



BANKING LEGISLATION & POLICY

First Quarter 2012

Volume 31, Number 1

HIGHLIGHTS

This issue contains detailed descriptions of:

- [The Administration's Plan to Help Responsible Homeowners and Heal the Housing Market](#), including:
 - [New Refinancing Initiative](#)
 - [Streamlined Refinancing for GSE Borrowers](#)
 - [Incentives to Build Up Home Equity](#)
 - [Expansion of HAMP](#)
 - [New Protections Against Predatory Lending](#)
 - [Conversion of Foreclosed Homes into Rental Properties](#)
 - [Enhanced Protection for the Unemployed](#)
 - [Joint Investigation into Mortgage Origination and Servicing Abuses](#)
- [Consumer Financial Protection Bureau: Overview and Regulations to Date](#), including:
 - [Function](#)
 - [Organization](#)
 - [Scope of Authority](#)
 - [Examination Process](#)
 - [Regulations: Proposed and Enacted](#)

In addition, it summarizes [other notable legislative, regulatory, and judicial developments that occurred during the first quarter of 2012](#).

The Administration's Plan to Help Responsible Homeowners and Heal the Housing Market

The Obama administration released a broad [proposal](#) to help further support the recovery of the U.S. housing market. The proposal was announced during the State of the Union address, and details were released on February 1, 2012. This proposal would build on the efforts of the Making Home Affordable Program, an initiative begun in 2009 to

further support and strengthen the weak housing market.¹

Two major aspects of the [Making Home Affordable Program](#) that this plan builds upon are the Home Affordable Refinance Program (HARP) and the

¹ For more information about the Making Home Affordable program (including HARP and HAMP), see [Banking Legislation and Policy, Volume 28, Number 1](#).

Home Affordable Modification Program (HAMP). HARP is a program that provides low-cost refinancing to borrowers who cannot otherwise refinance due to insufficient home equity. Since interest rates are at very low levels, refinancing provides a method for easing some of the financial burden on middle-class families who are currently paying higher interest rates on their mortgages. However, because of falling housing prices, many homeowners find themselves with little or negative home equity, making them ineligible for more traditional forms of refinancing. HARP allows borrowers with mortgages owned or guaranteed by a government-sponsored entity (GSE), who could not otherwise refinance due to insufficient home equity, to refinance if, among other things, they are current on their loan payments.

In October 2011, the administration and the Federal Housing Finance Agency (FHFA) relaxed the eligibility requirements for HARP in order to make the refinancing program available to more “underwater” borrowers. Of particular note was the elimination of the program’s 125 percent loan-to-value (LTV) cap. This change allows borrowers to participate, regardless of the size of the decline in their home’s value. The program was also extended until December 31, 2013.

In contrast to HARP, HAMP is a program targeted at those borrowers who are delinquent or near-delinquent on their mortgages. The modification program reduces monthly payments for these borrowers in order to reduce the risk of foreclosure.

The recently proposed plan would use a range of tools to support homeowners, including new mortgage refinancing measures, protections against predatory lending, a pilot program to convert foreclosed properties into rentals, investigations into abuses by mortgage servicers and originators, and incentives to rehabilitate vacant and foreclosed homes and businesses. Certain aspects of the

administration’s plan can be initiated immediately, while others require congressional approval.

New Refinancing Initiative

The administration’s plan would provide broader access to mortgage refinancing in order to allow homeowners to take advantage of current low interest rates. Similar to HARP, this initiative aims to help homeowners with underwater or near-underwater mortgages (i.e., borrowers with little or negative home equity) to refinance. However, HARP, which was created in March 2009, applies only to mortgages owned or guaranteed by Fannie Mae or Freddie Mac (GSE mortgages), while this proposal would cover non-GSE mortgages. This refinancing program would be run by the Federal Housing Administration (FHA) and requires congressional approval.

Eligibility Requirements

According to the proposal, any borrower with a non-GSE mortgage (i.e., a private-label mortgage) would be eligible to refinance if they satisfy certain criteria. First, the borrower must be current on his mortgage payments; specifically, he must not have missed more than one loan payment in the past year and must have been current on his loan for the past six months. Also, the borrower must have a minimum FICO score of 580.² In addition, the loan the borrower is seeking to refinance must be for a single-family, owner-occupied principal residence, and the loan must be no larger than FHA conforming limits (jumbo mortgages would not be eligible for this program).³

Application Process

The proposal looks to implement a streamlined application process in order to limit the costs of

² The FICO score is a widely used credit score model in the United States. Approximately nine out of 10 borrowers have a FICO score of at least 580.

³ Currently, the FHA conforming loan limits range from \$271,050 to \$729,750 and vary geographically with the median area home price.

refinancing to both borrowers and lenders. In this process, lenders need only confirm that an applicant is employed in order for him to be eligible. If an applicant is not employed, he may still be eligible, but the lender must conduct a full underwriting of the applicant to ensure he meets the other eligibility requirements and presents limited credit risk. Also, borrowers will generally not be required to submit a new appraisal or tax return, eliminating a typical requirement that has proven costly in the past.

Funding for the Program

The estimated cost of this refinancing initiative is between \$5 billion and \$10 billion. It would be paid for by a portion of the financial crisis responsibility fee, a proposed tax on the largest financial institutions.⁴ A financial institution's size and the riskiness of its activities would determine the fee it faces. By using a portion of this fee to fund the refinancing initiative, the administration hopes to implement the program without adding to the government deficit.

LTV Limits

Although the proposal does not include an LTV limit in the eligibility requirements, those lenders looking to underwrite deeply underwater loans would have to write down the balance of these loans prior to refinancing. This requirement would aim to reduce some of the risk associated with the program.

Streamlined Refinancing for GSE Borrowers

Part of the administration's plan calls on Congress to enact legislation that streamlines the refinancing process for all GSE borrowers. Specifically, the administration's plan seeks to eliminate costly appraisals using mark-to-market accounting or

other alternatives.⁵ In addition, the plan would aim to increase competition among banks for borrowers' business by directing the GSEs to require the same streamlined underwriting for both new and current servicers. As it stands now, the current servicer of a mortgage faces a less costly underwriting process for refinancing than other potential lenders; this can lead to a lack of competition and higher prices for borrowers. This streamlined refinancing opportunity would be extended to all GSE borrowers, not just those with underwater or near-underwater loans.

The administration is also pushing for low-cost, streamlined refinancing alternatives for borrowers with mortgages insured by the Department of Agriculture and the FHA.

Incentives to Build Up Home Equity

The administration's plan would give homeowners participating in HARP or the FHA refinancing program outlined above the opportunity and incentive to build up equity in their homes. Borrowers will have the option to take the benefit of lower interest rates in the form of lower monthly payments, or they can keep the same monthly payment while paying down the principal at a faster pace (and consequently building up home equity).

To encourage the latter choice of rebuilding home equity, the GSEs and the FHA would cover the closing costs if a borrower refinances while maintaining the same monthly payment. On average, this will give the homeowner a \$3,000 benefit. A borrower with a standard 30-year mortgage must refinance into a mortgage with a 20-year term or less and must sustain monthly

⁴ For more information on the original proposal for the financial crisis responsibility fee, see [Banking Legislation and Policy, Volume 29, Number 1](#).

⁵ Determine eligibility for refinancing often means that borrowers must get costly home appraisals to determine the current value of their house. Using the value of similar homes to estimate the borrower's home value (known as mark-to-market accounting) could be a less costly alternative.

payments approximately equal to those of his current loan. In these cases, the lender will receive payment for the closing costs from one of the GSEs or the FHA, depending on the refinancing program.

Expansion of HAMP

HAMP was [expanded](#) on January 27, 2012, in order to encompass a broader pool of distressed borrowers. Prior to the expansion, a borrower was ineligible for a modification under HAMP if his first-lien mortgage debt-to-income ratio was below 31 percent. Now the program will allow servicers to use more flexible debt-to-income criteria that take into account various types of secondary debt. For instance, a borrower whose debt on his first mortgage is 25 percent of his income might still be eligible for HAMP if he also has a second mortgage. This enhancement should provide financial relief to homeowners with significant outside debt (e.g., a second-lien mortgage, medical bills, etc.), who otherwise would not be covered. HAMP eligibility, which was previously restricted to owner-occupied housing, will also be expanded to include mortgages on rental properties.

HAMP has been extended an additional year until the end of 2013. This new deadline conforms with the extended deadline of HARP. Servicers have also been provided with additional incentives to offer modifications with principal reduction where appropriate.

New Protections Against Predatory Lending

One aspect of the administration's proposal is a Homeowner Bill of Rights, which would provide a uniform set of federal standards that borrowers and lenders in the mortgage servicing industry must adhere to. The federal standards would aim to satisfy the following core principles: simple, easy-to-understand mortgage forms; no hidden fees and penalties; and no conflicts of interest.

The federal standards would provide additional assistance to at-risk homeowners. Servicers must contact delinquent borrowers or those facing financial hardship in order to communicate all of their options for avoiding foreclosure. These homeowners must then be given a reasonable amount of time to apply for a loan modification.

Servicers must also provide homeowners with access to a customer service employee if they are delinquent or have requested assistance. This employee should have access to all relevant documentation related to the loan, including a record of previous communications with the homeowner and the payment history on the loan. The employee should also have access to personnel with the authority to approve other options for loss mitigation.

In addition, the standards would include certain safeguards against inappropriate foreclosure. Specifically, homeowners would have the right to appeal any decision through a formal review process, and, prior to a foreclosure sale, a servicer must certify in writing to the foreclosure attorney and the borrower that they have considered appropriate alternatives and that the sale is consistent with applicable law.

Conversion of Foreclosed Homes into Rental Properties

On February 27, 2012, the FHFA, in coordination with the administration and the U.S. Department of Housing and Urban Development (HUD), [announced a pilot sale](#) of foreclosed homes to be converted into rental properties. The program, known as the real estate owned (REO) initiative, will allow qualified investors to purchase pools of foreclosed properties, provided that they rent out the properties for a certain number of years.⁶ The

⁶ REO properties are properties owned by a lender after an unsuccessful foreclosure auction. There are around 500,000

REO initiative hopes to ease a supply-demand mismatch in the housing market by transferring some of the excess supply of homes in the ownership market to the rental market where there seems to be much stronger demand. The program is targeting the hardest hit metropolitan areas. During the pilot phase, Fannie Mae will sell pools of assets, including rental properties, vacant properties, and nonperforming loans. The initial transaction included properties in Atlanta, Chicago, Las Vegas, Los Angeles, Phoenix, and parts of Florida.

The pilot phase will be used to better understand the level of investor interest (based on location size and composition of the property pools), the interactions between investors and local firms and organizations, the types of structures/financing that improve seller returns and home values, and the qualification process for investors. The hope is that this program will eventually include bulk sales on a much larger scale and that the private sector will adopt this method for unloading some of its REO inventories.

Enhanced Protection for the Unemployed

The administration hopes to push the mortgage service industry toward a new norm of providing 12 months of forbearance for those looking for work. Forbearance is an agreement between a lender and a borrower to delay foreclosure and defer part or all of the borrower's monthly payments. It often arises in situations in which a borrower faces temporary financial difficulties, such as when he is between jobs.

In January, Freddie Mac and Fannie Mae both announced that lenders servicing their loans could generally provide up to a year of forbearance, following a similar move by the administration last summer regarding FHA and HAMP borrowers.

such properties held by GSEs, banks, and other lenders in the United States.

Several key mortgage servicers (e.g., Wells Fargo, Bank of America) have also begun to offer this 12-month forbearance period on loans for the unemployed that they have on their books. Previously, such forbearance periods had typically been closer to three or four months.

Joint Investigation into Mortgage Origination and Servicing Abuses

The [Residential Mortgage-Backed Securities Working Group](#) was formed on January 27, 2012, to investigate misconduct in the pooling and sale of residential mortgage-backed securities that contributed to the financial crisis. The working group's goals include holding accountable those institutions that broke mortgage securitization laws and compensating the victims and those homeowners struggling from the housing market collapse. The working group brings together a number of federal and state agencies and partners that have already been investigating these issues separately, and it is a part of President Obama's Financial Fraud Enforcement Task Force.

Consumer Financial Protection Bureau: Overview and Regulations to Date

The Consumer Financial Protection Bureau (CFPB) was established by Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act ([H.R. 4173](#)), which was passed on July 21, 2010. The CFPB was created by the Dodd-Frank Act as part of a larger effort to supervise financial markets and to enforce federal consumer financial law.⁷ The CFPB has the dual mandate to help consumers understand their financial options by increasing the transparency of financial markets and to regulate the providers of consumer financial products and services.

⁷ For additional information and clarification on the term "federal financial consumer law," see the CFPB's [overview on the supervision and examination process](#).

Function

Section 1021 of the Dodd-Frank Act assigns six main functions to the CFPB. The first three functions relate to consumer financial education and advocacy. The remaining three functions relate to financial market supervision, rulemaking, and enforcement. To fulfill its mandate to help consumers navigate financial markets, the Dodd-Frank Act requires the CFPB to provide clarification and financial education programs to inform consumers of the benefits and risks of various financial options. One such preliminary program by the CFPB is the “[Know Before You Owe](#)” campaign, which aims to help customers compare different mortgage and student loans. The CFPB must also collect, investigate, and respond to consumer complaints. To this end, the CFPB created a national consumer response center to take in consumer financial complaints and provide answers on common financial questions. In addition to addressing existing consumer complaints, the CFPB must also identify financial products and services that pose risks to consumers and prevent transparent market transactions.

To carry out its second mandate as regulator of consumer financial markets, the CFPB is required by the Dodd-Frank Act to act as the primary supervisor, rule maker, and enforcer of consumer protection laws governing depository and nondepository institutions with more than \$10 billion in assets. Banks and nonbanks with less than \$10 billion in assets must also comply with CFPB regulations, but their consumer financial products and services are supervised by prudential regulators, such as the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), or the National Credit Union Administration, rather than the CFPB directly.

Organization

The CFPB is funded by but is independent of the Federal Reserve. The director of the CFPB is

appointed by the President and confirmed by the Senate and can hold office for five-year terms.⁸ The CFPB is split into six divisions: Consumer Education and Engagement; Supervision, Enforcement, Fair Lending, and Equal Opportunity; Research, Markets, and Regulations; General Counsel; External Affairs; and Chief Operating Officer. As the primary regulator of financial products and services, the CFPB has been transferred all the consumer protection powers of the seven federal agencies: the FDIC; the Federal Reserve; the Federal Trade Commission; HUD; the Office of the Comptroller of the Currency; the Office of Thrift Supervision; and the National Credit Union Administration.

Scope of Authority

The CFPB has broad rulemaking and enforcement authority over consumer financial products and services provided by certain bank and nonbank entities. Financial products and services that fall under the jurisdiction of the CFPB include, but are not limited to, the following credit, savings, and payment activities: extending credit and loans, such as student loans, credit card loans, payday loans, auto loans, and mortgages; brokering leases; real estate settlements; deposit-taking; issuing financial and payment instruments; checking transactions; financial data processing and tailored advisory services; debt collection; and foreclosures.

Although the CFPB has wide-ranging authority, it is constrained by existing state and federal regulators. While the CFPB is the primary regulator of these financial products and services, it must work with state and other federal prudential regulators to obtain examination reports whenever possible. The CFPB is required to coordinate

⁸ The current head of the CFPB, Richard Cordray, was recess appointed by President Obama on January 4, 2012. Since Cordray was recess appointed, he can serve only through the end of 2013.

information and enforcement activities with the Federal Trade Commission (FTC) by Section 1024 of the Dodd-Frank Act. The CFPB and the FTC released a joint [memorandum of understanding](#) on January 23, 2012, which explains that they will coordinate their actions and consult with each other by holding regular meetings regarding consumer complaints, rulemaking, investigations, and law enforcement activities. The CFPB and the FTC will also hold joint training sessions when possible and share computer databases to avoid duplicating each other's actions.

Section 1027 of the Dodd-Frank Act details the limitations of the CFPB. The CFPB does not have authority over entities that are already regulated by the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission, the Farm Credit Administration, a state securities commission, or a state insurance regulator. In addition, the Financial Stability Council can overturn CFPB rules if it believes them to be detrimental to the financial system. The CFPB also does not have authority over attorneys and insurance companies and cannot set usury limits.

Examination Process

On October 13, 2011, the CFPB released its ["Supervision and Examination Manual,"](#) which details how it will examine bank and nonbank institutions to detect risks to consumers and assess adherence to federal consumer financial laws. The CFPB will examine a combination of quantitative and qualitative data, including, but not limited to, the amount of a company's assets, the company's risk profile, the volume of consumer financial transactions, customer complaints, and the extent of oversight by other state and federal regulators. The examination process can be split into the three phases outlined below:

- Investigation: For the investigation, the CFPB will collect and review information from

federal and state regulators and directly from the supervised entity. The CFPB requires supervised entities to comply with examinations by giving "[full and unfettered access to information.](#)"⁹ In addition to institution-specific investigations, the CFPB conducts "target reviews" of customer complaints and "horizontal reviews" across the financial industry to identify trends and risks that may require further attention.

- Notification: The CFPB will notify all agencies it investigates. The examinee will then have 20 days to contest the investigation if it disagrees.
- Conclusion: After investigation and analysis, the CFPB will write a conclusion based on the findings and send it to the regulated entity for review. If no violations are found, then the investigation is closed. However, if the investigation does find regulatory violations, then the conclusion will also include corrective actions that the institutions should take and any penalties that will be imposed.

Possible penalties that the CFPB may enforce include, but are not limited to, rescinding contracts, restitution, return of property, public notification of the violation, and monetary penalties. In regard to monetary penalties, the CFPB can impose penalties up to \$1 million per day for purposely violating consumer financial law. Furthermore, depending on the nature of the violation, the CFPB may also pass the findings on to the appropriate regulatory agencies (e.g., the Internal Revenue Service) or the courts (e.g., the Department of Justice).

⁹ In response to fears that privileged information handed to the CFPB could be released to outside parties, the CFPB proposed and the House of Representatives passed [H.R. 4014](#), which states that privileged information given to the CFPB will not be subject to third-party waivers and will receive the same statutory protection applied to information given to prudential regulators. Although this proposal has passed the House, it is still pending in the Senate and is not yet law.

Regulations: Proposed and Enacted

The CFPB amendment to Regulation E of the Electronic Fund Transfer Act ([77; Federal Register; pp. 6194-6200](#)) became effective February 7, 2012. The amendment protects consumers when sending funds — such as remittance transfers — abroad by requiring the transferring agency to fully disclose the cost of the transfer, the amount delivered to the recipient, and the date it is available. Consumers will also have 30 minutes after payment to cancel a transfer.

On February 15, 2012, the CFPB finalized the amendment to Regulation C of the Home Mortgage Disclosure Act (HMDA) ([77; Federal Register; pp. 8721-22](#)). Prior to the change, HMDA regulations required mortgage lenders with over \$40 million in assets to provide regulators and the public with annual reports on their mortgage activities. The CFPB has increased the exception threshold to \$41 million in order to reflect the increase in the consumer price index.

In addition to already enacted regulation, the CFPB has proposed numerous other regulatory efforts. On February 16, 2012, the CFPB published a proposal on how to define large nonbank financial participants ([77, Federal Register pp. 9592-9608](#)). The CFPB proposed this rule because of its regulatory duty under the Dodd-Frank Act to regulate “larger participants” in the nonbank financial market.¹⁰ The proposal focuses specifically on defining larger participants in the consumer debt collection and credit reporting markets. The proposal states that a consumer debt collection agency will be considered a large participant if it has annual receipts of more than \$10 million and a consumer reporting agency

if it has annual receipts of more than \$7 million. Within nonbank financial markets, the Dodd-Frank Act authorizes the CFPB to regulate nonbanks of all sizes in the mortgage, payday lending, and private student loan markets. However, the CFPB’s authority is restricted to “larger participants” in other consumer financial markets. The CFPB will release the initial rule no later than July 21, 2012.

On April 10, 2012, the CFPB released [mortgage lending rules](#) that it is considering for proposal. The rules aim to improve mortgage providers’ transparency and accountability. To facilitate transparency, the proposal would require mortgage companies to provide consumers with clear monthly statements that show the account balance; allocation of payments to principal, interest, and escrow; the due date and amount of the next payment; recent transactions; and late fee warnings. Mortgage providers are also required to notify borrowers before changing the interest rate, imposing additional fees, or enrolling the borrower in expensive “force-placed” property insurance. The providers must explain how the changes affect the borrower’s account and provide a list of alternatives if the borrower is unable to afford the new monthly payments. The provider is also required to communicate with delinquent borrowers and inform them about their options for avoiding foreclosure. To increase mortgage providers’ accountability, the proposal requires providers to immediately credit the consumer account on the day the payment is made, keep records current and accessible to the borrower, address consumer concerns about errors within five days, conclude investigations into errors within 30 days, and provide access to foreclosure prevention help. The CFPB expects to release the notice of proposed rulemaking this summer and finalize it by January 2013.

¹⁰ Nonbank consumer financial institutions include, but are not limited to, consumer debt collectors, consumer credit reporting agencies, money transmitters, and check-cashing and prepaid card providers. The proposed rule covers the consumer debt collection and consumer reporting market.

Federal Legislation

Enacted Legislation

JOBS Act to Ease Capital Formation

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (JOBS Act), which looks to reshape the securities law regime in order to ease access to capital, particularly for startups and small businesses ([H.R. 3606](#)). The SEC will be primarily responsible for the implementation of this legislation.

Among other things, the law defines a new class of issuers known as emerging growth companies (businesses with less than \$1 billion in total annual gross revenues in the most recent fiscal year) that are subject to fewer securities restrictions and more exemptions as they seek to become public. For instance, emerging growth companies (EGCs) will have to supply audited financial statements only for the previous two fiscal years in their initial public offering (IPO) filings (previously, all companies were required to include three years of income and cash flow statements in their IPO filings). They will also be exempt from certain Dodd-Frank provisions, such as the requirement that shareholders have a (nonbinding) vote on executive compensation. Additional corporate governance and disclosure requirements will be scaled down for EGCs.

EGCs will also face lighter restrictions on the types of communications and activities that are allowed surrounding a registered offering. These provisions aim to improve the availability of information about EGCs. For example, EGCs will be allowed to communicate with certain potential investors to gauge their interest in a securities offer during the pre-filing period (the period when a company has decided to publicly offer securities but has not yet filed a registration statement with the SEC). Previously, any communications containing written or oral securities offers in the pre-filing period were prohibited.

More generally, the JOBS Act provides a registration exemption for crowdfunding, which allows companies to raise capital from a large number of small investors, usually through online platforms. It also relaxes certain registration thresholds under the Securities Exchange Act of 1934. Private companies with more than 500 investors were previously required to file certain financial information with the SEC, but the JOBS Act raises this threshold to 2,000 shareholders excluding employees. The new legislation also limits the general solicitation ban that previously prevented companies seeking private fundraising from advertising publicly (e.g., a company seeking private placements could not go on TV to talk about its products).

Proposed Legislation

On January 23, 2012, Senator Carl Levin (D-Mich) introduced the [Derivatives Blended Rate Loophole Act \(S.2033\)](#) to amend Section 1256 of the Internal Revenue Code (IRC). Section 1256 of the IRC applies to all regulated futures, foreign currency contracts, dealer securities futures contracts, and nonequity and dealer equity options.¹¹ Section 1256 allows traders of these derivatives to claim 60 percent of their derivatives income as long-term capital gains and thus be taxed at the lower 15 percent rate, regardless of how briefly they hold the derivative. The amendment seeks to eliminate this provision of Section 1256, to decrease derivatives speculation, and to use the additional revenue to lower the budget deficit.

¹¹ For definitions of these terms, see IRC Section 1256(g) at <http://www.law.cornell.edu/uscode/text/26/1256>.

On March 9, 2012, Representative Kevin Brady (R-Texas) introduced the [Sound Dollar Act \(H.R. 4180\)](#), which would change the Federal Reserve's dual mandate to facilitate price stability and maximum employment to a single mandate of price stability. The bill maintains that since monetary policy cannot increase long-term economic output or employment, the Federal Reserve should focus solely on price stability.

On March 19, 2012, Representative Charles Rangel (D-N.Y.) introduced [H.R. 4202](#), which proposes to extend the Mortgage Forgiveness Debt Relief Act of 2007 (MFDRA) from the end of 2012 through the end of 2014. Generally, the IRS treats forgiven debt as taxable income. However, the MFDRA exempts forgiven mortgage debts from being taxed as income.

On March 28, 2012, three House Democrats – Representatives Jim McDermott (D-Wash.), John Larson (D-Conn.), and Shelley Berkley (D-Nev.) – proposed the [Homeowners Tax Fairness Act \(H.R. 4290\)](#). The proposal comes shortly after five major banks – Ally Financial, Bank of America, Citigroup, J.P. Morgan Chase, and Wells Fargo – agreed to pay a \$25 billion settlement to homeowners whose homes were wrongly foreclosed on. The proposal exempts these individuals from paying taxes on the legal settlements they receive. Similar to H.R. 4202 discussed above, this proposal also seeks to extend the mortgage debt forgiveness tax exemption. However, whereas H.R. 4202 seeks to extend the exemption only through 2014, this proposal seeks to extend the exemption through the end of 2016.

Federal Regulation

Multiple Sponsors

Guidance on Junior Lien Loss Allowance

On January 31, 2012, the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration, and the Office of the Comptroller of the Currency [issued guidance](#) on how financial institutions should estimate allowance for loan and lease losses (ALLL),¹² specifically for junior liens on one- to four-family residential properties.¹³ The interagency guidance focuses specifically on junior liens, as they are generally riskier loans. The guide advises management to review junior loans and the associated senior loans; adequately segment loan portfolios by risk; adjust estimates to reflect “qualitative or environmental factors”; and remain consistent with generally accepted accounting principles. The guide also advises examiners to evaluate the methods, procedures, and documentation an institution uses to estimate the ALLL.

FATCA Implementation

On February 8, 2012, the Treasury and the IRS released a [joint proposal](#) for implementing the Foreign Account Tax Compliance Act (FATCA), which was enacted by Congress on March 18, 2010, as part of the [Hiring Incentives to Restore Employment Act of 2010](#). FATCA was created to prevent U.S. residents from evading taxes through the use of offshore accounts. The joint proposal requires foreign financial institutions (FFIs)¹⁴ and nonfinancial foreign entities (NFFE) to follow certain due diligence procedures to identify accounts and

¹² ALLL is an estimate of the value of bad loans and is used to reduce the book value of loans and leases to the amount that is expected to be collected.

¹³ Examples of junior liens are second mortgages and home equity lines of credit.

¹⁴ FFIs include (but are not limited to) banks, brokers, dealers, insurance companies, hedge funds, securitization vehicles, and private equity funds.

investments held by U.S. taxpayers. They must file documents annually with the IRS on these accounts and investments or else face financial penalties. On the same day this interagency joint proposal was released, France, Germany, Italy, Spain, and the United Kingdom issued a [joint statement](#) with the U.S. Treasury stating their commitment in cooperating with the U.S. to improve tax compliance and implement FATCA. As a result, FFIs and NFFEs in these five countries will report to their own government agencies rather than directly to the IRS.

FATCA requires FFIs to report preexisting U.S. taxpayer accounts with a balance of \$50,000 or more to the IRS. Due diligence procedures on identifying U.S. taxpayer accounts differ, depending on the account balance. For accounts with a balance of \$50,000 to \$1,000,000, FFIs may limit their search to electronic records. For accounts with a balance of \$1,000,000, FFIs must also conduct an enhanced manual paper record search because the electronic records do not return the necessary information. For new accounts, FFIs may rely on information they are already required to collect under anti-money laundering and “know your customer” laws.¹⁵ FATCA also requires NFFEs to identify and file annual documents on U.S. investors that own 10 percent or more of said NFFE. FFIs and NFFEs may register with the IRS online starting in January 2013; registration must be completed before June 30, 2013, in order to avoid a 30 percent withholding tax on “withholdable payments” originating from the U.S.¹⁶

Proposed Revisions to Leveraged Finance Guide

On March 26, 2012, the Federal Reserve Board of Governors (Board), the FDIC, and the Office of the Comptroller of the Currency (OCC) jointly published [proposed revisions](#) to the leveraged finance guide that they originally released in 2001. The revisions address new issues and weakness in the lending system that the agencies have observed as a result of leveraged credit growth and the involvement of nonregulated participants. The proposed revisions apply to highly leveraged transactions and aim to “outline high-level principles related to safe and sound leveraged lending activities.” The criteria the proposal uses to define a leveraged financial transaction include (but are not limited to):

- if total debt/EBITA is in excess of 4 to 1 and senior debt/EBITA is in excess of 3 to 1;
- if the borrower has a high debt-to-net-worth ratio; and
- if the borrower’s post-financing leverage, measured by its leverage ratios, debt-to-assets, debt-to-net-worth, and debt-to-cash flow, exceeds industry norms or historical levels.

Examples of highly leveraged transactions include leveraged buyouts or borrowing heavily to finance a corporate acquisition or recapitalization. The proposal guides leveraged institutions in five key areas of the lending process and requires that they establish a risk management framework, practice sound underwriting standards, set valuation standards, assess pipeline exposure through regular stress tests, and use management information systems to monitor higher risk credits and report to management at least quarterly.

Financial Stability Oversight Council

Regulation of Nonbank Financial Companies

¹⁵ For information on anti-money laundering and “know your customer” regulations, see the [Bank Secrecy Act and Anti-Money Laundry Examination Manual](#) and [Section 326 of the Patriot Act](#).

¹⁶ Withholdable payments include payments of income from sources within the U.S. as well as proceeds from the sale of equity or debt instruments issued by U.S. entities.

On April 3, 2012, the Financial Stability Oversight Council (FSOC) adopted a [final ruling](#) on the criteria it will use to identify nonbank systemically important financial institutions (SIFIs).¹⁷ This fulfills Section 113 of the Dodd-Frank Act, which created and tasked the FSOC to select nonbank SIFIs for the Board to supervise. The FSOC's final rule retains the three-step procedure for identifying nonbank SIFIs set forth in its October 11, 2011, notice of proposed rulemaking. The three-step procedure includes applying quantitative and qualitative metrics, applying a six-category framework, and using in-depth analysis to evaluate the nonbank SIFI's importance to financial stability.¹⁸ The final rule includes minor clarifications to terms used in the previous proposal.

Federal Reserve Board of Governors

Proposed Amendment to Regulation Y

On April 2, 2012, the Board [proposed an amendment](#) to its February 11, 2011, [notice of proposed rulemaking \(NPR\)](#) related to the identification of nonbank financial companies. The proposed amendment clarifies the definition of "financial activity" for the purpose of identifying companies "predominantly engaged in financial activities" under Title 1 of the Dodd-Frank Act. These terms are relevant for determining if an entity qualifies as a nonbank financial company, which might then be subject to stricter supervision. The proposed amendment also includes an appendix that lists all activities that would be considered financial activities.

Federal Deposit Insurance Corporation

Resolution Plans for Insured Depository Institutions

On January 17, 2012, the FDIC adopted a [final rule](#) that requires insured depository institutions with \$50 billion or more in total assets to submit an annual resolution plan to the FDIC. In the event of the institution's failure, the resolution plan will act as a living will and help the FDIC to ensure that depositors receive access to their deposits within one business day of the institution's failure, maximize the value of the sale or disposition of the institution's assets, and minimize the amount of loss to the institution's creditors.

The rule became effective April 1, 2012, and applies to both U.S. banks and non-U.S. banks in the U.S. with over \$50 billion in assets. The largest institutions, defined as those with more than \$250 billion in assets, must submit plans by July 1, 2012. Institutions with \$100 billion or more in assets must submit plans by July 1, 2013. The remaining institutions must develop plans by the end of 2013.

Bank Stress Test Requirements

On January 23, 2012, the FDIC [issued a proposal](#) that requires certain banks to perform annual stress tests for the purpose of implementing Section 165(i)(2) of the Dodd-Frank Act. The proposal applies to FDIC-insured state nonmember banks and state savings associations with \$10 billion or more in assets. The FDIC defines a stress test as a procedure to evaluate "the potential impact on the...consolidated earnings, losses, and capital of the covered bank over a set planning horizon, taking into account the current condition of the covered bank and its risks, exposures, strategies, and activities."

¹⁷ Examples of nonbank SIFIs include, but are not limited to, insurance companies, hedge funds, private equity funds, asset managers, and nonbank lenders.

¹⁸ For more information on the three-step procedure, see [Banking Legislation and Policy, Volume 30, Number 4, p.10.](#)

The proposal also gives preliminary guidance on the types of quantitative and qualitative information that covered banks should report in their stress tests. After the banks have conducted the stress tests, the proposal requires that these banks report the results to the FDIC and publish a summary of the results. The FDIC will use the report to help assess the bank's capital adequacy and risk under different economic scenarios — baseline, adverse, and severely adverse conditions.

Enforcement of Subsidiary and Affiliate Contracts

On March 20, 2012, the FDIC issued a [proposed rule](#) for implementing section 210(c)(16) of the Dodd-Frank Act, which discusses the authority and responsibility of the FDIC as a receiver if a systemically significant financial institution (SSFI) becomes insolvent and cannot service its debts. The intended purpose of the FDIC's new authority is to mitigate systemic risk, maximize the financial value of assets owned by the SSFI, and facilitate orderly liquidation of the SSFI if necessary. If an SSFI fails, the FDIC may override the contract clauses of subsidiaries or affiliates that purport to terminate or otherwise change the contract based on the financial condition of the covered SSFI as long as the FDIC follows statutory rules. The proposal states that without this rule "otherwise viable affiliates of the covered financial company could become insolvent, thereby inciting the collapse of interrelated companies and potentially amplifying ripple effects throughout the economy."

To maintain the full effect of the contracts, the FDIC must either transfer any obligations of the SSFI that support the contracted subsidiary or affiliate to a bridge financial company or qualified third-party transferee by one business day, or provide protection to these contract counterparties.

Large Bank Pricing Assessments

On March 27, 2012, the FDIC published a [notice of proposed rulemaking](#) (NPR) to amend the terms and definitions used in the insured depository institution pricing scorecards. The scorecards are used to determine assessment rates for large institutions and are based on readily available quantitative measures that are helpful for predicting an institution's long-term performance.¹⁹ The amendment applies to higher-risk assets and affects large and complex insured depository institutions with \$10 billion or more in assets.²⁰ The NPR changes the terms "leveraged loans" and "subprime consumer loans" to "higher-risk C&I loans and securities" and "higher-risk consumer loans and securities," respectively, and clarifies additional terms. The NPR serves to help instruct the affected depository institutions on how to categorize and rate various loans and securities.

Securities and Exchange Commission

Final Rule on Performance Fee Restrictions

On February 15, 2012, the SEC issued a [final rule](#) that adjusts the criteria for determining if investment advisers can charge their clients performance fees. The rule is consistent with an SEC order issued in July 2011. Under the new rule, an investment adviser can charge performance fees only to clients with at least \$1 million under management or \$2 million in net worth excluding their primary residence. These thresholds were previously \$750,000 and \$1.5 million, respectively. The rule includes a grandfather clause, so investment

¹⁹ For additional information on the scorecard method, see the February 7, 2011, adopted [assessment regulations](#).

²⁰ In general, large depository institutions are defined as institutions with assets of \$10 billion or more, and complex institutions are defined as ones with assets of \$50 billion or more. For additional information, refer to footnotes three and four of the NPR.

advisers may continue to charge performance fees to clients who qualified under the old thresholds. The thresholds will also be revised every five years to account for inflation.

Proposal to Help Prevent Identity Theft

On February 28, 2012, the SEC and the Commodities Futures Trading Commission (CFTC) jointly proposed [new policies and procedures](#) to help protect investors from identity theft. Under the proposal, SEC- and CFTC-regulated entities must adopt a written program to identify, detect, and respond appropriately to red flags associated with identity theft.

Commodity Futures Trading Commission

As part of the rulemaking mandated by the Dodd-Frank Act, the CFTC and the SEC have defined a number of terms to describe different participants in swap markets. For more information on these terms, see the beginning of the “New Swaps Market Regulation” article in [Banking Legislation and Policy, Volume 30, Number 4](#).

Final Rule on Protection of Cleared Swaps Customer Collateral

On January 11, 2012, the CFTC [finalized a rule](#) that protects the customers of futures commission merchants (FCMs) by ensuring that collateral supporting cleared swaps is isolated from other business activities. The adopted model, known as the complete legal segregation model or legally segregated operationally commingled model (LSOC model), requires derivatives clearing organizations (DCOs) and FCMs to hold their own assets and customers’ collateral in separate accounts. If an FCM and one or more of its customers default, a DCO has recourse against the FCM and the collateral of defaulting customers only. The investment rules for the collateral of cleared swaps customers closely parallel the [rules](#) already governing the collateral of futures customers.

Final Rule on Business Conduct Standards for SDs and MSPs Dealing with Counterparties

The CFTC issued a [final rule](#) that creates comprehensive business conduct standards for swap dealers (SDs) and major swap participants (MSPs) regarding their interactions with counterparties. Among other things, the new standards prohibit fraud, manipulation, and other abusive acts. They also require confidential treatment of counterparty information, verification of a counterparty’s eligibility as a contract participant, and certain information disclosures to counterparties. SDs and MSPs must also provide counterparties with the daily mid-market value of uncleared swaps and must notify them of certain rights related to clearing. SDs face additional requirements beyond those faced by MSPs.

The business conduct standards contain supplementary prescriptions for the interaction of SDs and MSPs with “special entities,” which include federal and state agencies, states, municipalities, political subdivisions, employee benefit plans, government plans, and endowments.

Final Rule on Internal Business Conduct Standards for SDs, MSPs, and FCMs

On February 23, 2012, the CFTC adopted a [final rule](#) that pulls together five separate proposed rules related to the business conduct standards of SDs, MSPs, and FCMs in the swap market. The rule includes new reporting, recordkeeping, and daily trading records requirements for SDs and MSPs in order to provide a comprehensive record trail to promote internal compliance and support external supervision by the CFTC when necessary.

The new standards also establish certain duties for SDs and MSPs, including a risk management program that accounts for various types of risk (e.g., market risk or credit risk).

Another key aspect of the final rule is the establishment of appropriate informational firewalls between certain components or departments of SDs, MSPs, FCMs, and introducing brokers (e.g., between research and trading units or between clearing and trading units of an entity) in order to prevent conflicts of interest.²¹ Each SD, MSP, and FCM must also designate a chief compliance officer, who will ensure that the firm's policies and procedures conform to applicable regulations.

Final Rule on Swaps Clearing Process

On March 20, 2012, the CFTC issued a [final rule](#) that governs aspects of the clearing process for swaps. The rule outlines the required documentation between FCMs and their customers as well as between SDs and their counterparties. It also creates standards for the processing of trades in a timely fashion, minimizing the time between submission and the acceptance (or rejection) of a trade for clearing. Clearing members will also face enhanced risk management procedures in order to help preserve market integrity. All of these prescriptions for the clearing process aim to promote broad access to central clearing while supporting market transparency and risk management.

Volcker Rule Proposal

On January 11, 2012, the CFTC issued a [proposal](#) to implement the Volcker rule that is substantively similar to the joint proposal issued by the Federal Reserve, the OCC, the FDIC, and the SEC last October. Section 619 of the Dodd-Frank Act, known as the "Volcker rule," broadly prohibits banking entities from engaging in short-term proprietary trading, and it forbids them from owning, sponsoring, or having certain relationships with hedge funds or private equity funds.²²

Block Trading Proposal

On February 23, 2012, the CFTC [proposed](#) new measures to establish the minimum size of block trades and protect counterparty identities in swap transactions. Block trades are large notional swap transactions, and they are subject to delayed public reporting, since they contain sensitive price and size information. The rule would define criteria for grouping swaps into separate categories within asset classes (e.g., interest rate swaps) and would establish methodologies for setting minimum block sizes for these categories. Additional measures were also included to protect the identities of swap market participants along with the anonymity of their business transactions and market positions.

²¹ Introducing brokers (IBs) often act as intermediaries between clients and FCMs but do not hold client funds to margin.

²² For more information on the joint proposal to implement the Volcker rule, see [Banking Legislation and Policy, Volume 30, Number 3](#).