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DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law by President Barack Obama on July 21, 2010. It is one of the most important pieces of American banking legislation enacted since the Great Depression in the early 1930s.

The Act is more than 800 pages long, with sections scattered throughout the United States Code. It covers many areas of financial regulation. This summary covers the following four "Titles" in the Act:

- Title I -- the Financial Stability Act of 2010
- Title III -- the Enhancing Financial Institution Safety and Soundness Act of 2010
- Title X -- the Consumer Financial Protection Act of 2010
- Title XIV -- the Mortgage Reform and Anti-Predatory Lending Act

In very broad terms, Titles I and III address overarching changes in the American system of financial regulation and its core principles of safety and soundness. Titles X addresses consumer lending, and Title XIV addresses residential mortgage lending more specifically.

Other provisions of the Act, not covered here, create new kinds of securities and derivatives regulation; amend capital requirements; permanently increase the level of deposit insurance to $250,000 per institution; and create a Federal Insurance Office within the Treasury Department, whose powers will essentially be limited to monitoring all aspects of the insurance industry, but without any substantive regulatory role.

TITLE I - FINANCIAL STABILITY ACT OF 2010

Title I highlights:

- Establishes a Financial Stability Oversight Council made up of current bank and securities regulators.

- The Council's purpose is to identify risks to the overall financial stability of the United States arising from any material financial distress of large interconnected "**non-bank** financial companies" as well as from "**bank** holding companies." This represents a significant expansion of the Federal government's authority to regulate the safety and soundness of the financial system.

- For decades banks have been regulated and examined by the Federal government: national banks by the Office of the Comptroller of the Currency (OCC); state banks that are members of the Federal Reserve System by the Federal Reserve Board; state banks that are not members of the Federal Reserve System by the Federal Deposit Insurance Corporation (FDIC); federal savings and loan associations by the Office of Thrift Supervision (OTS); and credit unions by the National Credit Union Administration (NCUA).

- Similarly, for decades, "bank holding companies" -- entities that own banks -- have been regulated by the Federal Reserve Board, and "savings and loan holding companies" that own savings associations have been regulated and examined by the OTS.

- The Act permits the extension of such regulation to certain large "**nonbank** financial companies" - meaning companies that do not take deposits, but that are engaged in financial activities - whether or not they are affiliated with actual banks.

- This is a major extension of federal regulation over the financial markets.

- Before the Act, the key regulatory goal was to protect the bank deposit insurance fund by preventing bank failures, so that the government (FDIC) would not have to pay off depositors of failed banks, and to protect bank (and savings association) holding companies, so that their affiliated depository institutions would not fail.

- With the Act, federal regulation is extended to **nonbank** financial companies that do not accept deposits, and are not affiliated with depository institutions, if they are sufficiently large and "interconnected" with other financial companies. Again, this is a major extension of federal regulation.

- The Financial Stability Oversight Council will decide which nonbank financial companies will be subject to federal regulation. Specifically, the Council by a two-thirds vote may require that any nonbank financial company shall be supervised by the Federal Reserve Board if the Council determines that the nature, scope or size of such company could pose a threat to the financial stability of the United States. The criteria will include the extent of a company's leverage; the amount and nature of its assets and its liabilities; and the extent of off-balance sheet exposure.

- Nonbank financial companies that receive this designation are subject to Federal Reserve Board supervision as to all "activities financial in nature" conducted by such entities. Purely "commercial" activities, however, of such entities are not subject to supervision.

- Significantly, each such nonbank financial company so designated, as well as each bank holding company having $50 billion or more in assets, must periodically furnish to the regulators a plan for the company's orderly winding down in the event of a financial collapse - a so-called "living will." The reason for this is that in the 2008 financial meltdown, government regulators were frustrated with their limited ability to conduct quick and orderly dissolutions of large bank holding companies - and even more frustrated with their complete lack of authority over nonbank financial companies unaffiliated with depository institutions.

TITLE III - ENHANCING FINANCIAL INSTITUTION SAFETY AND SOUNDNESS ACT OF 2010

Title III highlights:

- Since 1989, all savings and loan associations - state chartered and federal chartered - have been regulated by the Office of Thrift Supervision (OTS), an agency within the Treasury Department.

- On July 22, 2011, one year after the Act's enactment, the OTS's functions relating to federal savings and loan associations will be transferred to the Office of the Comptroller of the Currency (OCC), the agency within the Treasury Department that is the chief regulator of national banks. The OTS's current authority over companies that own savings and loans associations - savings and loan holding companies - will be transferred on that date to the Federal Reserve Board, the regulator of bank holding companies.

- The OTS's limited functions as to state savings and loan associations will transfer to the FDIC on the same date.

- State chartered savings and loan associations will continue to be regulated at the state level by their state regulators.

- The savings and loan charter will be preserved. These entities will continue to operate, and will remain subject to the statutes under which they are chartered, but the federally chartered entities will be regulated by the OCC and the state-chartered entities will be regulated by the FDIC and state authorities.

- The OTS will cease to exist 90 days after the transfer of its functions just described - on October 19, 2011. All currently outstanding OTS orders and interpretations will remain in effect and will become enforceable by the OCC or Federal Reserve Board as applicable.

- The Act's abolition of the OTS was motivated by a belief that the OTS had become an ineffective regulator.

TITLE X - BUREAU OF CONSUMER FINANCIAL PROTECTION

Title X highlights:

- Establishes a new federal agency called the Bureau of Consumer Financial Protection, to be housed within the Federal Reserve Board, to regulate the provision of consumer financial products under federal consumer law.

- This is a controversial provision. Many in the financial services industry oppose it as making an already complicated system of federal agencies and regulations even more complicated.

- Currently, four other federal regulatory agencies - the Federal Reserve Board, the OCC, the OTS and the FDIC - issue consumer regulations covering deposit-taking entities within their respective jurisdictions (Federal Reserve Board - state chartered banks that are members of the Federal Reserve System; OCC - national banks; OTS - federally chartered savings associations; FDIC - state chartered banks that are not members of the Federal Reserve System; National Credit Union Administration - federally chartered credit unions.)

- Non-depository institutions, depending upon their activities, are subject to the Department of Housing and Urban Development and the Federal Trade Commission.

- <u>Rule-making</u>. Beginning July 22, 2011, the Bureau will be the federal agency with primary rule-making authority with respect to consumer financial protection.

- <u>Supervision and enforcement</u>. The Bureau will also have supervisory and enforcement authority, in addition to rule-making authority, for financial institutions with more than $10 billion in assets. Financial institutions with less than $10 billion in assets will be subject to the Bureau's regulations, but their primary federal regulator (i.e., the OCC for national banks) will supervise and enforce their compliance with the Bureau's rules.

- There is a potential that "turf wars" will develop between the Bureau and the various preexisting regulators; this may lead to duplicative and inconsistent regulation.

- The Bureau will also have authority to implement rules governing nonbank entities such as payday lenders, student lenders, debt collectors, consumer reporting agencies, and all mortgage related businesses, including mortgage brokers. All of these non-depository institution entities will be subject to the exclusive enforcement authority of the new Bureau.

- To clarify: the Bureau is already in existence, but the transfer of regulatory responsibility to it as described above shall not take place until July 22, 2011.

- The Act exempts motor vehicle dealers, licensed real estate brokers and agents, manufactured home retailers, accountants, tax preparers and attorneys from regulation by the Bureau. Real estate brokers and agents, as well as motor vehicle dealers, are subject to the Bureau to the extent that they are furnishing credit to their customers.

- Federal Preemption. The scope of federal preemption - the extent to which federal laws and regulations override state laws and regulations - has been reduced, although not eliminated, in the consumer financial protection arena.

  – For those of you who are federally chartered banks, savings associations, or credit unions, it will be more difficult than before to argue that you are exempt from various state consumer protection laws.

  – In essence, federal consumer protection provisions will not override state provisions unless the federal provision expressly provides that state provisions are overridden, or unless the state laws in question "significantly interfere" with the business of banking. Prior to the Act, federally chartered institutions had an easier time arguing that state laws were preempted due to the mere existence of a pervasive federal regulatory scheme.

  – The bottom line is that more federally chartered financial institutions will be subject to state consumer protection laws.

- The Fed will now have the authority to issue rules regulating interchange fees charged by large banks (with over $6 billion in assets) for debit card transactions. The Act requires that the bank's fee must be reasonably proportional to the actual cost of the transaction. This change seeks to reduce debit card fees charged to merchants.

TITLE XIV - MORTGAGE REFORM AND ANTI-PREDATORY LENDING ACT

Title XIV highlights:

- This Title was motivated by a concern that the residential mortgage market had broken down because loans were being issued to borrowers who had little or no chance of repaying, which harmed the companies that took assignment of the loans from the original lenders. Accordingly, a major component of Title XIV is the imposition of new duties on lenders to try to insure that borrowers will have the ability to repay their loans.

- The new Bureau of Consumer Financial Protection is required to issue final implementing regulations by January 22, 2013, (i.e., by 18 months after July 22, 2011), the date on which the Act transfers the primary responsibility for the federal regulation of consumer lending to the Bureau.

- The final implementing regulations must take effect no later than one year after their promulgation.

- On April 19, 2011, the Federal Reserve Board issued a proposed regulation under Board Regulation Z, implementing the federal Truth in Lending Act, which would require lenders to determine a borrower's ability to repay before extending a residential mortgage loan.

- Because primary rule making responsibility will transfer to the Bureau of Consumer Financial Protection on July 22, 2011, the responsibility for this proposed regulation regarding "ability-to-repay" will shift from the Federal Reserve Board to the Bureau, and will be finalized and possibly rewritten by the Bureau.

- Under the Federal Reserve Board's current proposal, a lender can meet the "ability-to-repay" standard by considering and verifying the following eight factors:

  – Income or assets relied upon in making the ability-to-repay determination
  – Current employment status
  – Monthly payment on the mortgage
  – Monthly payment on any other simultaneous mortgage
  – Monthly payment for mortgage-related obligations (taxes, insurance)
  – Other current debt obligations
  – Monthly debt-to-income ratio
  – Credit history

- The other main way of complying with the ability-to-repay requirement is for the lender to originate a “qualified mortgage.” The Board has requested comment from interested parties on two proposed alternative definitions of “qualified mortgage.”

  – Alternative one would define “qualified mortgage” as a loan which does not involve negative amortization, interest-only payments, a balloon payment, or a term exceeding 30 years; total points and fees do not exceed three percent of the total loan amount; and income or assets relied upon in the ability-to-repay determination are verified. Furthermore, the underwriting of the mortgage is based on the maximum interest rate that may apply in the first five years, uses a fully amortizing payment schedule over the loan term, and takes into account any mortgage-related obligations.

  – Note that Alternative one is a “safe harbor,” meaning that compliance with its terms would require a finding that the mortgage is a “qualified mortgage,” and that the ability-to-pay requirement has been met.

  – Alternative two would provide a rebuttable presumption of compliance rather than a safe harbor and would include all the Alternative one requirements, plus the requirement that the lender would have to verify the consumer’s employment status, current debt obligations, monthly debt-to-income ratio, and credit history as well as the consumer’s liability for a monthly payment under any simultaneous mortgage.

- Loans that do not meet the requirements of a “qualified mortgage” may not have prepayment penalties; for purposes of this requirement, however, a “qualified mortgage” does not include an adjustable rate residential mortgage.

- By way of amendment to the Truth in Lending Act (TILA), a consumer may assert violations of the ability-to-repay standards as a set-off or recoupment defense to a foreclosure action.

- No residential mortgage originator may receive from any person, directly or indirectly, any compensation that varies based on the terms of the loan other than the amount of the principal. (Prohibition on steering incentives).

- TILA civil penalties for certain violations have been doubled, and the statute of limitations for suing for violations has been extended from one year to three years.