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FINANCIAL SERVICES REGULATORY REFORM UPDATE

For the Week of May 24, 2010

With both chambers having passed its respective versions of Regulatory Reform, the focus now turns to the conference committee. During the past week, and heading into the Memorial Day District Work Period (which lasts through the first week in June), members, the administration and third-party stakeholders all began to posture and position themselves to engage in an "old fashioned" conference, the first between the banking committees since the passage of Sarbanes-Oxley in 2002.

SENATE ANNOUNCES CONFEREES - HOUSE TO WAIT TO AFTER THE MEMORIAL DAY RECESS

On Tuesday, the Senate appointed eight senators from the Banking Committee and four senators from the Agriculture Committee, keeping a 7:5 Democrat to Republican ratio, to take part in the House-Senate conference for financial regulatory reform. They are, from the Senate Banking Committee: Dodd, Johnson, Reed, Schumer, Shelby, Corker, Crapo, Gregg and from the Senate Agriculture Committee: Lincoln, Leahy, Harkin, and Chambliss.

In order to prevent a procedural maneuver to allow the House Republicans to offer politically charged motions to instruct conferees, the House is going to wait till the week of June 7th to formally nominate its members to the conference, and should commence its formal work the following week, which is convenient because everybody realizes that the conference wouldn't be able to pick up the derivatives section, which is perhaps the most controversial, prior to the results of the June 8th election in Arkansas being known.

In a memo distributed on Wednesday, House Financial Services Chair Frank said he would pick himself, six subcommittee chairs (Reps. Kanjorski, Gutierrez, Waters, Watt, Meeks and Moore), and Rep. Maloney Frank (formerly a subcommittee chair) as the Democratic representatives for the House side of the conference committee. Frank stated his goal that the conferees act as "agents of collective decision making" rather than autonomous deciders, and that will have regular caucuses with members of his committee and with the caucus generally.

Although Frank has provided his recommendations to the Speaker, it is not clear who from the Agriculture Committee will represent the Democrats, and whether members of other Committees, and particularly the Energy and Commerce Committee, which was critical in shaping the substantial expansion of power for the Federal Trade Commission in the House bill, will be included as well. Additionally, House Republicans have not yet reached a similar consensus as to which members of the

Financial Services Committee should be selected, though based on Frank's memorandum it appears that they will have five slots to fill. The final Republican roster will provide insight into their conference strategy, since they are blessed with both thoughtful and firebrand conservatives on the committee. Our prediction is that at the end of the day Chairman Bachus, Shelly Moore Capito, Jeb Hensarling, and Scott Garret are on the conference with the final spot going to Ron Paul, Judy Biggert, Gary Miller or Frank Lucas. Given all of the attention that Paul has received for his quest to audit the Fed, as well as the fact that his the ranking member of the subcommittee on monetary policy, his omission may have some populist reverberations, however with only five slots and six subcommittees at least two Republican subcommittee ranking members are bound to left out.

With both Chairman Dodd and Chairman Frank indicating that the bills don't have much overlap there are only a few major contentious items to work out. Among these differences include how large financial institutions are dismantled, with the House bill containing a $150 billion fund that would cover the costs of a large firm's collapse, but not similar fund in the Senate's bill. The conferees will also be settling differences on mandatory exchange trading (only in the Senate bill), the limitations on interchange fees (only in the Senate bill), capital requirements for bank holding companies (different language in each chamber), the exemption for auto dealers from the consumer protection entity (House bill) and the authority of the GAO to audit the Fed (different language in each chamber).

LINCOLN'S CONTROVERSIAL DERIVATIVES LANGUAGE

Opposition to Lincoln's derivatives measure, which would "spin off" the derivatives desks from commercial banks, has come fast and furious from both sides of the aisle and both chambers of Congress. On Tuesday, Democratic Rep. Ackerman circulated a letter to his colleagues, calling on potential House conferees to take out Lincoln's provision, stating that the tough language would force U.S. banks to "move their $600 trillion derivatives businesses overseas" at the expense of the New York and U.S. economy. As was stated above, Lincoln's counterparts on the Senate Agriculture Committee have openly expressed their disdain for her measure, and even the Senate Democratic leadership is not coming to her defense.

House Financial Services Committee Chair Frank predicts that some form of the Volcker Rule (banning commercial banks from proprietary trading) is more likely to pass as an alternative to Lincoln's strict derivatives spin-off provision. Frank posited that the Volcker Rule would accomplish the same goals that Lincoln set out to achieve, but that Lincoln's language goes too far in prohibiting banks from hedging their own commercial risk with derivatives. He added that the Volcker Rule will be sufficient because it would apply to all transactions, including derivatives, so that banks still will not be allowed to run separate profit centers where they trade with each other. Frank stated his belief that banks should be able to conduct some derivatives trading within the limits of the over-the-counter market.

Fed Chair Bernanke and FDIC Chair Bair concur that the Lincoln language goes too far, both arguing that it would simply push derivatives trading to less regulated markets. White House officials also offered "tempered" criticism of the language, likely to avoid too much political damage to Lincoln.

Assistant Treasury Secretary Michael Barr warned that financial markets could be disrupted if banks are not allowed to buy and sell derivatives. Barr did, however, express his overall support for derivatives regulation in the Senate bill, specifically the requirement that most derivatives be guaranteed through a neutral third-party clearinghouse and then placed on a public exchange.

MORE CONCERNS WITH REG REFORM

Many financial institutions have expressed their concerns with the "skin in the game" provision that is included in both the House and Senate versions of reg reform. Each bill would require securitizing banks to retain 5% of the credit risk associated with the securitizations they originate, and each bill also has exemptions to this rule. The House bill would allow regulators to increase or decrease the required retention amount, while the Senate bill would permit regulators to set risk retention regimes for different asset classes. Both bills would prohibit the securitizing party from hedging or transferring the risk associated with retaining the economic interest.

Banks are worried that this risk retention could lead to a decrease in consumer lending, and they also argue that they already retain some credit risk because of the way certain deals are structured (e.g. those with credit card or auto loans as the underlying assets). The American Bankers Association has explicitly expressed its concern with the legislative language being too broad and sweeping all types of securitizations into a single set of regulations. The Executive Director of the American Securitization Forum also added his consternation about the difficulty of enforcing the rules that would prevent banks from hedging against risk retention requirements, and the fact that strict new disclosure rules could lead to additional costs for banks. The ABA stated its preference for securities regulators already familiar with the marketplace to be the ones imposing any new regulations, instead of the new legislation enacted by Congress.

A bipartisan group of House representatives is also pushing for the conferees to retain the Senate-passed amendment that would severely limit interchange fees. Reps. Welch, Shuster and Carney addressed a letter to House Speaker Pelosi and Minority Leader John Boehner emphasizing their support for the swipe fee amendment, which they claim supports small businesses by curtailing fees imposed by the credit card industry. Various other members from both sides of the aisle showed their support at a press conference. The amendment would direct the Fed to ensure that fees small businesses pay to process debit card transactions are reasonable and proportionate to the costs incurred in processing credit card transactions. The amendment also prohibits card networks from penalizing small businesses from incentivizing customers to pay in cash, and prohibits anti-competitive network restrictions that limit choice. Currently, an estimated $36 billion per year is paid in interchange fees.

Conversely, banks and credit unions are working to keep the amendment off the final bill. The National Association of Federal Credit Unions also sent a letter to Pelosi and Boehner on Monday, opposing the interchange amendment because of the negative impact it would have on both credit unions and consumers. The letter stated that Durbin's interchange amendment would merely shift costs from big retailers to consumers, because there is no stipulation ensuring that the merchants' cost savings would be passed on to consumers in the form of lower prices. The Obama Administration has not officially taken a side on the interchange fee debate.

HOUSE EXTENDERS BILL INCLUDES MODIFICATION TO CARRIED INTEREST

On Friday, the House passed the H.R. 4213, the American Jobs and Closing Tax Loopholes Act (a/k/a the extenders bill), which among other things increased taxes on how private equity, venture capital, REITs and others can used carried interest. The $145 billion bill, which will be up for debate on the Senate floor at some point after the Memorial Day recess, removes a favorable tax rate that was applied to investment fund managers. These individuals would now be prevented from paying taxes at capital gains rates on investment management services income received as carried interest in an investment fund. If the carried interest reflects a return on invested capital, then it will continue to have the lower capital gain tax rate. But if the carried interest is earned elsewhere, the bill would require investment fund managers to treat 75% of the remaining carried interest as ordinary income. A transition rule would apply for the period leading up to 2013, when the new law would potentially go into effect.

Prior to Friday's vote there had be a lot of rumors that this provision would be modified, and while it still may be altered when the Senate takes up the bill, Speaker Pelosi was able squash any changes from occurring in the House.

EUROPE REACTS TO THE U.S.'S REG REFORM

Global discord over the United States' reg reform package came to light on Wednesday, when Treasury Secretary Geithner landed in Europe for talks with his British and German counterparts. The U.S. and Europe agree in principle on the need for more oversight over markets and banks, and that taxpayers should be shouldering the burden of a future financial crisis, but in practice the governments are responding differently. Initially, world leaders had pledged to respond to the financial crisis together, by making financial rules consistent internationally and closing regulatory loopholes. Now, with American reg reform taking shape, it looks likely that a "patchwork of reforms" could continue to allow companies to exploit national differences. Countries that thwart the efforts of regulators and that have more lax regulatory regimes will persist in enticing companies to move their operations there. If banking is overseen that differently in European capitals than in New York, American firms will simply move overseas, rather than actually complying with the new American regulations.

European diplomats have expressed their dismay over particular reg reform provisions, including a Collins measure that could force European financial firms to shift significant amounts of capital to their U.S. subsidiaries to cover potential losses. Europeans also have a "one-stop-shopping" banking culture, in which firms conduct a variety of transactions under the same roof. The controversial measure that would require U.S. banks to spin off their derivatives practices is particularly worrisome to Europeans for this reason. This rule and the "Volcker Rule" banning proprietary trading both have the potential to encourage U.S. firms to shift some of their trading overseas, which would merely result in risk being exported to Europe or Asia.

As a counterpoint to these potential American reforms, some new German regulations are angering U.S. officials as well. Last week, Germany moved to crack down on naked short selling, which a Treasury official denounced as counterproductive and damaging to the markets. Europe is also

pushing to increase oversight of hedge funds, which U.S. officials argue would impede American funds from bringing on European clients. The U.S. is also criticizing Europeans for failing to force their banks to have greater capital requirements. FDIC Chair Sheila Bair stated that Europe should be making it clear to the markets and international community that they have strong rules in place to bolster their banking system, and help with the local and global economic recovery.

The British government is in the process of setting up a commission to determine whether large financial institutions should be broken up to ensure that they are not too big to fail. The U.K. is unlikely to actually adopt these recommendations, though, if the U.S. doesn't do the same, because the U.K. would be at a competitive disadvantage. As the U.S. reg reform package stands, banks would be left largely intact, with Congress opting for more federal oversight instead.

UPCOMING HEARINGS

With Congress in its Memorial Day District work period from May 31st – June 6th there will be no hearings in Washington, DC next week.