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FINANCIAL SERVICES REGULATORY REFORM UPDATE

For the Week of July 19, 2010

OBAMA SIGNS WALL STREET REFORM INTO LAW

On Wednesday, July 21st at 11:30am, in the Reagan Room of the White House, President Obama signed the Wall Street Reform and Consumer Protection Act ("Dodd-Frank") into law. The regulatory overhaul is the most sweeping change of financial regulations since the 1930's. Reportedly, the legislation achieved "90%" of what the President set out to accomplish – protecting consumers, constraining the growth and risk-taking of the largest financial institutions, and addressing too-big-to-fail. Focus will turn to the most immediate implementations of Dodd-Frank, which include the all-important presidential nomination of the director of the new Consumer Financial Protection Bureau (CFPB), and the creation of the Financial Stability Oversight Council to monitor systemic risk to the economy.

Talk continues to swirl in both chambers of Congress around a technical corrections bill. If this legislation is deemed necessary, it would likely be taken up after midterm elections in November. Oversight hearings will probably be held in September, according to Senate Banking Committee member Jack Reed (D-RI), to determine if these technical changes need to be made. Although deemed "technical," there is often a temptation for legislators to slip in substantive changes to the law.

Speaking of midterm elections - following financial reform debate and now the enactment of Dodd-Frank, speculations about Democrats' fundraising problems seem to be becoming a reality, especially if Goldman Sachs is any indication. Goldman executives are decreasing their contributions to Democrats, and the cash split is now 50-50 between Democratic and Republican campaigns. During the last election cycle, 64% of Goldman PAC contributions went to Democrats.

DODD-FRANK: POST-ENACTMENT

Consumer Financial Protection Bureau:

One of the largest outcomes of Dodd-Frank, the creation of the Consumer Financial Protection Bureau (CFPB), will be conceived no later than 60 days after the enactment of the law. By that date, the Treasury Department, in consultation with federal banking regulators, the Federal Trade Commission (FTC), the Department of Housing and Urban Development (HUD), and the White House Office of Management and Budget (OMB), will be required to publish a date for transferring consumer financial functions and personnel to the new bureau. The transfer must be completed within 6 months, although the Treasury extend this to 18 months upon submitting an explanation to Congress.

Treasury Secretary Timothy Geithner is authorized to perform the functions of the bureau until a director is nominated by the President and confirmed. TARP Congressional Oversight Panel chief Elizabeth Warren continues to be the leading contender, as was confirmed by White House senior advisor David Axelrod. Because of the importance of the first director of the CFPB in shaping the role of the bureau, the fact that the term is for 5 years, many expect that a potential confirmation hearing for Warren would be a particularly fierce battle.

The CFPB will have a research department, an Office of Fair Lending and Equal Opportunity, and Office of Financial Education, and Office of Service Member Affairs, and an Office of Financial Protection for Older Americans. The new director of the CFPB will have the authority to select the head of each of these departments, along with a deputy director.

Credit Rating Agencies:

As a result of certain credit rating provisions in Dodd-Frank, the three major raters – Standard and Poor's, Moody's Investors Services, and Fitch Ratings – have expressed concern that they will be exposed to new liability. The new law requires issuers to obtain credit raters' consent when using their ratings in Securities Act registration statements and related prospectuses, and rescinds a rule that previously exempted credit rating agencies from being considered "experts" in this scenario. Because of the rating agencies' hesitation to take on increased liability, credit raters have pulled back from the asset-backed securities market and the market has effectively "seiz[ed] up," according to one congressman.

The SEC, in response to reports that rating agencies are pulling out of the ABS market, said on Thursday that it would allow ABS issuers to omit, for six months, credit ratings from their registration statements. The Division of Corporation Finance at the SEC expects to issue a "no action" letter in the very near future to allow issuers, rating agencies and other market participants with a transition period to implement the changes needed to comply with new statutory requirements.

Federal Reserve Chair Ben Bernanke, in a hearing on Thursday, stated that this is a matter for the SEC, but that he would be happy to work with the agency to find alternative solutions to the problem.

Federal Preemption of State Law:

Dodd-Frank will preserve federal preemption in most cases, but the language also raises a lot of interpretive problems and potential liability risk. National banks and other institutions will have to determine quickly whether they need to continue following state law or not, because no safe harbors or grandfather clauses exist for bank conduct as of the date of enactment. According to legal experts who interpreted the new law, state consumer protection will be preempted under Dodd-Frank in the case of:

1. State law discriminating against national banks
2. State law being preempted by another provision in federal law, or
3. State law running afoul of the 1996 Supreme Court ruling in *Barnett Bank of Marion County, N.A. v. Nelson* (517 U.S. 25), which prohibited the prevention of or significant interference with a national bank's exercise of its powers.

Understanding the implications of the law will take some time, but technically the preemption language went into effect as soon as the law was signed by President Obama on Wednesday.

SEC Expansion:

SEC Chair Mary Schapiro testified at a July 20th hearing before the House Financial Services Subcommittee on Capital Markets, stating that over time the agency will have to add as many as 800 new positions in order to carry out the new authority and requirements under Dodd-Frank. The law adds registration requirements for private equity fund advisers and credit rating agencies, mandates a number of studies, and expands rulemaking authority. The SEC is already starting to enhance its human resources staff and streamline the hiring process.

Debit Card Fee Limits:

Senate Majority Whip Richard Durbin's (D-IL) provision, requiring the Fed to make a rule limiting the fees a debit card issuer can charge a retailer to process transaction, had the banking industry calculating its cost even before it was enacted on Wednesday. Bank of America was the only bank to publish a prediction of the ramifications - it expects to lose between $1.8 billion and $2.3 billion in annual revenue, starting in the third quarter of 2011. Analysts at FBR Capital Markets also researched the top 20 debit card issuers and found that collectively they could lose nearly $6.7 billion in revenue if the rule were applied in 2010.

The largest institutions - including Wells Fargo & Co, Bank of America, and JP Morgan Chase & Co - would have a relatively minimal impact on overall earnings, with profits dipping between 3% and 6%. Smaller institutions, according to the analysts, could take a larger hit - between 7% and 16%. The numbers are based on the worst-case scenario, on the assumption that the Fed would not allow for any profit margin, which is highly unlikely. Still, the banking industry has counted on this revenue for years, and they are expected to make up for it by eliminating free checking accounts and raising fees for other services.

International Harmonization:

On Tuesday, at a Senate Banking Security and International Trade and Finance Subcommittee hearing, some Senators expressed their concerns that a lack of international agreement on financial regulatory reform could trigger a "race to the bottom" that could leave the global financial marketplace still at risk. Although the international community, via the Basel Committee, is working toward consensus on capital standards, derivative trading and other reform measures, anxiety still exists that certain countries might be able to take advantage of disparities in legal regimes to expand their market share. Senator Corker (R-TN) was specifically concerned with the Volcker Rule aspect of Dodd-Frank, that doesn't exist in many Asian countries. Subcommittee Chair Evan Bayh (D-IN), had similar fears because the European Union hasn't been taking strong enough measures in handling its sovereign debt crisis after the Greece financial crisis.

Experts agree that without international consensus on regulatory reform, U.S. businesses and capital will emigrate to countries with less restrictive financial regimes. However, at the G20 Summit in Toronto in June, international officials agreed to a communiqué calling for tough new capital standards. The International Monetary Fund and Financial Stability Board will be making assessments of major country's regulator frameworks to determine if they are implementing tough standards, and the Basel Committee is

expected to reach an agreement later this year on bank capital standards. Both of these actions have the potential to create some international consensus.

ADMINISTRATION TO TACKLE U.S. HOUSING MARKET NEXT

The U.S. housing market, which was conspicuously left off the table in the final financial regulatory reform law, will finally be addressed now that President Obama has signed Dodd-Frank into law. The administration is expected to pursue an overhaul of government policy that deviates from prior emphasis that has been placed on home ownership. The administration may wind down some federal backing of home loans and increase its focus on affordable rentals. This changed perspective, as compared to prior administrations, on who should own a home could have serious consequences for the economy and borrowers.

TREASURY EMERGENCY LOAN PROGRAM GUARANTEE LOWERED

On Tuesday, the Treasury Department announced that it is reducing the guarantee on the Term Asset-Backed Securities Loan Facility (TALF), because it does not expect its credit protection to be needed going forward. TALF, the recently expired emergency lending program for aiding securitization markets, was previously backed by the Treasury for $20 billion, and this sum will now be reduced to $4.3 billion. Treasuring credit protection came from the Troubled Asset Relief Program, and was second in line to absorb potential TALF losses. The Fed, which ran the program, was the first line of backing.

TALF loans reached $70 billion during the program's existence, and were provided to investors in highly-rated asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS). The program began in March 2009, and many of the loans were repaid as market conditions normalized and better interest rates were available outside of TALF. The Fed stopped providing loans for ABS and CMBS on March 31st and June 30th of this year, respectively. The TALF program has experienced no losses and all its outstanding loans are well-collateralized, according to the Fed.

TARP PROGRESS REPORT

At a Senate Finance Committee hearing on Wednesday, three overseers of TARP gave a mixed report on its progress. Overall, the repayments of capital are proceeding, but small financial institutions are missing schedule repayments unlike their larger counterparts. Elizabeth Warren, chair of the Congressional Oversight Panel and serious contender for the head of the new Consumer Financial Protection Bureau, noted that TARP funds went to 707 banks, with the 17 largest banks receiving 81% of all the funds. The remaining 690 banks are repaying the Treasury at a much slower pace, and 15% of these smaller banks have already missed one of their dividend repayments.

The panel of overseers expressed their support for the goals of the Small Business Jobs Act (H.r. 5297), though not its exact implementation because of oversight concerns. The panel also spoke about the Home Affordable Modification Program (HAMP), which is also administered by the Treasury. HAMP faced serious criticism for failing to meet its objective - preventing foreclosures by letting homeowners work with lenders to receive loan modifications. Warren testified that HAMP isn't working for homeowners, investors, or the economy overall. She warned that a crisis in commercial real estate is also looming, because of the questionable stability of many loans guaranteed by medium- and small-sized

banks. She added that these loans are disproportionately spread across banks, which will create "additional, profound stresses on the financial system."

BASEL COMMITTEE ANNOUNCES CAPITAL PROPOSAL

Last week, the Basel Committee on Banking Supervision publicized the details of its proposal requiring banks to build up stores of capital to be drawn on during tough economic times. The proposal is a "countercyclical buffer mechanism" that would establish set-aside requirements above the current minimum that was set by Basel II. This buffer would be in addition to the capital conservation buffers that are also part of the Basel III reform packages, and are intended for banks to have funds to draw upon in economic downturns. Each jurisdiction would have the flexibility to extend the size of the minimum buffer range established by the capital conservation buffer, and these decisions would be announced 12 months in advance in order to give banks time to make adjustments.

The Committee, which is comprised of banking supervisors from 27 major financial centers, met on July 14th-15th to discuss a variety of financial issues, including the definition of capital, the treatment of counterparty credit risk, the proposed leverage ratio, proposed liquidity ratios, and transition periods for the implementation of Basel III requirements. Besides the one proposal on capital requirements, the Committee is keeping details of the remaining issue areas under wraps. The chairman of the Committee, Nout Wellink, stated that much ground was covered at the meeting, and Basel III remains on track to make recommendations in for an entire package of capital and liquidity reforms, including design and calibration, in time for the November 2010 G20 Leaders Summit in Seoul.

Many in the banking industry expressed frustration about the lack of communication by the Committee, but some details will likely be made public after a July 26th meeting of central bank governors, in which the changes would be endorsed. The Basel Committee has called for all of its reforms to be implemented by the end of 2012, which was objected to by banks all over the world. The Committee has countered that it will be putting into place appropriate phase-in measures and grandfathering arrangements to ensure a smooth transition. A Basel Committee official stated that the entire revised Basel III package would be published only once agreement is reached among the supervisors on the final design and calibration - no later than November 11th-12th of this year, when the G-20 leaders meet in Seoul, and as early as September or October.

EXTENDING TAX CUTS SET TO EXPIRE

As was reported last week, taxes are set to rise on January 1, 2011, when tax cuts created under the Economic Growth and Tax Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 are set to expire. The two acts created a lower 10 percent tax bracket for everyone, and reduced the tax rates for individuals with higher earnings. Tax rates were capped at 35% for the highest income earners. If Congress does not act to extend these tax cuts, and all cuts are allowed to expire, the 10 percent tax bracket would disappear, and the top individual income tax rate will return to its pre-2001 level of 39.6%.

House Speaker Nancy Pelosi (D-CA) spoke out strongly against extending the tax cuts for top income earners, even temporarily, while Congress takes up a tax cut extension bill in the coming months. She asserted that middle-income tax cuts should be renewed for individuals earning less than $200,000 and

couples earning less than $250,000. She also stated that high-end tax cuts have not created jobs, and that extending these tax cuts for another 10 years would be 20 times more expensive than the $34 billion cost of extending unemployment insurance benefits that Republicans have been fighting because it lacked a budgetary offset.

Treasury Secretary Timothy Geithner echoed Speaker Pelosi's sentiments, and added that the Obama administration believes that tax cuts for the most fortunate should be allowed to expire. Democrats in both chambers of Congress have expressed differing points of view on the tax cuts – Senate Budget Committee Chair Kent Conrad (D-ND) stated his hesitation about increasing taxes in such a fragile economy, and that he would prefer a short-term extension of all the tax cuts. Sen. Ben Nelson (D-NE) shares this view, and Sen. Charles Grassley (R-IA) spoke about the psychological impact that an increase in taxes during a recession might have on all Americans.

Senate Finance Committee Chair Max Baucus (D-MT) didn't take sides on the issue, but did state that lawmakers need to find the right balance for encouraging economic growth and reducing the federal budget deficit. He asserted that the Senate Finance Committee would figure out what's best. House Ways and Means Committee Chair Sander Levin (D-MI) stated that the details of rate extensions and timing are still under discussion in the House, but a lot of what happens will depend upon the Senate. Levin wants to avoid a stalemate over a tax extension bill, which is what happened with the estate tax and extenders bill recently. Unfortunately, there is enough disagreement amongst Senators and only a short amount of time left in this Congress to proceed on the bill, which will make its imminent passage difficult.

UPCOMING HEARINGS

On Tuesday, July 27th at 10am, in 2128 Rayburn, the House Financial Services Committee will meet in open session to consider H.R. 2267, the Internet Gambling Regulation, Consumer Protection and Enforcement Act; H.R. 3421, the Medical Debt Relief Act of 2009; H.R. 4790, the Shareholder Protection Act of 2010; and H.R. 5823, the United States Covered Bond Act of 2010.

On Tuesday, July 27th at 10am, in 138 Dirksen, the Senate Appropriations Subcommittee on Financial Services and General Government will mark up draft legislation for FY 2011 Financial Services Appropriations and Agencies.

On Thursday, July 29th at time TBA, in 106 Dirksen, the Senate Appropriations Committee will mark up draft legislation for FY 2011 Financial Services Appropriations and Agencies.