ML Strategies Update

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Jason Rosenstock
JRosenstock@MLStrategies.com

Abby Matousek
Amatousek@MLStrategies.com

Follow us on Twitter: @MLSFinRegUpdate

ML Strategies, LLC
701 Pennsylvania Avenue, N.W.
Washington, DC 20004 USA
202 296 3622
202 434 7400 fax
www.mlstrategies.com

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Financial Services Legislative and Regulatory Update

Leading the Past Week

As was widely anticipated, President Obama announced that he was nominating Jack Lew to succeed Treasury Secretary Geithner. With Lew having already gone through the confirmation process twice before, it is expected that he will sail through. However, it does seem that he has some detractors, and that there could be opposition based more on policy than personality. And of course, there is "serious" concern about how his unique signature would appear on the nation's currency. The Congressional recess last week didn't prevent the CFPB from rolling out its much anticipated qualified mortgage, or "QM" standard, which was included as part of a larger "ability to repay rule". This new rule, along with the continued announcements of additional settlements between lenders and their regulators, the latest one dealing with questionable foreclosure practices, is seen by some as necessary to turn the page on the core causes of the financial crisis. Similarly, in international news, the Basel Committee finalized recommendations for liquidity standards and risk reporting, with the former offering concessions to the industry.

Legislative Branch

Senate

Senate Confirms Berner to Head Office of Financial Research

On January 1st, following the release of a hold by Senator Charles Grassley (R-IA), the Senate confirmed Richard Berner to head the Treasury Department's Office of Financial Research (OFR). Berner, who was confirmed for a six year term, will lead the newly created office designed in the Dodd-Frank Act to support the Financial Stability Oversight Council (FSOC) in improving transparency of financial information and analyzing potential threats to financial stability. Berner has been serving as a counselor to Secretary Geithner since April 2011, assisting in launching the OFR.

Sanders Introduces Legislation to Curb Conflict of Interest on Fed Boards

On January 9th, Senator Bernie Sanders (I-VT) introduced legislation to ban financial services industry executives from serving on the boards of directors of the twelve regional Federal Reserve Banks. In announcing the legislation, Sanders said the current system breeds conflict of interest, as "two-thirds of the directors at the New York Fed are hand-picked by the same bankers that the Fed is in charge of regulating." Sanders pointed to a 2011 GAO study which found that allowing members of the banking industry to elect and serve on Fed boards of directors leads to creates "an appearance of a conflict of interest" and poses "reputational risks" to the Federal Reserve System.

Transitions on Senate Banking Committee
It was announced that that Senators Tom Coburn (R-OK) and Dean Heller (R-NV) will be added to the Senate Banking Committee. Coburn and Heller will be filling the seats of departing Senators Roger Wicker (R-MS) and Jim DeMint (R-SC). Wicker is moving to the Senate Budget Committee and DeMint is departing the Senate to head the Heritage Foundation. Coburn's addition is interesting because it required him to relinquish his post on the powerful Senate Finance Committee.

<u>Executive Branch</u>
Treasury
Geithner to Leave Treasury; Jack Lew Nominated to Serve as Secretary
Last week, Treasury Secretary Timothy Geithner confirmed that he will be leaving the agency January 25th. While Geithner had previously pushed back his departure date from the Administration, on January 10th, to deal with the Fiscal Cliff issues, as was widely expected, the President officially nominated current White House chief of staff Jack Lew succeed Secretary Geithner. Lew's appointment was seen as a sign of the times, since Lew is a seasoned budget negotiator and will likely take the lead in dealing with Congress with the upcoming fights over the debt limit, sequester and entitlements.

However, beyond the budget issues, Lew will be confronted with a broad portfolio, including continued implementation of the Dodd-Frank Act, overhauling Fannie Mae and Freddie Max, and international economic issues in China and Europe. Several lawmakers have reacted negatively to Lew's appointment. Senator Jeff Sessions (R-AL) has publically announced opposition to Lew and Senator Bernie Sanders (I-VT) has said he will vote against Lew as Sanders believes he is not "is the right person at the right time to serve in this important position." Better Markets also voiced concern about the nomination, saying Lew's past statements indicate "suggesting a lack of knowledge about the financial crisis and its causes." Because Lew is not seen as someone with intimate knowledge of the financial markets, speculation about who will become Lew's Deputy Secretary.

CFPB
Bureau Announces Much Anticipated Ability to Repay Rule and Qualified Mortgage standard
On January 10th, the CFPB adopted its final qualified mortgage (QM) rule which will require lenders to ensure a borrower's ability to repay their mortgage. The rule was released in conjunction with a hearing on mortgage issues in Baltimore. In addition to the ability to repay requirements, the rule protects borrowers from risky lending practices such as "no doc" and "interest only" features that led to many delinquencies and foreclosures in the aftermath of the 2008 housing crisis. By some accounts, the CFPB was lauded for striking a favorable middle ground with the rule and including provisions that incentivize banks to issue safer, lower-priced loan products by offering lenders legal shields for these "qualified mortgage" products. "Qualified mortgages" are those that have no excess upfront points or fees, no toxic loan

features, no balloon payments, and that cap debt-to-income ratios. The same day, the Bureau also finalized escrow requirements under the Truth in Lending Act (TILA) to strengthen consumer protections for high-cost mortgages and to provide consumers with information about homeownership counseling.

Federal Reserve

Review of Foreclosure Practices at 10 Large Banks Resolved in $8.5 billion Settlement

On January 7th, the Federal Reserve and OCC announced that 10 large banks involved in a review of foreclosure files, agreed to pay over $8.5 billion as part of a settlement to resolve foreclosure abuses. The sum includes $3.3 billion in direct payments to eligible borrowers and $5.2 billion in other assistance, such as loan modifications and forgiveness of deficiency judgments. The settlement ends a review into the mortgage loan servicing and foreclosure processing of Aurora, Bank of America, Citibank, JPMorgan Chase, MetLife Bank, PNC, Sovereign, SunTrust, U.S. Bank, and Wells Fargo.

Following the announcement of the settlement, Representative Elijah Cummings (D-MD), Ranking Member of the House Oversight and Government Reform Committee, expressed deep disappointment at the terms of the deal. "I am deeply disappointed that the OCC and the Federal Reserve finalized this settlement and effectively terminated the Independent Foreclosure Review," said Cummings, continuing that the agencies should have provided "Congress answers to serious questions about how this settlement amount was determined, who these funds will go to, and what will happen to other families who were abused by these mortgage servicing companies, but have not yet had their cases reviewed."

Fed and FDIC Exploring Additional Debt Requirements for Winding Down Large Institutions

According to an FDIC spokesman, the Fed and the FDIC are beginning discussion on a rule that would require holding companies for the biggest U.S. banks to hold a minimum amount of long-term debt in order to assist in winding institution down should they fail. Efforts to go above and beyond the Dodd-Frank Act are being led by Fed Governor Daniel Tarullo, who heads bank supervision. Tarullo has previously laid out an aggressive agenda for reducing risk which includes strengthening supervision of shadow banking institutions which do not fall under traditional regulation. Tarullo has also called for requiring banks to fund more of their assets using long-term borrowing and limiting the risk that the largest banks become "too big to fail" through mergers and other added complexities.

OCC

OCC Extends Compliance Period for Swap Pushout Rule

On January 10th, the OCC published guidance giving insured depository institutions an additional two years to comply with the Swaps Pushout Rule, requiring banks to push out most derivatives trading from institutions receiving federal deposit insurance. The Swaps Pushout Rule implements Section 716 of the Dodd–Frank Act which bars any swaps entity from receiving federal assistance (i.e., deposit insurance or access to the Fed's discount window). The OCC extended the compliance period to July 2015, citing delays among other financial regulators. For example, the CFTC must first complete the regulatory framework "necessary for insured federal depository institutions to make well-informed determinations concerning business restructurings" that may result from the rule. The Fed and FDIC are expected to issue similar guidance to insured depository institutions under their jurisdiction. Banks must apply for this two year compliance extension by January 31st. In addition, the OCC confirmed that for non-US banks that book some of their swaps in US branches, they will still need to comply with the original July 16th deadline, as a quirk in the law only provides the safe harbor for US banks.

FHA

2013 Will Likely See Federal Housing, GSE Reforms

With news that the Presidents FY2014 budget will likely require taxpayer subsidies for the Federal Housing Administration (FHA) for the first time there is an increasing expectation that Congress will address federal housing finance. In 2013, the FHA's insurance fund's shortfall could grow to $16.3 billion. In the face of growing deficits in the insurance fund, lawmakers on both sides of the aisle are calling for changes at the FHA, including more clearly defining the agency's mission, setting an acceptable loan-failure rate, setting a target for the government share of U.S. home loans, and increasing annual fees charged to borrowers. In November, the FHA increased fees by 10 basis points but it remains unclear if the change will be enough to keep the agency solvent.

In December, Senate Banking Committee Chairman Tim Johnson (D-SD) said that he would pursue legislation to address the FHA's fiscal health "if the Administration's actions and proposals" were insufficient. Testifying at the same hearing, Housing and Urban Development Secretary Shaun Donovan floated raising the minimum credit scores for FHA loans and other steps to help shore up the insurance fund. In addition, lawmakers and other stakeholders see the potential for reforms to the FHA to open the door to work on a broader overhaul of mortgage finance system, including addressing government sponsored entities (GSEs) such as Fannie Mae and Freddie Mac. Senator Bob Corker (R-TN) has said FHA reforms and broader mortgage reform should go "hand-in-hand." The Obama Administration and lawmakers generally agree that the two GSEs should shrink or be replaced.

CFTC

Commission Plans Staff Roundtable on 'Futurization'

The CFTC will hold a staff roundtable on the "futurization" of the derivatives markets on January 24th. Commissioner Scott O'Malia has requested the roundtable to review the migration of over-the-counter swaps to futures. O'Malia has previously expressed concern that the CFTC's new derivatives rules would cause the migration by disincentivizing "trading on swaps venues by implementing burdensome swap dealer registration rules and disadvantageous margin requirements for swaps."

GAO

GAO Releases Report on TARP

On January 7th, the GAO released a report examining TARP-funded mortgage programs and the Treasury's efforts to better ensure that servicers are implementing new requirements designed to improve interactions with borrowers. The 2008 legislation that authorized TARP directs the GAO to report every 60 days on TARP activities in the financial and mortgage sectors. So far, the Treasury has exited 4 of the 10 nonmortgage-related programs, and in December 2012 Treasury announced the exit from a fifth program—the American International Group (AIG) Investment Program.

<u>Miscellaneous</u>

FINRA Expects Increasingly Stringent Oversight of Industry, including HFT and Dark Pools

In interviews with the New York Times and Wall Street Journal last week, Richard Ketchum, Chairman and CEO of the Financial Industry Regulatory Authority (FINRA), said the body would increase scrutiny of high-speed trading (HFT) and dark pools. The goal of the increased oversight would be to target leveraged loans, collateralized debt obligations and potential conflicts of interest at brokerage firms. The announcement coincides with FINRA filing more than 1,500 enforcement actions against financial firms and brokers in 2012, an unprecedented amount of cases. In 2012, FINRA assessed $68 million in fines, increasing disciplinary actions to 1,541 from 53 in 2011. Some skeptically believe the announcement is also an effort to head off new congressional action on HFT and Dark Pools, an area that Senator Reed and Senator Levin continue to champion.

<u>International</u>

Basel Committee Finalizes Revised, Loosened Liquidity Standards

On January 6th, the Basel Committee on Banking Supervision released a revised agreement on the regulation of banks' liquidity through the Liquidity Coverage Ratio (LCR). The final LCR rule is more flexible than the draft proposal put forth by the Committee two years ago. Among the changes, the final agreement expands the types of assets that banks can count toward complying with the new standards (including some equities and high-quality mortgage backed securities) and changes calculation methods to reduce the total size of liquidity buffers institutions will be required to hold to protect against outflows from runs. In addition to loosening standards, the new requirements will not be phased in until 2015 and will not need to be fully implemented until 2019. Finally, during "periods of stress" banks will be able to draw down liquid assets below the minimum Basel levels. While individual countries must write rules to implement the LCR agreement, the new requirements are intended to ensure that banks have enough liquid assets to cover outflows in the event of liquidity problems such as those that characterized the 2008 financial crisis.

Basel Committee Publishes Final Risk Reporting Guidelines

On January 9th, the Basel Committee on Banking Supervision released final guiding principles for effective risk data aggregation and reporting standards for banks, especially "too big to fail" banks. The Committee set out 14 principles intended to strengthen the infrastructure for reporting information, monitoring and managing risks, streamlining the management of information across entities, and diminishing the probability and severity of losses. The final guidelines make several changes to the draft issued in June 2012. Originally, banks would have been required to comply with all 14 principles at the same time; however, after weighing comments from banks, the Committee made some compliance exceptions. Banks must still meet all risk aggregation and reporting principles simultaneously but additional "trade-offs among Principles could be accepted in exceptional circumstances such as urgent/ad hoc requests of information on new or unknown areas of risk."

The guidelines will also contribute to the resolvability of globally systemic important banks (G-SIBs). Currently there are 28 banks identified by the Financial Stability Board as G-SIBs which must comply with higher capital requirements and other regulation. In releasing the principles, the Basel Committee urged national banking supervisors to begin planning implementation with the management of G-SIB banks as soon as possible in order for banks to become compliant by early 2016.

<u>Upcoming Hearings</u>

There are no hearings scheduled.

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