BANKING LEGISLATION & POLICY

First Quarter 2010 **Volume 29, Number 1**

HIGHLIGHTS

This issue contains detailed descriptions of:

- The proposed Restoring Financial Stability Act, including:
  - Creation of the Financial Stability Oversight Council
  - Orderly Liquidation Authority for Regulators
  - Realignment of Regulators
  - Regulation of Over-the-Counter Derivatives
  - Protections for Investors and Consumers
- The Protect Our Recovery Through Oversight of Proprietary Trading Act
- A Proposed Crisis Responsibility Fee

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

FINANCIAL REFORM BILL PROPOSED IN SENATE

On March 15, Senate Banking Committee Chairman Christopher Dodd (D-Conn.) introduced the Restoring Financial Stability Act of 2010 (S. 3217). The bill contains provisions that would give regulators more authority to regulate large, interconnected financial firms and credit rating agencies; liquidate failed banks; limit systemic risk; require over-the-counter derivatives to be cleared on exchanges; and protect investors and consumers of financial products and services.

This proposal follows the Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173), which was passed by the House of Representatives in December 2009 and referred to the Senate Committee on Banking, Housing, and Urban Affairs.[1] The two bills address the same issues but differ in many details. Sen. Dodd's current proposal replaces his earlier draft from November 2009. The bill was referred to the Senate Committee on Banking, Housing, and Urban Affairs.

[1] For more information on the Wall Street Reform and Consumer Protection Act, see *Banking Legislation and Policy, Volume 28, Number 4*.

Financial Stability Act

Title I of the bill, the Financial Stability Act, includes provisions that would create a Financial Stability Oversight Council and grant the Board of Governors of the Federal Reserve additional powers to regulate large, interconnected bank holding companies (BHCs) and nonbank financial institutions.

The Financial Stability Oversight Council would be made up of the heads of the Department of the Treasury, the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency (OCC), a new Bureau of Consumer Protection (established later in the bill), the Securities and Exchange Commission (SEC), the Federal Deposit Insurance Corporation (FDIC), the Commodities Futures Trading Commission (CFTC), the Federal Housing Finance Agency (FHFA), and an independent insurance expert. The council would be charged with identifying potential risks to the country's financial stability that could arise from distress or failure of a large, interconnected financial institution. It would also work to promote market discipline and respond to emerging threats to market stability.

In order to fulfill these duties, the council would monitor financial markets, identify gaps in regulation, and foster information sharing between regulatory agencies. In addition, it would identify systemically important financial institutions that would be subject to stricter prudential standards.

If a BHC or a nonbank financial institution were to be designated for enhanced regulation, the Federal Reserve would be charged with issuing rules for and conducting oversight of the firm. The regulations could include risk-based and contingent capital requirements, leverage and concentration limits, enhanced disclosure, creation of emergency resolution plans, and overall risk limits. To accomplish these goals, the Fed could require the firm to terminate or restrict certain activities or to sell some of its assets.

Orderly Liquidation Authority

To ensure that the government would be able to quickly resolve failed large, interconnected firms with minimum risk to taxpayers, the bill would establish an Orderly Liquidation Authority Panel in the United States Bankruptcy Court for the District of Delaware. The panel, which would consist of three judges from the court, would be able, under recommendation from the Treasury, to appoint the FDIC as receiver of a firm that was in default or in danger of default. The Treasury would work with the Federal Reserve and the FDIC to identify distressed, systemically important firms and would have to demonstrate to the panel why normal bankruptcy protection would not be appropriate for the firm.

Orderly liquidation of the firm would require creditors and shareholders to bear losses. The management of the firm would not be retained, and the FDIC would be required to ensure that any managers responsible for the failure would have to bear losses as well.

To fund these actions, the FDIC would create a new Orderly Liquidation Fund (OLF), similar to its Deposit Insurance Fund (DIF) for failed banks. The OLF would be funded by charging a risk-based assessment on BHCs and nonbank financial institutions with assets of $50 billion or more. These assessments would be collected over the next five to 10 years, until the fund reached its target size of $50 billion.

Enhancing Financial Institution Safety and Soundness Act

Title III of the bill, the Enhancing Financial Institution Safety and Soundness Act, would realign the regulatory responsibilities of the Office of Thrift Supervision (OTS), the OCC, the FDIC, and the Federal Reserve.

The Fed would have supervisory and regulatory power only over BHCs with $50 billion or more in assets. The OCC would become the primary regulator for national banks of all sizes and for BHCs below the $50 billion threshold. This would cause the Fed to lose its authority over the vast majority of the approximately 5,000 BHCs it currently supervises.

The FDIC would regulate all state-chartered banks, including those that are Federal Reserve System members. This transfer would cause the Fed to lose supervision of approximately 850 state-chartered banks; the FDIC currently supervises approximately 5,000 non-Federal Reserve System state banks.

In addition, the OTS would be abolished within 90 days of the bill's passage, and its regulatory responsibilities overseeing thrift institutions would be divided among the other agencies. The Federal Reserve would become responsible for institutions with $50 billion or more in assets. Of the remaining thrifts, those with state charters would be regulated by the FDIC, and those with federal charters would be regulated by the OCC. The federal thrift charter would be abolished.

Private Fund Investment Advisers Registration Act

Title IV of the bill, the Private Fund Investment Advisers Registration Act, would require managers of hedge funds and other private investment funds to register with the SEC. Managers of venture capital funds and private equity funds, as well as managers of funds with less than $100 million in assets, would be exempt from this requirement. In addition, regulators would collect more data from hedge funds in order to evaluate their systemic risk.

Insurance Provisions

Title V of the bill contains provisions that would affect the regulation of insurance companies. It would create an Office of National Insurance within the Department of the Treasury that would be charged with monitoring the insurance industry. This office would coordinate with the Financial Stability Oversight Council to determine which insurance companies were systemically important enough to warrant enhanced regulation. Although it would not release its own regulations, it would work with international and state insurance regulators to develop and coordinate policies.

Bank and Savings Association Holding Company and Depository Institutions Regulatory Improvements Act

Title VI of the bill, the Bank and Savings Association Holding Company and Depository Institutions Regulatory Improvements Act, would place new restrictions on the activities of financial institutions. It would prohibit new deposit insurance applications for credit card bank, industrial bank, or trust bank subsidiaries of commercial firms (those that derive 15 percent or more of their revenue from nonfinancial activities). It would also place new restrictions on a bank's transactions with its affiliates, especially in regard to transfers of derivatives and securities. The elective investment BHC framework would be eliminated.

The bill would attempt to rein in risky investing practices by insured depository institutions and the companies that control them by prohibiting them from engaging in proprietary trading. These insured depository institutions and their controlling companies would also be prohibited from sponsoring or investing in hedge funds and private equity funds. In addition, the bill would impose concentration limits on the banks' positions and decrease the size of allowable mergers.

Over-the-Counter Derivatives Markets Act

Title VII of the bill, the Over-the-Counter Derivatives Markets Act, would require most bilateral swaps to be traded on regulated public exchanges. Currently, most over-the-counter

(OTC) swaps are traded privately between counterparties. This lack of transparency has caused problems for regulators attempting to determine systemic risk and for accountants attempting to determine fair market values for the contracts. By allowing the swaps to be traded on public exchanges, the bill would seek to mitigate these problems.

Oversight of the derivatives market would be split between the CFTC and the SEC, with the CFTC handling commodities-based swaps and the SEC handling securities-based swaps.

All sufficiently standardized derivatives would have to be accepted by and cleared through registered exchanges. Data on the terms and conditions of contracts would have to be made public, as would information about the derivatives that would allow potential buyers to evaluate risk. Major swap parties and repositories would need to register as such, and they would be subject to increased capital and reporting requirements.

Custom trades that could not be cleared would not have to go through exchanges, but the parties involved would have to put up more collateral to offset the increased risk. Regulators would also be able to exempt "custom banking products" from the clearing requirement at their discretion.

Payment, Clearing, and Settlement Supervision Act

Title VIII of the bill, the Payment, Clearing, and Settlement Supervision Act, would allow the Federal Reserve to issue rules that would regulate payment, clearing, and settlement activities among financial institutions. In consultation with the Financial Stability Oversight Council, the Fed would create rules to promote safety and soundness for activities that it found were, or were likely to become, systemically important. This authority could also be exercised over systemically important market utilities — companies that manage or operate a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions.

Investor Protections and Improvements to the Regulation of Securities

Title IX of the bill contains numerous provisions to protect investors and regulate securities. The SEC would create new committees to issue rules that protect investors, and it would also be able to limit mandatory arbitration agreements between brokers or dealers and their clients.

Nationally recognized statistical ratings organizations (NRSROs) would be subject to stricter requirements. They would have to implement strict internal controls governing their ratings processes; they would also have to disclose the data they use and assumptions they make when determining ratings. In addition, they would have to use consistent symbols and definitions when issuing ratings and publish the historical performance and probability of default for their different ratings classes.

This bill would require securitizers to retain at least 5 percent of the credit risk of any asset-backed securities (ABS) they created. If the securitizer was not the originator, then the originator would also have to retain some of this risk. The originators and securitizers would also have to provide more details to investors about the loans underlying the ABS.

The bill also contains provisions that would require shareholders to approve executive compensation at public companies and make other changes to rules of corporate governance.

Consumer Financial Protection Act

Title X of the bill, the Consumer Financial Protection Act, would establish a new Bureau of Consumer Financial Protection within the Federal Reserve System that would work to protect consumers from unfair or deceptive acts or practices and from discrimination by providers of consumer financial products and services. These activities include, among others, taking deposits; providing consumer credit products such as mortgages, personal loans, and credit card loans; servicing loans; engaging in payday lending; collecting debts; leasing property; and offering financial advice.

All consumer financial protection functions of the Federal Reserve, the OCC, the OTS, the FDIC, the Federal Trade Commission (FTC), the National Credit Union Administration (NCUA), and the Department of Housing and Urban Development (HUD) would be transferred to the new bureau. The new bureau would work to promote transparency and efficiency in consumer financial markets as well as to ensure that federal consumer financial laws were enforced. It would also provide financial education services for consumers. In addition, it would work with other agencies to address consumer complaints against financial service providers.

The bureau would have the authority to create, administer, and enforce regulations covering consumer financial products and services. This authority would not apply to credit extended directly by merchants, retailers, or other sellers of nonfinancial services. In addition, real estate brokerages, manufactured and modular home retailers, accountants and tax preparers, attorneys, state-regulated insurers, CFTC-regulated companies, and charities would also be exempted from its requirements. The bureau would have the authority to levy fines against violators and distribute payments to victims. The enforcement powers of the states would be preserved.

The bureau would be able to restrict or prohibit mandatory pre-dispute arbitration agreements. However, it would not be able to set usury limits. In addition, the bill would prohibit prepayment penalties on residential mortgage loans.

Federal Reserve System Provisions

Title XI of the bill would expand the emergency lending authority of the Federal Reserve. However, the Fed would have to receive approval from the Treasury to enact emergency programs. The bill would also allow the FDIC to create a wide-reaching obligation guarantee program for solvent, insured depository institutions in times of severe economic distress.

PROTECT OUR RECOVERY THROUGH OVERSIGHT OF PROPRIETARY TRADING ACT OF 2010 PROPOSED

On March 10, Senate Banking Committee member Jeff Merkley (D-Ore.) introduced the Protect Our Recovery Through Oversight of Proprietary (PROP) Trading Act of 2010 (S.3098). The bill would amend the Bank Holding Company Act to prohibit banks from engaging in certain risky activities that could endanger their financial soundness, including proprietary trading and investing in hedge funds.

The PROP Trading Act is largely based on the Obama administration's "Volcker rule" proposal in January 2010. Although similar to some provisions of the Senate's proposed Restoring Financial Stability Act (S. 3217), the two bills differ in some details. The Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173), which the House of Representatives passed in December 2009, does not include a similar rule.[2]

The bill was referred to the Senate Committee on Banking, Housing, and Urban Affairs.

Ban on Proprietary Trading

The legislation would enact a general ban for all federally insured banks and BHCs on proprietary trading, which is defined as the buying or selling of stocks, bonds, options, commodities,

[2] For more information on the Wall Street Reform and Consumer Protection Act, see *Banking Legislation and Policy, Volume 28, Number 4*.

swaps, and other financial products for the benefit of the institution itself, instead of on behalf of a client.

The bill would allow regulators to grant exemptions for certain activities or institutions if they were to deem the activity to be low risk, if no evidence of a conflict of interest between the institution and its client existed, if the institution remained sound, and if there were no threat to the nation's financial stability.

Ban on Relationships with Hedge Funds and Private Equity Funds

The legislation would prohibit depository institutions from sponsoring or holding any equity in a hedge fund or private equity fund, partially restoring the Glass-Steagall Act's separation between commercial and investment banking.

Nonbank Financial Companies and Securities Brokers

The bill would also impose limits on similar activities of nonbank financial companies and securities brokers. The level at which nonbank financial companies would be able to participate in proprietary trading or own any part of a hedge fund or private equity fund would be limited, and those that continued such practices would be required to hold additional capital. The appropriate trading limits and capital levels would be determined jointly by the Board of Governors of the Federal Reserve, the FDIC, the SEC, and the CFTC.

The legislation would also prohibit proprietary trading by any underwriter, agent, purchaser, or sponsor of an ABS. Regulators would determine the exact restrictions for securities brokers.

FINANCIAL CRISIS RESPONSIBILITY FEE PROPOSED

On January 14, President Obama announced the Financial Crisis Responsibility Fee, a proposal to recoup losses from the Troubled Asset Relief Program[3] (TARP) by taxing the debt of the largest and most leveraged firms in the financial industry. The fee would be assessed annually for 10 years or until it fully covered the estimated $117 billion cost of the TARP.

The fee targets federally insured depository institutions, insurance companies, securities broker–dealers, and bank and thrift holding companies with over $50 billion in consolidated assets, all of which were either direct or indirect beneficiaries of the government's emergency relief programs during the financial crisis. U.S. automakers that were supported by TARP funds would not be subject to the fee.

Approximately 60 institutions could be affected by the fee,[4] and the 10 largest institutions would account for over 60 percent of the total revenue. Domestic firms would be assessed by the amount of covered liabilities held globally. The operations of U.S. subsidiaries of foreign firms would be consolidated for the purpose of meeting the $50 billion threshold.

The fee would be levied at 15 basis points of "covered liabilities," defined as assets less tier 1 capital, FDIC-assessed deposits, and insurance policy reserves. Tier 1 capital traditionally includes equity capital and disclosed reserves.

[3] For more information on the Troubled Asset Relief Program, see *Banking Legislation and Policy*, Volume 27, Number 4.
[4] According to a March 4, 2010, report from the Congressional Budget Office.

Federal Legislation

Enacted Legislation

Elimination of Subsidies and Guarantees for Student Loans

On March 23, the President signed into law the Reconciliation Act of 2010 (Public Law No. 111-152). Section II of this legislation ends both the Federal Loan Insurance Program and the Federal Family Education Loan program, which provided subsidies and loan guarantees for originators and servicers of student loans. The Department of Education instead will use the funds allocated to the programs to make loans directly. This change will be effective on July 1, 2010.

Federal Regulation

Board of Governors of the Federal Reserve

Final Risk-Based Capital Rule Related to FASB Statements 166 and 167

On January 21, the Board of Governors of the Federal Reserve, in conjunction with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, issued a final rule (75, *Federal Register*, pp. 4636-54) that will subject banks to higher risk-based capital requirements for many items, including securitized assets, that banks had previously held off balance sheet. In June 2009, the Financial Accounting Standards Board (FASB) issued new statements that will require many banks to move these items back onto their balance sheets. For more information on the FASB statements, see *Banking Legislation and Policy*, Volume 28, Number 2.

Final Rule on Credit Card Penalty Fees

On February 3, the Board of Governors of the Federal Reserve issued a final rule (75, *Federal Register*, pp. 12334-75) amending Regulation Z to limit the penalty fees — that credit card issuers can charge — to an amount that is "reasonable and proportional" to the violation, as required by the Credit Card Accountability Responsibility and Disclosure Act of 2009 (Public Law No. 111-24). Fees will not be able to exceed the actual dollar amount of the customer's violation, and inactivity fees will be banned. Because some issuers increased customers' rates in anticipation of this rule, all rate increases that have occurred since January 1, 2009, will have to be re-evaluated within six months and reduced if there have been no changes in the consumers' creditworthiness. The rule will be effective on August 22, 2010.

Final Rule for Gift Card Disclosures

On March 23, the Board of Governors of the Federal Reserve issued a final rule (75, *Federal Register*, pp. 16580-621) amending Regulation E to require enhanced disclosure and limit fees on prepaid gift cards. The rule, which was required by the Credit Card Accountability Responsibility and Disclosure Act of 2009 (Public Law No. 111-24), requires details about the card's fees to be printed on the card itself. It also prohibits inactivity fees from being charged if the card has been inactive for less than a year and then allows only one charge per month. The rule will be effective on August 22, 2010.

Department of the Treasury

Modifications to HAMP to Help "Underwater" Borrowers

On March 26, the Department of the Treasury announced several changes to its Home Affordable Modification Program (HAMP). Under the changes, lenders and servicers will be prohibited from foreclosing on a mortgage that may be HAMP-eligible even if the borrower has not yet applied for HAMP assistance. An unemployed borrower who meets certain eligibility criteria will be able to have his monthly mortgage payments reduced to an "affordable" level for three to six months while he searches for a new job. If a loan is "underwater" — the value of the loan exceeds the value of the house — lenders and servicers will be offered incentives to forbear the portion of the loan's balance that exceeds the home's current appraised value. The loan would become eligible for Federal Housing Administration (FHA) refinancing programs if the reduced loan were at most 97.75 percent of the home's current value. For more information on HAMP's original provisions, see *Banking Legislation and Policy*, Volume 28, Number 1.

Federal Housing Administration

Tightened Standards for Agency-Backed Mortgages

On January 20, the Federal Housing Administration (FHA) issued more restrictive standards for borrowers and lenders of FHA-backed mortgages. The mortgage insurance premium will increase from 1.75 percent to 2.25 percent. Only borrowers with FICO scores of 580 or greater will continue to qualify for the FHA's 3.5 percent down-payment program; borrowers with lower scores will have to make a down payment of at least 10 percent. Seller concessions — money given to sellers to cover closing costs — will be lowered from 6 percent to 3 percent of the purchase price to reduce the incentive for sellers to inflate appraised values. The FHA will also increase its enforcement efforts against lenders.

Federal Housing Finance Agency

Proposed Rule to Set New Affordable Housing Goals for GSEs

On February 17, the Federal Housing Finance Agency proposed new goals for affordable housing supported by the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac (75, *Federal Register*, pp. 9034-72). Under the proposed rule, low-income housing goals would be revised, only conventional mortgages would be counted toward the new goals, and the definition of low-income borrowers would be adjusted. Comments on the proposed rule were due on April 12, 2010.

Judicial Decisions

Circuit Court Rulings

Debt Collectors Do Not Need Original Documents in Bankruptcy Cases

On January 25, the U.S. Court of Appeals for the Sixth Circuit reversed a lower court's ruling, allowing a debt collection company to pursue its claims in bankruptcy court despite not having the original loan documents (*In re: Gerald Wingerter and Janice Keller-Wingerter (B-Line LLC v. Wingerter)*, 6th Cir., No. 08-4455, 1/25/10). The company purchases loans from creditors and receives detailed information about the loans and borrowers, which it stores in an electronic database; however, the company does not receive the original paperwork. The court ruled that the company could reasonably bring a claim in bankruptcy court using the information in its database and that forcing it to produce the original documents would be unnecessarily costly and burdensome.

Federal Reserve Must Disclose Data on Market Assistance Programs

On March 19, the U.S. Court of Appeals for the Second Circuit affirmed a lower court's ruling that the Board of Governors (BOG) of the Federal Reserve must disclose details about its emergency lending facilities, including the names of the borrowers and the terms of the loans (*Bloomberg L.P. v. Board of Governors of the Federal Reserve*

System, 2nd Cir., No. 09-4083-cv, 3/19/10). The Federal Reserve had argued that details about these loans were exempted from Freedom of Information Act (FOIA) requests under a clause that protects "financial information obtained from a person [that is] privileged or confidential." The court ruled that because the information was not "obtained from" the commercial banks, and because releasing it would not cause any harm to the Reserve Banks, it was not protected. In a related opinion, the court overturned a lower court's ruling regarding whether the BOG must disclose information about lending activities at each of the 12 Federal Reserve Banks (*Fox News Network LLC v. Board of Governors of the Federal Reserve System*, 2nd Cir., No. 09-3795-cv, 3/19/10). Citing the same FOIA clause, the Second Circuit ruled that information on these lending programs held by the individual Reserve Banks must be searched for and disclosed by the BOG.

Prepared by the Research Department. For further information, contact Robert O'Loughlin at 215-574-4335 or bob.oloughlin@phil.frb.org. To subscribe to this publication, go to http://www.philadelphiafed.org/philscriber/user/dsp_content.cfm.