Accounts	
Winners	Small and medium-sized business plan providers, Charles Schwab Corp. (SCHW), T. Rowe Price Group Inc. (TROW), BlackRock Inc. (BLK)
Losers	N/A

Congress looks poised to pass a package of bills called "the SECURE Act 2.0," which will jumpstart retirement accounts and savings in the coming years.

We expect SECURE 2.0, which was attached to the year-end spending bill, will pass in late 2022. We believe the provisions in the bill will boost participation in retirement plans, particularly for small and medium-sized businesses (SMBs) through a variety of provisions that build on the 2019 Setting Every Community Up for Retirement Enhancement (SECURE) Act. In particular, the bill includes a provision that requires 401(k) and 403(b) plans to automatically enroll employees (while requiring them to opt-out if they wish not to participate) at a contribution rate between 3% and 10%. Research has shown automatic enrollment boosts employee participation rates given higher employee take-up rates compared to a voluntary (opt-in) model. SECURE 2.0 also seeks to expand plan access by increasing the small business plan startup credit from 50% to 100% for companies with fewer than 50 employees, a category which currently disproportionately lacks retirement plan access. The expanded tax credit is set to go into effect on December 31, 2022, which we expect to drive an increase in plan offerings through 2023.

> We believe the bill will provide tailwinds for retirement plan providers through a host of additional provisions

We believe the bill will provide tailwinds for retirement plan providers through a host of additional provisions, such as enabling small businesses without plans to offer starter 401(k) plans to employees, allowing employers to match student loan payments, and increasing the required mandatory distribution age. Combined, the provisions are designed to allow more employees access to plans, increase savings, and leave assets in retirement accounts longer over their lifetime which should drive greater retirement savings accumulation in 2023 and beyond.

Regulators Will Ramp Up Scrutiny of Auto Dealers

Winners and Losers of Increased Auto Dealer Scrutiny	
Winners	N/A
Losers	AutoNation Inc (AN), Group 1 Automotive, Inc. (GPI), Asbury Automotive Group, Inc. (ABG)

We expect the FTC to proceed with enforcement actions against auto dealers for misleading sales practices, while it moves toward finalizing its recently proposed Motor Vehicle Dealers Trade Regulation Rule in 2024.

The FTC has been highly critical of auto dealer practices, especially the aggressive marketing of add-on products such as vehicle service contracts, guaranteed asset protection (GAP) waivers, anti-theft protection, and more. The FTC's proposed Motor Vehicle Dealers Trade Regulation Rule would seek to prohibit the sale add-ons that provide no value to the consumer and force dealers to publish standardized pricing.

While the commission continues to develop the rule through 2023, we expect it to take aggressive enforcement on sales and marketing practices related to add-ons, as well as monitoring complaints related to pricing for any disparate impact.

Add-on products are a major profit generator for auto dealers. According to the National Automobile Dealers Association (NADA), add-ons generate around 25% of dealer gross profit, despite accounting for just over 3% of vehicle revenue. AutoNation disclosed that add-ons accounted for 28% of the company's gross profit in 2021, down from nearly 30% in 2020 and other publicly listed dealers reported similar reliance. We anticipate that a crackdown on ancillary product sales would inhibit pricing and lower attach rates which could reduce add-on revenue by up to 40% in a worst-case scenario, reducing dealer gross profit by roughly 10%.

Source: Obi - @pixel7propix on Unsplash

The CFPB Will Ramp Up Its Scrutiny of the Credit Reporting Industry

Winners and Losers of Increased Credit Reporting Scrutiny	
Winners	N/A
Losers	Experian plc (EXPN on the London exchange), TransUnion (TRU), Equifax Inc. (EFX)

We expect credit reporting to rise to the forefront of CFPB scrutiny in 2023, which could translate into both proposed rulemaking and enforcement activity.

During his tenure at the CFPB, Director Chopra has been a steadfast critic of the credit reporting industry and focused on ensuring that consumer information is reported accurately, and when necessary, disputes are handled promptly and fairly. In November, the bureau issued a circular affirming the responsibilities of credit reporting companies and data furnishers to investigate consumer disputes, which the CFPB identified in its latest supervisory highlights report as a shortcoming for both groups.

Meanwhile, in April, the CFPB sued TransUnion for violating a 2017 law enforcement order requiring the company to stop engaging in deceptive marketing behavior. The CFPB alleges that TransUnion continued to deploy digital dark patterns to trick consumers into unknowingly signing up for subscriptions or purchasing products or services. Equifax has also disclosed that it received a civil investigative demand (CID) from the CFPB regarding how it responds to consumer disputes for inaccurate information. As credit reporting remains the primary source of consumer complaints to the CFPB, we expect the bureau to continue scrutinizing the actions of the credit reporting agencies, which will force more thorough and manual reviews of consumer disputes, driving an increase in compliance costs for the companies.

Source: Jonathan Cooper on Unsplash

The Card Networks Will Remain in the Crosshairs

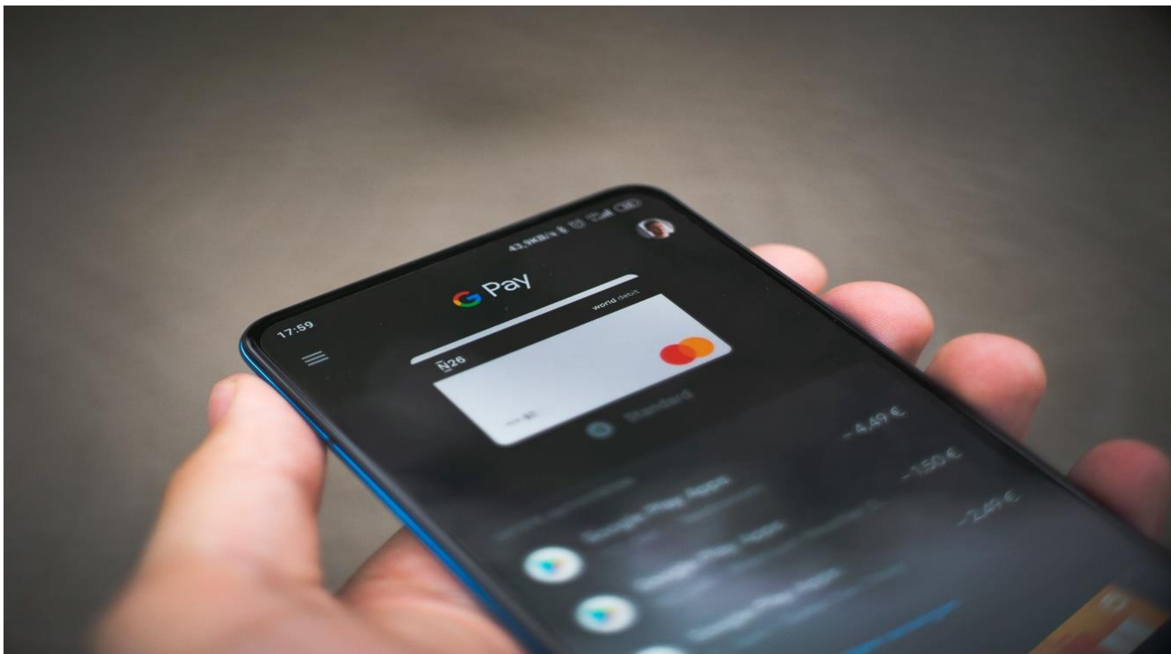
Winners and Losers of a Regulator Focus on Card Networks	
Winners	N/A
Losers	Visa Inc. (V), Mastercard Inc. (MA)

The Fed's recently finalized changes to its rules implementing the Durbin Amendment will become effective in 2023, creating a revenue drag for Visa Inc. (V) and Mastercard Inc. (MA), while the card issuers continue to fight proposed legislation that would go even further in promoting competition.

The Fed's changes to Regulation II go into effect in July 2023 and clarify merchants' ability to route debit transactions over a second, unaffiliated network for card-not-present transactions. Visa and Mastercard have been dominant in the growing card-not-present market, routing 94% of the transactions in 2019, the last year for which data is available. We expect the rule change will result in that market share declining to around 65% as it moves closer to the card-present market where merchants currently have competitive routing choices.

Additionally, we believe ongoing investigations into the companies' debit practices – both companies have disclosed an FTC inquiry and Visa is also being investigated by the Department of Justice – will weigh on them. We believe regulators could advance their cases in 2023, at least by demanding further information from the companies and the regulatory scrutiny will limit how aggressively the companies can respond to increased competitive pressures in the card-not-present debit routing market and from new payment models.

We continue to believe the Credit Card Competition Act (S. 4674), a bill introduced in July 2022, is unlikely to pass. The bill seeks to increase competition among US credit card networks by allowing merchants to route payments through unaffiliated networks – similar to provisions already in place for the debit card market.



Source: Obi - @pixel7propix on Unsplash

Real Estate Brokerages Will Face Continued Risk from Antitrust Investigations

Winners and Losers of Real Estate Antitrust Investigations	
Winners	N/A
Losers	Anywhere Real Estate Inc (HOUS), Re/Max Holdings Inc. (RMAX), Redfin Corp. (RDFN), Berkshire Hathaway Inc. (BRK/A), eXp World Holdings Inc. (EXPI), Zillow Group, Inc. (ZG)

Realtors are currently on the defensive as the U.S. Department of Justice (DOJ) and a pair of class action lawsuits are exploring anticompetitive behavior in the residential real estate industry.

We expect the US Department of Justice (DOJ) will continue its investigation—launched in July 2021—into the real estate brokerage practices of the National Association of Realtors (NAR) and real estate brokerage firms that are potentially anticompetitive. To-date, the investigation has been held up by a petition filed by NAR in the US District for the District of Columbia. We will be watching in 2023 for any indication of when the District Court could rule on the petition – a prerequisite for allowing the investigation to formally proceed.

Meanwhile, NAR and real estate brokerage firms continue to battle with home sellers in two major lawsuits—Sitzer v. National Association of Realtors, et al in the US District Court for the Western District of Missouri and Moehrl v. National Association of Realtors, et al for the US District Court in Northern Illinois. In both cases, home sellers allege brokers violated US antitrust law by enforcing NAR's buyer broker commission rule. The rule requires all member brokers to make a blanket, non-negotiable offer of buyer broker compensation when listing properties on multiple listing services (MLS). Plaintiffs allege enforcement of the rule has kept broker commission rates artificially inflated. In 2022, plaintiffs in Sitzer were granted class certification—a blow to defendants that potentially puts brokers on the hook for the $1.3B buyer broker commissions plaintiffs argue were paid in excess of what plaintiffs allege were appropriate in the last eight years. The motion for class certification in Moehrl remains pending. Both cases are slated to head to trial in late 2023 (Sitzer) and early 2024 (Moehrl).

We believe an outcome from either the DOJ's investigation or the pending lawsuits would ultimately put pressure on brokerages to reduce commission rates

We believe an outcome from either the DOJ's investigation or the pending lawsuits would ultimately put pressure on brokerages to reduce commission rates, impacting brokerage firms and real estate technology players that now rely on the stability of the commissions. If broker commissions declined from the current industry average of 4.9% to the international average of 3.4%, the industry would lose roughly 30% of annual commissions revenue, which would be roughly $32 billion in 2021.

Insurance Regulators Will Roll Out Reforms Aimed at Addressing PE Investment

Winners and Losers of PE Investment Reform	
Winners	N/A
Losers	Private equity firms focused on insurance industry investment, current private equity-owned insurers, offshore reinsurers

In 2023, we expect working groups at the National Association of Insurance Commissioners (NAIC) to issue policy recommendations aimed at addressing the growth of PE investment in insurance carriers.

> Private equity investment in the insurance market is likely to face headwinds in 2023

Capstone believes private equity investment in the insurance market is likely to face headwinds in 2023 as the NAIC continues its internal review of risks such investments pose to policyholders. On December 7, 2021, the NAIC voted to expose a list of "regulatory considerations applicable (but not exclusive) to [PE] owned insurers" for a 30-day comment period. The report identifies 13 topics of consideration and concern related to PE ownership of insurance companies. The list of considerations covers a wide range of topics, including investment management agreement structure, private equity owner investment horizon and affiliated investments, increased investments in less-liquid structured securities, use of offshore reinsurers, and pension risk transfers. To-date, the NAIC has assigned various internal working groups and task forces to investigate each area of concern and determine whether further action—in the form of industry guidance or model law—is warranted.

We believe the NAIC is keenly focused on:

1) the tendency of PE-owned insurers to take on more risk in insurer portfolios and

2) an apparent lack of transparency in investment management agreements (IMAs) between PE owners and insurers.

During the NAIC's recent Fall National Meeting, commissioners agreed there should be a focus on:

1) reevaluating disclosure requirements, particularly for parties that may have less than 10% ownership but retain less clear levers of control,

2) educating examiners on complex control structures, and

3) facilitating better communication across state insurance departments to understand mechanisms of control being used today.

We expect the NAIC's intended responses to these and other issues raised in its list of considerations to become more clear throughout 2023.

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