

Washington Research: Financial Regulatory Reform VI - The End Game

Highlights

- The Senate yesterday passed Financial Regulatory Reform (FRR) by a vote of 60-39. The measure passed the House late last month. And now, a year after the Obama Administration unveiled its sweeping plans to reform the financial services sector, Congress is ready to send comprehensive financial regulatory reform legislation to the President for his signature within the week.
- Bill negotiators were sent back to the negotiating table at the eleventh hour to re-open the conference agreement. In the end, conferees agreed to delete the \$19 billion bank tax which would have assessed large banks with over \$50 billion in assets and financial firms that manage hedge funds with over \$10 billion in assets. To cover the cost of the bill, negotiators agreed instead to increase deposit insurance assessments on banks with over \$10 billion in assets and to end the Troubled Assets Relief Program (TARP) three months early. This change was enough to attract the 60 votes needed for Senate passage of the legislation.
- In our analysis, we highlight outcomes of the issues we focused on throughout our FRR coverage, and we discuss the importance of the next stage of the process – the interpretation and implementation of various provisions of the bill by Federal agencies. Furthermore, we will identify a few areas we will be watching where agency discretion could be particularly important:
 - **Derivatives.** As we projected in our June 16, 2010 research call, *Washington Research: Financial Regulatory Reform V – House-Senate Conference Works to Reconcile Competing Versions of the Legislation*, Senate Agriculture Chair Blanche Lincoln's 716 provision, which required banks to spin off their derivatives trading activities, was modified but remained in the final legislation.
What to Watch – How will the SEC and CFTC determine the criteria for a swap dealer and major swap participant? How will regulators determine the standardization of contracts as well as collateral and margin requirements for derivatives contracts?
 - **Volcker Rule.** The outcome on the Volcker Rule, under which banks would be banned from proprietary trading and firms would be restricted from investing in or sponsoring hedge funds and private equity funds, is also similar to our projections in our June 16, 2010 analysis.
What to Watch – What will be the results of the Council's study and recommendations? Will the regulators feel pressure to implement the Council's recommendations or will they be willing to make changes? How will agencies interpret and apply their authority to permit activities that promote the stability and the safety and soundness of the financial system?
 - **Consumer Protection.** As we expected, the Consumer Financial Protection Bureau (CFPB) was established in the Federal Reserve, but remains largely independent.

What to Watch – Who will be named the Director and who will be placed in key staff positions? How active will the CFPB be in first couple of years (we expect they will be very active)? Which areas will the CFPB initially focus on, and how aggressive will CFPB be in establishing and enforcing new rules?

- **The Financial Stability Oversight Council.** This council of regulators was established to monitor, identify, and make recommendations for mitigating any threats to U.S. financial stability.

What to Watch – How aggressive will the Council be in making systemic risk determinations? How will “heightened” standards be defined?

- **Broker-Dealer Standards of Care.** The SEC will promulgate rules to set out the standards of care for broker-dealers and investment advisers that provide personalized advice to retail customers.

What to Watch – Will the SEC implement a blanket fiduciary standard?

- **Other provisions included in the final legislation—**

-- **Interchange Regulations.** While there was widespread opposition to Senator Durbin's (D-IL) interchange amendment, which allowed the Federal Reserve to oversee interchange fees on debit transactions for large issues (over \$10 billion in assets) in order to ensure they are "reasonable and proportional" to the costs of the transaction, as we predicted, it couldn't overcome the provision's bipartisan support in the Senate.

-- **Capital Standards.** The final bill also contained an agreement on capital standards proposed by Senator Collins (R-ME), which will impose heightened standards on banks and Bank Holding Companies.

Details

Outline

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Section 1: Overview

A year after the Obama Administration unveiled its sweeping plans to reform the financial services sector, Congress will send comprehensive financial regulatory reform legislation to the President for his signature within the week.

Two events prevented the bill from being enacted before Independence Day. First was the passing of Senator Robert C. Byrd (D-WV), which meant one less critical "yes" vote for Senate passage. Second was

that other Members counted on for "yes" votes walked away due to a bank tax added to the bill during the final hours of conference negotiations. These issues combined required conferees to go back to the negotiating table, which was highly unusual, and re-open the conference agreement. In the end, conferees agreed to delete the \$19 billion bank tax which would have assessed large banks with over \$50 billion in assets and financial firms that manage hedge funds with over \$10 billion in assets. To cover the cost of the bill, negotiators agreed instead to increase deposit insurance assessments on banks with over \$10 billion in assets and to end the Troubled Assets Relief Program (TARP) three months early. This change was enough to attract the 60 votes needed for Senate passage of the legislation.

The Dodd-Frank bill is 2,300 pages long and contains changes to every aspect of financial sector oversight by the Federal government.

In this research, we will highlight outcomes of the issues we focused on throughout our FRR coverage and discuss the importance of the next stage of the process – the interpretation and implementation of various provisions of the bill by Federal agencies. Furthermore, we will identify a few areas we will be watching where agency discretion could be particularly important.

Section 2: Outcomes of Highlighted Issues

Derivatives: As we projected in our June 16, 2010 research call, *Washington Research: Financial Regulatory Reform V – House-Senate Conference Works to Reconcile Competing Versions of the Legislation*, Senate Agriculture Chair Blanche Lincoln's 716 provision, which required banks to spin off their derivatives trading activities, was modified but remained in the final legislation. The outcome represents a compromise between the politically vulnerable Senator Lincoln, who insisted her language remain in the bill, and moderate Democrats and the New York delegation, who insisted the provision be watered down and clarified.

The final language allows financial firms to trade in interest rate swaps, foreign-exchange swaps, gold, silver, credit and other derivatives used to hedge risk. However, certain derivatives activities will need to be done through a separately capitalized affiliate. This includes what Congress considers riskier investments, such as commodities, equities, certain credit default swaps, metals, energy, and agriculture. Swaps that remain on a bank's balance sheet will have to be cleared through a central clearinghouse.

Volcker Rule: The outcome on the Volcker Rule, under which banks would be banned from proprietary trading and firms would be restricted from investing in or sponsoring hedge funds and private equity funds, is also similar to our projections in our June 16, 2010 analysis.

As we expected, proprietary trading restrictions moved in the direction pushed by Senators Levin (D-MI) and Merkley (D-OR): limits on proprietary trading are better defined, and banks are permitted to engage in customer-related activities, underwriting and market-making activities, small business related investments, and activities to hedge risk. The final language permits banks to make a *de minimus* investment in hedge and private equity funds. They cannot, however, invest more than 3 percent of tier one capital in these funds, and bank investment is limited to 3 percent of the fund's total ownership interest. To help ensure that Senator Scott Brown (D-MA) would continue to support the bill, the Volcker rule allows insurance companies to continue trading activities conducted in the normal course of business.

Volcker restrictions will not be implemented immediately. First, the newly created Financial Stability Oversight Council will study and make recommendations on the Volcker restrictions within 6 months of the bill's enactment. After the study is complete, Banking regulators have 9 months to promulgate rules implementing the restrictions. Then, banks will have 2 years from the bill's enactment or one year from when the agencies issue their rules, whichever is earlier, to bring their activities and investments into line with the new restrictions, and this 2 year deadline may be extended for an additional 3 years under certain circumstances determined by the Fed.

Consumer Protection: As we expected, the Consumer Financial Protection Bureau (CFPB) was established in the Federal Reserve, but remains largely independent. The CFPB will have broad authority to promulgate and enforce rules on all consumer protection statutes for financial companies (auto dealers excluded, payday lenders covered). The only check on the Bureau is through the Financial Stability Oversight Council, which can veto a Bureau rulemaking by a 2/3 majority vote based on safety and soundness concerns – a high bar. The CFPB will likely be active, and this will be an area we will track going forward.

Interchange Regulations: While there was widespread opposition to Senator Durbin's (D-IL) interchange amendment, which allowed the Federal Reserve to oversee interchange fees on debit transactions for large issues (over \$10 billion in assets) in order to ensure they are "reasonable and proportional" to the costs of the transaction, as we predicted, it couldn't overcome the provision's bipartisan support in the Senate. The Durbin language was kept mostly intact in the final legislation; the most significant change expands the definition of "reasonable and proportional" to include incremental costs to process the transaction as well as fraud prevention costs.

Capital Standards: The final bill also contained an agreement on capital standards proposed by Senator Collins (R-ME), which will impose heightened standards on banks and Bank Holding Companies. The final bill will allow banks with less than \$15 billion in assets (up from \$10 billion in another concession to Senator Lincoln) to retain trust-preferred securities as tier 1 capital. However, larger banks will have five years to phase out the securities.

Section 3: Next Steps

Enactment of FRR is only the beginning of the re-regulation of the financial services sector. Though the legislation contains many specific mandates and requirements, the next stage – the regulatory process – will be key to determining how the bill will be implemented. The regulatory, or rulemaking, process is where federal agencies and regulatory agencies interpret the statute and provide specific guidance as to how the statute should be implemented. How the agencies interpret and implement the various provisions of the Dodd-Frank bill matters—they have discretion in almost all areas of the bill.

As Washington moves from the legislative to the regulatory phase of the process, below are some of the areas we believe agency discretion could be particularly important.

Derivatives: The bill seeks to increase transparency in the over-the-counter derivatives market by requiring exchange trading and central clearing for standardized derivatives contracts that are accepted for clearing. Commercial end users who use derivatives to hedge commercial risk are exempt from the clearing requirements. Much of the particulars are left up to the regulators to decide. For instance, the SEC and CFTC will determine the criteria for a swap dealer and a major swap participant, meaning these definitions will determine the extent of end user exemptions from clearing requirements. Regulators will determine the standardization of contracts as well as collateral and margin requirements for derivatives contracts.

- *What to Watch – How will the SEC and CFTC determine the criteria for a swap dealer and major swap participant? How will regulators determine the standardization of contracts as well as collateral and margin requirements for derivatives contracts?*

Volcker Rule: While the Volcker rule limits banks' proprietary trading activities and investment and sponsorship in hedge funds and private equity funds, many of the definitions and exact restrictions depend on regulatory action.

As discussed above, the Council has the responsibility of conducting a study and making recommendations for implementation of the Volcker Rule within 6 months of the bill's enactment. Within 9 months of the council's study submission, prudential regulators, the SEC, and CFTC must issue rules to implement the Volcker rule with consideration to the council's findings. The Council's recommendations will therefore serve as the foundation for all regulatory action thereafter, shaping the implementation of the Volcker rule. In addition, regulatory agencies may permit any activities they believe will promote the stability and safety and soundness of the U.S. financial system.

- *What to Watch – What will be the results of the Council's study and recommendations? Will the regulators feel pressure to implement the Council's recommendations or will they be willing to make changes? How will agencies interpret and apply their authority to permit activities that promote the stability and the safety and soundness of the financial system?*

Consumer Financial Protection Bureau: The bill establishes a Bureau of Consumer Financial Protection (CFPB) housed within the Federal Reserve, but essentially independent, which is responsible for oversight and enforcement of federal consumer protection laws.

The CFPB will be responsible for defining "unfair, deceptive or abusive acts and practices" for designated entities and will have broad enforcement power to prohibit such activities. The bureau will also have broad rulemaking power to better ensure compliance with federal law, including increased disclosure requirement. The only check on the bureau is through the systemic risk oversight council which can stay a bureau rulemaking by a 2/3 majority vote based on safety and soundness concerns.

- *What to Watch – Who will be named the Director and who will be placed in key staff positions? How active will the CFPB be in first couple of years (we expect they will be very active)? Which areas will the CFPB initially focus on, and how aggressive will CFPB be in establishing and enforcing new rules?*

The Financial Stability Oversight Council: This council of regulators was established to monitor, identify, and make recommendations for mitigating any threats to U.S. financial stability. The council make up is as follows:

- Treasury Secretary (chair)
- Federal Reserve Chair
- The Comptroller of the Currency
- Consumer Financial Protection Bureau Director
- Securities and Exchange Commission Chair
- Federal Deposit Insurance Corporation Chair
- Commodities and Futures Trading Commission Chair
- Federal Housing Finance Agency Director
- National Credit Union Administration Chair
- Independent member having insurance expertise appointed by the President and confirmed by Senate will serve 6 year term
- Non-voting advisory members: Office of Financial Research Director, Federal Insurance Office Director, State Insurance Commissioner, State Banking Supervisor, State Securities Commissioner

The council may designate nonbank financial companies, bank holding companies, and foreign banking companies treated as bank holding companies with at least \$50 billion in assets as a systemic risk through a 2/3 majority vote. If this were to occur, the designated company must register with the Fed within 180 days after the council determination. Any company or financial activity identified by the council as a risk will be subject to “heightened” prudential standards and supervision by the Federal Reserve, including increased risk-based capital, liquidity, and leverage requirements as well as requirements to submit living wills and undergo stress tests.

- *What to Watch – How aggressive will the Council be in making systemic risk determinations? How will “heightened” standards be defined?*

Broker-Dealer Standards of Care: The SEC will promulgate rules to set out the standards of care for broker-dealers and investment advisers that provide personalized advice to retail customers. Though there was a push to establish a fiduciary duty instead of the current suitability standard, in the end, Congress left the hard decisions to the SEC. The SEC has 6 months to study the issue—to look at the difference between the suitability standard and fiduciary responsibility. SEC Chair Shapiro has indicated support for a blanket fiduciary standard.

- *What to Watch – Will the SEC implement a blanket fiduciary standard?*

Conclusion

A year after the Obama Administration unveiled its sweeping plans to reform the financial services sector, Congress will send comprehensive Financial Regulatory Reform legislation to the President for his signature within the week. The Dodd-Frank bill is 2,300 pages long and contains changes to every aspect of financial sector oversight by the Federal government.

Enactment of FRR, however, is only the beginning of the re-regulation of the financial services sector. Though the legislation contains many specific mandates and requirements, the next stage – the regulatory process – will be key to determining how the bill will be implemented. The regulatory process, or rulemaking process, is where federal agencies and regulatory agencies interpret the statute and provide specific guidance as to how the statute should be implemented. How the agencies interpret and implement the various provisions of the Dodd-Frank bill matters—they have discretion in almost all areas of the bill.

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