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FINANCIAL SERVICES REGULATORY REFORM UPDATE

For the Week of March 1, 2010

Last week, while Congress continued to work on building bipartisan consensus for the various “job creation” initiatives moving through both Chambers, Chairman Dodd and members of the Senate Banking Committee continued their effort to reach a consensus on some type of Consumer Financial Protection component to be included in the regulatory reform bill. After two previous efforts at compromise failed to secure the necessary bipartisan sign-off, Committee leaders went back to the drawing board in the hopes of producing a draft that could win the approval of their Democratic and Republican colleagues. By the end of the week it appeared that both sides were closer to language that could potentially satisfy the concerns of both parties.

DODD AND CORKER CONTINUE NEGOTIATIONS ON CFPA

Negotiations on the CFPA proposal continued this week as Senator Chris Dodd (D-CT), Chairman of the Senate Banking Committee, and Senator Bob Corker (R-TN) met with their respective Republican and Democratic colleagues on the committee in order to brief them on the status of the negotiations.

The CFPA continues to remain a major point of contention, with Members from both sides of the aisle expressing concern with creating a stand-alone agency with such broad power and authority. In order to address these concerns, Dodd proposed a compromise on the CFPA, which would eliminate the creation of a stand alone agency and instead establish a consumer protection unit within the Treasury Department. This new consumer protection unit would be granted direct rulemaking, examination, and enforcement authority for all banks and non-bank mortgage firms with more than \$10 billion in assets. The proposal would also give indirect power over smaller banks and credit unions with assets of \$10 billion or less. This proposed compromise was rejected by Corker as well as Ranking Member Shelby (R-AL), both of whom appeared to be engaged in negotiations with Chairman Dodd.

As predicted, a couple of days later Shelby offered Dodd two separate counter-proposals that he felt would address the consumer protection issue, but would also give a new regulator far less power and authority than was prescribed in Dodd's proposal. The first plan would establish a Financial Products Consumer Protection Council within the Federal Deposit Insurance Corporation and the second proposal would create a stand-alone consumer council answerable to the FDIC. However, Dodd was apparently unimpressed with Shelby's offer and quickly rejected it as a viable option.

Senator Corker was also working on his own counter-proposal, which in turn proved to be more palatable to the Chairman. Corker's proposal would house the CFPA in the Federal Reserve and give it rule-writing authority as long as the Fed Chairman signed off. After Dodd signaled that he would be willing to work with Corker on this proposal, the two lawmakers immediately started to work on refining the proposal and building support for the proposal from their fellow colleagues, which, not surprisingly, proved to be challenging.

The decision by Dodd to apparently acquiesce on having the consumer protection functions within the Fed surprised many since Dodd had previously accused the Fed of lax consumer oversight. However, many in town believe that Dodd is using the Fed as a stalling horse to get the agency back under the Treasury as his initial compromise outlined.

Furthermore, Dodd attempted to alleviate the fears of his colleagues and told Members that if the consumer regulation ends up at the Fed, the regulation would be much different than the central bank's efforts in the years leading up to the crisis. He also emphasized that he is pushing for four main principles that would ensure the new entity would be effective in protecting consumer protection: (1) a director who is presidentially appointed and confirmed by the Senate; (2) a dedicated funding source; (3) independent rule-writing authority; and (4) enforcement powers.

Corker has also been trying to gain the support of his fellow Republican Members, including Shelby. Corker has dismissed concerns that his "three-way" talks with Dodd and Shelby have complicated matters, however he admits that the negotiation process has taken a "twist". Even though Shelby said that he would not rule out the central bank as a home for the CFPA, he still asserted that financial regulators should have veto authority over the rules developed by the consumer division. Dodd has explicitly said that he will not accept this provision, which could prove to be a sticking point for Shelby, who has the power to sway the other GOP Members on the Committee.

While it remains unclear whether Dodd and Corker will ultimately win the support of Shelby or of their fellow Banking Committee Members, the proposal has already received criticism from a number of other key players in this debate. House Financial Services Chairman, Barney Frank (D-MA), announced last Wednesday that he does not support housing the CFPA in the Fed. He said that he could support Dodd's original proposal of placing the unit within the Treasury Department "provided that the entity has sufficient independence and broad regulatory scope to accomplish the mission of protecting consumers." Treasury Secretary Geithner also conveyed a similar message and reiterated the Administration's stance that a financial regulatory reform bill must have strong consumer protections.

Elizabeth Warren, the Harvard professor who initially developed the idea of creating the CFPA, also spoke out about Dodd and Corker's proposal last week. Although it appeared she accepted the likelihood that the proposed agency would have to be melded into an existing agency in order to be accepted by the Committee, she continued to call for the unit to have independence from outside supervision, and took a particularly harsh tone saying "there is no point in creating one more bloated bureaucracy that isn't designed to get the job done."

Negotiations are expected to continue this week on the latest CFPB proposal. Dodd had originally hoped to unveil the latest comprehensive draft of the financial regulatory reform bill last week, but that has been delayed until work can be completed on the CFPB proposal. However, other sections of the bill seem to be coming together. Last week, Senator Warner (D-VA) presented the section that he and Corker had been working on that would allow the federal government to dissolve at-risk firms. Senator Reed (D-RI) also presented the section that would regulate over the counter derivatives. However, it remains uncertain whether the corporate governance section that Senator Schumer (D-NY) and Senator Crapo (R-ID) were working on will be in the final bill, despite reports that Schumer is aggressively pushing for its inclusion. Dodd still has hope that the bill will be able to pass committee in the near future, however, in light of the less than warm reception for Dodd and Corker's CFPB proposal, it appears that the timetable for the movement of this bill could be delayed.

VOLKER RULE NOW TO TARGET ALL FINANCIAL FIRMS

On Wednesday, the Treasury Department released a summary of the draft legislative language for the so called "Volker Rule", which was proposed by President Obama and former Federal Reserve Chairman Paul Volcker in January. The Treasury summary released this week differed from the original proposal, surprising many by including tougher limits on all financial firms that practice proprietary trading, not just commercial banks.

According to the summary, all major nonbank firms can continue to engage in proprietary trading, but the entities will be under new quantitative limits and have additional capital requirements. In addition, banks would be prohibited from buying or selling stocks, bonds, options, commodities, derivatives, or other financial instruments, unless on behalf of a client or as part of "market making activities." However, banking firms would still be permitted to serve as investment advisers to private funds, but with the caveat that lending, providing brokerage services, or engaging in any transactions that support a private fund would be strictly prohibited. Furthermore, the summary also would limit the size of a financial institution, by preventing a financial firm from purchasing another company, if the merged entity would have more than 10 percent of the liabilities of the financial system.

The Administration remains hopeful that the Senate will include this provision in the financial regulatory overhaul currently being drafted. However, this expanded proposal could pose additional challenges to Dodd as he tries to build consensus not only with the Republican Members on the Banking Committee, but with his fellow Democratic colleagues. Several Committee Members on both sides of the aisle have expressed their skepticism regarding the effectiveness of the proposal. Dodd himself has only offered luke-warm support for the Volker rule and has expressed concern about including the language in the regulatory reform package this late in the game. Dodd and other Members of the Committee have suggested that the proposal should be moved separately after the reform package passes the Senate, in order to give the committee more time to review the proposal and possible alternatives.

CBO REPORTS THAT ADMINISTRATION'S BANK FEE WOULD BE PASSED ONTO CUSTOMERS

In a letter sent this week to Senate Finance Committee Ranking Member, Chuck Grassley (R-IA), the Congressional Budget Office wrote that the bank fee proposed by the White House back in January that would impose a fee to prevent firms from engaging in systemically risky behavior would undoubtedly be borne by a covered entity's customers, employees, and investors. As initially laid out, the fee would only apply to all financial firms with \$50 billion or more in assets, therefore excluding small to medium size firms as well as community banks, however, the White House indicated that auto manufacturers and Fannie Mae and Freddie Mac would not be covered under the current plan.

The White House estimated that the fee would raise \$90 billion to help pay down the deficit and would ensure that Wall Street is paying the taxpayers back for the assistance provided during the past two years, although critics pointed out that financial firms that didn't receive direct assistance from TARP would still be included. Cynically, the proposal seemed nothing more than a blatant attempt by the Administration to score political points with Americans angered over Wall Street's actions before and, more importantly, after the meltdown. Ironically, the CBO analysis found that it would be individuals that would be hit the hardest by the fee, not the institutions. The CBO reported that through higher borrowing rates and other charges, the customer would bear the brunt of the fee. Furthermore, although the CBO analysis did find that the fee would make small-to-medium size banks more competitive with larger banks, it determined that this leveling of the playing field would slightly decrease the level of the overall credit available to small businesses, which is a major focus of both Houses of Congress at the moment.

The CBO analysis also found that most of the firms that would be targeted by the fee would not be those that generated losses from the TARP. According to the report, out of the \$99 billion in TARP losses, auto companies are responsible for \$47 billion. Since auto companies would be exempted from the Administration's proposal, the fee would in turn target firms that did not generate losses from TARP or target those that have already repaid or about to repay their TARP debts.

The release of this report could potentially hinder the implementation of this proposal in the future as Democratic and Republican lawmakers weigh the potential consequences of this fee, not only on financial firms, but on their constituents as well. However, House Democrats have been tinkering with the proposal and it has been reported that they may want to use the fee to offset some of their job creation initiatives. A number of key Members on both side of the aisle have indicated that they would want to exempt firms that did not take TARP funds, a significant difference from the President's proposal.

WEBB AND BOXER OFFER AMENDMENT TO CURB EXCESSIVE EXEC BONUSES

Last week, the Senate began debate on the American Workers, State, Business Relief Act of 2010, also known as the tax extenders package. During the debate, a number of amendments were offered from Members on both sides of the aisle, including one by Senator Webb (D-VA) and Senator

Boxer (D-CA) that would impose a 50 percent tax on bonuses in excess of \$400,000 received by executives at the 13 firms that received more than \$5 billion in TARP funds.

Not surprisingly, the financial services industry and the Chamber of Commerce were opposed to the measure. However, the proposal not only received significant populist support, but it also could reduce the cost of the bill by billions of dollars, a major consideration in these times of austere budgets. It was unclear by the end of the week whether the amendment would see floor time, since Reid was hoping to wrap up debate on the floor and move to cloture vote on Tuesday of this week.

FED SETS CREDIT CARD FEE CRITERIA

Last week, the Federal Reserve Board approved the proposed rule that would determine the “reasonable and proportional” credit card penalty fees, including late payment fees. This rule would be the third phase of the Fed’s implementation of the Credit Card Accountability Responsibility and Disclosure Act (CARD ACT) that was enacted last May.

The newly adopted rule includes a number of provisions that will affect the way credit card issuers do business in the future. In addition to prohibiting card issuers from charging penalty fees in excess of the actual dollar amount associated with the customer’s violation of the account terms, the rule would also ban inactivity fees and prevent issuers from charging multiple penalty fees based on a single late payment. According to the Fed, these provisions will go into effect August 22nd.

In addition to these new restrictions, the Fed also determined that card issuers would be required to review and reconsider any interest rate increases. According to the rule, issuers would now be required to inform consumers of the reason for any interest rate increases and also reevaluate any rate increases since January 1, 2009 and determine the reasons for the hike, and if appropriate, reduce the rate. Although the rule requires issuers to examine their interest rate practices, it does not mandate or offer criteria for reducing the rates or by what percentage they should be reduced.

The proposed rule will be published in the Federal Register in the near future. The Fed has announced that they will allow 30 days for comment after the publication of the rule in order for stakeholders to provide feedback on the rule and its implementation.

BOSTON FED PRESIDENT CALLS FOR STRONG FED ROLE IN SUPERVISORY ACTIVITIES

While speaking at the Global Interdependence Center’s conference in Philadelphia last week, Federal Reserve Bank of Boston President, Eric Rosengren, argued that the Fed’s low interest rate policies over the past nine years have not led to the spike in housing prices, which experts say played such a big role in the recent financial crisis. He continued by saying that monetary policy alone was not responsible for the 2008 meltdown and that it will not avert future crisis as some have indicated. Instead, Rosengren suggested that lawmakers can reduce the potential for additional harm to the country’s vulnerable financial system by adopting a forward-looking, systemic system of regulating financial risk.

Rosengren said that the best approach to mitigating future meltdowns is to involve a combination of monetary policy and supervisory policy, with the focus not on individual institutions but on the financial system as a whole. He explained that there is a serious gap since there “is no assigned responsibility for forward looking systemic risk supervision”. Rosengren said it is imperative that lawmakers try to fill this gap in some way as they put together the regulatory reform package. He recommended that lawmakers should specifically task an agency with systemic oversight of the financial system and that the agency should focus on “misperceptions and mispricing” of risk and the way it is dispersed throughout the financial system.

Not surprisingly, Rosengren offered the Federal Reserve as the appropriate agency to handle this task. He said that the Fed is well-suited for the task and should play a significant role in overseeing systemically important institutions and addressing systemic risks, while continuing to supervise community banks.

CHAIRMAN FRANK CALLS FOR FANNIE AND FEDDIE'S DEBT TO BE GIVEN DIFFERENT LEGAL STANDING THAN TREASURY DEBT

On Friday, Chairman Frank released a statement that reiterated his position that the debt of the two Government-Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac, should not have the same legal standing as Treasury debt. Apparently, this statement was made in response to media inquiries regarding Frank's position and he wanted to ensure that the record was clear on his position.

In his statement, Frank explained that it would be a mistake for Congress to treat the debt of the GSEs the way it treats Treasury debt, even though the markets treat them the same. However, Frank said that this fact does not prevent the Treasury from treating the debt in a manner that best supports the “important goal of stabilizing the financial system.” He also said that he fully supported the Treasury's actions in December, when it announced it would not cap the amount of money it would spend to keep the two entities viable. Frank argued that it is important that the Treasury act in a way that would provide stability to the housing market and financial system. In terms of moving forward, Frank announced that as the Committee looks to restructure housing finance, they will ensure that there are no implicit “guarantees, hints, suggestions or winks and nods.” He said that the Committee will be “explicit about what is and is not an obligation of the federal government.”

This could become an issue as Congress looks to restructure Fannie and Freddie in the coming months. Even though Frank has reiterated his position that the GSEs' debt should be treated differently, Republicans have attempted on multiple occasions to put the two entities' debt on the government's books and will likely do so again in the future.

UPCOMING HEARINGS

The House Financial Services Committee is scheduled to hold a number of hearings in the upcoming week. On Tuesday, March 9th, 2010, at 2:00 p.m. in 2128 Rayburn the Full Committee

will hold a hearing on: “Community Development Financial Institutions (CDFIs): Their Unique Role and Challenges Serving Lower-Income, Underserved and Minority Communities”.

On Wednesday, March 10, 2010, at 10:00 a.m. in 2128 Rayburn the Subcommittee on Financial Institutions and Consumer Credit will hold a hearing on “Regulation of Money Service Businesses”. Following this hearing, at 2pm, the Subcommittee on Housing and Community Opportunity and Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will hold a joint hearing entitled “Approaches to Mitigating and Managing Natural Catastrophe Risk: H.R. 2555, The Homeowners’ Defense Act”

On Thursday, March 11, 2010, at 10:00 a.m. in 2128 Rayburn the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will hold a hearing entitled “Corporate Governance after *Citizens United*”. Then at 2pm the Subcommittee on Housing and Community Opportunity will hold a hearing entitled “The FHA Reform Act of 2010”

The House Judiciary Committee’s Subcommittee on Constitution, Civil Rights, and Civil Liberties Subcommittee will hold a hearing on "Protecting the American Dream: A Look at the Fair Housing Act" on March 11th at 1:30 p.m. in 2141 Rayburn Bldg.

The Senate Banking Committee does not have any hearings scheduled for this week.