

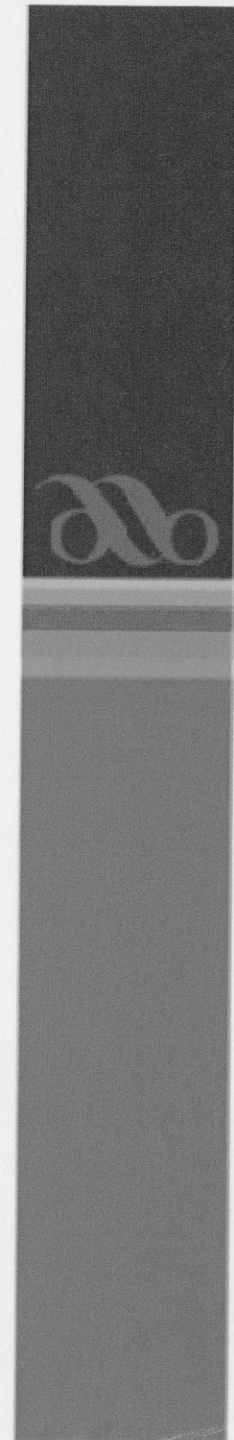


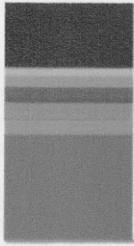
American
Bankers
Association

Dodd-Frank Act Capital Markets Reform

IBFed Financial Markets Working Group
September 2011

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Topics:

- Financial Stability Oversight Council
- Swaps Regulation
- Volcker Rule
- Securitization Reform



Financial Stability Oversight Counsel

Purpose of the Financial Stability Oversight Counsel (FSOC):

1. Identify risks to U.S. financial stability
 - Horizontal supervision of large, interconnected bank holding companies, nonbank financial companies, and financial market utilities
 - Information sharing and data collection
2. Promote market discipline by eliminating “moral hazard”
 - Remove expectation of U.S. government bailout
 - Shareholders, creditors, and counterparties no longer insulated from losses in the event of failure
3. Respond to emerging threats to U.S. financial stability



FSOC: Voting Members

10 voting members:

- Secretary of the Treasury – FSOC Chairperson
- Chairman of the Board of Governors of the Federal Reserve
- Comptroller of the Currency
- Director of the Bureau of Consumer Financial Protection
- Chairman of the Securities and Exchange Commission (SEC)
- Chairperson of the Federal Deposit Insurance Corporation
- Chairperson of the Commodity Futures Trading Commission (CFTC)
- Director of the Federal Housing Finance Agency
- Chairman of the National Credit Union Administration Board; and
- Independent member with insurance expertise (nominated by President and confirmed by Senate for a six-year term)



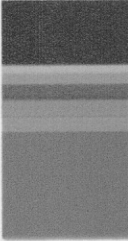
FSOC: Nonvoting Members

Nonvoting members:

- Director of the Office of Financial Research
- Director of the Federal Insurance Office
- State Insurance Commissioner designated by the state insurance commissioners
- State banking supervisor designated by the state banking supervisors; and
- State Securities Commissioner designated by the state securities commissioners


FSOC composition reflects distribution of regulatory supervision between federal and state governments

– Banking, securities, and insurance



FSOC Progress and Other Regulator Restructuring

- FSOC has met six times and issued its first required annual report to Congress
 - Financial market utilities (FMUs): established criteria for designating as systemically important
 - Systemically important nonbank financial companies: proposed rule on designations
 - Systemically important financial institutions (SIFIs): establishing more stringent regulatory guidelines
- Consumer Financial Protection Bureau established
 - Awaiting confirmation of Director
- Office of Financial Research established
- Federal Insurance Office established
- Office of Thrift Supervision to be abolished in October



Swaps Regulation: New Regulatory Framework

- The Dodd-Frank Act (Dodd-Frank) mandates:
 - Central clearing
 - Exchange trading
 - Transaction reporting
 - Registration and regulation of swap dealers and major swap participants
 - Capital and margin for uncleared swaps
- Purpose:
 - Reduce counterparty risk
 - Increase market transparency



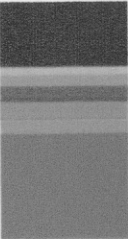
Swaps Regulation: New Regulatory Framework (cont.)

Swaps markets were largely unregulated

- Transactions generally done over-the-counter (OTC) rather on an exchange
- In the future, cleared swaps will have to be exchange traded

How central clearing works:

- (1) Rather than one contract between two parties, the transaction is split into two contracts with a clearinghouse in between the parties; and
- (2) Clearinghouses manage default risk primarily by requiring members to post cash or U.S. Treasury securities as collateral, including initial and daily mark-to-market margin.



Swaps Regulation: Clearing Mandate

Clearing will be mandatory if:

1. Applicable regulator determines it must be cleared; and
2. Clearing organization accepts swap for clearing.

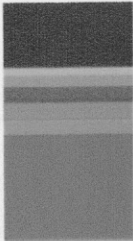
End-User exception to clearing mandate:

- If one swap counterparty is:
 1. Not a financial entity; and
 2. Is using swaps to hedge or mitigate commercial risk
 3. Notifies regulator how meets financial obligations for uncleared swaps
- CFTC and SEC also required to consider an end-user exception for small banks



Swaps Regulation: Product Definitions

- Swaps and security-based swaps (together “swaps”):
 - Exchange of payments tied to the value of interest rates, foreign exchange, commodities, securities, or other instruments
- Regulatory jurisdiction:
 - CFTC has jurisdiction over swaps, including interest rate and foreign exchange (fx) swaps
 - Interest rate swaps are by far the largest segment of the market
 - FX swaps are a distant second
 - SEC has jurisdiction over security-based swaps



Swaps Regulation: Treasury's FX Determination

- The Treasury Department has authority to exempt FX swaps from most Dodd-Frank regulations
- Treasury has issued a proposed determination for public comment
 - Appears likely that Treasury will exercise its exemptive authority
 - If adopted as proposed, it would provide the broadest exemption possible under Dodd-Frank
 - Does not include FX options, currency swaps, and non-deliverable forwards



Swaps Regulation: Market Participants

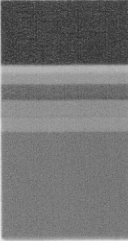
- Swap Dealer:
 - Holds itself out as a dealer
 - Makes a market in swaps
 - Regularly enters into swaps with counterparties as an ordinary course of business for its own account
- Swap Dealer Exemptions:
 - Insured depository institutions that enter into swaps in connection with originating loans
 - *De minimis* swap dealing activities
- Major Swap Participant (MSP):
 - Maintains substantial swaps position, except hedging or risk mitigating
 - Whose outstanding swaps create substantial counterparty exposure



Swaps Regulation: Market Participant Regulation

Swap dealers and MSPs will have to comply with new requirements for:

- Registration
- Business conduct, including stringent requirements for transactions involving pension funds and other special entities:
 - If advisor, then duty to act in the best interest of the special entity;
 - If counterparty, then may have duty to have reasonable basis to believe special entity has qualified independent representative
- Recordkeeping and reporting
- Capital and margin for uncleared swaps



Swaps Regulation: Margin for Uncleared Swaps

CFTC, SEC, and banking regulators are required to establish minimum initial and variation margin requirements for swap dealers and MSPs

- Purpose: Offset the greater risk of uncleared swaps to the market participant and the U.S. financial system
- CFTC proposal would: (i) exempt commercial end-users from posting margin; and (ii) not exempt banks
- Banking regulator proposal would: (i) require commercial end users to post margin over a threshold set by the swap dealer; and (ii) not exempt banks
- SEC has not yet issued proposed rule



Swaps Regulation: Rulemaking

CFTC and SEC have rapidly proposed dozens of rules

- Had a one year statutory deadline to finalize these groundbreaking rules
- Extending timeline to ensure appropriate opportunity for public notice and comment
- Roundtable discussions, thousands of comment letters, and hundreds of meetings
- “Substantially complete mosaic” of proposals
 - Continuing to accept comments as public analyzes the framework
 - SEC has still not issued its proposal on margin and capital for uncleared swaps



Swaps Regulation: Effective Dates

- Generally effective:
 - No earlier than 60 days after final rulemaking; or
 - July 16, 2011 if no rulemaking required
- CFTC and SEC issued temporary exemptive orders before July 16 for “self-effective” provisions
 - Primary industry concern was potential private litigation
 - Some concern over regulatory supervision/enforcement
 - Highlighted the tight statutory deadlines



Swaps Regulation: Pushout Rule

- No swap dealers or major swap participants can receive federal assistance
 - Includes FDIC insurance, the Federal Reserve discount window, or guarantees
- Exceptions for insured depository institutions that are only:
 - Hedging or mitigating risk
 - Engaging in swaps involving rates or other investments permissible by national banks (including FX and cleared credit default swaps)
- Conformance period
 - Two years after enactment of Dodd-Frank
 - Two year compliance phase-in
 - Possible one year extension



Swaps Regulation: Impact

- Current uncertainty about impact on swaps business
 - Thousands of pages of rule proposals to analyze
 - Many banks have been assuming the rules will only apply to largest and most active dealers
 - Potentially subject to supervision by new regulator
 - May need to reorganize corporate structure
- Concerns about implementation phasing/sequencing
 - Regulators are seeking input
 - Likely that swap data reporting will be implemented early
- Potential international implications for global firms



Volcker Rule

Prohibits banks that benefit from federal assistance from:

1. Engaging in proprietary trading; and
2. Investing in or sponsoring hedge and private equity funds

Prudential “backstop” if other activity would result in:

- Material conflict of interest;
- Material exposure to high-risk assets or high-risk trading strategies;
- Threat to safety and soundness of banking entity; or
- Threat to financial stability of the United States.



Volcker Rule:

Permitted Proprietary Trading Activities

Exceptions from the proprietary trading prohibition for core banking activities:

- Market making
- Risk-mitigating hedging
- Underwriting
- Transactions on behalf of customers
- Transactions in government securities
- Certain insurance activities
- Investments in small business investment companies
- Certain offshore activities
- Other activities regulators determine would promote safety and soundness of banks and U.S. financial stability



Volcker Rule: Proprietary Trading

- Proprietary trading generally:
 - Bank seeking to profit from near-term price movements
- Some “bright line” characteristics:
 - Sole purpose of generating profits from trading strategies
 - No formal market making responsibilities or customer exposure
 - Physical and/or operation separation from market making and other customer operations
 - Compensation structures similar to hedge fund and other private fund managers

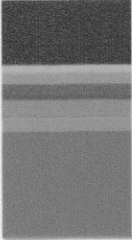


Volcker Rule:

Challenges Defining Proprietary Trading

Many challenges distinguishing proprietary trading from permissible activities:

- Inventory: can be used for market making, underwriting, or proprietary trading
- Measurement of risk, “near term” account, and “short-term” price movement varies widely by asset class
- Accumulating inventory or interdealer trading in anticipation of customer demand
- Inconsistent or incomplete hedging
- Source of profit and revenues can be difficult to determine
- Combined effects of permitted activities



Volcker Rule: Quantitative Metrics

FSOC recommends that regulators consider using quantitative metrics, including:

1. Revenue-based metrics – historical revenue comparison or profitability of position on day one relative to all positions or to total trading activity
2. Revenue-to-risk metrics – percentage of profitable trading days, revenue per unit of risk or value-at-risk, or standard value at risk measurements
3. Inventory metrics – turnover and aging
4. Customer-flow metrics – ratio of customer-initiated trades to number of trades, inventory, or revenues



Volcker Rule:

Hedge Funds and Private Equity Funds

- Banks prohibited from owning or sponsoring hedge funds and private equity funds
- Funds defined as structured under common exclusions from Investment Company Act of 1940
 - Section 3(c)(1) – beneficially owned by no more than 100 persons
 - Section 3(c)(7) – owned exclusively by qualified purchasers
 - Regulators may designate similar funds, such as commodity pools
- May inadvertently capture subsidiaries, joint ventures, pension funds, and securitization vehicles
- Debate about excluding venture capital funds



Volcker Rule: Funds Exception

Banks may organize and offer or invest in funds to facilitate advisory services for customers if the bank:

- Provides bona fide trust, fiduciary, and investment advisory services to the customers
- Retains only a *de minimis* ownership interest limited to:
 - 3% of any single fund; and
 - 3% of bank's Tier 1 capital
- Meets other conditions, such as not providing a guarantee or sharing the same name

Note: “Customer” is not defined in the statute



Volcker Rule: Compliance Regime

- Policies and procedures – describe strategies and permissible/impermissible activities
- Supervision to monitor trading activity and investigate potential violations
- Recordkeeping and reporting
- Independent testing by internal and/or external auditors
- Engagement of Board of Directors and CEO public attestation of compliance



Volcker Rule: Implementation Timeline

- FSOC completed the required implementation study within 6 months of enactment
 - Received more than 8,000 comments
- Agencies required to adopt rules within 9 months of study
 - Consult and coordinate so rules are as comparable and consistent as possible
 - Rule not yet proposed and will not be final until at least Q4 2011
- Conformance period
 - Takes effect in July 2012 regardless of whether rule issued
 - Two year compliance phase-in
 - Possible one year extensions for a maximum of three years



Volcker Rule: Impact

- Some banks have already shut down:
 - Dedicated proprietary trading operations
 - Hedge fund and private equity fund businesses
- Competitive disadvantage for U.S. banks
 - Unlikely other regulators will adopt similar restrictions
- Significant uncertainty about implementation because restrictions relate to strategy and objectives



Securitization Reform: Asset-Backed Securities

Definition of Asset-Backed Security (ABS):

- Fixed-income or other security;
- Collateralized by any self-liquidating financial asset, including a loan, lease, mortgage, or secured or unsecured receivable; and
- Holder receives payments that depend primarily on cash flow from the asset.

Includes collateralized:

- Mortgage obligations
- Debt obligations (CDOs)
- Bond obligations
- CDOs of ABSs
- Other securities as determined by the SEC



Securitization Reform: Participants

Securitizer

- Issuer of an ABS; or
- Person who organizes or initiates an ABS transaction
 - Selling or transferring assets to the issuer
 - Either directly or indirectly through an affiliate

Originator

- Creates a financial asset that collateralizes an ABS; or
 - Through extension of credit or otherwise
- Sells an asset to a securitizer



Securitization Reform: Overview

- Investor protection: emphasize collateral quality
- Areas of reform:
 1. Risk Retention: securitizers and originators must retain 5% credit risk
 - “Skin in the game”
 - Incentive to maintain high quality underwriting and risk management practices
 2. Conflict of Interest: prohibit material conflict of interest with investor
 3. Disclosure: require additional disclosure to enable investors to independently assess credit quality



Securitization Reform: Risk Retention

Risk Retention Requirement

- Economic interest at default level of no less than 5%
- Prohibition against hedging and risk transfer
- Risk allocated between securitizers and originators
 - Distribution will not increase level of risk retention
 - Risk requirement for securitizer reduced by amount allocated to originator



Securitization Reform: QRM Exemption

Qualified Residential Mortgages (QRM) with reduced risk of default based on:

- Documentation and verification financial resources;
 - Income relative to housing and other monthly payment obligations;
 - Mitigation for payment shock of adjustable rate mortgages;
 - Mortgage guarantee insurance; and
 - Limitations on balloon payments, negative amortization, prepayment penalties, interest only payments, and other features associated with increased risk of default;
- Broad discretion, but cannot be broader than definition of “qualified mortgage” under Truth in Lending Act (as amended by Consumer Financial Protection Act of 2010)



Securitization Reform: Other Total or Partial Exemptions

- Other ABS with high underwriting standards
 - Different underwriting rules establishing reduced credit risk for each asset class
 - Residential mortgages, commercial mortgages, commercial loans, auto loans, other
 - In public interest and appropriate for investor protection
- Assets issued or guaranteed by U.S. government or agency
 - Including Fannie Mae and Freddie Mac while under conservatorship or receivership of FHFA
- Securities issued by finance subsidiary and held by parent company or affiliate



Securitization Reform: Exemptions (cont.)

Notes:

1. All underlying assets must qualify for the exemption
 - If even one underlying asset is not qualified, then 5% risk retention required
2. No final rule yet – Aug. 1 deadline for comments on proposed rule



Securitization Reform: Issuer Due Diligence

ABS issuer must review underlying assets to assess the quality of the assets

- Registration statement must include “reasonable assurance” that disclosure is accurate in all material respects
- Issuer must also disclose the nature of the review
- Independent third party may conduct the review if:
 - Named as “expert” for liability purposes; or
 - Issuer adopts the findings and conclusions

Due diligence rule has been finalized



Securitization Reform: Conflicts of Interest

Conflict of Interest Prohibition:

- ABS underwriter, placement agent, initial purchaser, sponsor, or any affiliate or subsidiary cannot:
 - Engage in transaction that would result in material conflict of interest with investor
 - For one year after first closing
- Exemptions:
 - Risk-mitigating hedging activities
 - Purchases or sales to provide liquidity
 - Bona fide market making
- SEC rule not yet proposed



Securitization Reform: Disclosures

- Asset Level Information: Issuer must disclose information on assets backing each tranche or class of security
- Disclosures Accompanying Ratings: rating agencies must provide enhanced disclosure about the representations and warranties, including how they differ from similar securities
- Repurchase Requests: securitizers must disclose its history of repurchase requests and fulfillment or non-fulfillment across all ABS issuers

- Disclosure rules have been finalized



Securitization Reform: What Next?

- Will securitization markets recover as:
 - Regulatory risk diminishes as applicable rules are finalized; and
 - Economic growth stabilizes?
- Covered bonds as an alternative?
 - Full recourse to the credit of the sponsoring bank
 - Secured, on-balance sheet financing
 - But no incremental credit