Banking - USA

Conference Committee Report on Dodd-Frank Act is approved

Contributed by **Sidley Austin LLP**

July 09 2010

Author

William S Eckland

Introduction

At 5:39 am on Friday June 25, by separate votes along strict party lines of 20 to 11 and seven to five, House of Representatives and Senate conferees separately approved the Conference Committee Report on the financial regulatory reform bill, HR 4173, now known as the Dodd-Frank Wall Street Reform and Consumer Protection Act. Different versions of the act had been approved by the House of Representatives in December and by the Senate in May. Following reaction by some legislators to the so-called 'bank tax' to fund the estimated $22 billion administrative and other costs of the act over 10 years, conferees reconvened on June 29 to adopt an alternative funding mechanism provision by a similar partisan vote. House Financial Services Chairman Barney Frank presided over the seven-plus days of televised public hearings of the conferees. The act was approved by the House of Representatives on June 30 by a 237 to 192 vote, with Senate action to follow. President Obama is expected to sign the measure into law shortly after final approval by the Senate. The act will generally take effect one day after the date of enactment, with certain exceptions.

This update summarizes the key provisions that will impact on the banking sector. An in-depth discussion of the act in full can be accessed at http://www.sidley.com/files/News/9daacd6d-9deb-446a-b4da-57b96610f49a/Presentation/NewsAttachment/adc9ea2a-2fd6-4462-a79c-97dbef2

Financial Stability Oversight Council

Composition
Title I, Subtitle A of the act establishes an interagency council to identify and monitor systemic risks posed by financial firms and financial activities and practices. The Financial Stability Oversight Council comprises: (i) 10 voting members - the heads of the federal financial regulatory agencies, the new Bureau of Consumer Financial Protection and an independent member with insurance expertise; and (ii) five non-voting members - the heads of the new Office of Financial Research and the new Federal Insurance Office, a state insurance commissioner, a state banking supervisor and a state securities commissioner. The council is chaired by the secretary of treasury.

Authority
Designation of non-bank financial companies for supervision
The council is charged with designating US and foreign non-bank financial companies that could pose a threat to the financial stability of the United States. Designated companies are required to register with the Board of Governors of the Federal Reserve System and, along with bank holding companies with consolidated assets of $50 billion or more, are subject to supervision and enhanced prudential standards established by the Federal Reserve Board.

Supervision recommendations.
The council can make recommendations to the Federal Reserve Board for stricter

prudential standards to be applied to designated companies and large bank holding companies, on an individual basis or by category. The council can also make recommendations to the primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices. The primary financial regulatory agency must adopt recommended standards within 90 days or explain its determination not to follow the recommendation.

Other duties
The council's other duties are, among other things:

- to facilitate information sharing and coordination among the member agencies and other federal and state agencies;
- to identify gaps in regulation;
- to identify systemically important financial market utilities and payment, clearing and settlement activities; and
- to monitor domestic and international financial regulatory proposals and developments, and advise Congress and make recommendations in these areas.

The council also can authorize the Federal Reserve Board to take certain actions with respect to a designated company or large bank holding company to mitigate grave threats to financial stability, including limiting new affiliations or financial products, requiring the company to terminate one or more activities or imposing conditions on conduct of activities.

Enhanced supervision and prudential standards

Covered entities
US and foreign non-bank financial companies
Companies subject to designation for enhanced supervision and prudential standards are US and foreign non-bank financial companies that are "predominantly engaged in financial activities" that could pose a threat to the financial stability of the United States in the event of their material financial distress or based on their activities.

A company is 'predominantly engaged in financial activities' if 85% or more of its consolidated annual gross revenues are derived from, or 85% or more of its consolidated assets relate to, activities that are financial in nature, as defined in Section 4(k) of the Bank Holding Company Act of 1956, or the ownership or control of one or more insured depository institutions.

The criteria for designation of a US non-bank financial company for prudential regulation by the Federal Reserve Board include:

- extent of leverage;
- extent of off-balance-sheet exposures;
- nature, scope, size, scale and concentration;
- interconnectedness and mix of activities;
- the degree to which the company is already regulated by one or more primary financial regulatory agencies;
- the degree of reliance on short-term funding; and
- any other risk-related factors deemed appropriate by the council.

The criteria are substantially the same for foreign non-bank financial companies. The Federal Reserve Board, on behalf of and in consultation with the council, can establish criteria for exempting certain types or classes of non-bank financial companies from board supervision.

Large bank holding companies
Bank holding companies with total consolidated assets of $50 billion or more are subject to the enhanced supervision and prudential standards established under the act. Under the so-called 'Hotel California' provision of the act, large bank holding companies that have received Troubled Asset Relief Programme (TARP) funds cannot avoid Federal Reserve supervision by dropping their banks.

More stringent standards
Title I, Subtitle C of the act authorizes the Federal Reserve Board to establish prudential standards applicable to designated companies and large bank holding companies. Standards must be more stringent than those applicable to non-bank financial companies and bank holding companies that do not present similar risks to US financial stability, and can be imposed on an individual basis or by category, taking into consideration risk-related factors such as capital structure, riskiness, complexity, financial activities and size. Standards will include risk-based capital requirements and leverage limits, liquidity requirements, overall risk management requirements, resolution plan and credit exposure report requirements, concentration limits and stress tests, and may also include a contingent capital requirement and short-term debt limits (other than deposit liabilities), among others.

Other supervisory requirements

Intermediate holding company
Designated companies engaged in commercial activities can, or may be required to, segregate financial activities in an intermediate holding company, which is not required to conform activities to the requirements of Section 4 of the Bank Holding Company Act, and the company's non-financial activities are expressly excluded from Federal Reserve Board supervision and prudential standards.

Acquisitions of bank shares subject to Bank Holding Company Act
Designated company acquisitions of bank shares are made subject to Section 3 of the Bank Holding Company Act as if such companies were bank holding companies. In addition, designated companies and large bank holding companies must provide written notice to the Federal Reserve Board prior to the acquisition of voting shares of a company engaged in financial activities that has total consolidated assets of $10 billion or more, with certain exceptions.

Increased leverage and risk-based capital requirements
Minimum leverage and capital ratios
Under the so-called 'Collins Amendment', the federal banking agencies must adopt minimum leverage and risk-based capital requirements on a consolidated basis for all insured depository institutions, depository institution holding companies and designated companies. The minimum requirements cannot be less than minimum ratios currently in effect for depository institutions. The intent is to require large banks and bank holding companies, as well as designated companies, to meet, at a minimum, the same capital standards imposed on small banks. Small bank holding companies (with consolidated assets under $500 million), debt or equity securities issued to the United States under TARP and any federal home loan bank are excepted. Capital ratios for leverage purposes are measured by average total assets, thereby eliminating any incentive to engage in so-called 'Repo 105' transactions.

Trust preferred securities
The act phases in a requirement that depository institution holding companies and designated companies exclude trust preferred securities from Tier I capital. Existing trust preferred securities that were issued before May 19 2010 are grandfathered for all depository institution holding companies with less than $15 billion in total consolidated assets and mutual holding companies. Holding companies with $15 billion or more in total assets have five years to comply with the provision, with three years to phase out their trust preferred securities, beginning on January 1 2013. Thrift holding companies are also subject to the three-year phase-out of their trust preferred securities, but have five years to comply with the minimum leverage and risk-based capital requirements.

Financial market utilities
Title VIII of the act grants new powers to the Federal Reserve Board and Financial Stability Oversight Council (acting in conjunction with the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC)) over 'financial market utilities' (including clearinghouses) designated as systemically important, and over financial institutions other than clearinghouses that engage in systemically important payment, clearing and settlement activities. Title VIII authorizes these regulatory bodies to mandate risk management standards, provides new examination and enforcement powers, and authorizes imposition of new information gathering, reporting and record-keeping requirements. Title VIII also grants designated financial market utilities access to certain Federal Reserve Bank services, including discount and borrowing privileges, under certain limited circumstances.

Orderly liquidation
With a view to ending 'too big to fail', Title II of the act creates a special orderly liquidation regime (for the orderly dissolution of systemically important "financial companies" modelled on the existing Federal Deposit Insurance Act regime for the resolution of failed Federal Deposit Insurance Corporation (FDIC) insured depository institutions, and administered by the FDIC as receiver.

Under the act, a financial company can be taken out of the bankruptcy regime that would normally apply to it and placed into the orderly liquidation regime upon certain determinations by the treasury secretary, in consultation with the president. This can occur before a financial company would have become subject to a proceeding under the normally applicable bankruptcy regime or even after such a proceeding has commenced. Once a financial company is placed into the orderly liquidation regime, its receivership must be completed within three years, subject to two one-year extensions. Although the orderly liquidation regime allows for the use of 'bridge financial companies' for the purpose of liquidating a failed financial company, there is no option for rehabilitation or reorganization, or for a Federal Deposit Insurance Act-style conservatorship under which the failed financial company can continue to be run as a going concern.

The FDIC's powers as receiver under the orderly liquidation regime are similar to the powers it has as receiver under the Federal Deposit Insurance Act, with certain modifications intended to reduce differences between the Federal Deposit Insurance

Act and the Bankruptcy Code regime. The FDIC is required to exercise such powers in a manner that mitigates significant risk to the financial stability of the United States and minimizes "moral hazard" so that:

- creditors and shareholders will bear the risk of losses of such financial company;
- management responsible for the financial condition of the financial company will not be retained; and
- all parties having responsibility for the condition of the financial company bear losses consistent with their responsibilities, including actions for damages, restitution and recoupment of compensation and gains not compatible with such responsibility.

An orderly liquidation fund, which is to be funded only after an insolvency of a financial company subjected to the orderly liquidation regime, is established to fund liquidations under the regime. The orderly liquidation fund is to be funded with repayments to the FDIC with respect to the insolvent financial company, through assessments and with borrowings from the Treasury (subject to specified limitations). Amounts needed to repay Treasury borrowings are required to come first from assessments on entities that received more under the orderly liquidation regime than they would have received in a liquidation of the financial company, and then from assessments on bank holding companies with total consolidated assets of $50 billion or more, non-bank financial companies supervised by the Federal Reserve Board and other financial companies with total consolidated assets of $50 billion or more. Assessments are to be levied on a graduated basis, with larger and riskier companies paying a higher assessment rate.

Banking reform

Elimination of Office of Thrift Supervision
While the act preserves the thrift charter, Title III of the act abolishes the Office of Thrift Supervision (OTS). OTS authority with respect to savings associations, their holding companies and their affiliates will be transferred to the Office of the Comptroller of the Currency (OCC), the FDIC and the Federal Reserve Board. The effective date for the elimination of the OTS is one year after enactment of the act, unless the timeline is extended.

Deposit insurance changes
Title III of the act modifies the calculation of the 'assessment base' upon which deposit insurance premiums are calculated. In general, the new assessment base will equal the average total consolidated assets of an insured depository institution minus the sum of the average tangible equity of the insured depository institution during the assessment period. Additional amounts will be subtracted from average total consolidated assets for custodial banks and banker's banks. In addition, the act grants the FDIC greater authority to build up excess reserves when the bank insurance fund has otherwise met its targets.

Title III of the act will increase the deposit insurance fund reserve ratio from 1.15% to 1.35% by September 30 2020. The cost of this increase will be borne by insured depository institutions with assets of $10 billion or more.

Title III of the act makes permanent the increase in standard maximum federal deposit and share insurance limits from $100,000 to $250,000. Although unlimited federal insurance of the net amount of non-interest-bearing transaction accounts is extended from December 31 2010 through December 31 2013, the definition of 'non-interest-bearing transaction account" is more restrictive than the definition currently used in the FDIC's transaction account guarantee programme.

Emergency lending and financial stabilization authority
Title XI of the act requires the Federal Reserve to establish policies and procedures governing emergency lending under Section 13(3) of the Federal Reserve Act. The act requires that these procedures be designed to ensure that emergency lending is used to provide liquidity to the financial system and not to aid failing financial companies, and that collateral for emergency loans be sufficient to protect taxpayers from losses. The act includes several provisions aimed at making the use of such emergency lending programmes transparent, including:

- a requirement that the Federal Reserve make reports to Congress on the programmes and facilities created under this authority;
- a requirement that the Federal Reserve publicly disclose the identity of participants in such programmes and facilities; and
- a grant of authority to the Government Accountability Office to audit the programmes and facilities created under this authority.

Title XI of the act also requires the FDIC to establish a debt guarantee programme to guarantee the obligations of solvent insured depository institutions or solvent depository institution holding companies if it is determined that a statutorily defined 'liquidity event' exists, and to establish policies and procedures governing the issuance of such guarantees. The amount of debt that the FDIC may guarantee under a debt guarantee programme will be subject to a maximum cap.

Shift of regulatory focus
Title III of the act contains several provisions aimed at shifting the economic burden of regulation to the largest institutions and increasing regulatory focus on fairness and non-discriminatory treatment. Such provisions include expressly charging the OCC with:

- assuring "fair access to financial services and fair treatment of customers by, the institutions and other persons subject to its jurisdiction";
- requiring the Federal Reserve to impose fees on certain large bank holding companies and savings and loan holding companies; and
- requiring each federal banking agency to establish an Office of Minority and Women Inclusion that will be responsible for all matters of the agency relating to diversity in management, employment and business activities, including increasing women and minority-owned business in the programmes and contracts of the agency.

Capital rules and source of strength
In Title VI of the act, the authority of the federal banking regulators to establish bank holding company and savings and loan holding company capital standards is clarified, and federal banking regulators are instructed to make capital requirements for such holding companies and for depository institutions countercyclical.

A source of strength doctrine is applied to all depository institution holding companies, including commercial companies that control a depository institution. If a holding company is not a bank holding company or savings and loan holding company, it may be required to submit a report under oath assessing its ability to serve as a source of strength.

The Volcker Rule
In Title VI of the act, federal banking agencies, through a joint rule-making, are required to prohibit proprietary trading or sponsoring or investing in a hedge fund or private equity fund by a 'banking entity', defined as an insured depository institution, a company that controls a depository institution, a company treated as a bank holding company and any subsidiaries of such institutions or companies (including broker-dealer and fund manager affiliates or subsidiaries). Several exceptions to the rule may apply, including with respect to risk-mitigating hedging activities and trading conducted on behalf of customers. Regulators are directed to impose additional capital requirements and quantitative limits on excepted activities.

Additionally, a banking entity that organizes and offers a hedge fund or private equity fund may make and retain an initial investment if, within one year of establishment of the fund, the investment is reduced to 3% or less of total ownership interests and is immaterial to the banking entity (the maximum of all such investments must be 3% or less of the banking entity's Tier 1 capital). The Federal Reserve Board may extend the one-year period for two additional years.

Banking entities must dispose of prohibited investments or relationships within: (i) two years of the Volcker Rule requirements becoming effective (which occurs on the earlier of 12 months after the issuance of final regulations or two years after enactment of the act); or (ii) two years after a banking entity becomes a non-bank financial company subject to Federal Reserve Board supervision under Title I of the act, subject to up to three possible one-year extensions. An additional exemption of up to five years may be granted by the Federal Reserve Board to the extent necessary in the case of a banking entity that is subject to a contractual obligation that was in effect on May 1 2010 regarding an investment in or capital commitment to an illiquid fund. Regulators are directed to issue rules to apply during the divestiture period that impose additional capital requirements and other restrictions on banking entities that sponsor or invest in hedge funds or private equity funds.

While the Volcker Rule does not apply to non-bank financial companies that are not banking entities, the Federal Reserve Board is required to adopt rules that impose additional capital requirements and quantitative limits on non-bank financial companies that it supervises pursuant to Title I of the act and that engage in proprietary trading or sponsoring or investing in hedge funds or private equity funds.

Concentration limit on expansion
In Title VI of the act, depository institution mergers and acquisitions are prohibited if they result in a greater than 10% concentration of US deposits in a single holding company or institution. Also, financial company mergers and acquisitions are prohibited if the total consolidated liabilities of the acquiring financial company upon consummation of the transaction would exceed 10% of the aggregate consolidated liabilities of all financial companies. 'Financial companies' include depository institutions, companies that control them and non-bank financial companies supervised by the Federal Reserve

Board under Title I of the act.

Consumer protection

Bureau of Consumer Financial Protection

Title X of the act, as contemplated by the Obama administration's original reform proposal, creates a new federal entity to serve as a dedicated consumer protection watchdog. This element of the act is intended to respond to the concern that existing federal agencies have not adequately prioritized their consumer protection mission and have permitted the industry to offer products unsuited to consumers.

Structurally, the act creates the Consumer Protection Bureau as a new office within the Federal Reserve. The new bureau, however, will be independent of the Federal Reserve Board. The Federal Reserve Board will be prohibited from interfering with the personnel or functions of the bureau. The bureau will have broad authority to issue regulations and interpretations under the existing panoply of federal consumer protection law (which will be transferred to the new bureau), as well as under its new authorities to issue regulations concerning, among other things, unfair, deceptive and abusive practices, and disclosure requirements.

Exemptions

A key political issue, finally resolved by the Conference Committee, concerned exclusions from the direct oversight of and examination by the new bureau. Under the act, only the following entities are generally subject to direct examination by the bureau:

- large depository institutions;
- mortgage lenders, brokers and servicers;
- lenders of private student loans and payday loans; and
- other large providers of consumer financial products.

(The bureau will have enforcement authority with respect to other non-bank entities as well.) In addition, certain entities are entirely exempt from bureau oversight (although they may be subject to rules issued by the bureau under its authorities), including auto dealers, real estate brokers and persons subject to regulation by the SEC, CFTC or state insurance regulators.

Enforcement

The bureau will have broad investigative and enforcement authority to enforce the existing statutes transferred to its jurisdiction, as well as existing regulations and any new regulations issued by the bureau. In litigation, the bureau will have the right to seek substantial relief, including restitution and damages on behalf of consumers, injunctive relief and reformation of contracts. Civil penalties for violations can range from $5,000 to $1 million per day of violation.

Federal pre-emption

Title X of the act, which creates the bureau, also modifies existing federal law regarding the pre-emption of state law with respect to the business and operations of national banks under the National Bank Act, and federal savings banks under the Home Owners' Loan Act. The National Bank Act and Home Owners' Loan Act will pre-empt state consumer laws only if the state laws are determined by the court or the OCC, on a case-by-case basis, to prevent or significantly interfere with the exercise by the bank of its powers, "in accordance with the legal standard for pre-emption" in *Barnett Bank of Marion County, N.A v Nelson (*517 US 25 (1996)). Non-bank operating subsidiaries of national banks and federal savings banks will lose the benefit of federal pre-emption. State attorneys general will be permitted to enforce non-pre-empted laws against federal depository institutions; states will also be free to enact additional consumer protections beyond those that may be adopted by the bureau under its Title X authorities, and will have the power to enforce their own regulations as well as the bureau's.

Mortgage reform and anti-predatory lending

Title XIV of the act, the Mortgage Reform and Anti-Predatory Lending Act, includes a series of amendments to the Truth in Lending Act of 1968 with respect to mortgage loan origination standards affecting, among other things, originator compensation, minimum repayment standards and pre-payments. With respect to mortgage loan originator compensation, except in limited circumstances, an originator is prohibited from receiving compensation that varies based on the terms of the loan (other than the principal amount). The amendments to the Truth in Lending Act also prohibit a creditor from making a residential mortgage loan unless it determines, based on verified and documented information of the consumer's financial resources, that the consumer has a reasonable ability to repay the loan. The amendments also prohibit certain pre-payment penalties and require creditors offering a consumer a mortgage loan with a pre-payment penalty to offer the consumer the option of a mortgage loan without such a penalty. In addition, the act expands the definition of a 'high-cost mortgage' under the Truth in Lending Act, and imposes new requirements on high-cost mortgages and new disclosure, reporting and notice requirements for residential mortgage loans, as well as new requirements with respect to escrows and appraisal practices.

Improving access to financial institutions

Title XII states that the treasury secretary is authorized to establish a multi-year programme to promote initiatives to enable low and moderate-income individuals to establish accounts in a federally insured depository institution.

The treasury secretary is authorized to establish multi-year demonstration programmes to provide low-cost small loans to consumers that will provide alternatives to more costly payday loans.

Pay It Back Act

Title XVI of the act, as originally approved by the Conference Committee on June 22, established a $19 billion Financial Crisis Special Assessment Fund to pay administrative and other costs of the act. The fund was to be funded by assessments levied on financial companies with $50 billion or more in consolidated assets and financial companies that manage hedge funds with assets under management of $10 billion or more.

However, as a result of objections to the fund from Senator Scott Brown and others, the Conference Committee was reconvened on June 29 and the fund was removed. In its place, Title XIII of the act prohibits any new obligations from being incurred under TARP for a programme or initiative that was not initiated thereunder prior to June 25 2010, and reduces the total authorization under the TARP from $700 billion to $475 billion. The other costs of the act are to be funded by an increase (provided for in Title III of the act) in the minimum reserve ratio for the Deposit Insurance Fund from 1.15% of estimated insured deposits to 1.35% of such deposits. Additional assessments needed to reach the 1.35% level are to be paid by depository institutions with more than $10 billion in consolidated assets. The FDIC is given until September 30 2020 to meet the new minimum level.

Proceeds from the sale of Fannie Mae, Freddie Mac and Federal Home Loan Bank debt purchased by the Treasury Department under its emergency authority and unused amounts under the American Recovery and Reinvestment Act are required to be used for the sole purpose of deficit reduction.

For further information on this topic please contact William S Eckland at Sidley Austin LLP by telephone (+1 202 736 8000), fax (+1 202 736 8711) or email (weckland@sidley.com).