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**HIGHLIGHTS**

This issue contains detailed descriptions of:

- The Basel III Accord, including:
  - Capital Regulation
  - Liquidity Regulation
  - Transition Schedule
  - Possible Effects of New Capital Standards
- Mortgage Reform Activity: Final and Proposed Rules

In addition, it summarizes other notable legislative, regulatory, and judicial developments that occurred during the third quarter of 2010.

## BASEL III ACCORD

On September 12, the Group of Governors and Heads of Supervision[1] announced an international accord to strengthen capital and liquidity standards for internationally active banking organizations. Central bank representatives from 27 countries collaborated on the Basel Committee on Banking Supervision's (Basel Committee) proposed regulatory framework, nicknamed Basel III. This article will describe the core agreement, transition schedule, and possible implementation effects of the accord.

### Capital Regulation

The centerpiece of the proposal is an effort to increase the quantity, quality, and transparency of regulatory capital held by banks. The Basel Committee agreed to increase the minimum common equity[2] requirement from 2 percent to 4.5 percent of risk-weighted assets and impose an additional "conservation buffer" of 2.5 percent, which lifts the cumulative common equity minimum to 7 percent of risk-weighted assets. Banks that draw on the conservation buffer during periods of financial stress will have to restrict distributions, such as dividends and bonuses, until they rebuild sufficient equity.

In addition, banks will need to increase their tier 1 capital, which includes common equity and other subordinated instruments, from 4 percent to 6 percent of risk-weighted assets. The Basel

[1] The oversight group for the Basel Committee on Banking Supervision (Basel Committee)

[2] Common equity includes common shares (or the equivalent for non-joint-stock companies) plus retained earnings and other comprehensive income net of the associated regulatory adjustments.

Committee narrowed the definition of tier 1 capital by capping the aggregate deductions for mortgage servicing rights, deferred tax assets, and significant investments in other financial institutions at 15 percent of the common equity component. It also imposed limits on counterparty credit risk.

A "counter-cyclical capital buffer" consisting of common equity or other fully loss-absorbing capital is recommended on top of the other requirements during periods of rapid credit growth to limit excessive growth in leverage in the future. National regulators will have discretion to determine when and how to impose the counter-cyclical buffer, which could range from zero to 2.5 percent. When economic conditions improve enough to accommodate the extra capital cushion, the counter-cyclical buffer would serve as an extension of the conservation buffer; when a financial crisis occurs, banks could draw down on both buffers to preserve the flow of credit and mitigate the impact of tightening credit conditions. These buffer provisions directly address the pro-cyclical effects of existing capital requirements, which were thought to exacerbate the recent financial crisis by permitting excessive growth in leverage during the expansion and a violent process of deleveraging during the crisis.

**Leverage Ratio**

The Basel Committee agreed to develop a simple but meaningful leverage ratio to supplement the risk-based capital requirements for individual banks and to evaluate the financial system as a whole. The proposed ratio, defined as tier 1 capital over average quarterly assets, will be set at a minimum of 3 percent and will feature stronger treatment of off-balance-sheet items and derivatives than in the past. The Basel Committee will test the ratio's underlying components from 2011 to 2013 and follow up with a parallel run that will require bank-level disclosure of the ratio by 2015. The final metric will be implemented by 2018.

**Liquidity Regulation**

The Basel Committee plans to test and calibrate two liquidity ratios in 2011 to address liquidity risk management over the short and medium time horizons; final implementation would not occur until 2018.

The liquidity coverage ratio (LCR) will be calculated for a number of acute stress scenarios, such as a significant downgrade of the institution's credit rating or a partial loss of deposits. The measure is defined as the stock of high-quality liquid assets (yet to be defined by the committee) divided by net cash outflows; banks must maintain a ratio of over 100 percent over a 30-day period to be considered adequately liquid. Banks will also be required to list contingent liabilities and their triggers.

The Basel Committee intends to measure the liquidity risk profiles of institutions on a slightly longer horizon—one year—with the net stable funding ratio (NSFR). The NSFR applies concepts from conventional net liquid asset and cash capital metrics but provides for the recognition of off-balance-sheet (OBS) items and maturity mismatches. It is calculated as the available amount of stable funding[3] divided by the required amount of stable funding; the regulatory minimum will be 100 percent.

**Future Regulation**

The Basel Committee believes that systemically important international banking organizations should be subject to stricter oversight, but it could

[3] Stable funding is characterized as financing that is readily accessible during a period of economic stress; it includes capital, preferred stock with a maturity of one year or more, liabilities with maturity dates of one year or more, demand deposits, and deposits with a maturity of less than a year that are expected to remain with the institution.

not agree on a common model. Surcharges, contingent capital, and bail-in debt issues are currently under review, as well as resolution mechanisms for nonviable banks.

**Transition Schedule**

The Basel Committee will finalize some technical details for presentation and approval at the G20 meeting in November, but it may take more time to release other components. Basel III must also go through a country's rulemaking process to make the agreement binding to its institutions, since it is not enforceable legislation by itself. Although national regulators are given the opportunity to apply their own standards in a number of areas, all countries are expected to meet or exceed the Basel III minimums while writing the new laws over the next few years.

The implementation of the Basel III Accord will occur in gradual steps to accommodate banking institutions that have to raise significant regulatory capital while supporting the capital demands of the economic recovery. The first goal is to increase the minimum common equity capital ratio and minimum tier 1 capital ratio to 3.5 percent and 4.5 percent, respectively, by January 2013. The second phase features incremental increases in the capital ratios, capital conservation buffer, and deductions from common equity in tier 1 capital. The entire process would be completed by 2019.

Capital instruments that are issued by a non-joint-stock company, treated as equity under prevailing standards, or that receive recognition as tier 1 capital under current banking law will be phased out of common equity tier 1 capital over a 10-year horizon (2013-2023); all other newly excluded capital instruments must be removed from common equity tier 1 capital by 2013.

**Possible Effects of New Capital Standards**

Many U.S. banks already hold capital ratios at or near the minimums required by Basel III, so some believe that U.S. regulators should impose more stringent requirements during the rule-writing process. The Federal Reserve, FDIC, and OCC issued a joint statement in approval of the Basel III Accord but did not indicate how they would adopt the rules.

In contrast, European banks would need more time to raise the necessary capital. Nevertheless, members of the Executive Board of the European Central Bank have spoken in support of Basel III and believe the implementation costs are worth it in order to have a more stable financial system.

Banks that hold more equity in relation to risk-weighted assets are more resilient during economic downturns. Industry representatives, such as the Institute of International Finance (IIF), claim that the higher capital requirements come at a significant cost—less capital available for loans and ultimately a lower rate of economic growth. In an interim report evaluating the possible cost of Basel III reforms as proposed in December 2009, the IIF projected an annual average reduction in real GDP for the United States, the Euro Area, and Japan of 0.6 percent in the first five years of implementation and 0.3 percent over the entire 10-year implementation schedule.

The Basel Committee issued its own assessment of the long-term impact of its proposed reforms and found that they would reduce the probability of another global financial crisis with minor costs to the banking industry. The Basel Committee estimates that a 0.7 percent increase in lending spreads could make up for a 1-percentage-point increase in the capital ratio and that higher levels of capitalization significantly decrease the chance of a financial crisis, especially when the existing minimum capital ratio is under 10 percent. They

also forecast a 0.87 percent net increase in the level of output from raising the capital ratio from 7 to 8 percent (assuming financial crises have a moderate impact on long-term growth).

Academic researchers Anil Kashyap, Jeremy Stein, and Samuel Hanson also project that borrowers would experience minimal increases in the cost of loans over the long term if regulatory reform is implemented gradually.[4] They find that an increase of 2.5 to 4.5 basis points in lending spreads could make up for a 1-percentage-point increase in the capital ratio.

## MORTGAGE REFORM ACTIVITY

On August 16, the Federal Reserve System and other federal regulators released final rules and proposed regulation on several mortgage issues. Although the policies were written before the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act[5] (Dodd-Frank Act) and were not intended as a response to it, some topics are covered in the directives. Regulators will issue separate rules to fully implement the act's mortgage and predatory lending reform.

### Final Rules

***Residential Mortgage Loan Originators Prohibited from Unfair Compensation and Steering Practices***

A final rule (75, *Federal Register*, pp. 58509-38) by the Federal Reserve to curb unfair compensation and steering practices in the residential mortgage industry prohibits loan originators from receiving compensation based on loan terms, such as the interest rate, but allows them to receive compensation based on the loan amount. Originators may not receive compensation from both the consumer and a lender. The rule also requires originators to give consumers the opportunity to accept plain vanilla loans and to show them loan options with the lowest interest rate, points, and origination fees feasible; it bars an originator from pushing a loan that increases his compensation if it is detrimental to the customer. The new restrictions, effective April 1, 2011, apply to mortgage loan officers in depository institutions, mortgage brokers, and companies that employ mortgage brokers.

***Disclosure Required After Mortgage Sold or Transferred***

The Federal Reserve published a final rule (75, *Federal Register*, pp. 58489-504) amending the Truth in Lending Act (Regulation Z) that requires the new owner of a sold or transferred mortgage to inform the affected consumer within 30 days. The disclosure rule applies to any person or entity that procures more than one existing mortgage loan per year but excludes parties that resell the loan within the 30-day window, buy the loan as part of a repurchase agreement, or acquire only a partial interest in the loan. The interim rule released in 2009 is valid until the final rule becomes effective on January 1, 2011.

### Proposed Regulation

***Federal Reserve Proposes Consumer Protections for Home-Secured Credit***

The Federal Reserve's proposed rule regarding home-secured credit (75, *Federal Register*, pp. 58539-788) would amend the Truth in Lending Act (Regulation Z) by strengthening consumer protection measures related to home-secured credit disclosures.

The rule would prohibit creditors from stipulating the purchase of another financial or insurance product in connection with a reverse mortgage, which is a complex loan product that allows borrowers to draw on their home equity while

[4] Anil K. Kashyap, Jeremy C. Stein, and Samuel Hanson, "An Analysis of the Impact of 'Substantially Heightened' Capital Requirements on Large Financial Institutions," Working Paper (May 2010).

[5] For more information on the Dodd-Frank Wall Street Reform and Consumer Protection Act, see *Banking Legislation and Policy*, Volume 29, Number 2.

remaining in their homes. Creditors would have to provide consumers clearer information about the unique features of reverse mortgage products, as well as force consumers to complete counseling about reverse mortgages early in the application process.

The amendment would allow consumers to withdraw an application and receive a refund for any fees incurred within three days of receiving an estimate of the credit terms. Current regulation allows consumers three days after closing to rescind but extends the window to up to three years after closing if the originator fails to disclose certain information, including a notification of the "extended right to rescind." The proposal revises the list of required disclosures to better guide customers; for example, disclosures of the loan amount and loan term would replace disclosure of the amount financed.

The rule would also restrict misleading advertisements and require fair disclosures of any key loan modification, credit insurance, and debt cancellation and suspension products.

***Interim Rule Revises Disclosure Requirements for Closed-End Mortgages***

The Federal Reserve imposed a revision to disclosure requirements (75, *Federal Register*, pp.58470-89) on closed-end mortgages, which would implement amendments to the Truth in Lending Act (Regulation Z). Creditors would be required to inform the borrower of interest rate and payment details for fixed-rate mortgages and additional information for variable rate mortgages, such as negatively amortizing or balloon payment options. Creditors must also alert consumers that there is no guarantee they will be able to refinance the loan in the future.

***Jumbo Mortgage Escrow Accounts Requirement Revised***

The Federal Reserve proposed a rule (75, *Federal Register*, pp. 58505-08) to require mortgage lenders to establish an escrow account for any first-lien jumbo loan with an APR of 2.5 percentage points or more above the prime rate. Jumbo loans, defined as mortgages that exceed the conforming loan limits of Fannie Mae and Freddie Mac, previously needed escrow accounts for APRs of 1.5 percentage points or more above the prime rate. The rule would implement part of section 1461 of the Dodd-Frank Act. The Federal Reserve will propose separate rules to implement the remainder of the section. The rule does not change the escrow account threshold for smaller mortgage loans.

***Proposed Restrictions on Consumer Mortgage Advertising***

The Federal Trade Commission (FTC) proposed a rule to prohibit deceptive mortgage advertising for consumer mortgage credit products, including closed- and open-end credit, traditional and alternative finance products, and forward and reverse mortgages. In effect, any misrepresentation in commercial communication—by inclusion, omission, or practice—that may affect a consumer's judgment about a product's fees, costs, obligations, or availability would subject the entity to civil penalties. The restriction would apply to any person or institution under FTC jurisdiction that engages in unfair or deceptive acts; the rule would not affect banks, thrifts, credit unions, nonprofits, and telecommunications common carriers.

## Federal Legislation

### *Enacted Legislation*

*Small Business Jobs Act of 2010*

On September 27, President Obama signed into law the Small Business Jobs Act (H.R.5297). The stated intent of the new law is to improve access to credit for small businesses through a special Small Business Lending Fund (SBLF) of up to $30 billion administered by the Treasury. Banks, thrifts, and bank holding companies with total assets of $10 billion or less will have access to the fund, provided they stay off the problem bank list of the Federal Deposit Insurance Company (FDIC) and have a plan for how to assist local businesses with revenues of $50 million or less. Community development financial institution loan funds are also eligible for the SBLF, but they face stricter requirements to participate. Institutions that directly increase the flow of credit to small businesses will receive more favorable rates during repayment of the government funds. The act also contains provisions to reduce the tax burden of small businesses.

*Increase in Federal Housing Authority Insurance Premiums*

On August 11, President Obama signed into law a measure (Public Law No. 111-229) that amends the National Housing Act by increasing the cap on insurance premiums for Federal Housing Authority (FHA) mortgages secured by single and multifamily dwellings. The bill was introduced on July 30 by House Financial Services Committee Chairman Barney Frank (D-Mass.) after a broader bill that contained a similar provision (H.R.5072)[6] stalled in the Senate. The new law authorizes the Secretary of Housing and Urban Development to raise annual insurance premium payments up to 1.5 percent (from 0.5 percent) for mortgages with original principal obligations under 90 percent of the appraised value of the property and up to 1.55 percent (from 0.55 percent) for mortgages with original principal obligations greater than or equal to 90 percent of the value. The FHA also announced its intention to lower upfront premiums by 100 basis points at the same time it raises the annual premiums. The FHA expects to gain $300 million per month after the changes take effect, which will help offset substantial capital reserve losses it sustained due to defaults during the housing market collapse.

### *Proposed Legislation*

*Covered Bond Act of 2010*

On July 22, Rep. Scott Garrett (R-N.J.) introduced a second version of the United States Covered Bond Act of 2010 (H.R. 5823) to establish a regulatory regime for covered bonds, which are debt instruments backed by high-quality assets known as a "cover pool." Assets in the cover pool remain on the issuer's balance sheet and assets that fall below certain eligibility requirements must be replaced by performing assets; these characteristics make covered bonds more transparent than standard mortgage-backed securities, which typically exist off the balance sheet. In addition, unlike covered bonds most mortgage-backed securities are not actively managed.

The bill would authorize the Comptroller of the Currency (OCC), in consultation with other federal regulators, to set up evaluation procedures for new and existing covered bond programs of insured depository institutions, bank holding companies, and approved nonbank financial companies. The OCC would also determine eligibility standards for collateral (residential and commercial mortgages, public sector loans or

[6] For more information about the proposed FHA Reform Act of 2010, see *Banking Legislation and Policy*, Volume 29, Number 2.

securities, small business loans, and other approved assets), stipulate over-collateralization levels, and require periodic tests to ensure that the cover pool sufficiently insured the principal and interest due on the bond.

Although covered bonds are successful in Europe, very few institutions have taken advantage of them in the U.S. The FDIC and Treasury issued complementary guidelines in 2008 to lay the foundation for a framework that would help develop a standardized and transparent market. The FDIC's statement clarifies what would happen to the collateralized assets of covered bonds.[7] The FDIC would include covered bonds in the standard rule for liquidating collateral: contracting parties must obtain consent from the FDIC to liquidate collateral or terminate a contract within the first 45 days of a conservatorship or the first 90 days for a receivership. The FDIC would comply with the terms of the contract until it paid off the covered bonds in cash (up to the value of the pledged collateral) or with liquidated collateral. The Treasury's statement provides a template of best practices for covered bonds backed by high-quality residential mortgages. Garrett's proposal would codify some of the regulators' suggestions, but it has a broader scope in terms of eligible issuers and cover pool assets.

Garrett proposed a similar bill with an identical title (H.R. 4884) in March 2010 that was not included in the Dodd-Frank Wall Street Reform and Consumer Protection Act. The current version of the bill was passed by the House Committee on Financial Services and reported to the full House of Representatives for consideration.

**Federal Regulation**

***Federal Deposit Insurance Corporation***

*Overdraft Payment Program Guidance*

On August 11, the FDIC proposed guidance on how banks can monitor their overdraft payment programs and comply with consumer protection laws. The guidance directs banks to improve disclosure and communication on available programs, set daily limits on overdraft fees, and process transactions in a way that does not intentionally maximize the cost to the consumer. The FDIC encourages banks to contact consumers who rely on overdraft payment programs for credit or otherwise misuse the programs, which are intended for accidental circumstances, and discuss lower-cost alternatives. The guidance reminds banks to require consumers to opt in to electronic overdraft programs (as described in the Federal Reserve's update to Regulation E) and allow them to decline coverage for nonelectronic overdrafts.

***Multiple Sponsors***

*Federal Regulators Revise Community Reinvestment Act*

On September 29, the Federal Reserve, OCC, FDIC, and the Office of Thrift Supervision (OTS) issued a final rule (75, *Federal Register*, pp. 61035-46) revising the way regulators evaluate an institution's efforts to meet the credit needs of low- and moderate-income neighborhoods according to the Community Reinvestment Act (CRA). As part of the implementation of the Higher Education Opportunity Act, regulators will begin to take into account any low-cost education loans to borrowers with income below the local median income. They

[7] To limit risks to the deposit insurance fund, the FDIC's policy applies to covered bonds secured by performing eligible mortgages, up to 10 percent AAA-rated mortgage securities, and substitution collateral such as cash and Treasury securities. Securities backed by tranches in other securities or assets, such as collateralized debt obligations (CDOs), are not acceptable collateral.

will also consider capital investment, loan participations, and other ventures with women- or minority-owned financial institutions or low-income credit unions that would benefit an underserved area.

*Federal Regulators Jointly Issue Final Rules on Registration of Mortgage Originators*
One July 28, the Federal Reserve, OCC, OTS, NCUA, and FDIC issued final rules (75, *Federal Register*, pp. 44656-708) to implement the national registry of residential mortgage loan originators employed by national and state banks, savings associations, Farm Credit System institutions, credit unions, and other regulated institutions, as required by the 2008 passage of the Secure and Fair Enforcement for Mortgage Licensing (S.A.F.E.) Act. The rule defines a mortgage loan originator as an individual who takes a residential mortgage loan application and offers or negotiates terms of a residential mortgage loan for compensation or gain. The registry will store background information and employment history, along with a unique identifier, for each individual. Loan originators will be responsible for updating and renewing their registrations annually. The rule took effect on October 1, 2010, but the registry will not be ready to populate until early in 2011.

***National Credit Union Administration***
*Credit Unions Allowed to Offer Short-Term Loans*
On September 16, the NCUA amended its general lending rule to allow federal credit unions to offer small, short-term loans to consumers that have been credit union members for at least one month. The NCUA's new rule applies to loan amounts between $200 and $1000, with terms between one and six months. Credit unions will be able to charge a higher interest rate (up to 28 percent) than currently permitted under the Federal Credit Union Act. The rule also imposed limits on the amount loaned to any one member and a $20 cap on application fees.

**Judicial Decisions**
***Settlements***
*SEC Settles Disclosure Cases with Goldman Sachs and Citigroup*
On July 19, the U.S. District Court for the Southern District of New York approved the settlement between the Securities and Exchange Commission (SEC) and Goldman, Sachs & Company for a record $550 million, which will be split between investors harmed by the misconduct ($250 million) and the Treasury ($300 million). On April 16, the SEC initially charged Goldman Sachs with securities fraud and presented evidence in the form of internal communications that showed the company misled investors during the marketing of a synthetic collateralized debt obligation (CDO) called ABACUS 2007-AC1. Although Goldman Sachs reached the settlement without admitting or denying guilt, the company admitted that it was a mistake not to include certain key facts in the marketing materials. In particular, Goldman Sachs did not reveal to investors that the hedge fund that selected the contents of the portfolio (Paulson & Co. Inc.) also had financial interests that would benefit from the portfolio's failure; on the contrary, the company stated that the party that selected the elements of the portfolio had financial interests congruent with those of the investors. The company agreed to abide by remedial requirements to amend its mortgage securities review and approval process by enhancing the supervision of marketing materials, conducting internal audits to ensure compliance, and training its employees on disclosure requirements.

The SEC also settled with Citigroup Inc. for $75 million over a disclosure charge. The settlement will be approved by the U.S. District Court for the District of Columbia if both parties can show that Citigroup has

modified its policies to prevent future violations. On July 29, the SEC charged Citigroup with significantly understating the extent of its exposure to subprime mortgages in 2007, at "a time of heightened investor and analyst interest" and while it was offering and selling securities to investors. Specifically, Citigroup repeatedly assured investors it had contained its exposure to subprime risks while failing to disclose an additional exposure to subprime assets of $39 billion in the form of CDO and liquidity put holdings.

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