



# BANKING LEGISLATION & POLICY

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## HIGHLIGHTS

This issue contains detailed descriptions of:

- The proposed [Risk Retention for Securitized Assets](#), including:
  - [Options for Compliance](#)
  - [Hedging, Transfer, and Financing Restrictions](#)
  - [Exemptions for Certain Asset-Backed Securities](#)
- [The Administration's Proposed Reforms to the Housing Finance Market](#)
- [Additional Swap Market Regulation](#)

In addition, it summarizes [other notable legislative, regulatory, and judicial developments that occurred during the first quarter of 2011](#).

### Risk Retention for Securitized Assets

On March 29, six federal agencies — the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), the Federal Housing Finance Agency (FHFA), and the Department of Housing and Urban Development (HUD) — [jointly issued a proposal](#) to increase risk retention requirements for sponsors<sup>1</sup> of asset-backed securities (ABS) and prohibit transference or hedging of the retained credit risk in an effort to reduce moral hazard in

the securitization market. The proposed rules implement section 941(b) of the [Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Dodd-Frank Act)<sup>2</sup> and would affect all ABS offerings, including securities sold in transactions exempt from registration with the SEC, such as collateralized debt obligations (CDOs), unless explicitly exempt as discussed below. The proposed rules would require a sponsor to maintain an economic interest of at least 5 percent of the aggregate credit risk of the assets in each securitization. The agencies believe this “base” requirement would motivate sponsors to monitor and control the quality of the underlying assets.

<sup>1</sup> The proposed rule considers a sponsor to be an entity that organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, to the issuer.

<sup>2</sup> For more information on the Dodd-Frank Wall Street Reform and Consumer Protection Act, see [Banking Legislation and Policy, Volume 29, Number 2](#).

### *Options for Compliance*

Sponsors would be allowed to select from a handful of options to comply with the risk retention rule. A sponsor using the *vertical risk retention option* would retain at least 5 percent of each class of ABS interests issued. As a result, the sponsor would be exposed to 5 percent of the credit risk that each class of investors has to the underlying assets.

A sponsor using the *horizontal risk retention option* would retain a first-loss residual interest of at least 5 percent of the par value of all ABS interests issued in the transaction. The horizontal residual interest would not receive any payments of principal made on a securitized asset until all other ABS interests were paid in full. Instead of holding a horizontal residual interest, the proposed rules would allow a sponsor to pre-fund a horizontal reserve account at closing with an amount equal to at least 5 percent of the par value of all the ABS interests issued in the transaction. The reserve account would be held by a trustee for the issuer and would be exposed to the same first-loss credit risk on the underlying assets as the horizontal residual interest. The reserve account would cover payments on ABS interests if an underlying asset has insufficient funds to pay the amount due.

A sponsor using the *L-shaped risk retention option* would split risk retention equally between the vertical and horizontal approaches to achieve the base risk retention requirement of 5 percent.

A sponsor of a revolving master trust collateralized by revolving lines of credit, such as credit card accounts, may satisfy the minimum risk retention of 5 percent with a "seller's interest." The seller's interest is a direct claim on the payoffs from a portion of the underlying pool of assets. A sponsor of a securitization transaction could also use a *randomly selected representative sample*, materially identical to the aggregate assets, to meet

the risk retention requirements. Sponsors would retain at least 5 percent of the unpaid principal balance of all the securitized assets.

The agencies' proposal includes risk retention options specifically designed for structures involving asset-backed commercial paper and commercial mortgage-backed securities. It also requires a sponsor that sells interest-only claims, thereby monetizing the excess spread on the underlying assets, to establish and fund a premium capture cash reserve account, which would be used to cover losses on underlying assets before any other interest, including a horizontal interest or horizontal cash reserve account.

### *Allocation to the Originator*

The proposed regulation would provide sponsors of a securitization with a limited option to shift some of the credit risk exposure to the originator of the securitized assets. Sponsors that employ the horizontal or vertical approach to risk retention would be able to transfer a portion of the risk retention obligation to any originator that contributed at least 20 percent of the aggregate underlying assets. Originators would hold an allocated share greater than 20 percent, but not exceeding the percentage of securitized assets it originally created.

### *Hedging, Transfer, and Financing Restrictions*

The proposed regulation would prohibit a sponsor and any consolidated affiliates from hedging the credit risk the sponsor is required to retain. The rules would also prohibit the transfer of any interest or assets to an entity that is not a consolidated affiliate so that the organization retains appropriate exposure to the credit risk.

### *Exemption for ABS with Qualified Residential Mortgages*

The Dodd-Frank Act provides an exemption from risk retention requirements if a securitization's

assets are all qualified residential mortgages (QRMs), which are closed-end first-lien mortgages to purchase or refinance a property that is the borrower's principal dwelling. These mortgages must meet a variety of standards set by the agencies to be considered a QRM, such as borrower credit history, payment terms, and loan-to-value (LTV) ratio caps, which promote robust underwriting standards and high credit quality. Loans with higher delinquency rates (negative amortization, interest-only payments, or significant rate increases), as well as time shares, reverse mortgages, construction loans, and other loans with complex underwriting or higher credit risk, would be excluded from potential QRM status. For a mortgage loan to qualify as a QRM, a borrower must pay 20 percent down. The down payment must come from an acceptable source, as outlined in the [HUD Handbook](#), and can include a borrower's own funds, gifts, and certain down payment assistance programs. For their loans to qualify as QRMs, borrowers must not have been 60 or more days past due on any debt obligation within the preceding 24 months, must not have been a debtor in a bankruptcy proceeding nor have engaged in a short sale in the preceding 36 months, and must not be currently 30 or more days past due on any debt obligation. Borrowers must also have LTV<sup>3</sup> ratios not exceeding 80 percent for a purchase transaction, not exceeding 75 percent for rate and term refinance loans, and not exceeding 70 percent for cash-out refinance loans. The proposed requirements for QRMs also include the analysis of a borrower's ability to repay the mortgage, a restriction on points and fees, and the incorporation of default mitigation procedures.

#### *Exemption for ABS with Other Qualifying Loans*

The proposed risk retention regulation allows securitizers to avoid the risk retention requirement

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<sup>3</sup> The LTV ratio is the amount of a loan as a percentage of the total appraised value of a property. Default rates are lower for borrowers with lower LTV ratios.

of some ABS backed exclusively by commercial real estate, commercial, and automobile loans with lower credit risk. The agencies proposed conservative underwriting standards for such loans, which include a borrower's ability to repay, risk management and monitoring, LTV ratios, valuation of collateral, and a review of the borrower's credit history.

#### *Exemption for ABS with Loans Backed by the U.S. Government*

Any ABS securitization with underlying loans guaranteed by the U.S. government or one of its agencies, such as the Government National Mortgage Association, would be exempt from the risk retention requirement. In addition, the proposed rule would not subject the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), both under conservatorship of the Federal Housing Finance Agency (FHFA) since 2008, to the risk retention requirement. Fannie Mae and Freddie Mac were chartered to issue securities backed by pools of conventional mortgage loans with a guarantee of timely payment of principal and interest and are exposed to 100 percent of the credit risk in the underlying assets. The exemption would apply only while Fannie Mae and Freddie Mac are under conservatorship and would be amended by the agencies after further progress of the housing reform currently underway.

#### **Proposed Reforms to the Housing Finance Market**

On February 11, the administration [published a report outlining](#) the reforms needed to wind down the government-sponsored entities (GSEs) Fannie Mae and Freddie Mac and encourage the privatization of the market for housing finance.

#### *Minimizing the Role of the GSEs*

Fannie Mae and Freddie Mac do not make loans directly to homebuyers, but they guarantee the payment of interest and principal of loans that meet specific guidelines (known as "conforming

loans”). The agencies, along with the Federal Housing Administration (FHA) and the Government National Mortgage Association (Ginnie Mae), currently insure or guarantee over 90 percent of mortgage originations. Fannie Mae and Freddie Mac also derive income and provide liquidity to the secondary mortgage market by purchasing mortgages from lenders to retain in their financial portfolios or to bundle into securities to sell to investors.

The report outlines a number of ways to reduce the role of the GSEs in insuring or guaranteeing mortgages. The administration recommends that the FHFA gradually increase the guarantee fees charged by Fannie Mae and Freddie Mac over the next several years to more accurately reflect the market price of the risk.<sup>4</sup> Since the fees are currently at a level that would not be profitable for private firms, raising fees would permit private firms to compete for the mortgages. The administration also recommends that Fannie Mae and Freddie Mac purchase additional credit-loss protection and require larger down payments by borrowers. The administration’s long-term goal is for every borrower to pay at least 10 percent down on every mortgage insured by the GSEs.

The administration proposes to lower the size of the loan eligible for GSE guarantees, which is known as the conforming loan limit. The conforming loan limit for a single-family residence varies by location, but the [national maximum](#) stands at \$417,000. Loans higher than the conforming limit would be funded solely through the private market. The administration also advises the GSEs to shrink their investment portfolios by at least 10 percent per year.

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<sup>4</sup> A bill to increase guarantee fees charged by Fannie Mae and Freddie Mac ([H.R. 1222](#)) was introduced by Representative Randy Neugebauer on March 29.

#### *Targeted Assistance Through the FHA*

The FHA is a government agency that provides mortgage insurance on loans made by approved lenders. Its insurance premiums are lower than those from private mortgage providers, allowing consumers with lower income or shaky credit histories to finance homes. The FHA insures nearly one-third of the mortgages in the nation as a result of the financial crisis.

The administration aims to decrease the FHA’s market share to 15 percent or lower with two actions: increasing the price of FHA mortgage insurance and decreasing the maximum loan size that can qualify for FHA insurance. Like Fannie Mae and Freddie Mac, the FHA will continue to increase the premium on its mortgage insurance, the most recent of which was [a 25-basis-point hike](#). The administration plans to allow the temporary loan limit (125 percent of local median house price) established in the Economic Stimulus Act of 2008 to expire in October, restoring the FHA loan limit to 95 percent of local median house price. The administration may also pursue further reductions in the FHA loan limit.

#### *Federal Home Loan Banks*

Federal Home Loan Banks (FHLBs) are cooperatives regulated by the FHFA that help community-based lenders fund mortgages. The proposal would limit the amount of advances FHLBs give to large financial institutions and require them to reduce their financial portfolios.

#### *Options for Long-Term Structure of Housing Finance*

The proposal offers three paths for the long-term transition from public support of the housing market to private financing. All three options would limit the government’s role to insuring mortgages of a narrowly defined target population through the FHA, the Department of Agriculture, and the Department of Veterans Affairs. While promoting broad access to credit, the plans were

designed to limit taxpayer liability, distorted markets, and financial instability. The first option would limit the role of government mortgage insurance without creating any new mechanisms to establish economic stability during a financial crisis. The administration worries that the higher cost of credit under this option would limit credit availability to families that do not qualify for FHA-guaranteed loans.

The second option would limit the role of government mortgage insurance and provide a mechanism for the government to offer public insurance if an economic crisis impairs liquidity. During a financial crisis, additional public insurance could be accessed through a high guarantee fee competitive only in the absence of private capital or through a temporary increase in the allotted amount of public insurance sold.

The third option would limit the role of government mortgage insurance and allow the government to provide reinsurance for the securities of certain mortgages, a feature that, of the three options, would provide the lowest-cost access to mortgage credit and offer the most flexible response to a financial crisis. The reinsurance would be paid out to holders of the securities in the event of a financial catastrophe. The premium for the reinsurance would cover future claims and losses to taxpayers. The administration recognizes the risk of artificially inflating housing assets and introducing moral hazard with its third option.

### **Addendum to Swap Market Regulation**

The Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) continued to propose swap and security-based swap market regulation, as required by the [Dodd-Frank Act](#). The commissions started proposing regulation to establish a new regulatory framework for the mandatory clearing of over-the-counter (OTC) derivatives in the fourth quarter of

2010<sup>5</sup> by defining specific swap-related terms and entities, setting the process for mandatory clearing and its exemptions, and outlining governance requirements for market participants. The following proposals are an addendum to this initial slate of regulation and add detail to the governance requirements for clearing organizations. The proposed regulations also identify clearing, margin, capital, and counterparty relationship requirements for swap market participants.

### *Clearing Agency Standards*

The SEC's [proposed rules on operation and governance standards](#) for clearing agencies of security-based swaps complement the standards that the CFTC proposed for commodity-based swaps in 2010. A clearing agency settles obligations between parties, upholds contract terms, and may act as a central counterparty (CCP) to the trade. A CCP intermediates trades by becoming the counterparty to both the buyer and the seller of a swap. Certain swap dealers and swap execution facilities (SEFs) would be exempt from the rules that apply to clearing agencies. An SEF is a new type of registered entity, created by the Dodd-Frank Act, that provides a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers, excluding national exchanges.

All clearing agencies would be required to process settlements efficiently while mitigating a variety of risks. Participants would be required to have sufficient financial resources to meet the requirements set by the clearing agency. Clearing agencies would be required to hold assets in safe and relatively liquid instruments and establish procedures to handle a participant's default. Each clearing agency would also need to give market

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<sup>5</sup> For more information on the proposed regulatory framework for swaps, see [Banking Legislation and Policy, Volume 29, Number 4](#).

participants the necessary information in order to assess the risks and costs associated with using its services. All clearing agencies would need to address conflicts of interest, protect confidential trading information, and appoint a chief compliance officer.

Clearing agencies that perform CCP services would need to comply with additional measures associated with risk management, membership, and transparency. These clearing agencies would be required to limit exposure to participants through margin requirements and ensure operational continuity in the event that the largest participants default. A clearing agency with CCP services would be prohibited from denying membership to those who do not perform dealer services and from establishing a minimum portfolio size or transaction volume but would be allowed to offer scalable services based on a member's net capital. Clearing agencies with CCP services would also need to disseminate certain pricing and valuation information.

#### *Time Frames for Submitting, Clearing, and Processing Swaps*

The CFTC proposed rules regarding the time frames for submitting, clearing, and processing swaps ([76, Federal Register, pp. 13101-11](#)). Swap dealers (SDs), major swap participants (MSPs), and—where applicable—futures commission merchants (FCMs) would have to submit swaps subject to mandatory clearing to a derivatives clearing organization (DCO) on the day of execution. A DCO is an entity that enables parties involved in an agreement, contract, or transaction to substitute the entity's credit for their own; that settles obligations between parties; or that provides clearing services or arrangements that transfer credit risk. Swaps not subject to mandatory clearing would need to be submitted for clearing the day after the execution of the swap or the agreement to clear (whichever is later). SEFs and

designated contract markets (DCMs) would be required to submit swaps to a clearing organization upon execution. A DCM is a board of trade or exchange that allows market participants to trade futures, options on futures, or options on commodities.

The rule also proposes requirements for DCOs to ensure the efficient processing and clearing of swaps; these requirements depend on the platform used to carry out the transaction, for example, whether the transaction was initiated on an exchange (a SEF or DCM). In addition, SEFs and DCMs would be required to develop rules and procedures with DCOs to enable efficient processing.

The CFTC's rule would also require DCOs to transfer a customer's portfolio of positions and related funds to another clearing member upon request and without unnecessary close-out and re-booking of positions.

#### *Swap Margin and Capital Requirements*

On April 12, the [CFTC proposed a margin requirement rule](#) similar to a [jointly proposed margin and capital requirements](#) rule by the Federal Reserve, the FDIC, the FHFA, the OCC, and the Farm Credit Administration for SDs and MSPs that enter into noncleared swaps. The proposal establishes a minimum amount of initial and variation margin collected from counterparties and sets the timing of the calculation and collection of the variation margin, all of which vary based on the relative riskiness of the counterparty and the swap. The initial margin is a percentage of the value of the contract posted as collateral with the CCP (or dealer) at the outset of the transaction, while the variation margin is the additional collateral posted on a daily or intraday basis to reflect changes in the value of the contract. Margins are used to cover the CCP's (or dealer's) losses in the event of a default by a counterparty. SDs and

MSPs with nonfinancial counterparties would not be required to pay or collect margins but would be required to enter into credit support arrangements. Eligible collateral for the margin requirement would include cash funds and liquid U.S. government debt, which would be held by third-party custodians. Swap entities would be allowed to set a threshold below which a margin would not be required of lower-risk counterparties. The agencies would require the swap entities to comply with regulation on capital standards, which address noncleared swaps and security-based swaps.

#### *Counterparty Relationships*

The [SEC proposed a rule](#) concerning the relationships between counterparties to a trade. Security-based SDs and major security-based swap participants would be required to acknowledge trades with counterparties within 24 hours and verify their terms. The rule specifies which entity should provide the trade acknowledgment. Entities could satisfy the requirement by processing the transaction through a registered clearing agency.

The [CFTC also proposed rules](#) governing the relationships between counterparties. Under the rules, SDs and MSPs would be required to set terms of a transaction in writing and to agree on margin requirements and custodial arrangements with counterparties. The rule would require counterparties to agree on methods and procedures to determine the value of swaps under any circumstance, as well as notify the CFTC of any valuation disputes. All terms of cleared swaps must conform to the rules of the DCO settling the transaction. SDs and MSPs would also be required to verify the right of a counterparty to exercise the end-user exception from mandatory clearing. In

addition, SDs and MSPs must agree to follow the new orderly liquidation authority under Title II of the Dodd-Frank Act and the existing processes in the Federal Deposit Insurance Act, as well as assess how the resolution of a counterparty would affect their portfolios. Each entity must consent to the transfer of swaps to a performing third party if a counterparty's insolvency is subject to resolution by the FDIC.

#### *Investment Advisers, Commodity Pool Operators, and Commodity Trading Advisors*

The CFTC proposed regulations that define commodity pool; commodity pool operator (CPO), essentially, hedge funds that engage in futures trading; and commodity trading advisors (CTA), the advisors to these hedge funds ([76, Federal Register, pp. 11701-5](#)). It also amended existing regulations applicable to CPOs and CTAs to include swap activities.

The CFTC and the SEC [jointly proposed a rule](#) that covers reporting requirements for advisers to private funds registered with the SEC, and CPOs and CTAs registered with the CFTC. The entities would be required to submit information about private funds, such as the amount of assets under management, the use of leverage, counterparty credit risk exposure, and trading and investment positions. Entities registered with both agencies and with managed assets of under \$1 billion would be required to file certain information on an annual basis, and those with managed assets of \$1 billion or more would be required to update the commissions on a quarterly basis.

The CFTC proposed regulation for additional reporting for CPOs and CTAs that are not dual registrants ([76, Federal Register, pp. 7976-8066](#)). In the same rule, the CFTC narrows the allowable exemptions from registration for CPOs and CTAs.

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## **Federal Legislation**

### ***Proposed Legislation***

#### *Amendments to the Dodd-Frank Act*

A number of amendments have been introduced to modify or repeal portions of the Dodd-Frank Act. The Asset-Backed Market Stabilization Act, sponsored by Representative Steve Stivers (R-Ohio) and referred to the House Committee on Financial Services, would reinstate the 1933 Securities Act Rule 436(g) to exempt nationally registered statistical rating organizations (NSROs) from being considered “experts” when their ratings are used in registration statements ([H.R. 1539](#)). Rule 436(g) had exempted NSROs from the provisions for experts, which would require them to provide consent for use of their ratings on securities documents and from being held liable for a rating that contains an untrue statement or misleads investors. NSROs pulled back from the asset-backed securities (ABS) market by universally denying consent to use their ratings after the Dodd-Frank Act repealed the rule, prompting the SEC to announce that it would not enforce the credit ratings requirement on registered ABS offerings.

The Small Business Capital Access and Job Preservation Act, introduced by Representative Robert Hurt (R-Va.), would amend the Investment Advisers Act of 1940 to provide a registration exemption for private equity fund advisers ([H.R. 1082](#)). The bill would repeal a measure in the Dodd-Frank Act that required such registration and was referred to the Subcommittee on Capital Markets and Government Sponsored Enterprises.

The Business Risk Mitigation and Price Stabilization Act, sponsored by Representative Michael Grimm (R-N.Y.), would provide end-user exemptions from certain CFTC and SEC swap market regulations ([H.R. 1610](#)). The bill was referred to the House Committee on Financial Services and the Committee on Agriculture.

The Burdensome Data Collection Relief Act, introduced by Representative Nan Hayworth (R-N.Y.), would repeal section 953(b) of the Dodd-Frank Act to prevent the SEC from requiring companies to release the median income of their employees (except the CEO) and a comparison of that number to the income of the CEO ([H.R. 1062](#)). The bill was referred to the House Committee on Financial Services.

The Consumer Financial Protection Oversight Act of 2011, introduced by Representative Randy Neugebauer (R-Texas), would transfer the Consumer Financial Protection Bureau from the Federal Reserve System to the Department of the Treasury but insulate it from the influence of the Secretary of the Treasury ([H.R. 557](#)). The bill was referred to the Subcommittee on Financial Institutions and Consumer Credit.

Representative Michele Bachmann (R-Minn.) proposed legislation to repeal the Dodd-Frank Act in its entirety and restore the provisions of law that had been changed by it ([H.R. 87](#)). The bill was referred to the House Committee on Financial Services and a number of other relevant congressional committees.

#### *Proposed Legislation on Interchange Fees*

Soon after the Board of Governors of the Federal Reserve (Federal Reserve) issued a proposed rule on debit

and interchange fees and routing,<sup>6</sup> lawmakers endeavored to suspend or delay the action. Senators Jon Tester (D-Mont.) and Bob Corker (R-Tenn.) introduced the Debit Interchange Fee Study Act of 2011 ([S. 575](#)) to extend by two years implementation of the rules mandated by section 1075 of the Dodd-Frank Act. The bill would also commission a study to determine the appropriate regulatory structure for electronic debit card transactions. The bill was referred to the Senate Committee on Banking, Housing, and Urban Affairs.

Representatives Shelly Moore Capito (R-W.Va.) and Debbie Wasserman Schultz (D-Fla.) proposed the Consumers Payment System Protection Act, with similar aims ([H.R. 1081](#)). The bill would delay by one year the implementation of proposed or final rules relating to the Dodd-Frank Act's rules on electronic debit transaction fees and commission a study on the impact of the Federal Reserve's proposed regulation. The bill was referred to the House Subcommittee on Financial Institutions and Consumer Credit.

## **Federal Regulation**

### ***Board of Governors of the Federal Reserve***

#### *Proposed Standards for Systemically Important Financial Market Utilities*

On March 30, the Federal Reserve proposed a rule to enhance the supervision of systemically important financial market utilities (FMUs), which would implement part of Title VIII of the Dodd-Frank Act ([76, \*Federal Register\*, pp. 18445-54](#)). The proposed requirements are based on its [Policy on Payment System Risk](#) and the international risk-management standards developed by the Committee on Payment and Settlement Systems of the Bank for International Settlements and the Technical Committee of the International Organization of Securities Commissions. The rule would establish heightened standards related to an FMU's payments, clearing, and settlement operations. FMUs would be required to establish procedures to manage credit and liquidity risks, inform participants of the risks, perform timely settlement, allow open and fair participation, and ensure operational reliability, transparency, and good governance. FMUs would also be required to hold assets in safe and liquid instruments, mitigate known risks, develop loss containment strategies, and ensure that participants have sufficient financial resources to cover obligations, among other responsibilities. The rule would apply to systemically important FMUs, except clearing agencies registered with the SEC or derivatives clearing organizations registered with the CFTC. The Federal Reserve estimates that fewer than five large-value payments systems would meet the conditions to be affected by the proposed rule.

#### *Proposed Rule on the Designation of Systemically Important Nonbank Financial Companies*

On February 8, the Federal Reserve proposed a rule pertaining to the designation of systemically important nonbank financial companies by the Financial Stability Oversight Council ([76, \*Federal Register\*, pp. 7731-40](#)). The rule implements two provisions of the Dodd-Frank Act, establishing the criteria under which a company is "predominantly engaged in financial activities" and defining the terms "significant nonbank financial company" and "significant bank holding company." A company would be deemed predominantly engaged in financial activities only if 85 percent or more of the company's assets or revenues relate to activities deemed financial in nature under the Bank Holding Company Act in one of the two most recently completed fiscal years. A nonbank financial company or bank holding company would be considered "significant" if its total consolidated assets exceed \$50 billion or it has previously been designated as systemically important by the council. In designating a firm as systemically important, the council must consider its relationships with other

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<sup>6</sup> For more information on the Federal Reserve's proposed rule, see [Banking Legislation and Policy, Volume 29, Number 4, page 11](#).

“significant” firms. The designation of “significant” does not in itself imply that a firm is systemically important.

#### *Final Rule to Expand Coverage of Consumer Protection Regulations*

On March 25, the Federal Reserve adopted two rules that amend Regulation Z (Truth in Lending) and Regulation M (Consumer Leasing) by increasing the minimum amount of a loan eligible for exemption from higher regulatory standards from \$25,000 to \$50,000 ([76, Federal Register, pp. 18349-54](#) and [76, Federal Register, pp. 18354-65](#)). The rule reflects the Dodd-Frank Act’s expanded consumer protection mandate for credit transactions and leases.

#### *Final Rule and Proposed Rule on Escrow Account Requirements for Home Mortgage Loans*

On February 23, the Federal Reserve issued both a [final rule](#) and a [proposed rule](#) regarding the escrow account requirements for home mortgage loans. The final rule, which went into effect on April 1, 2011, raises the annual percentage rate (APR) threshold on first-lien “jumbo” mortgages for which an escrow account is required from 1.5 percentage points to 2.5 percentage points above the average prime rate. The proposed rule would make escrow accounts for first-lien higher priced mortgages mandatory for five years (previously one year). The mandatory period could be extended under circumstances of loan default or delinquency, and certain creditors operating in “rural or underserved” counties would be exempt from the escrow requirement entirely. The proposal would also require disclosures to consumers regarding the nature and effects of an escrow account at least three business days prior to mortgage consummation and would require an additional disclosure to consumers three days before the closure of an escrow account.

#### *Proposals on Risk-Based Pricing and Adverse Action Notices*

On March 1, the Federal Reserve and the Federal Trade Commission jointly proposed that disclosure of credit scores and related information in risk-based pricing notices would be required when a consumer’s credit score is used in determining the terms of credit ([76, Federal Register, pp. 13902-21](#)). In a similar proposal, the Federal Reserve would require the disclosure of credit scores and related information in adverse action notices when the consumer’s credit score is used in taking adverse action ([76, Federal Register, pp. 13896-902](#)). These proposals reflect the new credit score disclosure requirements of the Dodd-Frank Act.

#### *Proposed Amendments to Availability of Funds and Collection of Checks*

On March 3, the Federal Reserve proposed rules that would amend Regulation CC (Availability of Funds and Collection of Checks) to encourage banks to clear and return checks electronically, shorten certain hold periods on deposited funds, and add provisions for electronic items cleared through the check collection system ([76, Federal Register, pp. 16861-976](#)). The proposal would require the expeditious return of a check if the depository bank agrees to receive it electronically. Banks responsible for paying a check would be able to require same-day check settlement requests to occur electronically. Regulation CC’s collection and return provisions would apply to electronic check images that meet certain requirements. The proposal would shorten the safe-harbor period for an exception hold to four business days due to faster collection and returns on electronic systems. An exception hold is a period of time that allows a bank to exceed the maximum hold periods defined in [Regulation CC](#), for reasons such as nonsufficient funds in an account or doubtful collectability on a check. References in Regulation CC to nonlocal checks would be eliminated to reflect check processing consolidation in the Federal Reserve System.

## *Federal Deposit Insurance Corporation*

### *Rules for Claims Process in Orderly Liquidation*

The FDIC issued an [interim final rule](#) and a [related proposed rule](#) to implement certain orderly liquidation provisions under Title II of the Dodd-Frank Act. The interim final rule is nearly identical to the rule proposed in October 2010, which covered the priority of payment to creditors, the authority to continue operations of the covered financial company, the treatment of creditors, and the application of proceeds from the liquidation of subsidiaries, but includes changes in the valuation of certain collateral and the treatment of contingent claims. The interim final rule would prevent a creditor from meeting the criteria to receive “additional payment” beyond the standard proportional share of the claim, unless approved by the FDIC, and that such payments are subject to recoupment if recovered funds fail to offset government liquidity support during an orderly liquidation. The rule also emphasizes that taxpayer money would never be used to cover the losses associated with the failure of a large financial institution.

The proposed rule further develops the framework that defines the rights of creditors in an orderly liquidation and begins by defining a “financial company” as one whose revenue from financial activities (as defined by the FDIC) constitutes at least 85 percent of total consolidated revenue for either of its two most recent fiscal years.

The FDIC’s proposal clarifies the priority of payments to creditors, as well as the process for filing claims and pursuing claims in court. The rules are based on the FDIC’s goal to treat similarly situated creditors in a comparable manner.

The proposal also establishes criteria for the circumstances under which the FDIC, acting as a receiver, can recoup compensation from executives and directors responsible for the failure of a financial institution. Compensation received two years prior to the date of receivership could be garnered from executives or directors who did not fulfill their responsibilities or who underperformed on the job in a way that directly crippled the financial institution.

In addition, the proposed rules seek to harmonize the orderly liquidation process with the bankruptcy code in its treatment of fraudulent and preferential transfers.

### *Final Rule on Assessments, Dividends, Assessment Base, and Large Bank Pricing*

On February 7, [the FDIC approved a final rule](#) that changes the assessment system for the deposit insurance fund (DIF), originally proposed in the fourth quarter of 2010.<sup>7</sup> The assessment base will shift from adjusted domestic deposits to average consolidated total assets minus average tangible equity to better reflect risks to the DIF. Banks with high-risk asset concentrations, less stable balance-sheet liquidity, or high potential losses in a failure will be charged higher assessment rates. The rule will allow a financial institution to lower its assessment rate when it is more heavily funded by unsecured debt, an incentive for banks to use subordinated debt to fund their activities. The FDIC believes that while the assessment amount charged per bank may change, the aggregate assessment amount collected will be close to unchanged. The final rule also gradually reduces the assessment rate schedule when the DIF reaches various milestones.

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<sup>7</sup> For more information on the FDIC’s proposed rules, see [Banking Legislation and Policy, Volume 29, Number 4, page 14](#).

## ***Securities and Exchange Commission***

### ***Final Rule on Executive Compensation Arrangements***

On January 25, the SEC adopted [a final rule](#) amending regulation on executive compensation and golden parachute arrangements. The rule implements section 951 of the Dodd-Frank Act and requires companies to allow shareholders to vote on executive compensation arrangements at least once every three years and on the frequency of such votes once every six years. Companies involved in a merger are also required to provide enhanced disclosures about compensation agreements with executives. Smaller companies, with a public float of less than \$75 million, are given a two-year deferral to comply with the new rule.

### ***Proposed Elimination of Mandatory Credit Ratings***

The SEC proposed a series of rule amendments and new rules governing the use of credit ratings in its regulations and forms, pursuant to Title IX of the Dodd-Frank Act ([76, Federal Register, pp. 8946-61](#) and [76, Federal Register, pp. 12896-916](#)). The SEC proposed the removal of credit ratings as one of the conditions for companies that use the short-form registration when registering securities for public sale. In place of the ratings, the SEC proposed a standard based on the amount of debt and other nonconvertible securities a firm has sold in the past three years: to qualify for the short-form registration, a firm must have issued over \$1 billion within the time frame. The SEC also proposed the elimination of credit ratings requirements for money market funds. Money market funds would be required to assess the credit quality of each security and rate it in one of two tiers based on risk. In addition, the proposal would eliminate references to credit ratings regarding securities collateralizing repurchase agreements, business and industrial development companies, and shareholder reports. The SEC will consider removing references to credit ratings in more of its rules and forms in the coming months.

## ***Department of the Treasury***

### ***Proposed Regulation of Certain Nonbank Financial Companies***

On January 18, the Financial Stability Oversight Council (FSOC) [proposed criteria](#) for identifying systemically important nonbank financial companies to place under the supervision of the Federal Reserve. The FSOC would use six categories to determine how a firm might pose a risk to the broader economy and how vulnerable a firm is to financial distress: size, lack of substitutes for the firm's services and products, interconnectedness with other financial firms, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. The FSOC would start to screen nonbank financial companies on a regular basis upon approval of a final rule.

Systemically important nonbank financial companies would face more robust supervision by the Federal Reserve and be required to comply with heightened prudential standards, including higher capital requirements. They would also be required to submit a resolution plan that outlines how the company would be efficiently dismantled in the event of its failure.

### ***Proposed Criteria to Determine Systemically Important Financial Market Utilities***

The FSOC [proposed criteria](#) to identify systemically important financial market utilities (FMUs). As defined in the Dodd-Frank Act, FMUs operate or manage multilateral systems to transfer, clear, or settle payments, securities, or other financial transactions among financial institutions or between financial institutions and the

FMU.<sup>8</sup> FMUs have a central and interconnected role in financial markets; FMUs that pose high liquidity and credit risk to the overall market can be designated as “systemically important” by the FSOC, in consultation with the Federal Reserve and the FMU’s supervising agency. As prescribed in the Dodd-Frank Act, systemically important FMUs would be required to adhere to more stringent risk management standards, pursuant to Title VIII of the Dodd-Frank Act.

The FSOC’s proposed assessment includes collecting data on the FMU’s aggregate value of transactions processed, aggregate exposure to its counterparties, and interdependencies with other FMUs, as well as an estimate of the effect of its failure on the broader financial system. The second stage in the process would be a case-by-case review of the potential impact of an FMU’s failure. If the FSOC ultimately determines that an FMU is systemically important, it would notify the FMU of its determination and would give the FMU an opportunity to contest the decision at a hearing. The proposed rule also includes a provision that would allow the FSOC to bypass all of the aforementioned steps to designate an FMU as systemically important during a financial emergency.

### ***Multiple Sponsors***

#### *Proposed Limits on Incentive Compensation*

On March 30, the Federal Reserve, the FDIC, the FHFA, the NCUA, the OCC, the OTS, and the SEC [jointly proposed a rule](#) to force regulated financial institutions with over \$1 billion in assets to consider the consequences of excessive risk when creating incentive compensation contracts. The proposal would prohibit financial institutions from providing incentive-based compensation arrangements that encourage executive officers, employees, or shareholders to take inappropriate risks. The compensation agreements would be required to have three features: adjusted financial rewards that reduce risk-taking, effective internal controls and risk management, and strong corporate governance. Financial institutions with at least \$50 billion in assets and credit unions with at least \$10 billion in assets would face more stringent requirements.

#### *Proposed Rule on Resolution Plans and Risk Exposure for Systemically Significant Firms*

On April 12, the Federal Reserve and the FDIC [jointly proposed a rule](#) that would require nonbank financial companies designated by the FSOC to be supervised by the Federal Reserve and bank holding companies with consolidated assets of \$50 billion or more to regularly submit resolution plans and credit exposure reports. The rule would implement part of section 165 of the Dodd-Frank Act.

An annual resolution plan would be required to show the institution’s strategy for winding down its operations in the event of a bankruptcy. Each institution would have to include an outline of the ways in which interdependent business lines and operations would affect the firm’s viability if disrupted. A quarterly credit exposure report would be required to show the nature and extent of the credit risk exposure an institution has with other large firms and the credit risk exposure that other large firms have to the institution.

#### *Proposed Repeal of Ban on Interest-Bearing Checking Accounts*

The Federal Reserve and the FDIC proposed similar rules to allow state member banks and nonmember banks to pay interest on demand deposits. The Federal Reserve’s [proposal to repeal Regulation Q](#) implements section

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<sup>8</sup> The Dodd-Frank Act exempts certain designated contract markets and national securities exchanges that meet certain criteria.

627 of the Dodd-Frank Act and would effectively repeal the Federal Reserve's authority to set such interest restrictions.

### *Proposed Changes in Thrift Reporting Requirements*

On February 3, the Federal Reserve, the OTS, the OCC, and the FDIC [jointly proposed changes to reporting requirements](#) for savings associations and savings and loan holding companies regulated by the OTS. Savings associations would be required to file quarterly Call Reports rather than the Thrift Financial Report, as well as file through the FDIC's Summary of Deposits. Monthly collection of data on median cost of funds would be terminated. Savings and loan holding companies would be required to file the same reports as the bank holding companies currently regulated by the Federal Reserve.

## **Judicial Decisions**

### *Supreme Court Decisions*

#### *Federal Reserve Ordered to Disclose Emergency Lending Information*

On March 21, the U.S. Supreme Court decided to allow the release of the names, loan amounts, and loan dates of individual borrowers that requested loans from the Federal Reserve's discount window<sup>9</sup> during the financial crisis, and left standing two decisions by the U.S. Court of Appeals that declared that the information was not automatically exempt from requests under the Freedom of Information Act ([Clearing House Association v. Bloomberg, No. 10-543](#) and [Clearing House Association v. Fox News Network, No. 10-660](#)). The court decided not to hear the appeals brought by the Clearing House Association LLC, a trade group backed by major U.S. banks, which claimed that releasing the loan-level data would "cause significant competitive injury" to participating financial institutions and that unveiling the identities of institutions that borrowed from the Federal Reserve could undermine its ability to stabilize a financial crisis in the future. Historically, the Federal Reserve treated data on traditional discount window lending as confidential. The passage of the Dodd-Frank Act included a mandate to release the data after a two-year lag. The Federal Reserve also complied with another Dodd-Frank provision in December 2010, releasing [data on the Federal Reserve's emergency lending facilities](#) during the financial crisis. In compliance with the Supreme Court decision, on March 31 the Federal Reserve released roughly 25,000 documents, covering August 2007 to March 2010.

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<sup>9</sup> The discount window is a permanent lending program through which the 12 regional Federal Reserve Banks, subject to Board regulation and supervision, lend funds on a secured, short-term basis to eligible depository institutions in their Districts. In response to the recent financial crisis, the Board authorized the Reserve Banks to initiate a number of additional, temporary special credit and liquidity facilities to relieve severe liquidity strains on the market and reduce risks to financial stability.

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Prepared by the Research Department. For further information, contact Cara Stepanczuk at 215-574-3816 or [cara.stepanczuk@phil.frb.org](mailto:cara.stepanczuk@phil.frb.org). To subscribe to this publication, go to [http://www.philadelphiafed.org/philscriber/user/dsp\\_content.cfm](http://www.philadelphiafed.org/philscriber/user/dsp_content.cfm).