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FINANCIAL SERVICES REGULATORY REFORM UPDATE

For the Week of July 26, 2010

POST-DODD-FRANK: THE AFTERMATH

Now that the Dodd-Frank Wall Street Reform and Consumer Protection Act is the law of the land, companies from Wall Street to Main Street are attempting to comprehend the impact to their business. Interestingly, one of the unintended consequences of this legislation is that many small banks are expected to consolidate in order to survive the effects of financial regulatory reform. Although the new legislation is on the whole less burdensome on community banks than their larger counterparts, the new rules and tighter scrutiny are still expected to impose a substantial onus on small banks. Increased compliance costs for areas such as mortgage disclosures, combined with stricter capital and lending standards, is expected to have an almost immediate impact on bank profits. One industry expert called it "the end of community banking as we know it," as these small banks are unable or unwilling to bear the brunt of added costs on their own. Another expert agreed with this assessment, but stated that it depends on how Dodd-Frank is implemented and how bank examiners and the consumer czar carry out their responsibilities.

This result is particularly interesting, given the strong public show of support by the Independent Community Bankers of America (ICBA) and many individual small banks in favor of Dodd-Frank during the debate, which was supposed to result in "exemptions" for these smaller institutions. For example, the Consumer Financial Protection Bureau (CFPB) will only have jurisdiction over banks with more than $10 billion in assets. Banks with less than $10 billion in assets will be required to adhere to CFPB rules, but will be overseen by other regulators that are already familiar with bank operations. Additionally, the FDIC will be basing deposit insurance assessments on banks' average total assets, rather than on its deposit base, which will result in result in smaller banks paying a smaller, and more proportionate share of the Deposit Insurance Fund for bank failures. It remains to be seen what the effects of Dodd-Frank will be, and the extent to which mergers and acquisitions will decrease the size of the small bank community.

Another ancillary impact of the legislation that is being closely watched by industry is the amount of collaboration is requires amongst federal government agencies, especially with regard to joint rulemaking. Specifically, there is potential for the Securities and Exchange Commission (SEC) and Federal Deposit Insurance Corporation (FDIC) to butt heads on big issues such as over-the-counter derivatives and risk retention. The two agencies' perspectives center around investor protection and bank supervision, respectively, which do not always mesh perfectly.

Other concerns exist about the calculation of pay ratios required under investor protection provisions, which are difficult for multinational corporations to determine. Industry experts have stated that this pay ratio provision is "fraught with implementation difficulties and uncertainties," and that it is up to the SEC

to make it work. The SEC's potential rulemaking imposing a fiduciary duty on broker-dealers would also "radically change" the way in which brokers sell products, and could result in a significant increase in litigation. The growth of hybrid entities is also expected to be quite pronounced after SEC advisor registration requirements under Dodd-Frank are fully in effect. Financial entities are not always easily characterized as hedge, private equity or venture capital funds, and in order to avoid the new advisor registration rules, many funds will be changing their structures.

The SEC is also expected to focus its near-term efforts on Dodd-Frank's provisions on say-on-pay, golden parachutes and proxy access, in order to put these requirements in place for 2011.

One of the more controversial Dodd-Frank provisions that didn't get much press while the bill was being debated is Section 929I, which allows records obtained from registered entities to be kept confidential by the SEC if obtain as part of its "regulatory and oversight activities." Specifically, the measure amends the 1934 Securities Exchange Act, the 1940 Investment Company Act, and the 1940 Investment Advisors Act to allow risk assessment and surveillance functions to remain confidential, analogous to other SEC examinations. While the SEC supports this provision because it "removes an opportunity for [registrants] to refuse to cooperate with" the SEC's examination process, opponents such as Reps. Issa (R-CA) and Bachus (R-AL) called it a "reward [of] even more authority and discretion" for Democrats, which led them to have concerns about a lack of SEC oversight. As a result, Issa, who is the Ranking Member of the House Oversight and Government Reform Committee, introduced a bill on Thursday that would repeal Section 929I – the "SEC Freedom of Information Restoration Act."

Dodd-Frank does explicitly state that the SEC may not withhold the information from Congress, other federal agencies and courts. Private citizens and private watchdog groups are the only entities that are restricted from accessing information from these examinations. A spokesman for House Financial Services Chair Barney Frank (D-MA) responded that Dodd-Frank puts the SEC in the exact same position as other banking regulators including the Federal Reserve and the FDIC, which are given company information on a proprietary basis and are kept confidential.

SENATE APPROPS COMMITTEE APPROVES FY2011 FINANCIAL SERVICES BILL – PUTS THE BRAKES ON DURBIN INTERCHANGE FEES AMENDMENT

After being voted out of the Senate Financial Services and Governmental Operations Subcommittee on Tuesday, the full Appropriations Committee voted two days later, by a vote of 18-12, to also approve the $48.3 billion fiscal 2011 financial services spending bill. The bill funds the Treasury Department, the Executive office of the President, the federal judiciary, the Small Business Administration, the SEC, several smaller agencies, and the District of Columbia. The bill offered legislators a chance to beef up the agencies that oversee small business, consumer safety and financial markets, and that were granted new authority under Dodd-Frank. The Subcommittee Chair, Senator Durbin (D-IL), stated that he was determined to give agencies such as the SEC and the Commodity Futures Trading Commission (CFTC) the ability to administer the new responsibilities required by the Wall Street Reform and Consumer Protection Act.

In the bill, the SEC would receive $1.3 billion – 18% more than its FY2010 appropriations and 3% more than President Obama requested. The funding is intended for increasing legal and investigative staffing

for oversight and enforcement responsibilities. The CFTC would also receive $286 million in appropriations, which is $117 million more than it was granted in FY2010.

Finally, the Committee defeated an amendment offered by Senator Durbin that would have capped interchange fees paid by the federal government for transactions that use credit cards. This amendment, which had passed a subcommittee vote two days earlier, was defeated at the full committee markup by Sen. Susan Collins (R-Maine), who convinced enough Democrats that it was necessary to let the Government Accountability Office study conduct its study, as required by Dodd-Frank. Interestingly, according to Fred Becker, president and chief executive officer of the National Association of Federal Credit Unions, payment card networks already offer the government some of the lowest interchange rates available, and some agencies also have been able to negotiate reductions or customized arrangements. Collins's substitute amendment ultimately passed the full committee by voice vote, and became part of the appropriations bill sent to the Senate floor where the bill as a whole faces an uncertain future.

HOUSING FINANCE NEXT ON ADMINISTRATION'S AGENDA

On Tuesday, Treasury Secretary Timothy Geithner announced that he will be holding a conference on August 17th to examine the "future of housing finance." The event will be to bring together academics, consumer advocates and members of the financial industry to discuss restructuring the mortgage market, with an emphasis on Fannie Mae and Freddie Mac. It has been almost two years since the Federal Housing and Finance Agency (FHFA) placed the two government sponsored enterprises (GSEs) in conservatorship, and now that financial regulatory reform has come to fruition, the Obama administration is moving on to this new reform.

Republican lawmakers have been highly critical that Democrats and the administration took this long to deal with the GSEs, and for excluding them from financial regulatory reform. The Treasury has been soliciting public comments on the future of Fannie and Freddie, and Republicans (House Financial Services Committee Ranking Member Spencer Bachus (R-AL) in particular) have called this a stalling tactic for actually dealing with the problems. Democratic legislators countered that it would have been irresponsible to reform the mortgage market in mid-recovery from the financial crisis. Fannie and Freddie, along with the Federal Housing Authority account for about 90% of newly originated mortgages in the U.S., and administration officials have asserted that a careful approach to reform is needed for this very reason. Of the 400 comments received by the Treasury relating to the GSEs, almost none have supported retaining Fannie and Freddie without dramatic change in their structure and operations.

Regardless of timing, the options for restructuring Fannie and Freddie have been clearly outlined and it simply remains to be seen which alternative will be most appealing to lawmakers. The first choice would be to privatize the two GSEs, and potentially break them down into a group of smaller firms that would continue guaranteeing mortgage-backed securities. A second option would be to nationalize Fannie and Freddie into one institution, and re-orient the new government agency towards backing mortgages for the low- and moderate-income housing market. The final potential would be to regulate the GSEs like public utilities, which has been advocated for by former Treasury Secretary Henry Paulson and others. Congress will also have to determine whether to address the Federal Home Loan Bank System, a group of 12 GSEs throughout the country, all of which provide cash for banks to create mortgages. The bank system is owned by member financial institutions, and is also overseen by the FHFA.

House Financial Services Chair Barney Frank (D-MA) stated that he will be introducing mortgage market reform legislation post-recess in September. However, the Treasury is not required to provide Congress with its recommendations for Fannie and Freddie until the end of January, and it is unlikely that Congress will even be ready for debate on the issue before 2011. The Treasury will be making recommendations on both the GSEs specifically and the future of U.S. housing finance in general.

THE DISCLOSE ACT: STALLS IN SENATE, SEES NEW EFFORTS IN HOUSE

The DISCLOSE Act (S. 3295), drafted in response to the Supreme Court's *Citizens United* decision striking down limits on corporate spending in elections, saw some major action this week. Senate Democrats failed to stymie a Republican filibuster against the bill on Tuesday – 60 votes are needed to invoke cloture, and the final tally was along party lines at 57-41. The Boston Globe reported that this failed vote "end[s] the Democrats' quest for stronger rules" in the campaign finance realm. The House version of the bill, H.R. 5175, passed the House in June. The bill is a major priority of the Obama administration, and would amend the Federal Election Campaign Act of 1971 to require corporations and unions to disclose their role in funding political campaigns, and to bar domestic subsidiaries of foreign corporations from spending to influence campaigns.

Meanwhile, legislation introduced by Rep. Michael Capuano (D-MA) that would give shareholders limited approval over a company's political expenditures was voted favorably out of the House Financial Services Committee on Thursday. That bill, H.R. 4790, the Shareholder Protection Act of 2010, would amend the Securities Exchange Act of 1934 to require that shareholders annually approve any corporate federal campaign expenditures over $50,000, by majority vote. The bill would also require corporations to detail any political spending over $10,000 in annual shareholder reports, and would grant the SEC new rule-making authority in this realm. The proposed law would not apply to expenditures in state and local races, and would not allow shareholders to dictate *how* the money is spent. The final Committee vote was 35-28, largely along party lines, but with Democratic Reps. Donnelly, Minnick and Childers voting against. This bill is likely to come to the House floor post-recess in September, and it appears unlikely that Capuano's bill would advance independently in the Senate after that chamber's failure to pass the initial DISCLOSE Act.

BASEL COMMITTEE ISSUES PROPOSED CHANGES

This past Monday, the Basel Committee on Banking Supervision released details of amendments to its proposed Basel III rules, which would affect parameters for determining minimum capital set-aside requirements and the phase-in period for implementing the changes. Otherwise, central bank governors and heads of banking supervision agencies from the Basel Committee's 27 member countries endorsed the majority of the recommendations agreed to by the Committee at its mid-July summit, and the "overall design of the capital and liquidity reform package" put forward by the Basel Committee. Agreed-upon provisions include the definition of capital, the treatment of counterparty credit risk, the leverage ratio, and the proposed global liquidity standard.

The governors and supervisors are also expected to reach consensus on proposed capital buffers and set amounts for capital set-aside requirements and phase-in arrangements before the end of the year. However, the Basel Committee also reports that one of its member countries "still has concerns" about the main design elements of the package, and is reserving judgment until the final figures and

arrangements are decided when the governors and supervisors next meet in September. The Basel Committee would not identify the one country with concerns, and stated that it is still on course to deliver a final package of recommendations for the next G-20 Summit on November 11th in Seoul, South Korea.

Central Bank governors and regulatory supervisors also endorsed other proposals to address systemic risks to the global financial system. One of the proposals, for which the Basel Committee issued a proposal for consultation, would require that contractual terms be written into capital instruments, giving regulators the option to write off or to convert instruments to common shares in case a troubled bank fails to secure private sector financing. The governors and supervisors also reviewed an issues paper on the potential use of contingent capital to meet a portion of the capital buffers requirement. The Basel Committee will have a progress report at its September meeting, and will review a full proposal on the issue at its December issue.

EU BANKS PERFORMING BETTER THAN EXPECTED

Of the 91 banks subjected to a stress test last week, only seven of them (almost all Spanish) failed, and the rest were given a clean bill of health. European banking regulators and governments determined that only $4.4 billion in recapitalization would be needed, and that the European banking sector was doing well on the whole. Of the second failing institutions, five are small Spanish savings banks, which lost billions of dollars in the Spanish real estate market collapse. The remaining two banks were a Greek bank (ATEBANK) and German bank (Hypo Real Estate). Those banks failing the stress test will have to find funds for recapitalization, and some banks that barely passed have already announced their own recapitalization plans. The Committee for European Banking Supervisors made a public statement that this is an indication of the European banking system's resilience, but that "this outcome is partly due to the continued reliance on government support for a number of institutions." In total, European governments have provided almost $300 billion in bailouts to keep banks afloat.

The European stress test was said to be more severe than those held in the U.S. in 2009, and included a 3% drop in overall EU GDP in the next two years, a sovereign debt crisis similar to the Greek one, a spike in the unemployment rate (10.8% in 2010 and 11.5% in 2011), and a further decline in real estate prices. To pass the tests, European banks had to have Tier 1 capital over a 6% level. The banking regulators did not factor in a possible debt default by Greece, Spain or Portugal, even though each of these countries has been facing severe public finance pressure. Some of also critical of the fact that Germany's "Landesbanken" (regional government-owned institutions saddled by debt) passed the stress test, calling into question the credibility of the results.

The IMF Director General called the stress test results an important turning point for the EU, after the May crisis that almost sank the EU single currency. As a result of the crisis, the EU governments and the IMF set up a $1 trillion fund to aid any euro zone country that would potentially face a sovereign debt default. European government officials are now much more optimistic about the "transparency and resilience of European banks. Treasury Secretary Timothy Geithner also welcomed the good news, and praised the EU for its efforts to "increase disclosure on the conditions of individual European financial institutions and enhance market stability."

UPCOMING HEARINGS

On Tuesday, August 3rd at 10am, in 608 Dirksen, the Senate Budget Committee will hold a hearing on the status of the U.S. economy.

The House of Representatives will be in recess until Monday, September 13th.