The Dodd-Frank Act and the new Consumer Financial Protection Bureau

What's all the fuss about?

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Agenda

- The Financial Crisis
  - Causes
  - U.S. Government Response
- The Dodd-Frank Act
- Title X: Consumer Financial Protection Bureau
  - Origins and Structure
  - Jurisdiction and Authority
  - Some Proposed Regulations
  - Outlook
- Questions?

Overview of the Financial Crisis

The Financial Crisis

The greatest financial crisis since the Great Depression.

- Years in the making
- String of events which ignited the full blown crisis in the fall of 2008:
  - Collapse of the housing bubble (fueled by low interest rates)
  - Easy credit ("stated income" a/k/a "liar's loans")
  - Ineffective regulation and supervision(?)
  - Toxic mortgages
- When the bubble burst - hundreds of billions of dollars in losses in mortgages and mortgage-related securities shook markets all over the world
- Liquidity dried up, stock market plummeted
- Economy plunged into deep recession

Causes of the Financial Crisis

- Many early warning signs of potential for a crisis
  - Explosion in risky subprime lending and securitization
  - Unsustainable rise in housing prices
  - Widespread reports of egregious and predatory lending practices
  - Dramatic increase in household mortgage debt
  - Exponential growth in financial firms' trading activities, unregulated derivatives and short term "repo" lending markets
- Lack of Corporate Governance and Risk Management
  - Financial firms took too much risk, with too little capital, and too much dependence on short-term funding

Causes of the Financial Crisis

- <u>Lack of Corporate Governance and Risk Management cont.</u>
  - Explosion in risky subprime lending and securitization
  - Large investment banks and bank holding companies took on enormous exposures in acquiring and supporting subprime lenders (e.g. Citigroup, Lehman Brothers and Morgan Stanley)
  - Created, packaged, repackaged, and sold trillions of dollars in mortgage-related securities
  - Embraced mathematical models as reliable predicators of risk
  - Risk management became risk justification
  - Compensation systems – rewarded the quick deal, short-term gain

Causes of the Financial Crisis

- Excessive Borrowing, Risky Investments and Lack of Transparency
  - Too many financial institutions and households borrowed more than they could afford
  - For example – Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley operated with very high leverage
  - From 2001 to 2007, the national mortgage debt nearly doubled and the amount of mortgage debt per household rose more than 63%
  - Transparency lacking – e.g. shadow banking system, derivatives not traded on exchanges

Causes of the Financial Crisis

- Breakdown in Accountability and Ethics
  - Mortgage fraud
  - Lenders made loans to borrowers who they knew could not afford to repay the loans.
  - Predatory lending
- Failures in Financial Regulation and Supervision
  - 30 years of deregulation stripped away key safeguards
  - Opened up gaps in oversight of critical areas with trillions of dollars at risk
  - Regulators failed to rein in risky home mortgage lending (e.g. Federal Reserve failed to establish and maintain prudent mortgage lending standards)

Causes of the Financial Crisis

- Government Not Prepared for the Crisis
  - Government agencies did not have a clear grasp of the financial system
  - No comprehensive and strategic plan for containment due to lack of understanding of the risks and interconnections in the financial market
  - Inconsistent handling of major financial institutions during the crisis (e.g. decision to rescue Bear Stearns, place Fannie Mae and Freddie Mac into conservatorship, but not to save Lehman Brothers, and then to save AIG) created uncertainty

“Bail Outs” by U.S. Government

Bear Stearns

- The Federal Reserve issued a nonrecourse loan of $29 billion to Bear Stearns
- “Bail Out” was to avoid a potential fire sale of nearly $210 billion of Bear Stearns’ MBS

Fannie Mae and Freddie Mac

- On September 5, 2008, the Treasury Department confirmed that both Fannie Mae and Freddie Mac would be placed into conservatorship with the government taking over management of the pair

“Bail Outs” by U.S. Government

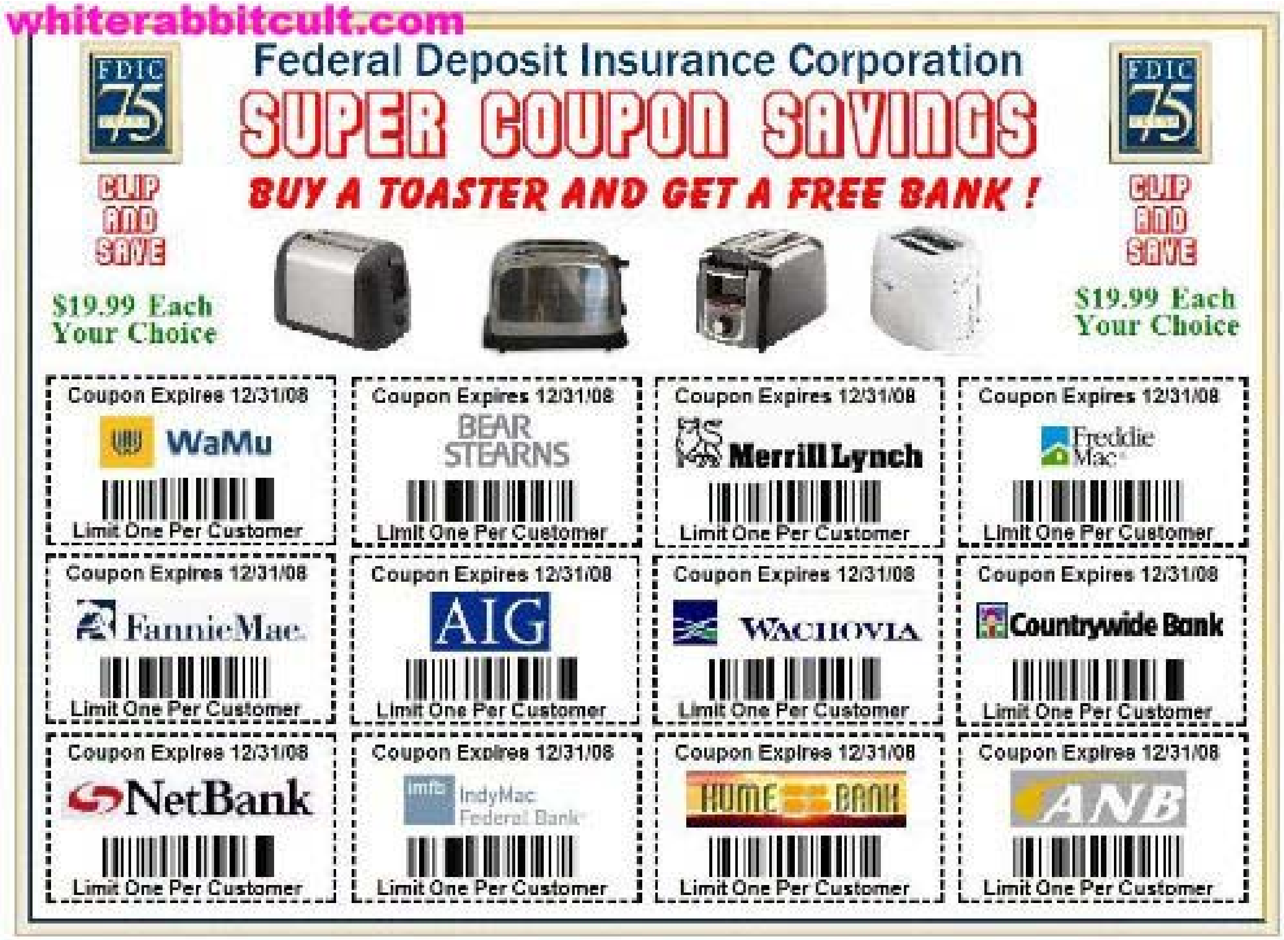
Independent National Mortgage Corporation (IndyMac)

- On July 11, 2008, citing liquidity concerns, IndyMac Bank was placed into conservatorship by the FDIC
- IndyMac Federal Bank, FSB, a bridge bank, was established to assume control of IndyMac Bank's assets and secured liabilities, and was put into conservatorship under the control of the FDIC
- IndyMac Bancorp filed for Chapter 7 bankruptcy on July 31, 2008

AIG

- The Federal Reserve on September 16, 2008 created an $85 billion credit facility for AIG to:
  - meet increased collateral obligations consequent to the credit rating downgrade, in exchange for the issuance of a stock warrant to the Federal Reserve Bank for 79.9% of the equity of AIG.
- By May 2009 the Federal Reserve had increased the potential financial support to AIG.

“Bail Outs” by U.S. Government



"Bail Outs" by U.S. Government

Additional U.S. Government Response

- Enacted various legislation such as:
  - Housing and Economic Recovery Act of 2008
  - Emergency Economic Stabilization Act of 2008 (Troubled Asset Relief Program)

AND

  - **The Dodd-Frank Wall Street Reform and Consumer Protection Act**

Summary of the Dodd-Frank Act

Background

- The Dodd–Frank Wall Street Reform and Consumer Protection Act signed into law by President Barack Obama on July 21, 2010.
- Most sweeping change to financial regulation in the United States since the Great Depression
- The Act is categorized into sixteen titles
- The stated aim of the legislation is:

"*To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes*."

Summary of the Dodd-Frank Act

Title I – Financial Stability

- Establishes broad regulatory framework to protect US financial system from systemic risks posed by certain financial companies and activities
- Creates Financial Stability Oversight Council
- Authorizes the Federal Reserve to: subject activities of (i) nonbank financial companies under its supervision and (ii) interconnected bank holding companies to more higher standards and reporting and disclosure requirements

Title II – Orderly Liquidation Authority

- Creates new liquidation authority which allows FDIC to unwind failing bank holding companies and nonbank financial companies to prevent adverse effects on national financial stability
- Taxpayer bailouts expressly prohibited

Summary of the Dodd-Frank Act

Title III – Transfer of Powers to the Comptroller of the Currency, the Corporation, and the Board of Governors

- Eliminates the Office of Thrift Supervision (OTS) and transfers OTS's power to other federal banking regulators
- Reforms FDIC's revenue-raising provisions which are intended to offset the costs of this Act

Title IV – Regulation of Advisers to Hedge Funds and Others

- Expands SEC's registration requirements to cover advisers to most private funds
- Applies to advisers with at least $25 million in assets under managements (but only where states do not require registration)
- SEC will require registration of covered private funds with at least $100 million in assets under management

Summary of the Dodd-Frank Act

Title V – Insurance

- Establishes a new Federal Insurance Office (FIO) within the Treasury Department, with authority to perform tasks relating to all lines of insurance other than health insurance

Title VI – Improvements to Regulation of Bank and Savings Association Holding Companies and Depository Instructions

- Imposition of capital requirements on bank and holding companies
- Implements a version of the "Volcker Rule" – barring proprietary trading and hedge fund or private equity fund sponsorship by banking entities, with a series of exceptions

Summary of the Dodd-Frank Act

Title VII – Wall Street Transparency and Accountability continued

- Devoted to over-the-counter (OTC) derivatives market
- Subjects almost all swaps and security-based swaps to regulation – all swaps required to be cleared through a derivatives clearing organizing or a clearing agency (DCO)
- Traded on an exchange or alternative execution facility
- Implements substantial registration, recordkeeping, and reporting requirements for DCOs, swap repositories, exchanges and alternative execution facilities, swap participants and swap dealers
- Exemptions are available, but are narrow
- Jurisdiction over the OTC derivatives markets is divided between the SEC (security-based swaps) and Commodity Futures Trading Commission (CFTC) (swaps)

Summary of the Dodd-Frank Act

Title VIII – Payment, Clearing and Settlement Supervision

- Authorizes the Federal Reserve, the SEC, and the CFTC to prescribe risk management standards for the conduct of "systemically important" payment, clearing and settlement activities by financial market utilities and financial institutions (i.e. broker-dealers, investment advisers and investment companies)

Title IX – Investor Protections and Improvements to the Regulation of Securities

- The "Investor Protection Title" – addresses wide range of issues relating to the function of securities markets and operation of the SEC
- Organized into 10 subtitles

Summary of the Dodd-Frank Act

Subtitle A: Increasing Investor Protection

- Establishes Investor Advisory Committee and an Office of the Investor Advocate
- Requires an SEC study within 6 months of enactment of Act on expanding duty of care of investment advisers to cover broker-dealers
- SEC authorized to promulgate rules at the end of the study

Subtitle B: Increasing Regulatory Enforcement and Remedies

- Expands the jurisdiction and enforcement authority of the SEC

Subtitle C: Improvements to the Regulation of Credit Rating Agencies

- Modifies oversight of credit rating agencies

Subtitle D: Improvements to the Asset-Backed Securitization Process

- “skin in the game” section of the Act – defines asset-backed securities (ABS) broadly
- Requires regulators impose an unhedged risk retention requirement on securitizers of ABS

Summary of the Dodd-Frank Act

Subtitle E: Accountability and Executive Compensation and Strengthening Corporate Governance

- Imposes new standards relating to corporate governance, executive compensation and disclosure
- Standards not limited to financial services firms

Subtitle F: Improvements to the Management of the SEC

- Addresses SEC internal processes and operations
- Requires new reports and independent consultant study on SEC structure

Subtitle H: Municipal Securities

- Imposes a number of reforms on the municipal securities market (i.e. new registration and regulation requirements)

Summary of the Dodd-Frank Act

Title IX – Investor Protections and Improvements to the Regulation of Securities (continued)

- *Subtitle I – Public Company Accounting Oversight Board, Portfolio Margining, Other Matter*
  - Expands regulatory authority of the Public Company Accounting Oversight Board ("PCAOB")
  - Exempts small public company issuers from the Sarbanes-Oxley Act requirement of an audit of internal control over financial reporting
- *Subtitle J – SEC Match Funding*
  - SEC will continue to be subject to the appropriations process, but with modifications
  - Provide SEC with access to "Reserve Fund"

Title X – Bureau of Consumer Financial Protection

- Establishes the Bureau of Consumer Financial Protection

Summary of the Dodd-Frank Act

Title XI – Federal Reserve System Provisions

- Grants Federal Reserve and the FDIC substantial economic stabilization powers, but only for broad-based programs
- May not use powers to assist individual financial firms

Title XII – Improving Access to Mainstream Financial Institutions

- Creates programs to assist low and moderate income individuals to establish deposit and other accounts with banks and credit unions

Summary of the Dodd-Frank Act

Title XIII – Pay it Back Act

- Shortens duration and reduces amount available to the Secretary of the Treasury under TARP
- Requires that Fannie Mae, Freddie Mac and Federal Home Loan Bank obligations or securities sold by the Treasury Department be used to reduce the deficit

Title XIV – Mortgage and Reform and Anti-Predatory Lending Act

- Enacts various consumer protections for residential mortgages
- Strengthens underwriting by prohibiting creditors from extending residential mortgages to borrowers who cannot demonstrate ability to repay the loan
- Bans various residential mortgage lending practices (i.e. balloon payments and prepayment fees)

Summary of the Dodd-Frank Act

Title XV – Miscellaneous Provisions

- Includes provisions limiting use of US support for IMF loans that are unlikely to be repaid
- Improves transparency of payments regarding commercial development of oil, gas and minerals, among other

Title XVI - Section 1256 Contracts

- Ensures that certain swaps that will be required to be exchange-traded will not be treated as Section 1256 contracts under the Internal Revenue Code

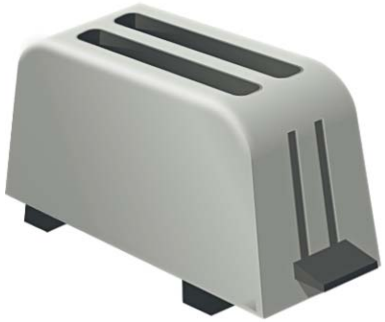
Bureau of Consumer Financial Protection

Title X – Bureau of Consumer Financial Protection

- Establishes the “Bureau of Consumer Financial Protection”
  - Provides for the structure, administration and funding of the Bureau
  - Establishes the Bureau’s rule-making, supervisory and enforcement powers
- Requires the Board of Governors of the Federal Reserve to issue interchange legislation – the “Durbin Amendment”
- Studies and reports, including on reverse mortgages, private educational loans and lenders and credit scores

Origins and Structure

How to Make a Federal Agency from a Toaster



Impetus from a 2007 article by Elizabeth Warren in *Democracy:*

- *"It is impossible to buy a toaster that has a one-in-five chance of bursting into flames and burning down your house. But it is possible to refinance an existing home with a mortgage that has the same one-in-five chance of putting the family out on the street."*

Origins and Structure

Theory Behind the Bureau

- The creation of a single agency whose sole mission is to protect consumers from misleading and dangerous financial products
  - Increase transparency and understandability of consumer financial products
    - Allow consumers to compare and analyze financial products
  - Provide financial education to consumers
  - Consumer protection through rule-making, supervision and enforcement
    - “A cop on the beat”

Origins and Structure

Evolution of the Bureau

- Administration proposal - June 2009
- House Bill - December 2009
- Senate Bill - May 2010
- Finalization of House-Senate conference – June 2010
- Approval by the House – June 2010
- Approval by the Senate and signature by President Obama – July 2010

Origins and Structure

Structure of the Bureau

- Headed by Director – appointed by President, by and with the advice and consent of Senate
- Associate Directors
  - Chief Operating Officer
  - Consumer Engagement & Education
  - Research, Markets & Regulation
  - Supervision, Fair Lending & Enforcement
  - External Affairs
- General Counsel

Origins and Structure

Relationship with the Board of Governors

- Board of Governor's delegation authority
- Bureau's autonomy from the Board of Governors
  - No intervention in any matter or proceeding, including examinations and enforcement actions
  - No ability to appoint, direct or remove an officer or employee
  - No merger or consolidation ability
- No approval or review authority by the Board of Governors

Origins and Structure

Funding

- Bureau is funded out of the combined earnings of the Federal Reserve System
- Funding Cap
  - 10% of total operating expenses of the Federal Reserve System for 2011, 11% for 2012 and 12% for 2013 and each year thereafter
- No review by Committees on Appropriations of the House and the Senate
- Additional funds available – up to $200,000,000 for each of fiscal years 2010, 2011, 2012, 2013 and 2014

Jurisdiction and Authority

Authority to Regulate

- Covered Person – "(A) any person that engages in offering or providing a consumer financial product or service; and (B) any affiliate of a person described in subparagraph (A) if such affiliates acts as a service provider to such person"
- Consumer Financial Product or Service – a consumer financial product or service that "is offered or provided for use by consumers primarily for personal, family, or household purposes"
- Financial Product or Service – includes:
  - Stored value or payment instruments
  - Check cashing or collection
  - Deposit-taking activities

Jurisdiction and Authority

Authority to Regulate

- Rule-Making Standard – consider costs and benefits to covered persons and consumers
- Rules against unfair, deceptive or <u>abusive</u> acts or practices
  - Substantial injury to consumers versus benefits to consumers and competition
  - Rules regarding disclosures to consumers

Jurisdiction and Authority

Authority to Regulate

- Review of Bureau regulations by the Council
  - Requires the vote of 2/3 of the members of the Council
  - Standard – a regulation or provision may be set aside if the Council determines "that the regulation or provision would put the safety and soundness of the United States banking system or the stability of the financial system of the United States at risk"
- Upon such a determination of the Council, the applicable regulation that was issued by the Bureau will be unenforceable

Jurisdiction and Authority

Supervisory Authority

- Very Large Banks, Savings Associations and Credit Unions – insured depository institutions and insured credit unions with total assets of more than $10 billion
  - Bureau has “exclusive authority to require reports and conduct examinations on a periodic basis”
    - Compliance with Federal consumer financial laws
    - Information gathering
    - Risk assessment
- Coordination of regulation with prudential and State bank regulators

Jurisdiction and Authority

Supervisory Authority of Bureau

- Other Banks, Savings Associations and Credit Unions – insured depository institutions and insured credit unions with total assets of $10 billion or less
  - Possible reporting requirements
- Nondepository Covered Persons
  - Reporting and examination requirements based on risk assessment
  - Coordination with prudential and State regulators

Jurisdiction and Authority

Enforcement Authority

- Investigation powers
- Subpoena powers
- Demand powers
  - Including the production of documents and tangible items, written reports and oral testimony
- Power to conduct hearings and adjudicative proceedings
  - Decisions issued 90 days after submission to the Bureau for final decision
  - Parties may appeal a decision by the Bureau in the Court of Appeals

Jurisdiction and Authority

Preemption of State Law and State Enforcement

- State statutes or regulations that are not <u>inconsistent</u> with the provisions of Title X of the Dodd-Frank Act will not be affected
- Inconsistent – State statutes and regulations that afford consumers greater protections shall not be inconsistent
  - Determination made by the Consumer Protection Bureau
- State enforcement – In general a State AG may bring a civil action in a State of Federal court in their State
  - Certain limitations with respect to national banks and Federal savings associations

Some Proposed Regulations

The Durbin Amendment (Interchange Regulation)

- Implementation by the Board of Governors of the Federal Reserve
- Interchange fees must be reasonable and proportional
  - Board of Governors instructed to distinguish between incremental costs incurred with respect to authorization, clearing and settlement and other costs
- Exempt institutions
  - Institutions with less than $10 billion in assets (including assets of affiliates)
  - Government-administered programs
  - Certain reloadable prepaid card programs
- Rules to be in place and effective by July 21, 2011

Some Proposed Regulations

Mortgage Underwriting Proposal

- Proposed rule published by the Board of Governors
  - Comments must be received by July 22, 2011
  - Rule-making authority to transfer to the Bureau on July 21, 2011
- Expansion of scope of ability-to-repay requirement
  - Coverage for consumer credit transactions secured by a dwelling (with certain exceptions)
- Establishment of ability-to-repay standards, limits on prepayment penalties and retaining of records requirement

Looking Ahead

Appetite for Tweaking the Dodd-Frank Act

- Possible deferral of interchange regulation?
- Political pressure
  - Bills by Republicans on the House Financial Services Committee
  - House Financial Services Committee Chairman Spencer Bachus – “what is actually radical is the current leadership structure of the CFPB. It is unlike any other found in the Federal bureaucracy.”

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Looking Ahead

Leadership of the Bureau

- Elizabeth Warren – Assistant to the President and Special Advisor to the Secretary of the Treasury for the Consumer Financial Protection Bureau
- Senior Hires
  - Leonard Chanin – chosen to head rule-making team (from Fed)
  - Leonard J. Kennedy – General Counsel
  - Gail Hillebrand – Associate Director of Consumer Education and Engagement
  - Rajeev V. Date – Associate Director of Research, Markets and Regulations
  - Sendhil Mullainathan - Assistant Director for Research
  - Patrice Ficklin - Assistant Director for Fair Lending

Questions?

Further Reading

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