Dodd-Frank and the capital markets

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The Dodd-Frank Act does not directly address market regulation and trading issues; however, that by no means should lead one to conclude that the Act will not effect dramatic changes in the capital markets. Like any reform legislation, the Act targets the perceived capital markets related evils that presumably were root causes of the financial crisis. Underlying the various measures we discuss below are certain important prevailing views: that our financial institutions must maintain higher regulatory capital levels; that financial institutions should limit the use of leverage; that 'simpler' financial products with a higher equity content will be more loss absorbent during financial downturns; that certain financing activities, including proprietary trading, securities lending, derivatives and securitisation, are inherently 'risky'; and that market participants should be subject to greater oversight, especially in respect of their interactions with retail investors. If this is the point of departure for regulatory reform, it is clear that the resulting legislation necessarily will affect the capital markets and the effects will be most acute for financial institutions. The Act also introduces a number of new agencies and regulators, including the Bureau of Consumer Financial Protection. Financial institutions already are consumed with assessing the impact on their business operations of the Act. Significant resources will continue to be devoted to regulatory compliance for at least the next 12 to 24 months as many of the most important details of regulations will not be revealed until additional rule-making is undertaken or mandated studies are completed. This heightened regulatory focus will, of course, have its own special impact on capital markets activity.

Although the capital markets as a whole will be affected by the Act, for operating companies (not financial institutions) the effects will be more indirect – bank loans may be more difficult to obtain and may be more expensive; they may face higher costs as derivatives end users, they may find that there is less interest on the part of financial intermediaries in financing companies farther down in the pecking order; and private equity may be less available and so on. Individuals will be directly affected in their access to consumer financial products and in their interactions with financial services intermediaries, including investment advisers and broker-dealers. Below, we focus on the aspects of the Act which relate most directly to the capital markets.

Financing needs and financing alternatives for banks will change. Financial institutions will be limited in their ability to use leverage, they will face higher regulatory capital requirements and they will not be able to use the same funding tools that they relied upon in the past. The Act requires that bank regulators establish heightened prudential standards for risk-based capital, leverage, liquidity and contingent capital. Systemically important institutions, which include the largest bank holding companies, will be subject to more onerous regulatory capital, leverage and other requirements, including a maximum debt-to-equity ratio of 15-to-1. The Collins amendment provisions included in the Act require the establishment of minimum leverage and risk-based capital requirements. These are set, as a floor, at the risk-based capital requirements and Tier 1 to total assets standard applicable currently to insured depository institutions under the prompt corrective action provisions of the Federal Deposit Insurance Act. Final regulatory capital ratios will not be set for some time. The legislation limits regulatory discretion in adopting Basel III requirements in the United States and raises the possibility of additional capital requirements for activities determined to be 'risky', including, but not limited to, derivatives, securitisation and securities lending.

Consistent with the emerging guidance relating to the Basel III framework, the Act no longer permits bank holding companies to include certain hybrids, like trust preferred securities, within the numerator of Tier 1 capital. The legislation applies retroactively to trust preferred securities issued after 19 May 2010. Bank holding companies and systemically important nonbank financial companies will be required to phase-in these requirements from January 2013 to 2016. Mutual holding companies and thrift and bank holding companies with less than \$15bn in total consolidated assets are not subjection to this prohibition. Within 18 months of the enactment of the legislation, the General Accounting Office must conduct a study on the use of hybrid capital instruments and make recommendations for legislative or regulatory actions regarding hybrids. For US financial institutions that have long depended on hybrid capital issuances for funding, this is a significant change. Financial institutions also will be watching closely as additional details of the Basel III framework are finalised. These proposals emphasise the quality, consistency and transparency of the capital base. We already know that Tier 1 capital must consist predominantly of 'common equity', which includes common shares and retained earnings. This new definition of Tier 1 capital is closer to the definition of 'tangible common equity'. Financial institutions and their advisers will be required to analyse the types of securities issuances that will meet these new requirements and provide cost-efficient funding.

The Act raises the possibility that 'contingent capital' instruments may be a partial solution to the funding dilemma. Regulators usually have referred to contingent capital instruments as hybrid debt that is "convertible into equity when (1) a specified financial company fails to meet prudential standards…and (2) the [regulatory agency] has determined that threats to…financial stability make such conversion necessary". It is likely that quite a number of different formulations of contingent capital instruments, including instruments with principal write-down features, may be considered; however, many tax and other questions relating to these products remain unanswered.

The Act also subjects transactions between certain affiliates of banks to more onerous restrictions. The Act amends Section 23A and Section 23B of the Federal Reserve Act, which establish parameters for a bank to conduct 'covered transactions' with its affiliates, with the goal of limiting risk to the insured bank in order to prevent the bank from transferring to its affiliates the benefits of its to the federal 'safety net'. The Act broadens the definition of 'affiliate' and expands 'covered transactions' to include, among other things, derivatives transactions and securities lending transactions. Covered transactions will be subject to enhanced collateral requirements and tightened qualitative safeguards. These new restrictions will serve to limit a financial institution's flexibility and may limit their participation in certain markets.

As we discuss above, the Act targets activities viewed as 'risky' and markets perceived to have been lacking in transparency and suffering from insufficient regulatory oversight. In this context, the Act implements the Volcker Rule, which imposes certain prohibitions on proprietary trading and on fund activities. Except for certain permitted activities, a 'banking entity' cannot: (i) engage in proprietary trading; or (ii) acquire or retain any equity, partnership or other ownership interest in, or sponsor, a hedge fund or private equity fund (collectively 'fund activities'). A 'nonbank ▸▸

financial company' supervised by the Federal Reserve may engage in proprietary trading or fund activities, but, to the extent that it does so, it will be subject to additional capital requirements and quantitative limits, that will be established by rule. A banking entity may make and retain an investment in a fund that the banking entity organises and offers, provided that its investment is within the 'de minimis' standards set out in the rule. A banking entity also may engage in a specified list of 'permitted activities'. Fiduciary, or asset management, activities are within this exclusive list. While there are certain areas of ambiguity in connection with the Volcker Rule provisions, it is clear that the intent is to remove banking entities from proprietary trading. It is not difficult to predict the adverse effect that removing significant market participants (banking entities) from certain parts of the market (through the prohibition on proprietary trading) will have on pricing and liquidity, and, it is difficult to anticipate whether other entrants (for example, hedge funds) will supplant the banking entities in certain markets.

The Act creates a new regulatory structure for OTC derivatives over which the SEC and the CFTC share oversight responsibilities. The Act requires registration of swap dealers and major swap participants; subjects most swaps to central clearing; subjects swap dealers and major swap participants to heightened margin requirements; imposes new minimum capital requirements; establishes broader position limits; and creates new business conduct standards for participants in this market. The Act also includes the Lincoln 'swaps push out' provisions, which provide that no federal assistance will go to an insured depository institution unless it limits its swap activities to certain permitted activities, which include hedging and risk mitigation activities and swap activities involving certain rates and reference assets, such as foreign exchange, precious metals, government and GSE obligations and investment grade corporate debt. Financial institutions, traditionally the largest and most active 'derivatives dealers', also will be keeping a close eye on the changes to be effected by the Basel III framework that will affect their derivatives activities. Basel III incentivises banks to use derivatives that are centrally cleared and 'penalises' banks (by making these more costly) for using bespoke, non-cleared derivatives.

To the extent that financial institutions and other market participants have relied on securitisation as a financing tool, the Act also will result in significant changes. The Act includes a number of provisions that affect the securitisation market. These focus on 'credit risk retention' and require originators and securitisers of financial assets to retain a portion of the credit risk of securitised financial assets or, in more popular terms, to have 'skin in the game'. The Act generally requires credit risk retention of 5 percent of any asset included in a securitisation, or less than 5 percent if the assets meet underwriting standards established by regulation. Risk retention requirements also will be required for collateralised debt obligations, securities collateralised by collateralised debt obligations, and similar instruments collateralised by other asset-backed securities. The Dodd-Frank Act prohibits a securitiser from directly or indirectly hedging or otherwise transferring the credit risk that the securitiser is required to retain with respect to an asset unless regulations to be adopted specify otherwise. The 'costs' of securitisation also, of course, have been affected by accounting changes and other regulatory developments and will be affected as well by Basel.

We have not commented on the investor protection measures included in the Act, such as the possible imposition of a fiduciary duty standard of care for broker-dealers, but these also will have an effect on the capital markets. Any assessment of the impact of the Act on capital markets needs to be infused with a large dose of humility. There are a staggering number of variables, having little or nothing to do with this legislation, that will have at least as much impact on the health and stability and competitiveness of the US capital markets. ■

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