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FINANCIAL SERVICES REGULATORY REFORM UPDATE

April 4th, 2011

With the looming deadline of Friday April 8th quickly approaching, Congress needs to pass a federal budget this week or else the government will have to shut down because of a lack of funding. Negotiations are ongoing between the White House, Senate Democrats and House Republicans and a senior member on the House Budget Committee commented to us late last week that his best guess is that there is a 50-50 chance that no agreement will be made and that the government will have to shut down. Additionally, senior congressional aides on the Senate side have also shared with us that they think the government might have to shut down for at least a few days, to give Speaker John Boehner (R-OH) a "victory" for the Tea Party elements in his conference.

However, assuming that the Congress is able to come to an agreement on a budget for 2011, it will then immediately have to begin dealing with two, even potentially more complicated issues; the FY2012 budget, and raising the debt ceiling. House Budget Committee Chairman Paul Ryan is expected to release his budget for 2012 this week, which will include substantial reforms to some, but not all of the entitlement programs. The debt ceiling is expected to be reached in late April or mid-May, and there are concerns that Congress' potential failure to increase the limit, driven in large part by the unified position of Senate Republicans on this issue (see more below) could negatively impact the positive economic growth that has been occurring in the United States. As was widely reported, this past week the U.S. managed to add 216,000 new jobs in the month of March, with unemployment now down to 8.8%, and over the past three months the economy added an average of 188,000 jobs per month, with this growth coming mainly in the professional/business services (78,000), health care (37,000) and manufacturing (17,000) sectors. Although this is a positive development, some economists caution that the economy has not fully recovered, especially with the lowest labor participation rate (64.2% of adults) in 25 years. Economists are also apprehensive about international turmoil in the Middle East, debt problems in Europe, the massive recovery needed in Japan, the potential government shutdown in the U.S, and the impact of a failure to raise the debt ceiling, all of which are externalities that could impact the U.S. recovery.

This past week also saw a lot of action in the implementation of the Dodd-Frank, with the release of multiple rulemakings, including much anticipated rules related to risk retention, living wills and executive compensation being formally proposed. Additionally, we saw the introduction of another bill (S. 712) to repeal the Dodd-Frank Act, this one introduced by Sen. Jim DeMint (R-SC), and 18 of his colleagues on Friday. DeMint, has already introduced legislation to overturn the health care law, so it is little surprise that he is also leading this similar effort in the Senate. Like the companion measure introduced in the House by Rep. Michele Bachmann's (R-MN), another Tea Party favorite, neither of these bills is likely to move forward because of strong opposition by Democrats, a sure veto by President Obama and the fact that there is less political support for helping the banks. As Rep. Shelley Moore Capito (R-WV), a senior member of the House Financial Services Committee conceded earlier in March, it is more realistic to chip away at pieces of Dodd-Frank, rather than to go after the entire bill. It is not surprising then that her efforts are more targeted, with legislation to replace the director of the Consumer Financial Protection Bureau with a five-person commission or a bill to delay the interchange rules put in place by the Durbin amendment.

SENATE GOP PROPOSES CONSTITUTIONAL AMENDMENT TO BALANCE BUDGET – LIKELY TO BE TIED TO ANY VOTE ON RAISING THE DEBT CEILING

On Thursday, all 47 Senate Republicans, led by Sen. Orrin Hatch (R-UT), introduced S.J. Res. 10 – a proposed constitutional amendment that would require a balanced budget within five years after its adoption, and would restrict Congress's ability to increase revenues. Specifically, the resolution would require the President to submit to Congress, and for Congress to adopt, a balanced budget in which spending does not go over 18% of GDP of the year prior to the budget's fiscal year. A supermajority would be required to bypass the deficit requirement for any given fiscal year or during certain military conflicts, and a simple majority would be needed to waive the requirement during a declared war. A two-thirds vote is needed in order to amend the Constitution, and it is unclear whether the Senate GOP has 20 Democrats willing to sign on to meet this constraint. A similar proposal was made in the mid-1990's, and failed by a single vote.

Some Senate Republicans have asked for a vote on the proposed amendment as a condition for raising the federal debt ceiling. This ceiling is expected to be reached sometime between April and June, and so we anticipate S.J. Res. 10, in some form or another, to be an important component of the negotiations on the debt ceiling vote. Complicating those negotiations is the fact that members of the GOP have also promised to filibuster any legislation to increase the federal debt ceiling over $14.3 trillion. For example, Sen. Mike Lee (R-UT), a member of the Senate Tea Party Caucus, has promised his constituents that he would fight any efforts to add to the nation's debt, though he left himself some wiggle room by indicating he would consider backing down if the White House and Democrats agree to a "very significant, very permanent and very binding" concession. The threat of the filibuster, means that Senate Majority Leader Harry Reid (D-NV) will need to find 60 votes for approval, and it appears that he will not have a unified caucus, as Senator Joe Manchin (W.Va) has already announced he will vote against the measure. A failure to do so could force the U.S. Treasury to default on its bonds for the first time ever, and "the impact on the economy would be catastrophic," according to Austan Goolsbee one of Obama's senior economic advisors. Many Senate Republicans, on the other hand, argue that a default would not necessarily ensue from failing to raise the debt limit, though we understand that banks and other financial institutions are preparing contingency plans in the event that U.S. Treasuries go into default.

HOUSE GOP UNVEILS HOUSING FINANCE REFORM PROPOSALS

As a first step in a massive revamping of government housing policy, House Republicans (led by House Financial Services Chair Spencer Bachus (R-AL)) released eight legislative proposals this week, on top of the broader GSE overhaul bill introduced by Rep. Jeb Hensarling (R-TX) earlier in March. Bachus called the package integral to "our promise to the American people" to unwind Freddie Mac and Fannie Mae, and to reduce the federal government's role in the housing sector. The proposals are as follows:

1. *The Equity in Government Compensation Act*, which would establish a compensation program at Fannie and Freddie that is consistent with senior executives in the federal government.
2. *The Fannie Mae and Freddie Mac Accountability and Transparency for Taxpayers Act*, which would require the GSE Inspector General to regularly report to Congress on a range of Fannie and Freddie issues.
3. *The GSE Mission Improvement Act*, which would end all affordable housing goals set by Fannie and Freddie.
4. *The GSE Subsidy Elimination Act*, which would increase the guarantee fee over the course of two years to "eliminate embedded subsidies" at Fannie and Freddie, and "bring pricing parity between the private market and GSEs."
5. *The GSE Portfolio Risk Reduction Act*, which would cap the current portfolios of Fannie and Freddie and increase their annual attrition rate.
6. *The GSE Risk and Activities Limitation Act*, which would prohibit Fannie and Freddie from engaging in any new activities or businesses.
7. *The GSE Debt Issuance Approval Act*, which would require formal approval by the Treasury for any new debt issuances by the GSEs.
8. *The GSE Credit Risk Equitable Treatment Act of 2011*, which would prohibit the exemption of GSE securities from the risk-retention requirements of Dodd-Frank.

Rep. Scott Garrett (R-NJ), Chair of the House Capital Markets Subcommittee, will begin marking up these bills this week, and stated his optimism that a similar effort will move forward in the Senate (albeit more slowly). However, there appears to be a disagreement amongst principles, as Sen. Richard Shelby (R-AL), ranking member of the Senate Banking Committee, was much more skeptical of the effort than his House counterparts. At a hearing devoted to the issue, Shelby stated that his committee should hold a series of hearings on housing financial reform and conduct extensive research before making any legislative proposals. Without this, any reform packages are "premature" and will be partisan and full of technical glitches that will have adverse effects on the housing market.

Meanwhile, across the pond the European Commission introduced its first pan-European rules to regulate the mortgage-lending industry. Foreclosure rates are not nearly as high in the EU as they are in the U.S., but the Commission still felt compelled to ensure proper credit checks and full loan rule transparency. Their proposal is aligned with Group of 20 recommendations for adequate supervision of housing markets, products and participants. The European Mortgage Federation, however, is adamant that the proposed rules would make it significantly more difficult for first-time homebuyers to get a mortgage because of an increased liability for lenders.

FED TO MISS INTERCHANGE FEE RULEMAKING DEADLINE –TESTER FILES AMENDMENT TO SMALL BUSINESS BILL

In a letter addressed to Senate Banking Committee Chair Tim Johnson (D-SD) and Ranking Member Richard Shelby (R-AL), as well as House Financial Services Chair Spencer Bachus (R-AL) and Ranking Member Barney Frank (D-MA), Federal Reserve Chair Ben Bernanke stated that his agency would not be meeting its April 21st deadline for an interchange fee cap proposal. The final rule, however, is still expected to go into effect on July 21st, 2011, as mandated by Dodd-Frank. Bernanke stated that the delay is partly because of the 11,000 comments received on the controversial proposal, and largely because of the complexity of the issues raised. Sen. Dick Durbin (D-IL), author of the provision in question, and merchants supporting the Fed proposal still claimed this as a victory because of the promise of July 21st as an effective date for the new regulation. Additionally, this week saw Senator Tester attempt to maneuver his legislation as an amendment to a small business measure that the Senate is considering. However, it is unclear whether his amendment will be taken up as there are numerous, and even more controversial amendments in front of Testers, and furthermore, it is unclear whether the Senator has the 60 votes needs for the measure, and we do not believe he will push for a vote that will not pass.

FDIC PROPOSES RISK RETENTION RULES FOR MORTGAGE LENDERS

On March 29, the FDIC proposed regulations that could make it more expensive for homebuyers to receive mortgages without a 20 percent down payment. The rules are designed to increase the stake that borrowers and lenders have in a loan. The regulations would require lenders to retain 5% of the credit risk when packaging asset-back securities for resale. The proposal exempts "qualified residential mortgages" from the risk-retention requirements. Consumer groups, advocacy organizations and some financial institutions opposed to the rules argue that the proposal would block credit to potential low- and moderate-income homebuyers.

Chairman Sheila Bair stressed that the goal of the rulemaking is to revitalize private securitization. Bair said the FDIC "hope[s] to bring the securitization market back with risk retention, and that that will be the bulk of the securitization market ... It does not mean that everyone is going to have to comply with these standards to get a mortgage going forward." However, the proposed regulations will have little impact without reform in the housing market as the rules only apply to private loans and currently 90 percent of new mortgages are backed by the government.

At the same session, the FDIC proposed a joint rule with the Fed which would provide guidance on "living wills" for the orderly liquidation of insolvent financial institutions. The goal of the rules is to unwind large financial firms in lieu of bailouts or bankruptcy and was met with concern by some financial institutions.

FEDERAL REGULATORS PROPOSE RULE TO REGULATE BANKS' INCENTIVE PAY

On March 30, federal banking regulators, including the Fed, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, National Credit Union Administration, Office of the Comptroller of the Currency, Office of Thrift Supervision and SEC, requested public comment on a joint proposed rule that would compel financial institutions to factor risk into incentive compensation. The SEC previously approved this rule on March 2. The proposed rule would apply to financial institutions with more than $1 billion in assets and would prohibit incentive compensation packages which encourage excessive risk taking. If enacted, this rule would have a significant impact on the pay structures at hedge funds, private equity firms, asset management companies and other, previously unregulated financial institutions.

SEC PROPOSES EXECUTIVE COMP RULE FOR U.S. SECURITIES EXCHANGES

On March 30, the five members of the SEC endorsed a preliminary proposal that would require executive pay at national securities exchanges to be determined by independent members of corporate boards. The proposal also requires new disclosure requirements on the use of compensation consultants and conflicts of interest. The proposed rules would "authorize the exchanges to exempt any category of company from all of the requirements of the new compensation committee listing standards."

Critics are already voicing concern over the proposed rules. J. Robert Brown, a specialist in corporate governance law at the University of Denver said the SEC punted on an opportunity to draft rules to protect investors as "the stock exchanges are unlikely to write as powerful a set of rules." Charles Elson of the University of Delaware said these rules will "have little impact because the committees are already independent and the consultants are already independent."

Interestingly, this rule came out as two major developments occurred in the US market for exchanges. First, BATS Global Markets, operator of the third largest stock exchange in the U.S., submitted draft rules to the SEC and confirmed that it will launch a market for primary listings in the fourth quarter of this year. A formal filing and public comment are expected shortly. Joe Ratterman, the president and CEO of BATS, stated the need for "an alternative listing venue in today's market, which has only been heightened in recent weeks as legacy exchanges weight different merger and acquisition strategies," in reference to the potential NYSE Euronext merger with either Deutsche Borse or Nasdaq OMX/IntercontinentalExchange (ICE) (who made a combined bid for NYSE Euronext). Last month, BATS agreed to purchase Chi-X Europe, and once this absorption is complete the company may launch a primary listings venue in London as well. BATS is based in Kansas and was only created 6 years ago, but thanks to lower fees and faster trading, it now conducts about 10% of trading in U.S. stocks. The company is now expected to create some competition for the dominant New York Stock Exchange and NASDAQ.

On a related note, the COO of NYSE Euronext (parent company of the New York Stock Exchange) was scheduled to testify on Friday before the House Judiciary subcommittee with jurisdiction over antitrust matters, but did not appear after the announcement of a rival bid for his company. The subcommittee was set to scrutinize the proposed Deutsche Bourse/NYSE Euronext merger, but when Nasdaq and ICE announced a joint takeover proposal of $11.3 billion (19% more than Deutsche Bourse's initial offer), legislators agreed that it was appropriate to cancel the COO's appearance in light of the news, but also cautioned that an examination of competition and consolidation in financial markets is still necessary. Rep. John Conyers (D-MI) called the Deutsche Bourse plan "totally unacceptable," and the rival bid "worse" because either would cut consumer choice and cost U.S. jobs.

SEC CALLS FOR COMMENTS ON MUNI MARKET AFTER CANCELING FIELD HEARINGS

The SEC is calling for market participants to share their comments on the municipal market and how it can be improved. The request is part of an agency-wide review of the muni market and comes after the SEC was forced, for budgetary reasons, to cancel a series of field hearings on the subject. The SEC is particularly interested in fact gathering on: disclosure, derivatives, credit ratings, bond insurance, Build America Bonds, municipal advising and public pensions. SEC Chairman Mary Schapiro has testified before Congress multiple times pushing the President's FY 2012 Budget. Schapiro said that the SEC needs to hire an additional 500 staffers to implement Dodd-Frank, 35 of which will be dedicated to municipal securities and municipal advisor registration testing.

The SEC's call for feedback on the municipal market comes as the US municipal bond market has frozen. Retail investors, generally the principle buyers of municipal debt, have fled the market, raising concerns over local infrastructure funding such as schools and roads. Demand for muni bonds has dramatically decreased and former investors have cashed out as fears of municipal default increase. This lack of appetite is also a result of the expiration of the Build America Bonds program, in which the federal government subsidized the issuance of infrastructure debt in order to attract investors.

GAO REPORT FINDS SIGNIFICANT WEAKNESSES WITH SEC CONTROLS

On March 29, the GAO released a report with thirty recommendations for the SEC in order to improve the agency's internal controls for information systems and financial reporting and accounting processes. The report builds on audits that occurred in FY2009 and FY2010 and identified significant weaknesses in the general support system, financial reporting, budgetary resources, accounting processes and disgorgement and penalties. The GAO said: "These material weaknesses may adversely affect the accuracy and completeness of information used and reported by SEC's management."

SEC Chairman Mary Schapiro responded that the correction of the deficiencies identified in the report is a "top priority" and that "the SEC will fill gaps in the functionality of the current system, eliminating many manual processes that are inherently prone to error, and enhance financial and management reporting." Schapiro said the SEC is also improving its internal control monitoring and tightening controls of future operations.

TREASURY OFFICIALS DEBATE EFFECTIVENESS OF DODD-FRANK

At a House Oversight and Government Reform hearing on March 30, Neil Barofsky (the departing Special Treasury Department Inspector General for TARP) was highly critical of the Dodd-Frank Act. Barofsky said the Act "clearly failed" to remedy the problems that caused the financial crisis. Barofsky also criticized TARP, saying the program made banks bigger and more dangerous and that it "failed Main Street."

Later in the week at a different hearing, Acting Assistant Secretary for Financial Stability at the Treasury, Timothy Massad, disagreed, saying that the Dodd-Frank Act will provide regulators with the tools they need to respond to another crisis. He also stressed that TARP has been a success and has brought in $20 billion in repayments already. Despite Massad's support of TARP he said it should never be repeated as it "is never fair to have to use taxpayer dollars to rescue any institution."

CHAMBER OF COMMERCE HOSTS 5TH ANNUAL CAPITAL MARKETS SUMMIT

On Wednesday, the U.S. Chamber of Commerce hosted its 5th Annual Capital Markets Summit, with keynote speeches by Rep. Spencer Bachus, (R-AL), special advisor to the president and Treasury secretary Elizabeth Warren, and Chamber Chairman and CEO Thomas J. Donahue. Notably, Bachus spoke about Dodd-Frank's overregulation and the great haste with which it is being implemented. He also acknowledged the need for more science and math education in the United States, and the importance of capitalism. Warren spoke favorably about the Consumer Financial Protection Bureau, and its important role in encouraging and ensuring competition in the economic marketplace and the marketplace of ideas. She added that CFPB regulation will be focused on creating better value for consumers, increased information and decreased costs. Donahue spoke about the Chamber's role in improving the Act during the legislative process, and how it was enacted too soon – before the financial crisis was fully understood. He stated the Chamber's commitment to engaging in the Dodd-Frank rulemaking process to ensure certainty, freedom and flexibility in the market.

IMF WEIGHS IN ON U.S. DERIVATIVES REGULATIONS

The International Monetary Fund (IMF) recently released a research paper finding that new regulations requiring derivatives to be traded through clearing houses may in fact be ineffective in removing systemic risks or preventing another taxpayer bailout of the financial system. The IMF report instead recommends alternative policies such as taxing banks' derivatives liabilities. The reason is because clearing houses could themselves become "too-big-to-fail" entities, as the risk shifts away from banks. The CFTC has already proposed dozens of rules on regulating the derivatives market, including limiting clearing house capital requirements for member dealers to $50 million, down from $5 billion. In a somewhat unique occurrence, The UK Financial Services Authority actually filed public comments on the CFTC's proposal, stating that this particular regulation could increase risk in the short- and medium-term because of the complexity and unique characteristics of some of the products.

FX MARKET NERVOUS ABOUT REG REFORM CONSEQUENCES

With the implementation of Dodd-Frank underway, and EU proposals on over-the-counter (OTC) derivatives regulation on the table, foreign exchange (FX) markets are apprehensive about new obligations and changes to the industry. Many members of the FX industry believe that FX played no part in the financial crisis of 2008, and in fact these markets continued functioning "normally" though the crisis and in ensuing months. The global deputy head of FX trading at BNP Paribas advised against overregulation in this area, which could lead to higher transaction costs for clients because of new clearing and reporting requirements, and also higher funding costs because collateral will need to be provided against initial margins and potential negative mark-to-market. The chief operating officer for FX and commodities at HSBC also expressed his concern with a "one-size-fits-all approach to regulation." The Association for Financial Markets in Europe (AFME) has also been outspoken in arguing for separate treatment of FX forwards and swaps from other financial derivatives. European regulators are still debating whether or not to require clearing for FX derivatives, and some reports are indicating that the U.S. Treasury could be close to exempting FX from Dodd-Frank requirements.

UNILEVER TESTS WATER IN DIMSUM BOND MARKET WITH NEW ISSUANCE

A new market is emerging for dim sum bonds, as international fund managers are looking for ways to profit from an appreciation in the Chinese Yuan (which is tightly controlled and monitored by the Chinese government). These bonds are denominated and settled in off-shore Yuan, mainly in Hong Kong. Fund managers are just beginning to test out the market, which for now is fairly limited in trading liquidity and has relatively low yields (1.8% for a three-year bond that was recently purchased from Sinochem Hong Kong). Some investors believe that this low yield and low liquidity are signs that the Yuan will appreciate. Hong Kong banks like HSBC and regional funds have traditionally dominated the small market, although earlier this week Unilever became the first European multinational to issue dim sum bonds, valued at about $45 million. The fast food chain McDonald's was the first U.S. issuer to do the same this past August. Many of the international companies that have issued dim sum bonds are funding their Chinese operations or are looking to demonstrate their commitment to that country. Regardless of the purpose behind each individual issuance, many see the increased interest in the dim sum bond market as progress towards freeing up the Chinese Yuan.

UPCOMING HEARINGS

On Tuesday, April 5th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises will hold a mark-up of pending legislation that would overhaul the operations of GSEs such as Fannie Mae and Freddie Mac.

On Wednesday, April 6th at 9:30am, in SVC-202/203 Capitol Building, the Joint Taxation Committee will hold a hearing to discuss ideas for overhauling the tax code.

On Wednesday, April 6th at 9:30am, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Subcommittee on Securities, Insurance and Investment will hold a hearing on the role of the accounting profession in preventing another financial crisis.

On Wednesday, April 6th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Financial Institutions and Consumer Credit will hold a hearing on legislative proposals to improve the structure of the Consumer Financial Protection Bureau.

On Wednesday, April 6th at 3pm, in 538 Dirksen, the Senate Banking, Housing and Urban Affairs Subcommittee on Financial Institutions and Consumer Protection will hold a hearing on "The State of Community Banking: Opportunities and Challenges."

On Thursday, April 7th at 10am, in 2128 Rayburn, the House Financial Services Subcommittee on Domestic Monetary Policy and Technology will hold a hearing on the U.S. Mint Bullion Program.

On Wednesday, April 13th at 10am (subject to the change), in 2128 Rayburn, the House Financial Services International Monetary Policy and Trade Panel will hold a hearing on the Export-Import Bank.

On Wednesday, April 13th at 2pm (subject to change), in 2128 Rayburn, the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity will hold a hearing on legislative proposals for the Federal Housing Administration and Ginnie Mae.

On Thursday, April 14th at 10am (subject to change), in 2128 Rayburn, the House Financial Services Subcommittee on Oversight and Investigations will hold a hearing on the alleged fraud at the Texas-based Stanford Financial Group.

On Thursday April 14th at 2pm (subject to change), in 2128 Rayburn, the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises will hold a hearing on risk retention.