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# Banking & Finance

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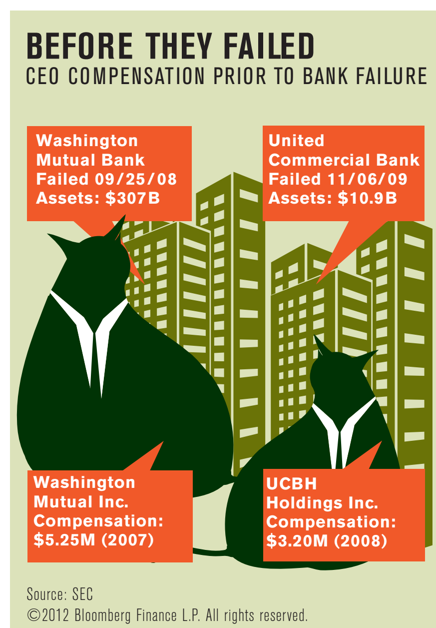

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# Dodd-Frank Act

## Banking Agencies

### In Their Own Words: Regulators Signal Significant Actions in 2012

Sonia Persaud | Bloomberg Law

#### Introduction

The financial reform legislation enacted in 2010 was only the first act. Now, more than a year after the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)[1] was signed into law by President Barack Obama, federal banking agencies are scrambling to perform their duties under this law while simultaneously working to reduce inefficiencies and disparities in the financial system. In this article, we explore four topics the federal banking agencies addressed this year and will diligently continue to pursue in 2012.

The Bureau of Consumer Financial Protection (CFPB), Federal Deposit Insurance Corporation (FDIC), Board of Governors of the Federal Reserve System (FRB), and the Office of the Comptroller of the Currency (OCC) (collectively, Agencies) have each signaled, through speeches or testimony, certain improvements they would like to make within the financial system. While there are many topics that the Agencies discussed throughout the year, we believe that in 2012 they will focus on (i) mortgage servicing, (ii) systemically important financial institutions (SIFIs), (iii) community banking, and (iv) consumer education and credit. Each of these topics contributed meaningfully to the financial crisis, and the Agencies have signaled that these are areas of major interest to them. Below, we address how these four topics contributed to the financial crisis and why regulators believe it is important that they continue reform efforts in these areas.

#### Mortgage Servicing: Improving and Simplifying a System Askew

Prior to the financial crisis, the U.S. financial industry stretched and sliced a single financial product–the humble mortgage loan–in ways that had far-reaching implications. Mortgage loans were originated by financial institutions that never intended to retain them and, instead, used the process of securitization to sell them to other financial institutions, where they were often subsequently bundled and sold to investors.[2]

As the number of mortgage loans and securitizations increased, other actors became necessary. Mortgage servicers were one such group. Without a single financial entity with a financial interest in the mortgages, mortgage servicers were used to manage the day-to-day tasks of administering mortgage loans on behalf of securitization investors. As the financial crisis spread, the outer boundaries of securitizations to generate profits were realized. Worse yet, both residential and commercial real estate began to see increasing foreclosures as property values plummeted and unemployment increased–and the U.S. financial industry has been unable to manage the process efficiently and fairly.

Misaligned incentives in the securitization, mortgage servicing, and foreclosure process created a system where no one had a stake in the main product–the mortgages.[3] The Agencies have signaled their intent to tackle the problem directly. While it will by no means happen quickly or easily, the Agencies have identified at least one way to rebuild the mortgage system. To ensure significant change occurs, in 2012 the Agencies must assist mortgage servicers through guidance while monitoring their actions.[4]

The Agencies have also recommended that pooling and servicing agreements include procedures for loan modifications and other non-foreclosure workout actions if, in the aggregate, such actions would not result in a greater loss than a foreclosure.

## Mortgage Servicers

The Agencies have had much to say about mortgage servicers in 2011. They have discussed the economics of mortgage servicing, the lack of sufficient training and staffing, and the development of national servicing standards. For 2012, the Agencies should focus on correcting the deficient servicing practices identified in their foreclosure reviews.[5]

The development of uniform national servicing standards will be a high priority for the Agencies in 2012. If done properly, these standards will address the management of both performing and non-performing loans, foreclosure avoidance strategies, and improving foreclosure processing. If the Agencies can implement these standards, servicers will be assessed through the same standards, regardless of their regulator.[6] Uniform standards for mortgage servicing would emphasize that mortgage servicing is a vital aspect of the mortgage industry and promote practices that benefit both borrowers and the broader housing market.

At a minimum, the Agencies have indicated that any such standards will require that mortgage servicers designate a single point of contact for borrowers[7] to increase transparency and reduce borrower confusion about the servicing of their mortgage. Further, to remediate some of the problems in the mortgage servicing industry, servicers will likely be required to implement more detailed policies and procedures that precisely describe the standards and processes by which internal operations are assessed. The Agencies have noted that senior executives must emphasize compliance and must discuss quality control and audit procedures.[8] Further, they have stressed that corrections must be made where needed.[9] It is this push for corporate leadership that the Agencies also will likely focus on next year to ensure that performance expectations that emphasize accountability are communicated.[10]

Beyond uniform national servicing standards for the mortgage industry and implementation of policies and procedures by mortgage servicers, the industry will also face pressure to improve the documentation that governs mortgage servicing. While the Agencies may have little input to the contracts between private entities, they have signaled that they would prefer that pooling and servicing agreements (the documents that govern mortgage servicing in a securitization) are more detailed. They have suggested that these agreements provide clear instructions regarding actions servicers can take in the course of their duties.[11] The Agencies have also recommended that pooling and servicing agreements include procedures for loan modifications and other non-foreclosure workout actions if, in the aggregate, such actions would not result in a greater loss than a foreclosure.[12]

## SIFIs: Resolution Plans

One of the causes of stress most visible to the public during the financial crisis in 2008 was the failure of Lehman Brothers. Its demise disrupted financial markets and demonstrated the inadequacies of the Bankruptcy Code for resolving complex, interconnected financial institutions.

The U.S. government reacted to the near failure of other SIFIs like AIG and Bear Stearns by providing financial assistance or hastily arranging (and financially supporting) takeovers by healthier institutions.

To avoid a recurrence of such ad hoc solutions, the Dodd-Frank Act requires financial institutions to be responsible to develop a "living will" or a plan for their "rapid and orderly resolution in the event of material financial distress or failure" (Resolution Plan).[13] These Resolution Plans will describe how SIFIs may be unwound under the Bankruptcy Code in a quick and organized manner upon their failure[14] so that important financial relationships are preserved and losses are the responsibility of shareholders and creditors.[15] In 2012 FDIC and FRB will receive the first batch of Resolution Plans from the largest financial institutions operating in the U.S. and must ensure that the plans outline credible resolution strategies as required by the Dodd-Frank Act.

Detailed Resolution Plans will promote a frank exchange of information, which was missing during the financial crisis of 2008.[16] Without a detailed Resolution Plan, there is a real danger that the complexity of some SIFIs could make their resolution costly and difficult. To that end, FDIC and FRB issued final regulations to implement new resolution planning and reporting requirements which became effective on November 30, 2011. The Dodd-Frank Act required these regulations to be finalized within 18 months.[17] However, it is important that FDIC and FRB continue to develop and refine a thoughtful and substantive process for reviewing a Resolution Plan to determine whether it is both credible and ensures an orderly resolution under the Bankruptcy Code.[18]

As regulators have noted, it is crucial to the safety and efficiency of our financial system that the management and stakeholders of SIFIs are aware that the government may allow them to fail.[19] The Resolution Plan requirements, which compel SIFI executives to devote substantial time and attention to developing a disassembly manual for their companies, reinforce this view. Regulators' critical review of each Resolution Plan received in 2012, and subsequently, will be a constant reminder to SIFIs and the market that no one is too big to fail.

It is crucial to the safety and efficiency of our financial system that the management and stakeholders of SIFIs are aware that the government may allow them to fail.

## Community Banking: Developing Main Street's Greatest Asset

Officials from each Agency have, throughout the past year, highlighted the importance of community banks to the U.S. financial system.[20] These officials have noted that community banks are uniquely positioned. Although they provide fundamental services to large numbers of Americans, they often bear regulatory burdens that are disproportionate to their size. Regulators also frequently observed that the 2008 financial crisis was caused largely by large banks and non-bank financial institutions rather than community banks. The Agencies noted that macroeconomic problems were less likely to arise when community banks are the source of credit because they are keenly aware of the credit needs of their communities and generally act accordingly.[21]

In 2012 the Agencies will likely rise to the challenge of supporting Main Street's greatest asset–the community bank. There are unique challenges faced by community banks, including decreased profits from weaknesses in the commercial real estate market and the scrutiny of overdraft protection programs' income.[22] While the new regulations and changes brought about by the Dodd-Frank Act may affect them disproportionately, community banks are expected to do what they do best: serve the community, act prudentially, and manage costs.[23]

The Agencies recognize that regulation can often be a burden to community banks. Many policies and proposals focus on safety and soundness and regulatory burdens of community banks.[24] Regulators have signaled that it will be important for them to ensure that regulatory changes reflect differences between community banks and large banks, thereby allowing community banks to become more competitive.[25] The Agencies have recognized that an important regulatory goal should be to ensure that community banks are well-run institutions and regulations and examinations serve to improve their internal systems.[26] At least one agency has recognized that it was the government's failure to set rules and scrutinize large banks and non-bank financial institutions that hurt community banks' competitiveness because they were subject to more regulation than the larger institutions.[27] To fulfill their regulatory objectives, the Agencies must focus on working with the community banks to ensure their range of services and options remain competitive and are not overly burdened.[28]

## Consumer Education and Credit: Increasing Financial Awareness and Access to Mainstream Credit

Consumers have discrete financial needs. They need access to safe and affordable savings, depository, bill payment, and check cashing services. They need access to credit. They need access to long-term savings. They need access to non-cash payment services.

In 2011 the Agencies signaled that they understand consumers' frustrations with limited access to financial services and products and discussed increasing financial education of consumers.[29] In 2012 the Agencies will push financial institutions to develop products and services that will foster economic inclusion of all consumers and encourage consumers to educate themselves.

Although the Agencies have recognized that products and services that serve core financial needs currently are not available to all Americans, there are few efforts to increase their availability. Unfortunately low- and moderate-income consumers may not meet banks' mandatory minimums for access to these financial tools or may not be able to afford the fees associated with them. The Agencies have signaled that they intend to encourage alternate programs that will allow underbanked consumers access to these financial tools. FDIC has made efforts in this area through programs over the past few years that tested offering small-dollar products to consumers.[30] Financial tools that include access to mobile banking and prepaid cards with alternate payment structures may help consumers to access mainstream credit.[31]

Consumers also need a working knowledge of basic financial terms and concepts. A better understanding of our financial system and the ways it can benefit the consumer may foster better economic decisions for individuals in the long run. In addition, there is a correlation between an individual's financial decisions and the financial stability of our economy.[32] The Agencies recognize that certain vulnerable consumers do not necessarily rely on mainstream financial services, and, consequently, are more apt to use alternative financial products.[33]

The Advisory Committee on Economic Inclusion, created by FDIC, has provided recommendations for expanding access to mainstream banking services to underserved consumers.[34] Other agencies can explore using this model to implement similar committees to support their financial institutions' increased products and services for consumers. Further, CFPB was directed by the Dodd-Frank Act to support increased consumer education and access to credit.[35] CFPB is also tasked with, among other things, preventing unlawful discrimination, promoting a fairer marketplace, and promoting credit availability.[36] With such a mandate, the Agencies should collaborate to prioritize increasing consumer financial products and services and consumer education to ensure that all consumers have the right financial information at the right time to make the best possible financial choices.[37]

## Conclusion

If the Agencies are creating New Year's resolutions, the issues identified in this article must surely be an integral part of their plan for 2012. With a little persistence and a measure of endurance they can achieve their goals–minimizing inefficiencies and disparities in the financial system while addressing the specific flaws that contributed to the financial crisis.

[1] Pub. L. 111-203 (2010).

[2] Sheila Bair, Speech, Summit on Residential Mortgage Servicing for the 21st Century (January 19, 2011).

[3] Sheila Bair, Speech, Summit on Residential Mortgage Servicing for the 21st Century (January 19, 2011).

[4] Sheila Bair, Speech, Summit on Residential Mortgage Servicing for the 21st Century (January 19, 2011).

[5] Board of Governors of the Federal Reserve System (FRB), Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), Interagency Review of Foreclosure Policies and Practices (April 2011).

[6] Janet Yellen, Speech, Housing Market Developments and Effects on Low- and Moderate-Income Neighborhoods (June 9, 2011).

[7] John Walsh, Speech, Remarks Before the American Banker Regulatory Symposium (Sept. 19, 2011).

[8] Sarah Bloom Raskin, Speech, Putting the Low Road Behind Us (Feb. 11, 2011).

[9] Raj Date, Testimony, Before the Subcommittee on Financial Institutions and Consumer Credit and the Subcommittee on Oversight and Investigations (July 7, 2011).

[10] John Walsh, Speech, Remarks Before the Women in Housing and Finance (April 14, 2011).

[11] John Walsh, Speech, Remarks Before the American Banker Regulatory Symposium (Sept. 19, 2011) and Raj Date, Testimony, Before the Subcommittee on Financial Institutions and Consumer Credit and the Subcommittee on Oversight and Investigations (July 7, 2011).

[12] John Walsh, Speech, Remarks Before the American Banker Regulatory Symposium (Sept. 19, 2011) and Raj Date, Testimony, Before the Subcommittee on Financial Institutions and Consumer Credit and the Subcommittee on Oversight and Investigations (July 7, 2011).

[13] Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. 111-203 § 165(d) (2010).

[14] Sheila Bair, Speech, Financial Reform: The Road Ahead (April 15, 2011).

[15] Sheila Bair, Speech, Financial Reform: The Road Ahead (April 15, 2011).

[16] Sheila Bair, Speech, FDIC Oversight: Examining and Evaluating the Role of Regulator During the Financial Crisis and Today (May 26, 2011).

[17] Dodd-Frank Act, Pub. L. 111-203 § 165(d) (2010). Daniel K. Tarullo, Speech, Regulating Systemically Important Financial Firms (June 3, 2011) and Michael H. Krimminger, Testimony, Does Dodd-Frank End Too Big to Fail? (June 14, 2011).

[18] Michael H. Krimminger, Testimony, Does Dodd-Frank End Too Big to Fail? (June 14, 2011).

[19] John Walsh, Speech, Remarks Before the American Bankers Association Government Relations Summit (March 15, 2011).

[20] Sheila Bair, Speech, Financial Reform: The Road Ahead (April 15, 2011), Ben S. Bernanke, Speech, Community Banking in a Period of Recovery and Change (March 23, 2011), John Walsh, Speech, Remarks Before the Annual Convention of the Independent Community Bankers of America (March 23,2011), and Elizabeth Warren, Speech, Remarks to the Independent Community Bankers of America (March 22, 2011).

[21] John Walsh, Speech, Remarks Before the Annual Convention of the Independent Community Bankers of America (March 23, 2011), Ben S. Bernanke, Speech, Community Banking in a Period of Recovery and Change (March 23, 2011), and Sheila Bair, Speech, Financial Reform: The Road Ahead (April 15, 2011).

[22] John Walsh, Speech, Remarks Before the Annual Convention of the Independent Community Bankers of America (March 23, 2011).

[23] John Walsh, Speech, Remarks Before the Annual Convention of the Independent Community Bankers of America (March 23, 2011).

[24] Ben S. Bernanke, Speech, Community Banking in a Period of Recovery and Change (March 23, 2011).

[25] Sheila Bair, Speech, Financial Reform: The Road Ahead (April 15, 2011).

[26] Sarah Bloom Raskin, Speech, Community Bankers and Supervisors: Seeking Balance (April 7, 2011).

[27] Elizabeth Warren, Speech, Remarks to the Independent Community Bankers of America (March 22, 2011).

[28] Elizabeth Warren, Speech, Remarks to the Independent Community Bankers of America (March 22, 2011).

[29] Elizabeth Duke, Speech, Research, Policy, and the Future of Financial Education (May 24, 2011) and Sarah Bloom Raskin, Speech, Economic and Financial Inclusion in 2011: What it Means for Americans and Our Economic Recovery (June 29, 2011).

[30] Robert W. Mooney, Testimony, An Examination of Availability of Credit for Consumers, Before the Subcommittee on Financial Institutions and Consumer Credit (Sept.22, 2011).

[31] Elizabeth Duke, Speech, Research, Policy, and the Future of Financial Education (May 24, 2011) and Sarah Bloom Raskin, Speech, Economic and Financial Inclusion in 2011: What it Means for Americans and Our Economic Recovery (June 29, 2011).

[32] Elizabeth Duke, Speech, Research, Policy, and the Future of Financial Education (May 24, 2011).

[33] Elizabeth Duke, Speech, Research, Policy, and the Future of Financial Education (May 24, 2011).

[34] Sheila Bair, Testimony, State of the FDIC: Deposit Insurance, Consumer Protection, and Financial Stability, Before the Committee on Banking, Housing and Urban Affairs (June 30, 2011).

[35] Dodd-Frank Act, Pub. L. 111-203 § 1013(d) (2010).

[36] Dan Sokolov, Testimony, Before the Subcommittee on Investigations, Oversight, and Regulations (July 28, 2011).

37 Elizabeth Duke, Speech, Research, Policy, and the Future of Financial Education (May 24, 2011).

## Consumer Financial Protection Bureau

# What Will Be the Most Significant Development for Consumer Financial Protection Next Year?

Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, Title X (2010)

Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) established a new executive agency within the Federal Reserve System, the Bureau of Consumer Financial Protection (CFPB). It officially began operations July 21, 2011, although the director nominated by President Obama, former Ohio Attorney General Richard Cordray, has yet to be confirmed by the U.S. Senate. The Dodd-Frank Act limits CFPB's ability to implement of a number of initiatives within the scope of its authority until a director is confirmed.

Bloomberg Law Reports®–Banking & Finance asked leading practitioners to discuss the development they believe will be the most significant for consumer financial protection in 2012.

### Suzanne F. Garwood, Venable LLP

One hopes that the most significant development for consumer financial protection next year will be the approval of a Director for the CFPB; however, that outcome, as of the date of this writing, remains unlikely. As those in the consumer credit industry are aware, the confirmation of a Director will finally transfer to the CFPB all of its supervisory powers, which powers were intended to be meted out in three phases. The first phase occurred on July 21, 2010, the date that the Dodd-Frank Act was signed into law. On that date, CFPB received authority to engage in administrative activities, such as finding office space and setting up phone lines. The second phase occurred on July 21, 2011, which transferred to CFPB authority over the "alphabet soup" of regulations that were previously administered by other agencies, such as the Board of Governors of the Federal Reserve System (FRB). The third phase will occur when a Director is approved by the Senate, and will bestow on CFPB its ability to supervise non-depository entities (*i.e.*, payday lenders, installment lenders and others) and depositories with assets of $10 billion and under. Political rancor over the nominee and the very existence and structure of CFPB suggest that a Director may not become a reality, even next year. Treasury Secretary Geithner pleaded with Congress to overlook politics and confirm a director, "Americans deserve the full protections signed into law under Wall Street reform. The longer the Senate fails to confirm Richard Cordray to lead the Consumer Financial Protection Bureau, the longer they will be denied that protection."

A more certain event to occur next year that will significantly affect the consumer credit markets is the adoption of the "Qualified Mortgage" and "Qualified Residential Mortgage" regulations. These shorthand references refer to two separate, but interrelated rulemakings. "Qualified Mortgage" refers to the rulemaking that began with the FRB in April 2011. The rulemaking set about to require lenders to determine a borrower's ability to repay a mortgage loan prior to origination of that loan, but would provide for certain safe harbors for loans that meet the definition of a qualified mortgage. Finalization of the rule falls within CFPB's jurisdiction. Accordingly, issuance of this final regulation likely will be CFPB's first substantive rulemaking.

> Thus, the interagency credit risk retention rulemaking cannot proceed in a meaningful way until after CFPB acts on qualified mortgages.

The "Qualified Residential Mortgage" rulemaking refers to an interagency effort to require the retention of 5 percent of the credit risk of an asset (*i.e.*, skin in the game) secured by mortgage loans. Qualified residential mortgage loans are exempt from this requirement. Under the Dodd-Frank Act, the interagency rulemaking cannot define a qualified residential mortgage loan more narrowly than the definition of a qualified mortgage loan. Said differently, a qualified residential mortgage cannot include mortgage loans that do not meet the definition of a qualified mortgage. Thus, the interagency credit risk retention rulemaking cannot proceed in a meaningful way until after CFPB acts on qualified mortgages. Industry experts expect that these definitions will shape the market for mortgage loans and will determine the availability of credit in the mortgage market, with some experts predicting that credit availability will grow tighter–especially in high cost regions and for low- to moderate-income borrowers.

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**David Katz,
Willkie Farr & Gallagher LLP**

The CFPB continues to develop and implement a consolidated regulatory, supervision, compliance, and enforcement framework for certain large banks and nonbanks. The most significant development for the CFPB in 2012 will be: if and when the CFPB will develop its supervisory authority over certain segments of the nonbank consumer financial services industry. The Dodd-Frank Act requires the CFPB to issue, by July 21, 2012, an initial rule identifying the specific market segments of the nonbank consumer financial industry that will be subject to the CFPB's authority and the underlying measurement data and dates which will be used in that regulatory process. However, the Dodd-Frank Act includes an important exception–the CFPB Director must first be approved and confirmed. The CFPB may not issue the initial rule or exercise its enforcement authority over nonbank companies until a Director is confirmed. As the Senate's nomination battle continues over Richard Cordray, the CFPB likely continues to fall further behind schedule to develop the initial rule by the due date and further, cannot exercise any enforcement authority with respect to nonbank companies. CFPB's regulations will provide federal supervisory authority over key areas of the industry for the first time, including mortgage industry lenders, participants and service providers; private education lenders; "payday" lenders; and other consumer financial products or services. Until the CFPB's Director is confirmed and its initial regulation is promulgated, the agency will be unable to fulfill a large portion of its statutory mandate.

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In my view, there are two alternative regulatory agendas by the CFPB that will be the most significant in the coming year, and will be predicated on whether or not a Director is finally appointed to the CFPB. This is because many of the expanded (as opposed to, transferred) powers provided to the CFPB depend upon the appointment of the first Director.

If a Director is not appointed, the CFPB's most significant activity will center around what promises to be a complete restructuring of the nation's residential mortgage origination process. Specifically, the CFPB will issue regulations implementing the so-called "QM" or qualified mortgage provisions of the Dodd-Frank Act–which will also directly impact the "QRM" or qualified residential mortgage provisions of the Dodd-Frank Act's so-called "skin in the game" requirements. Unless the CFPB elects to liberalize the proposed underwriting rules imbedded in these regulatory proposals, not only will the secondary market for mortgages remain dormant, but the housing market, including home prices, could continue to deteriorate because of the inability of a large segment of home loan applicants to obtain credit.

In addition to the QM and QRM rulemakings, the CFPB inherited from FRB a wholesale revision to the substantive and procedural mortgage origination requirements. These will be found in Regulation Z, and will require that mortgage lenders purchase or develop completely new loan origination systems.

Finally, and at long last, the CFPB will homogenize the disclosure requirements of the Real Estate Settlement Procedures Act and the Truth-in-Lending Act, which has been requested by both consumer and industry groups for several decades. Both of these regulatory changes are expected to be adopted in 2012.

If a Director is actually appointed, the importance of the mortgage lending changes will be overshadowed by the implementation of several of the CFPB's new regulatory powers. In that regard, two new authorities are particularly noteworthy. The first is the CFPB's authority to examine large non-depository consumer financial companies heretofore not subject to direct federal examination and supervision. A rulemaking will identify how those entities will be determined, following which, the CFPB will begin on-site and off-site examinations. Because Richard Cordray was a former attorney general, the CFPB could play the role of an aggressive enforcer of the federal consumer protection laws.

Perhaps most significantly, however, the CFPB's authority to identify "unfair, deceptive and abusive" practices in the consumer financial services arena will become effective, including the authority to prosecute companies for violations. As a practical matter, the "UDAAP" authority might be employed in a backward-looking manner, making loans and lending processes that have been legal to-date subject to potential investigation and enforcement because of alleged unfairness or overreaching by the lender.

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**Daniel S. Meade,**
**Hogan Lovells LP**

The most significant development would be if the Senate would move on the nomination of a Director or some other resolution to getting the CFPB its full menu of powers so that it could begin looking at nonbank financial providers.

Presuming that does not happen and we continue in the current stalemate, I believe the most significant development will be the interaction between state Attorneys General (AGs) and the CFPB. Section 1042 of the Dodd-Frank Act specifically allows state AGs to bring civil actions based on the federal consumer protection statutes. It also allows the CFPB to intervene if a state AG brings action against a national bank or federal thrift. It will be a very interesting dynamic to see if the CFPB and state AGs are working together or if they engage in a game of one-upmanship to prove who is the "tougher cop on the beat."

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## Credit Risk Retention

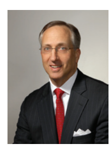
# What Is the Top Credit Risk Retention Issue That Regulators Must Address in 2012?

Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 941 (2010) (codified at 15 U.S.C. § 78o-11)

Board of Governors of the Federal Reserve System, Department of Housing and Urban Development, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Office of the Comptroller of the Currency, Securities and Exchange Commission, *Credit Risk Retention*, 76 Fed. Reg. 24090 (April 29, 2011)

Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) generally requires securitizers to retain five percent of the credit risk of securitized assets. In April, six federal agencies (Agencies) released a proposed rule to implement the so-called skin in the game requirement. To date, the Agencies have not released a final rule.

Bloomberg Law Reports®–Banking & Finance asked leading practitioners to discuss the most important issue related to the skin in the game rules that the Agencies must address in 2012.



**David Katz,**
**Willkie Farr & Gallagher LLP**

The Agencies face the difficult task of developing workable regulations for credit risk retention in securitization transactions. The sheer variety of asset classes and the different structures used in securitizations present many complex issues. Perhaps the biggest issue to be resolved is whether the Agencies adequately respond to industry concerns on the so-called "premium capture" rule. This aspect of the credit risk retention proposal exceeds the five percent risk retention requirement of the Dodd-Frank Act and may have significant and adverse effects on the future availability of mortgage credit to low- and moderate-income borrowers.

Under the proposed premium capture rule, residential mortgage loan securitizers would be effectively prohibited from monetizing the excess spread (generally defined as the spread between the interest collected on the underlying pool of mortgage loans and the interest paid to investors in the securitization) at the closing of a securitization. Historically, securitizers have used excess spread in a number of ways, *e.g.*, to recoup and manage the expenses and risks involved in making mortgage loans to less creditworthy borrowers. Because securitizations of subprime mortgage loans typically contain the largest amounts of excess spread, any rule that reduces or eliminates the ability of securitizers to profitably engage in such securitizations will inevitably reduce or eliminate securitizations as a source of capital to fund the underlying mortgage loans. By removing such a large and efficient market source of capital, the costs to originate subprime mortgage loans will naturally increase, and those costs will be borne by the mortgage loan borrower. Importantly, the government sponsored enterprises (*i.e.*, Fannie Mae and Freddie Mac) were excluded from the premium capture rule, which will serve to increase their dominance of the market, will decrease the likelihood of winding them down as has been proposed, and will impair the return of a robust private mortgage market.

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**Colleen McDonald, Reed Smith LLP**

The one overwhelmingly important credit risk retention issue that regulators must address in 2012 is "What constitutes a 'qualified residential mortgage' or 'QRM', and thus is exempt from the risk retention requirements of the Dodd Frank Act?" Until the scope of a QRM is determined, the private residential mortgage backed securities market is not going to come back in any meaningful way.

Until the scope of a QRM is determined, the private residential mortgage backed securities market is not going to come back in any meaningful way.

The stated purpose in designing the QRM rules was to devise underwriting standards and product features to help ensure that such residential mortgages are of very high credit quality. While the specificity around the proposed rules was impressive, many industry participants felt that the approach taken was dangerous in attempting to define eligibility rules for qualifying mortgage loans and would likely have unintended consequences. Instead, industry participants favored more of the type of risk retention that already exists in securitizations in the form of representations and warranties addressing underwriting risks.

In a typical securitization, the party transferring the mortgage loans to a securitization (the Sponsor) takes the risk that the loans were properly underwritten (*e.g.*, that the loans were underwritten in accordance with the applicable underwriting guidelines) and will perform in accordance with certain covenants (*e.g.*, without early payment defaults), and is obligated to repurchase mortgage loans if that is not the case. Ordinarily, the Sponsor controls this risk by requiring the party originating a mortgage loan (the Originator) to repurchase the same mortgage loan for breach of its representations, warranties, or covenants contained in the purchase agreement between the Originator and the Sponsor. Neither the Sponsor nor the Originator typically is obligated to repurchase a loan just because the borrower defaults on the loan.

A number of industry participants urged the regulators to recognize the risk retention features discussed above, and to use the loan representations, warranties, and covenants in a more standardized and broad-sweeping form rather than try to legislate loan eligibility characteristics. To date, there has been no official response to these comments, although several lawmakers have put forth their own proposals for overhauling mortgage loan financing.

When considering mortgage loan reforms in relation to securitization, the 800 pound gorilla is, of course, what to do with the GSEs–Freddie Mac, Fannie Mae, and Ginnie Mae? The GSEs are exempt from the Dodd Frank Act's risk retention rules. However, the determination as to what constitutes a QRM is likely to kick-start the private residential mortgage backed securities market, thereby reducing the market's current dependency on GSE securitizations. That should lay the foundation for resolution of the role of the GSEs.

*Colleen McDonald is a partner in the San Francisco office of Reed Smith.*

**Daniel S. Meade, Hogan Lovells LP**

It is really the seminal question of whether they can get a final rule done. Although the risk retention proposed rule applies to all manner of asset-backed securities, the portion that has received most of the press has been the definition of one of the exceptions, the qualified residential mortgage or QRM. Under the statute, institutions creating securitizations made only of QRMs will not be required to retain any of the risk. Many believe the proposed QRM definition requiring 20 percent down is too strict. In fact, it is one of the few issues to bring together the real estate industry and consumer groups. The fact that the fight over the QRM definition has become so politically charged brings in to question whether the various federal Agencies charged with writing the rule can come to any consensus to issue a final rule . . . in an election year.

*Hogan Lovells partner Daniel S. Meade (Washington, D.C.) advises clients in the financial institutions sector on corporate and regulatory matters. He previously served as senior counsel to the U.S. House of Representatives, Committee on Financial Services, and drafted portions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.*

## Systemic Risk

# What Is the Top Systemic Risk Issue That Regulators Must Address in 2012?

Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 101 et seq. (2010) (codified at 12 U.S.C. § 5311 *et seq.*)

Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) established a new regime to regulate systemic risk in the U.S. Under the Dodd-Frank Act, systemically important financial institutions (SIFIs)–*i.e.*, very large bank holding companies and nonbank financial companies designated as systemically important by regulators–are subject to heightened oversight from the Board of Governors of the Federal Reserve System (FRB).

Regulators have taken preliminary steps towards implementing this new regulatory concept, but much work remains to be done. Bloomberg Law Reports®–Banking & Finance asked leading practitioners to discuss the most important issue related to systemic risk that federal regulators must address in 2012.

**John B. Beaty,**
**Venable LLP**

The top systemic risk regulation issue that regulators must address next year is a question of will: whether the Financial Stability Oversight Council (FSOC) will decide to identify activities or practices that are not subject to the jurisdiction of a primary financial regulatory agency and that create or increase risk to the stability of the U.S. financial system.

The FSOC annual report acknowledges that the financial system constantly evolves and that financial activities migrate to less-regulated corners of the financial system where they can give rise to imbalances and new vulnerabilities. The report also observes that stricter regulatory regimes create powerful incentives to arbitrage the rules. The question this should raise for FSOC is whether it should identify where this has already happened.

Studies of the 2007-09 crisis suggest more and more that some unregulated financial activities and practices were major contributors to financial instability (*e.g.*, illusory implicit guarantees of money market mutual funds; escalating collateral requirements for repurchase agreements; undisclosed credit default swap exposures; due diligence required of credit rating agencies). Section 120 of the Dodd Frank Act enables FSOC to recommend new safeguards where activities could be overseen by existing regulators and directs FSOC to make recommendations to Congress if an activity is not under the jurisdiction of a primary regulator. FSOC will be fully operational soon, so the first such recommendation could be made next year.

Section 120 of the Dodd Frank Act enables FSOC to recommend new safeguards where activities could be overseen by existing regulators and directs FSOC to make recommendations to Congress if an activity is not under the jurisdiction of a primary regulator.

Thus, the top systemic risk regulation issue next year will be whether FSOC, a council comprised of primary financial regulators, will have the will to act to address risks to financial stability posed by the shadow banking system.

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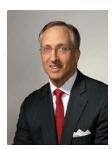

**David Katz,**
**Willkie Farr & Gallagher LLP**

Systemic risk regulation will be an area of key regulatory focus in 2012, particularly with respect to "nonbank financial companies." Although the federal agencies have promulgated a number of rules to satisfy the Dodd-Frank Act's many mandates, several key pieces of the new regulatory framework governing nonbank financial companies remain open. These missing pieces are particularly critical because they will serve as the links which will bind the framework together. With the recent adoption of the final rule regarding the preparation and submission of resolution plans, or "living wills," the initial submission of which is required in mid-2012 and 2013, there is now additional pressure to finalize both unfinished or undrafted rules and regulations needed to fully implement the living will requirements. The uncertainty surrounding the final regulations is of particular concern to certain nonbank financial companies because the new regulatory framework may subject those companies to a substantially more stringent regulatory and supervisory environment.

At least four pieces are needed to complete a basic and workable regulatory framework for certain nonbank financial companies.

First, FRB's regulation defining when a nonbank financial company is "predominantly engaged in financial activities," initially promulgated in February 2011, has been left unfinished since its initial publication. Second, FSOC has not finalized the final form of its process to determine which nonbank financial companies will be subjected to FRB supervision and prudential standards. FSOC's current proposal, released in October 2011, calls for a three-stage process to progressively narrow the universe of candidates for designation. It is unknown whether FSOC will make further modifications to the designation process's final structure, and whether or how they will address specific questions from industry observers regarding FSOC's application of quantitative metrics and qualitative analysis through the three stages. Third, FRB must still promulgate all of the enhanced supervision and prudential standards applicable to nonbank financial companies it will supervise, the form and substance of which may have significant impacts on a particular nonbank financial company's future business and operations. Fourth, with respect to the living wills final rule and FSOC's current proposed rule regarding nonbank financial company designation, many industry observers are not yet comfortable with the agencies' assurances that sensitive and nonpublic information provided by the nonbank financial company will receive sufficient protection under existing statute and regulation.

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**Joseph T. Lynyak,**
**Pillsbury Winthrop Shaw Pittman LLP**

There are two equally important systemic risk issues that regulators must address next year. The first is the degree to which the U.S. and global bank regulators can stabilize the international banking market as a result of the continuing crisis in the E.U. The second is to resolve within the U.S. market the current policy debate over whether the largest banks should be encouraged to divest assets and activities and shrink in size and complexity.

In regard to the stability of the international banking system, regulatory authorities have yet to develop and implement an oversight structure that properly addresses possible categories of risk that could cause systemic loss. By means of example, earlier versions of the Basel capital accords did not account for liquidity risk, with the result that central banks have recently intervened to ensure that interbank borrowing did not seize up due to counterparty risk among global banking entities. More recently, of course, the E.U. debt crisis exposed a similar unexpected risk created by the absence of realistic capital requirements for a bank holding sovereign debt. When evaluated in the context of the interconnectivity of global banks, it now appears that virtually any concentration is potentially worrisome from a systemic perspective–but that concern must be balanced against imposing significant capital increases at the expense of credit availability and global economic recovery.

The principal challenge for global regulators is to get ahead of the continuing series of crises and allow a sufficient amount of time to allow the global banks to increase capital in a manner that is reasonably predictive of actual risks.

In regard to the U.S. banking market, there is currently a policy debate taking place among federal financial institution regulators over whether the U.S.'s concentrated banking market (with the top ten banks holding approximately 85-90 percent of domestic banking assets) should continue or whether regulatory coercion should encourage the largest banks to shrink their balance sheets.

Stated another way, should the federal banking regulators address systemic risk by employing the Dodd-Frank Act's systemic tools to create reasonable capital buffers for the largest banks, or should those same regulatory powers be deployed in such a manner as to make size operationally untenable?

This debate has been described as whether some institutions are "too big to fail," "too big to manage," or "too big to regulate." Depending upon the stakeholder, the on-going policy debate focuses on the innumerable regulations still required to be issued to implement the Dodd-Frank Act, ranging from the manner of regulation of SIFIs by FRB, to the manner of implementing the Volcker Rule and preventing (or limiting) proprietary trading.

It is too early to determine how the policy debate will be resolved because the implementation of either approach will be based upon the same set of systemic risk authorities provided by the Dodd-Frank Act.

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**Daniel S. Meade,**
**Hogan Lovells LP**

There are two related systemic risk regulation issues that U.S. regulators must address next year–implementing Basel III in the U.S. and detailing the enhanced supervision requirements for SIFIs. As increased capital is one of the presumed enhanced requirements, any proposed rule FRB issues regarding enhanced supervision must interact with, and be consistent with, the Basel III capital rules the banking agencies must issue. There is a presumption that an enhanced supervision regime for SIFIs will be scalable rather than a one-size-fits-all approach, as what is necessary for a $1 trillion asset institution is likely different from what is required for a $51 billion institution, but that remains to be seen.

*Hogan Lovells partner Daniel S. Meade (Washington, D.C.) advises clients in the financial institutions sector on corporate and regulatory matters. He previously served as senior counsel to the U.S. House of Representatives, Committee on Financial Services, and drafted portions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.*

**Mark Oesterle, Reed Smith LLP**

This question presumes that what constitutes systemic risk has been established and that regulators can identify and address such risks. I do not think this is the case. In fact, I believe that it is nearly impossible to develop an ex ante concept of systemic risk upon which to construct a regulatory framework. Secretary Geithner, the head of the Financial Stability Oversight Council recently underscored this sentiment in testimony before the Senate Banking Committee: "We cannot predict the precise threat that may face the financial system. The best course is to plan for constant change and the potential for instability and recognize that the threats will come in ways we cannot predict or fully understand."

> I believe that it is nearly impossible to develop an ex ante concept of systemic risk upon which to construct a regulatory framework.

Secretary Geithner has correctly identified the inherent difficulty, if not impossibility, involved in identifying and addressing "the" particular systemic risk. His concerns also reflect the view that preparing for the wrong risk is the same, and just as dangerous, as not preparing for any risks at all. In other words, just as you could do nothing and be swept away by a flood, you could prepare for a flood and be devastated by a drought.

I think it is far more important to address the system rather than the systemic risks. By the "system," I mean the financial institutions and the markets they comprise. Instead of looking outwardly at the vast and unknowable risks, the focus should be on the firms and whether they are in the optimal position to deal with the problems that will come. This requires that firms be generally prudent, capable of facing an array of seen and unforeseen risks. Section 165 of the Dodd-Frank Act requires the regulators to, among other things, ensure firms hold capital against various potential losses, have ready sources of liquidity, and have the systems in place to monitor and act on risks as they present themselves.

This kind of supervision is very difficult because it requires consideration of systemic safety and economic growth. If it goes too far, *i.e.* the total elimination of risk, markets would cease functioning. If regulation is too modest, excessive risk taking can lead to market failure. One key tool regulators should rely on when striving to achieve a balance is the Bankruptcy Code. The Bankruptcy Code provides legal certainty which gives market participants full understanding of their rights and responsibilities. Such understanding promotes economic activity. The "living will" requirement of the Dodd-Frank Act, which directs firms to pre-plan for their own orderly resolution, provides regulators with a mechanism to ensure firms are dealt with through the Bankruptcy Code instead of bailouts.

Regulators need also recognize that they are not the only oversight game in town. Market participants such as investors and creditors must also monitor and check risk taking. Regulators must ensure they do not create disincentives to private sector due diligence efforts. The best outcomes are most likely when regulatory and private sector efforts are complementary.

Without a crystal ball available for systemic risk oversight, I think regulators should proceed in a manner that is mindful of their limits, draws on all the tools available to them, and is supportive of private sector due diligence efforts.

*Mark Oesterle is counsel in Reed Smith's DC office.*

## Volcker Rule

# What is the Most Important Volcker Rule Issue that Regulators Must Address Next Year?

Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 619 (2010) (codified at 12 U.S.C. § 1851)

Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 76 Fed. Reg. 68846 (Nov. 7, 2011)

Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) generally prohibits banks from proprietary trading and sponsoring, holding, or acquiring an ownership interest in hedge funds or private equity funds. These prohibitions are contained in a new Section 13 of the Bank Holding Company Act, the Volcker Rule.

Federal financial services agencies, the Board of Governors of the Federal Reserve System (FRB), the Commodity Futures Trading Commission (CFTC), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Securities and Exchange Commission (SEC) were tasked with issuing comparable regulations to implement this prohibition. Four of the five regulators issued an interagency proposal to implement the Volcker Rule. The CFTC has yet to issue its proposal.

Public comments for the proposed regulation were initially due January 13, 2012. However, the agencies extended the deadline by a month to February 13, 2012.

Bloomberg Law Reports®–Banking & Finance asked leading practitioners to discuss the most important issue that regulators must address regarding the Volcker Rule in 2012.

### Michael E. Bleier, Reed Smith LLP

What should be of concern is that Section 619 of the Dodd-Frank Act mandates that the new rules be fully implemented, including final regulations with a compliance program outline that will include detailed reporting and recordkeeping requirements, by July 12, 2012. The Volcker Rule is designed to more clearly delineate and preserve the strength and capital position of traditional banking from what is perceived as the riskier investment banking world. The rationale is that this approach will better accommodate the new U.S. universal bank model as distinguished from the more "global universal bank outside the US."

Leaving aside all the difficulties that the agencies have on the substance of the proposed regulations, as evidenced by the 10 page Volcker Rule in the Dodd-Frank Act becoming an over 200 page proposal with more than 1,000 questions, the proposed regulation is still incomplete as the CFTC, a major player of impact in this regulatory space, has not yet issued its proposal, nor indicated that it will sign on to the already issued proposal. Although there is no requirement that each agency issue the identical regulation, however, to the extent possible, they should be comparable and "provide for consistent application and implementation" to avoid an uneven playing field. The impacted organizations will include both banks and nonbanks, which have multiple and varied agendas, interests, strategies and goals. All of this will lead to an extremely difficult and protracted regulatory process.

One need only look back at the Gramm-Leach Bliley Act (GLBA), which was enacted in November 1999, and the extremely lengthy regulatory process that was required for the FRB and the SEC to agree on the required broker-dealer "push-out" rules. The final rules were not issued until September 2007, nearly eight years later and only after Congress pressured the FRB and the SEC to act by the passage of the Financial Services Regulatory Relief Act of 2006. The Volcker Rule's impact is even more significant and will be felt by many more financial services players. Accordingly, the July 12, 2012 statutory deadline may be a pipe-dream.

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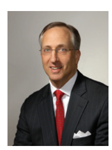

### David Katz, Willkie Farr & Gallagher LLP

It may be stating the obvious, but the most important Volcker Rule issue facing the regulators will be the challenge of adopting final rules before the statutory provisions take effect in July 2012 that adequately address even a significant portion of the myriad implementation issues posed by the Rule. The four regulatory agencies that jointly released the proposal asked approximately 1,400 questions in the proposal indicating the breadth and complexity of open issues inherent in this regulation, which, when adopted, will have a global impact on the financial services industry. The CFTC, which regulates the swaps and future markets, has not yet published its notice of proposed rulemaking related to the Volcker Rule.

To ensure consistent application and treatment across the financial services industry, all of the agencies' rules must be aligned and coordinated, as contemplated by the Dodd-Frank Act. The five agencies have a monumental task in the first half of 2012 if the Volcker Rule is to be implemented by July 2012 in a workable manner. Given the complex task ahead of them, the regulators' primary challenge will be to ensure that the regulations' definitions, prohibitions, and other provisions are drafted so that they are not overly broad and thereby unintentionally impact activities that the Volcker Rule was not intended to prevent. For example, the regulations governing private funds must be carefully crafted to avoid undue burdens on banks' ability to securitize their assets, which is a potential unintended consequence of the proposed language that was not the focus of the Volcker Rule. Similarly, banks must be able to fund themselves, hedge their risks, and underwrite securities in the ordinary course of their business without running afoul of the proposed restrictions on proprietary trading. If these and other issues are not carefully addressed, implementation of the Volcker Rule will unnecessarily hamper the recovery and future growth of the banking sector.

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### Daniel S. Meade, Hogan Lovells LLP

Can they simplify the rule? The proposed rule has been criticized by the banking industry as well as Paul Volcker himself as being unnecessarily complicated. Many proponents of the ban on proprietary trading channel Justice Potter Stewart and believe they know it when they see it, and thus believe there is no need for such a complicated rule. On the other hand, the industry would prefer not to leave regulators with such discretion and feel they need some concrete definitions. The question is whether these two positions can be balanced in a simple way.

*Hogan Lovells partner Daniel S. Meade (Washington, D.C.) advises clients in the financial institutions sector on corporate and regulatory matters. He previously served as senior counsel to the U.S. House of Representatives, Committee on Financial Services, and drafted portions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.*

### Michael W. Stocker, Labaton Sucharow LLP

Even if the Volcker Rule successfully navigates bitter inter-agency debates over implementation and intense lobbying efforts by industry interests, its greatest threat may come from a far more surprising source: the courts. In the months since the passage of the Dodd-Frank Act, the SEC has seen several proposed rules issued pursuant to the statute founder after legal challenges from business groups.

By law, the SEC is required to assess the economic costs of new regulations and to ensure that rulemaking is not capricious. While it is relatively simple to calculate the costs imposed by many Dodd-Frank Act reforms, it can be much more difficult to put a precise dollar figure on their benefit to the public.

In a recent decision, *Business Roundtable v. S.E.C.*, the United States Court of Appeals for the District of Columbia struck down the proxy access rule issued by the SEC pursuant to the Dodd Frank Act, reasoning that the SEC had failed to properly quantify the economic benefit of the new rule. The court held that the SEC had failed to supply sufficient "empirical data" illustrating the benefits to investors of a rule that increased their ability to participate in the election of directors.

While it is relatively simple to calculate the costs imposed by many Dodd-Frank Act reforms, it can be much more difficult to put a precise dollar figure on their benefit to the public.

There has already been some suggestion that the Volcker Rule may be subject to a similar challenge. The CFTC has raised concerns that draft versions of the Volcker Rule implementing regulations failed to provide sufficient analysis of the costs and benefits of new rules.

The stakes are certainly high. According to a September 7, 2011 report issued by the OCC, the Volcker Rule would ultimately result in nearly a billion dollars in capital costs for banks. Only about $50 million, however, would be associated with the cost of implementing the regulations.

While there can be little reasonable dispute about the benefit to the public of rules that discourage the kind of risky speculation that drove the financial crisis, some careful lawyering may be required to help the courts understand this point.

*Michael W. Stocker, a partner at the law firm Labaton Sucharow, represents institutional investors in securities and corporate governance matters.*

## Bloomberg News

# U.S. Regulators Extend Comment Period on Volcker-Rule Proposal

Cheyenne Hopkins | Bloomberg News

Dec. 23 (Bloomberg) – U.S. regulators will extend the comment period for the so-called Volcker rule, giving lawmakers and banks more time to seek changes in the proposed ban on proprietary trading, said a government official familiar with the process.

The comment deadline, initially set for Jan. 13, will be pushed back 30 days to Feb. 13, said the official, who declined to be identified because the decision isn't public. The change may extend the comment period until a vote by the Commodity Futures Trading Commission, the last of five agencies required to approve the Dodd-Frank Act measure. CFTC Chairman Gary Gensler said on Dec. 20 that the vote may come next month.

The proposed rule, named for former Federal Reserve Chairman Paul Volcker, was included in the regulatory overhaul to rein in risky trading by banks that benefit from deposit insurance and Fed borrowing privileges. The Fed, Federal Deposit Insurance Corp., Office of the Comptroller of the Currency and Securities and Exchange Commission released a joint notice of proposed rulemaking in October.

In a Nov. 30 letter, trade groups including the American Bankers Association and the Securities Industry and Financial Markets Association asked for a 90-day extension.

"The current proposal twists a simple concept into an overly complex and burdensome regulation," Representative Randy Neugebauer said yesterday in a letter urging a delay. "Going significantly beyond Congressional intent, this proposal will make it difficult for banking entities to manage risk prudently," the Texas Republican said in the letter signed by 121 House lawmakers, including four Democrats.

Neugebauer sought a 30-day extension and an interim proposed rule reflecting comments from banks and the CFTC.

### Impact on Banks

The proposed rule would ban banks from making trades for their own accounts while allowing them to continue short-term trades for hedging or market-making. It also would limit banks' investments in private-equity and hedge funds.

Industry groups and lawmakers cited the complexity of the proposal and the lack of coordination with the CFTC in seeking the comment-period extension. Banks including JPMorgan Chase & Co., Goldman Sachs Group Inc. and Morgan Stanley have shut or made plans to spin off proprietary-trading groups to prepare for the rule. State Street Corp.'s European division said this month that it stepped down as a market maker for U.K. government bonds, citing the Volcker rule as a reason.

"Ultimately, the significance of any final rule for American businesses, and by extension American households, cannot be overstated given the direct impact on the U.S. capital markets, which today are the deepest and most liquid in the world," the lawmakers wrote in the letter, which said the economic impact would be $45 billion for corporate bonds alone.

The industry groups found common ground with former FDIC Chairman Sheila Bair, who cited the complexity of the proposed rules in urging regulators to scrap the current plan.

### Bachus Letter

Representative Spencer Bachus, the Alabama Republican who leads the House Financial Services Committee, requested a similar extension in a Dec. 7 letter, noting that some agencies had refused to testify on the issue at a hearing originally set for Dec. 13 and saying his panel would be unable to reschedule the hearing until after the Jan. 13 comment deadline.

In a Nov. 30 letter, trade groups including the American Bankers Association and the Securities Industry and Financial Markets Association asked for a 90-day extension.

"Our members are deeply concerned about the potential impact of the proposal on capital formation, markets and liquidity for a range of asset classes and on the safety and soundness of banking entities and the businesses in which they engage," five lobby groups said in their letter.

The industry groups found common ground with former FDIC Chairman Sheila Bair, who cited the complexity of the proposed rules in urging regulators to scrap the current plan.

"The regulators should think hard about starting over again with a simple rule based on the underlying economics of the transaction, not on its label or accounting treatment," Bair said at a Senate Banking subcommittee hearing on Dec. 7. "If it makes money from the customer paying fees, interest and commissions, it passes. If its profitability or loss is based on market movements, it fails."

Dodd-Frank requires the Volcker Rule to go into effect on July 21 of next year, with a two-year transition period.

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# Finance Law

## Real Estate Finance

## MERS–"The Wikipedia of Land Registration Systems"?

**Blayne V. Scofield | Bloomberg Law**

*Culhane v. Aurora Loan Services of Nebraska*, No. 11-cv-11098, 2011 BL 299995 (D. Mass. Nov. 28, 2011)

- **MERS's method of using dual employees as "certifying officers" to execute assignments satisfies the requirements of Massachusetts law.**
- **However, because MERS lacks a beneficial interest in the note, it may not conduct nonjudicial foreclosures in Massachusetts.**

Massachusetts federal Judge William Young's November 28, 2011 opinion in *Culhane v. Aurora Loan Services of Nebraska* is notable for several reasons. First, Judge Young concludes that an assignment executed by a dual employee of the Mortgage Electronic Registration System (MERS) and the assignee is effective under Massachusetts law. Second, Judge Young devotes a substantial portion of the decision (which includes a footnote spanning six pages) to reflecting on the role of MERS in the foreclosure process. Third, this marks the second recent opinion from Judge Young that aggressively challenges foreclosure practices under Massachusetts law.

MERS is an electronic registry that facilitates securitizations by minimizing the paperwork needed to transfer a residential mortgage loan.

### MERS and Dual Employees

MERS is an electronic registry that facilitates securitizations by minimizing the paperwork needed to transfer a residential mortgage loan. In a typical MERS transaction, the lender funds the loan and holds the note. MERS holds the mortgage as the lender's (and its successors') nominee and is identified as the mortgagee in the applicable public records. MERS tracks ownership of (but does not hold) the note. If the original lender sells the note to another MERS member, the note is typically endorsed and physically provided to the purchaser. MERS continues to hold the mortgage and tracks the sale in its internal records. Because MERS remains the mortgage holder, no public filings or assignments of the mortgage are necessary.


A foreclosure notice is posted on the door of a home in the Moutain's Edge neighborhood of Las Vegas, Nevada
Credit: Jacob Kepler/Bloomberg

In certain cases, however, the noteholder may seek to withdraw the mortgage from MERS. This may arise when, for example, the noteholder sells the note to a party that is not a member of MERS or if a noteholder seeks to conduct a foreclosure itself or through its servicer rather than via MERS. In these situations, a formal assignment must be executed.

MERS relies on a system of dual employees to carry out assignments. MERS requires that each of its members designate at least one employee to act as an MERS officer (usually a vice president or assistant secretary). The appointment is formal rather than substantive–the employee is provided with a corporate resolution from MERS authorizing them to (among other things) execute documents as a "certifying officer" on MERS's behalf, but does not receive a salary from MERS or work in a MERS facility. When a MERS member seeks to withdraw a mortgage from MERS, its designated dual employee executes the assignment that reflects the withdrawal and transfer. This allows MERS to minimize the number of full-time, paid employees that it needs to carry out its operations.

### Assignment Executed by Dual Employee Was Valid under Massachusetts Law

In 2006, Oratai Culhane obtained a mortgage loan from Preferred Financial Group, Inc. (Preferred). MERS held the mortgage as Preferred's nominee. Preferred transferred the note to Deutsche Bank Trust Company Americas (Deutsche Bank), the trustee for a mortgage securitization. In 2009, Culhane defaulted and Deutsche Bank instructed MERS to assign the mortgage to its servicer, Aurora Loan Services of Nebraska (Aurora), so that Aurora could conduct the foreclosure. The assignment was executed by a dual employee of Aurora and MERS. After the assignment was executed, Aurora initiated foreclosure.

> The court took the position that MERS may not use nonjudicial foreclosure in Massachusetts.

Culhane challenged the foreclosure. The endorsement on the note purportedly transferring it from Preferred to Deutsche Bank was undated. Culhane argued that this prevented Aurora from establishing that Deutsche Bank was the noteholder on the date foreclosure was initiated as required by Massachusetts law. The court denied this argument. It noted that Massachusetts allows servicers to foreclose on behalf of noteholders. Further, it found that even though the endorsement was undated it was undisputed that Aurora was servicing the loan for Deutsche Bank at the time of the foreclosure. Thus, Aurora was a proper foreclosing party.

Culhane also claimed that the assignment from MERS to Aurora was invalid. The court again disagreed. It noted that Massachusetts law requires only that an assignment be executed by an appropriate officer of the assignor. Here, it found that the dual employee who signed the assignment was a duly appointed assistant secretary of MERS and that the assignment was executed before Aurora initiated foreclosure. Thus, the court granted summary judgment for Aurora and allowed the foreclosure to proceed.

### Notable Dicta

In the course of reaching its opinion, the court took the opportunity to weigh in on MERS's ability to initiate nonjudicial foreclosures in Massachusetts. It held that a mortgagee must hold the note to use nonjudicial foreclosure under Massachusetts law. After a lengthy examination of MERS's role in mortgage transactions and a careful parsing of the powers granted to MERS in the mortgage instrument, the court concluded that MERS "cannot exercise the power of sale, regardless of the language in the mortgage contract giving it this power." The power of sale in the mortgage instrument is the means by which foreclosing parties conduct nonjudicial foreclosures. The court took the position that MERS may not use nonjudicial foreclosure in Massachusetts. However, this finding was not necessary for the court's decision and should be regarded merely as dicta at this point.

The court cites a single, non-Massachusetts case to support this proposition: *Residential Funding Co., LLC v. Saurman*, 2011 BL 107887 (Mich. Ct. App. 2011). The Supreme Court of Michigan reversed this decision on November 16, 2011, *Residential Funding Co. v. Saurman*, 2011 BL 295470 (Mich. 2011), nearly ten days prior to the court's decision here in *Culhane*. While the court relies on other arguments to support its position, this may ultimately weaken the persuasiveness of the court's view.

### Judge Young's View of MERS

The court was generally skeptical of MERS's business methods. Although the court stated that "it appears that MERS works rather well as a land registration system," it found that MERS did so by "the thinnest possible veneer of formality and legality" and characterized MERS as "the Wikipedia of land registration systems."

The court was particularly unimpressed with MERS's dual employee approach to assignments. The court equated a MERS dual employee to an "Admiral in the Georgia navy or a Kentucky Colonel with benefits" rather than "any genuine financial officer." Although the arrangement satisfied that letter of the law, the court was "deeply troubled that, with little to no oversight, individuals without any tie to or knowledge of the company on whose behalf they are acting may assign mortgages–that is, they may transfer legal title to someone else's home."

### Other Challenges to Dual Employee Structure

*Culhane* stands in contrast to *Bank of New York v. Alderazi*, 2011 BL 95832 (N.Y. Sup. Ct. 2011), in which a New York Superior Court dismissed *sua sponte* a bank's foreclosure action under similar facts. In *Alderazi*, the court determined that a dual employee's signature on an assignment was insufficient because MERS (as nominee) could act only on the lender's instruction and the dual employee's signature on behalf of MERS provided "no evidence that the [lender] in fact approved or authorized the assignment." For more information, see *New York Court Dismisses Foreclosure* *and Finds MERS Did Not Have Authority to Assign Countrywide Mortgage*, Bloomberg Law Reports®–Banking & Finance (April 19, 2011).

### Judge Young and Massachusetts Foreclosure Law

This is the second recent foreclosure-related decision in which Judge Young has tested the frontiers of Massachusetts law. In July, he authored an opinion in *Dixon v. Wells Fargo Bank, N.A.*, 2011 BL 191469 (D. Mass. 2011), that allowed a challenge to a foreclosure action to proceed to trial. In *Dixon*, the borrower sought to compel the foreclosing lender to participate in loan modification negotiations.

In siding with the borrower, Judge Young accepted a minority theory of promissory estoppel that "[a]dmittedly, the courts of Massachusetts have yet to formally embrace" and that had been rejected by 31 of the 34 other courts that had considered it under similar factual circumstances. Judge Young himself acknowledged that the only three courts that had accepted the borrowers' theory were other Massachusetts federal district courts. Nonetheless, Judge Young found the result necessary in view of the "devastating and nationwide foreclosure crisis that is crippling entire communities." For more information about *Dixon*, see Sonia Persaud, *Massachusetts District Court Upholds Foreclosure Injunction, Allows Promissory Estoppel Claims to Proceed*, Bloomberg Law Reports®–Banking & Finance (Aug. 3, 2011).

# Seventh Circuit Deems Borrower's Testimony Sufficient to Overcome TILA Presumption

Sonia Persaud | Bloomberg Law

*Marr v. Bank of America, N.A.*, No. 11-01424, 2011 BL 307012 (7th Cir. Dec. 6, 2011)

- **The borrower challenged the closing agent's statements that standard procedures were followed during his refinance.**
- **The court was persuaded that the borrower's testimony and evidence presented a question of material fact.**

On December 6, 2011 the U.S. Court of Appeals for the Seventh Circuit ruled that a borrower's testimony was sufficient to rebut the presumption of delivery of the Truth in Lending Act (TILA) notices set forth at 15 U.S.C. § 1635(c) at the summary judgment stage of proceedings. The court reversed a summary judgment granted by the lower court and remanded for further proceedings.

### Borrower Claimed that "Standard" Practices Were Not Followed at Closing

Richard Marr refinanced his mortgage with Countrywide Bank in February 2007 with Summit Title acting as closing agent. Marr claimed he executed all documents with the title agent without time to review each and, when the documents were signed, the agent put them all into a folder which he took home. The agent stated that Summit Title's practice was to review instructions and checklists at closing with the borrower, discuss each closing document, and review the TILA disclosure of the right to rescind the transaction (Notice). Summit Title's agent stated that Marr received two copies of the Notice. Marr contested the agent's version of the closing.

Marr claimed that the documents from the closing were placed into a cabinet and remained undisturbed until he reviewed them with his attorney two years later. However, Marr's mortgage file contained documents dated after the closing date.

Marr alleged that Summit Title and his lender violated TILA when they failed to provide him with two copies of the Notice at, or after, the closing and sought to rescind the mortgage. Because Marr paid off the mortgage prior to litigation, he sought reimbursement of his interest payments, statutory damages, and attorneys' fees. The district court was unpersuaded by Marr's testimony and rebuttal affidavit about the circumstances of the closing. Consequently, it granted summary judgment to the lender.


Credit: Daniel Acker/Bloomberg News

### TILA and Regulation Z Requirements

Under TILA and Regulation Z, a residential mortgage lender must provide *two* copies of the Notice to the borrower at closing. If the borrower receives the Notice in a timely manner, the rescission period is three business days after the later of the closing, the date of delivery of all material disclosures, or the date the Notice was received. If a borrower does not receive the Notice as required, the right to rescind the transaction remains available for three years after the closing.

Section 1635(c) acknowledges that a lender may create a rebuttable presumption of delivery of the Notice if it obtains a written acknowledgement that the borrower received both copies of the Notice. The court clarified that the written acknowledgment executed by the borrower should not be elevated in importance because it "does no more than create" the presumption of delivery. The court applied Rule 301 of the Federal Rules of Evidence to determine whether Marr provided sufficient evidence to overcome the presumption at the summary judgment stage. Under Rule 301, a party faced with a presumption must produce evidence rebutting the presumption.

Section 1635(c) acknowledges that a lender may create a rebuttable presumption of delivery of the Notice if it obtains a written acknowledgement that the borrower received both copies of the Notice.

### Borrower's Testimony and an Affidavit Overcome TILA Presumption of Notice Delivery

Marr argued that summary judgment was inappropriate because a reasonable jury could find that he received only one copy of the Notice based on the evidence he presented. Marr provided testimony that his attorney retrieved only one copy of the Notice in the envelope of loan documents, his own statement that documents were not removed from the folder after the refinance, and an affidavit that his closing experience deviated from Summit Title's standard.

The court noted, in dicta, that TILA and Regulation Z did not contain hollow demands and do not allow for "substantial compliance" by parties.

The court assessed Marr's evidence in light of two decisions that addressed the quality and quantity of evidence required to rebut TILA's presumption of notice delivery. In a 2010 Seventh Circuit decision, *Montgomery v. American Airlines, Inc.*, 626 F.3d 382, the court found that testimony based on personal experience presented disputed material facts, even if it was self-serving or uncorroborated. The court also referenced a Third Circuit decision that tackled a TILA case addressing the rebuttable presumption. In *Cappuccio v. Prime Capital Funding LLC*, 649 F.3d 180 (3d Cir. 2011), the borrower's burden to rebut the presumption was deemed minimal and the court concluded that testimony alone was sufficient. For more information on *Cappuccio*, see Sonia Persaud, *Third Circuit Requires Only Borrower's Testimony to Rebut Presumption of TILA Notice Delivery*, Bloomberg Law Reports®–Banking & Finance (Aug. 24, 2011).

After reviewing Marr's evidence the court acknowledged it was sufficient to rebut the presumption of delivery and concluded that a reasonable jury might agree that only one Notice was provided. The court noted, in dicta, that TILA and Regulation Z did not contain hollow demands and do not allow for "substantial compliance" by parties. Consequently, the court reversed the summary judgment.

## Bloomberg News

# Ex-Cuomo Aide Said to Be Among 4 Foreclosure-Monitor Candidates

**Thom Weidlich and David McLaughlin | Bloomberg News**

Dec. 15 (Bloomberg) – A former aide to New York Governor Andrew Cuomo is among at least four candidates being considered to ensure that banks including JPMorgan Chase & Co. and Bank of America Corp. comply with any settlement of a nationwide foreclosure probe, a person familiar with the matter said.

Steven M. Cohen, who was the governor's secretary, is one potential foreclosure monitor, according to the person, who declined to be identified because the negotiations are secret. That person said North Carolina Commissioner of Banks Joseph A. Smith Jr. is also a candidate, as did a second person who asked not to be identified.

Selection of a monitor is one of the final issues to be worked out between the banks and state and federal officials, said the people. Selection of the monitor is a key issue for the regulators because success of the agreement will largely depend on his or her work, one of the people said.

Other candidates are Nicolas P. Retsinas, a former assistant secretary of the U.S. Department of Housing and Urban Development, and ex-Federal Deposit Insurance Corp. Chairman Sheila Bair, one of the people said.

All 50 states last year said they were investigating bank foreclosure practices following disclosures that the companies were using faulty documents in seizing homes. State and federal officials leading the talks are seeking an agreement that provides mortgage relief to homeowners and sets standards for foreclosure practices.

### Ensure Compliance

The monitor would ensure compliance with any agreement with mortgage servicers, according to a settlement proposal offered to the banks in March. In addition to JPMorgan and Bank of America, Citigroup Inc., Ally Financial Inc. and Wells Fargo & Co. are participating in the negotiations.

The job will come with the authority to review records and audit a servicer's performance, according to the proposal. Banks would be subject to penalties for failing to meet performance measures and timelines.

Joseph A. Smith, commissioner of banks for the state of North Carolina
Credit: Jay Mallin/Bloomberg

Before becoming the governor's secretary, Cohen was Cuomo's counselor and chief of staff when he was New York attorney general. Cohen is now a partner at law firm Zuckerman Spaeder LLP in New York. He was also chief of the violent-gangs unit as a federal prosecutor in Manhattan.

Cohen declined to comment on whether he was a candidate for the monitor post.

### Bank Commissioner

As North Carolina bank commissioner, Smith, 62, supervises mortgage companies, banks and lenders in the state. In 2010, President Barack Obama nominated Smith to oversee mortgage-finance companies Fannie Mae and Freddie Mac. His nomination to lead the Federal Housing Finance Agency won support from banks and consumer groups. Smith failed to win confirmation after objections from Senate Republicans.

Smith declined to comment on any nomination to monitor the foreclosure agreement.

Retsinas, 65, now a lecturer at Harvard Business School, is on the board of Freddie Mac and a former director of Harvard University's Joint Center for Housing. He was an assistant secretary of HUD under President Bill Clinton. He didn't immediately return a call seeking comment on the monitor position.

Bair, who led the FDIC from 2006 until this year, is supported by some states for the monitor position, though Citigroup opposes her selection because of her role in scuttling a deal for the bank to acquire Wachovia Corp. in 2008, one of the people said. Wells Fargo acquired Wachovia in 2009.

As part of the settlement, banks will be released from certain claims by state and federal officials.

### Release From Claims

As part of the settlement, banks will be released from certain claims by state and federal officials. One issue still to be worked out is the scope of the liability release agreed to between banks and the Consumer Financial Protection Bureau, one of the people said.

Bair, 57, now a senior adviser to the Pew Charitable Trusts, was approached about the job two months ago and turned it down, according to a third person who is familiar with the matter. She declined in part because of a book she is writing that is due in a few months, said the person, who asked not to be identified because the inquiry was private.

Geoff Greenwood, a spokesman for Iowa Attorney General Tom Miller, declined to comment on who is being considered for the monitor position. Miller is leading the talks for the states.

### Framework Agreed

Both sides in the settlement negotiations have agreed to the framework of a deal, according to the two people familiar with the talks. The accord with the five largest mortgage servicers could amount to $25 billion with banks agreeing to fund refinancings and writedowns of loan principal balances, among other steps, the people said.

Lawrence Grayson, a spokesman for Charlotte, North Carolina-based Bank of America, declined to comment on the negotiations. Mark Rodgers, a spokesman for New York-based Citigroup, also declined to comment.

The other companies involved in the talks are San Francisco-based Wells Fargo and Detroit-based Ally.

Gina Proia, an Ally spokeswoman, and Vickee Adams of Wells Fargo declined to comment. Thomas Kelly, a spokesman for New York-based JPMorgan, didn't immediately reply to an e-mail.

The value of a deal would be less if California Attorney General Kamala Harris doesn't sign on, the people said. She announced in September that she was breaking away from the talks to conduct her own investigation. The agreement would increase if more servicers are included, the people said.

*With assistance from Lorraine Woellert in Washington.*
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# Holding Companies

## Bank Holding Companies

## Shareholder Thwarted in Attempt to Gain Control of Bank Holding Company

Sonia Persaud | Bloomberg Law

*LNB Bancorp, Inc. v. Osborne*, No. 09-cv-00643, 2011 BL 301368 (N.D. Ohio Nov. 30, 2011)

- **The court granted summary judgment on a bank holding company's contract claim against a shareholder for violating a settlement agreement.**
- **The shareholder's attempts at corporate maneuvering in violation of the settlement agreement were enjoined by the district court.**

On November 30, 2011 the U.S. District Court for the Northern District of Ohio permanently enjoined Richard Osborne from engaging in conduct prohibited by a standstill provision of a settlement agreement with LNB Bancorp, Inc. (LNB). This decision is the latest in an ongoing struggle between Osborne and LNB in his attempt to gain control of LNB and, its bank, Lorain National Bank.

This decision is the latest in an ongoing struggle between Osborne and LNB in his attempt to gain control of LNB and, its bank, Lorain National Bank.

### Shareholder Seeks Control of Bank Holding Company

This dispute began when Osborne (and a third party) initiated a proxy contest in March 2008. Litigation between LNB and Osborne followed. A compromise was reached, the parties entered into a settlement agreement, and Osborne dismissed his suit. The settlement agreement allowed Osborne, and other parties to the suit, to designate two members of LNB's board of directors. In exchange, Osborne agreed to a standstill provision that prohibited him from engaging in certain activities (*e.g.*, seeking a position on LNB's board of directors, attempting to create a change of control for LNB or its subsidiaries, or initiating proxy or shareholder votes) for 18 months "during or after" the settlement date or "unless and until" Osborne's directors resigned. Injunctive relief and specific performance were specified as the only suitable remedies for a breach of contract.

Osborne designated his two directors in April 2008. Six months later, he waived this right to designate directors or successor directors and shortly thereafter his directors attempted to resign. Their resignations were refused. Osborne subsequently took a number of actions, including filing materials with the Securities and Exchange Commission (SEC) describing his intent to launch a proxy fight to replace LNB's leadership and seek a position on the board, that violated the settlement agreement's standstill provision. In 2009 LNB sought a temporary restraining order and preliminary injunction. It alleged that Osborne breached the settlement agreement and violated the Securities and Exchange Act of 1934. The court preliminarily enjoined Osborne from acting in violation of the standstill provision. Osborne attempted to dissolve the preliminary injunction in February 2010 and was denied. The Sixth Circuit affirmed the denial in Osborne's appeal. In this action, both parties sought summary judgment on their claims.

### Breach of Contract

LNB argued that Osborne violated the settlement agreement's standstill provision by attempting to replace LNB's chairman of the board, communicating with shareholders regarding LNB, and filing proxy solicitation materials with the SEC, among other actions. Osborne did not deny his actions, but instead claimed that the standstill provision ran for 18 months after the settlement date or until the designated directors resigned, at which point it terminated. Consequently, he argued, the standstill provision was ineffective.

The court was unpersuaded by Osborne's arguments. The court stated that the settlement agreement was unambiguous–it provided a specific period of time for Osborne to refrain from activity under the standstill provision and extended that time period if the designees' resignation occurred after that time period. Further, the court noted, Osborne's designees remained on the board of directors and, consequently, the standstill provision continued to be binding. Therefore, the court concluded that there was no genuine issue regarding the standstill provision's expiration and Osborne breached the settlement agreement when he acted in violation of the provision.

### Permanent Injunction

LNB sought a permanent injunction preventing Osborne from violating the standstill provision. The court evaluated the four factors federal courts generally consider when weighing a permanent injunction: success on the merits, the risk of irreparable injury to the requesting party, the balance of the injury to the requesting party and the opposing party, and the public interest.

LNB asserted that it satisfied all the requirements. It claimed that they would succeed on the merits because there was no genuine issue that the standstill provision remained effective under its terms. Further, LNB argued, it would suffer irreparable harm because it would not receive the benefit of the bargain under the settlement agreement, which authorized injunctive relief because the parties agreed that breaches were not "adequately compensable in damages". LNB also asserted that an injunction would not harm third parties, Osborne would not be harmed because he agreed to the standstill provision restrictions, and there was no public interest in Osborne's breach of the settlement agreement.

The court agreed that a review of the permanent injunction factors weighed in favor of granting the injunction.

Osborne argued that a genuine issue existed regarding the irreparable injury. He argued that the settlement agreement's acknowledgment of irreparable harm was not dispositive and, because LNB sought compensatory damages, there remained a question about whether the injury was in fact irreparable. LNB explained the compensatory damages represented money LNB spent defending against Osborne's prior violation of the settlement agreement and did not account for the time and effort it would expend if Osborne continued to violate the settlement agreement.

The court agreed that a review of the permanent injunction factors weighed in favor of granting the injunction. It found that LNB showed success on the merits, irreparable harm without an injunction, no harm to third parties, and service to the public interest by enforcing the settlement agreement.

### Securities Violations

Osborne argued that he was entitled to summary judgment on the securities claims for two reasons–the claims were speculative and any false and misleading statements to the SEC were made unintentionally. The court denied summary judgment because it found genuine issues of fact regarding Osborne's obligation to disclose information and whether or not he knowingly made false statements in his SEC filings.

### Permanent Injunction Issued

The court granted LNB partial summary judgment and permanently enjoined Osborne from engaging in conduct prohibited by the standstill provision unless and until the designated directors resigned.

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# National Banks

## Community Reinvestment

### Overview of the Community Reinvestment Act: Wholesale and Limited Purpose Banks

Blayne V. Scofield | Bloomberg Law

- **Wholesale banks (for CRA purposes) are those that engage in non-retail lending activities.**
- **Limited purpose banks (for CRA purposes) are those that offer a narrow product line.**
- **Wholesale and limited purpose banks are evaluated using the community development test.**

This Bloomberg LawNote® is the final installment in our three-part overview of the Community Reinvestment Act (CRA).[1] In the November 2011 Bloomberg Law Reports®–Banking & Finance, we examined the CRA's history and enforcement mechanisms, as well as the assessment process for large banks and banks with strategic plans. In the December 2011 Bloomberg Law Reports®–Banking & Finance, we looked at the requirements for defining an assessment area for CRA purposes and the assessment process for small and intermediate small banks. In this article, we conclude this series by discussing the assessment process for wholesale and limited purpose banks.

#### Wholesale Banks

A wholesale bank is a bank that does not engage in retail lending. Specifically, the CRA regulations define a wholesale bank as a bank that "is not in the business" of making residential mortgage, small business, or small farm loans to retail customers.[2] Note that this definition is not a blanket prohibition on wholesale banks making these types of loans from time to time. The interagency questions and answers (Interagency Q&A) confirm this view.[3] The definition only prohibits wholesale banks from being "in the business" of such activities. Regulators permit wholesale banks to engage in retail lending as long as it is "incidental and done on an accommodation basis".[4] To determine whether a bank is "in the business" of making retail loans, regulators look to whether the bank holds itself out as a retail lender and whether its revenues from retail activities are "significant,"[5] and consider whether the lending test provides a more accurate view of the bank's CRA activities.[6]

Based upon information from the regulators, there are currently 43 banks that are designated as wholesale banks for CRA purposes.[7]

#### Limited Purpose Banks

Limited purpose banks for purposes of the CRA are banks that offer a "narrow product line" to a regional or broader market.[8] Conceptually, these are banks that are dedicated to a single product like credit card loans or student loans and offer it nationally rather than locally. Regulators have indicated that a bank offers a "narrow product line" if it offers products other than those evaluated under the lending test (*i.e.*, residential mortgage, small business, and small farm loans).[9] Accordingly, a bank that specializes in residential mortgage loans cannot be a limited purpose bank for CRA purposes.

> A bank must apply to its primary federal regulator to obtain a wholesale or limited purpose bank designation.

Similar to wholesale banks, however, a limited purpose bank may periodically offer loan products outside of its narrow product line. The regulators have indicated that limited purpose banks may engage in such ancillary lending on "an infrequent basis." To evaluate whether a bank's ancillary lending is truly ancillary, regulators consider the frequency, volume, and amount of revenue the bank derives from the ancillary lending, whether the bank holds itself out as being in the market for the ancillary loan product, and whether the lending test provides a more accurate portrait of the bank's CRA activities.[10]

Based upon information from the regulators, there are currently 30 banks that are designated as limited purpose banks for CRA purposes.[11]

#### Approval

A bank must apply to its primary federal regulator to obtain a wholesale or limited purpose bank designation.[12] An application must be submitted at least 90 days prior to the effective date sought by the bank.[13] Based on guidance from the Office of the Comptroller of the Currency, an application for a wholesale or limited purpose designation generally should describe the bank's business and, if the bank engages in residential mortgage, small business, or small farm lending activities, describe them and demonstrate that they are infrequent and incidental (or ancillary, as the case may be) to the bank's business.[14] A designation may

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be revoked by the applicable regulator with one year of notice or voluntarily withdrawn by the bank.[15] Institutions that forfeit or lose their wholesale or limited purpose designation are evaluated under the test applicable to it based on its size (*i.e.*, as a small bank, intermediate small bank, or a large bank).

## Assessment Methodology

### – Overview

Wholesale and limited purpose banks are evaluated under a different test than traditional banks. One of the policy concerns motivating the adoption of the CRA was that banks were accepting deposits from low- and moderate-income customers but were refusing to lend to them. Thus, one of the factors (and, in some instances, the sole factor) considered by regulators when evaluating a traditional bank's CRA performance is its retail lending activity. However, wholesale and limited purpose banks only satisfy one side of this equation–they accept deposits, but, by definition, they do not engage in the types of retail lending evaluated by the CRA's lending test. Thus, a different test is applied–the community development test.[16] This test evaluates the extent to which a wholesale or limited purpose bank provides community development loans, qualified investment, and community development services.[17]

### – Community Development Loans, Qualified Investments, and Community Development Services

Community development loans are loans for which the "primary purpose"[18] is to support affordable housing, community services, small business or farms, certain community revitalization and stabilization activities, and certain foreclosure avoidance programs (collectively, Community Development Activities).[19] Examples include loans to facilitate the construction of affordable housing for low- and moderate-income individuals, loans for the renovation of a community food bank, and lines of credit for the operation of shelters for abused and neglected children.[20] A bank may count loans that it originates or that it purchases towards its community development loans.[21]

Qualified investments are investments, deposits, membership shares, or grants for which the primary purpose is to support Community Development Activities.[22] These include investments such as equity interests in companies that engage in Community Development Activities, mortgage-backed securities collateralized by mortgages to low- and moderate-income individuals, certificates of deposit from community development financial institutions, and charitable donations to entities that engage in Community Development Activities.[23]

For wholesale and limited purpose banks, community development services are those that have a primary purpose of supporting Community Development Activities and that are related to the "provision of financial services".[24] Examples of such services include bank employees teaching financial literacy skills to low- and moderate-income individuals, coaching and mentoring small business owners, and serving on the boards of directors of entities that engage in Community Development Activities.[25]

### – Performance Criteria and Geography

When regulators evaluate a bank's CRA performance under the community development test, they consider three factors: (i) the number and amount of the bank's community development loans, qualified investments, and community development services; (ii) the use of innovative or complex community development loans, qualified investments, and community development services, and (iii) the bank's responsiveness to credit and community development needs.[26]

Unfortunately, the ratings definitions tend to be qualitative rather than quantitative and offer little practical guidance regarding examiner expectations.

The primary geographic focus of the community development test is the bank's assessment area. Regulators evaluate the extent to which the bank has provided community development loans, qualified investments, and community development services within this region. However, unlike the tests applicable to traditional banks, regulators may also consider a wholesale or limited purpose bank's activities *outside* of its assessment area, provided that it has adequately met the needs of its assessment area.[27] In adopting this approach, regulators explained that wholesale and limited purpose banks "typically draw their resources from, and serve areas well beyond, their immediate communities."[28]

### – CRA Ratings

The CRA rating for wholesale and limited purposes banks is tied solely to its performance under the community development test. Such banks may receive one of four ratings–outstanding, satisfactory, needs to improve, or substantial noncompliance.[29] As set forth in the following table, the ratings definitions use the performance criteria described above. Unfortunately, the ratings definitions tend to be qualitative rather than quantitative and offer little practical guidance regarding examiner expectations.

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| | Number and Amount of Community Development Loans, Qualified Investments, and Community Development Services | Use of Innovative or Complex Community Development Loans, Qualified Investments, and Community Development Services | Responsiveness to Credit and Community Development Needs |
|---|---|---|---|
| **Outstanding** | High | Extensive | Excellent |
| **Satisfactory** | Adequate | Occasional | Adequate |
| **Needs to Improve** | Poor | Rare | Poor |
| **Substantial Noncompliance** | Few, if any | None | Very Poor |

Special purpose banks generally perform well in their CRA performance evaluations. Based on the most recent examination information available, only three wholesale banks (Builders Bank, First Bank and Trust Company of Illinois, and State Bank of India - New York) received ratings of Needs to Improve and none was rated Substantial Noncompliance. Of the remaining 42[30] wholesale banks, 13 are rated Outstanding and 28 are rated Satisfactory. We were unable to locate CRA ratings or a performance evaluation from the Office of the Comptroller of the Currency (OCC) for one bank, Bank of America Rhode Island, N.A.

Based on the most recently available examinations, only one limited purpose bank (World's Foremost Bank) received a rating of Needs to Improve and none has been rated Substantial Noncompliance. Even in the case of World's Foremost Bank, the problem was not in its performance under the community development test. Instead, it was penalized by the Federal Deposit Insurance Corporation for engaging in unfair or deceptive credit card practices. Of the remaining 29 limited purpose banks, 8 are rated Outstanding, 20 are rated Satisfactory. We were unable to locate CRA ratings or a performance evaluation from the OCC for one bank, RBC Bank (Georgia) N.A.

### Key Resources

| | |
|---|---|
| Community Reinvestment Act | Pub. L. 95-128, Title VIII (Oct. 12, 1977)<br>Text of Legislation (as amended)<br>12 U.S.C. §§ 2901 - 2908 |
| FDIC Regulations | 12 C.F.R. Part 345 |
| FRB Regulations | 12 C.F.R. Part 228 (Regulation BB) |
| OCC Regulations | 12 C.F.R. Part 25 |
| Interagency Questions and Answers | 75 Fed. Reg. 11642 (March 11, 2010) |
| Other Resources | Interagency CRA Rating Search<br>Interagency Interpretations |

[1] 12 U.S.C. §§ 2901 - 2908.

[2] Federal banking regulators have each adopted identical regulations to implement the CRA. Rather than cite each regulator's regulation, the citations used herein will use a generic form. For instance, the definition of wholesale bank is set forth in § __.12(x). To find the Board of Governors of the Federal Reserve System's (FRB) regulations, refer to the corresponding sections in 12 C.F.R. Part 228; the Federal Deposit Insurance Corporation's regulations (FDIC), refer to the corresponding sections in 12 C.F.R. Part 345; and the Office of the Comptroller of the Currency's (OCC) regulations, refer to the corresponding sections in 12 C.F.R. Part 25.

[3] OCC, FRB, FDIC, Office of Thrift Supervision (OTS), *Community Reinvestment Act; Interagency Questions and Answers Regarding Community Reinvestment Act; Notice*, 75 Fed. Reg. 11642, 11653, § __.12(x)-1 (March 11, 2010) (Interagency Q&A).

[4] Interagency Q&A § __.12(n)-1, 75 Fed. Reg. at 11652.

[5] Interagency Q&A § __.12(x)-1, 75 Fed. Reg. at 11653.

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[6] Interagency Q&A § __.12(n)-1, 75 Fed. Reg. at 11652.

[7] These are (by agency): FDIC (22) - Bank of Hapoalim B.M., Bank Leumi USA, Bank of Baroda, Bank of India, Bank of Tokyo-Mitsubishi UFJ Trust Co., Beal Bank USA (formerly Beal Bank Nevada), Beal Bank S.S.B., Builders Bank, Capmark Bank, Deutsche Bank Trust Co. Delaware, First Bank and Trust Company of Illinois, Interaudi Bank, Israel Discount Bank of New York, LCA Bank Corporation, Mitsubishi UFJ Trust and Banking Corp. (USA), Mizrahi Tefahot Bank Ltd., Mizuho Trust & Banking Co., Plus International Bank, Republic Bank, Inc., State Bank of India, Triumph Savings Bank, SSB, and Woodlands Commercial Bank; FRB (6) - The Bank of New York Mellon, BPD Bank, Deutsche Bank Trust Company Americas, Goldman Sachs Bank USA, Mizuho Corporate Bank - USA, and State Street Bank and Trust Company; OCC National Banks (10) - Bank of America Rhode Island, N.A., Bank of China, BNY Mellon, N.A., California First National Bank, Delta National Bank and Trust Company, Intervest National Bank, Morgan Stanley Bank, N.A., Safra National Bank of New York, Sterling National Bank, Wells Fargo Bank Northwest, N.A.; OCC Thrifts (5) (no link available) - Cenlar F.S.B, E*Trade Savings Bank, E*Trade United Bank, Prudential Bank & Trust, F.S.B., and T. Rowe Price Savings Bank. In some instances, where a foreign bank maintains multiple U.S. offices or branches, each branch or office is examined separately for CRA purposes. We have included these institutions once for purposes of the foregoing list.

[8] § __.12(n).

[9] Interagency Q&A § __.12(n)-1, 75 Fed. Reg. at 11652.

[10] Interagency Q&A § __.12(n)-2, 75 Fed. Reg. at 11652.

[11] These are (by agency): FDIC (9) - 5Star Bank, American Express Centurion Bank, Bank of New Castle, CIT Bank, College Savings Bank, Discover Bank, Eaglemark Savings Bank, Rancho Santa Fe Thrift and Loan Association, and World's Foremost Bank; FRB (2) - Community Capital Bank of Virginia and Marlin Business Bank; OCC National Banks (16) - Capital One Bank (USA), N.A., Cedar Hill National Bank, Chase Bank USA N.A., Credicard National Bank, Credit First N.A., Credit One, N.A., DSRM National Bank, FIA Card Services, N.A., HSBC Trust Company (Delaware), N.A., RBC Bank (Georgia), N.A., Talbots Classic National Bank, Target National Bank, TCM Bank, N.A., Town North Bank Nevada, N.A., Wells Fargo Financial National Bank, and World Financial Network National Bank; OCC Thrifts (3) (no link available) - American Express Bank, F.S.B, First Investors F.S.B., and GE Capital Retail Bank. There are four banks on OCC's list of limited purpose national banks which we have omitted here–Citibank (South Dakota), N.A. (merged into Citibank N.A. in June 2011), M&T Bank, N.A. (merged with Wilmington Trust, N.A. in July 2011), Department Stores National Bank (most recent exam indicates that strategic plan assessment was used), and HSBC Bank Nevada, N.A. (most recent exam indicates that strategic plan assessment was used).

[12] § __.12(n) (limited purpose); § __.12(x) (wholesale); § __.25(b).

[13] § __.25(b).

[14] Office of the Comptroller of the Currency, *Comptroller's Handbook: Community Reinvestment Act Examination Procedures*, at 71 (rev. May 1999).

[15] § __.25(b).

[16] § __.25(c).

[17] § __.25(a).

[18] The factors considered by regulators in determining the "primary purpose" of a loan are explained in Interagency Q&A § __.12(h)-8, 75 Fed. Reg. at 11650.

[19] § __.12(g); § __.12(h).

[20] Other examples are set forth in the Interagency Q&A §__.12(h)-1, 75 Fed. Reg. at 11648, and in OCC, FRB, FDIC, OTS, *Community Reinvestment Act Regulations and Home Mortgage Disclosure; Final Rules*, 60 Fed. Reg. 22155, 22160 n.1 (May 4, 1995) (1995 Final Rule).

[21] § __.25(c).

[22] § __.12(g); § __.12(t).

[23] 1995 Final Rule, 60 Fed. Reg. at 22162 n.3.

[24] § __.12(g); § __.12(i). Guidance regarding the "provision of financial services" is set forth in the Interagency Q&A § __.12(i)-1, 75 Fed. Reg. at 11650.

[25] Other examples are included in the Interagency Q&A § __12(i)-3, 75 Fed. Reg. at 11650, and in the 1995 Final Rule, 60 Fed. Reg. at 22160 n.2

[26] § __.25(c).

[27] § __.25(e).

[28] 1995 Final Rule, 60 Fed. Reg. at 22160.

[29] Appendix A, paragraph (c).

[30] This equals 45 banks. Above we indicate that 43 banks are designated as wholesale banks. The discrepancy results from the fact that State Bank of India maintains offices in three jurisdictions (New York City, Chicago, and California), each of which is evaluated separately by FDIC.

## Lending


Credit: Daniel Acker/Bloomberg

# Citi Lacked Standing to Foreclose in New York

Sonia Persaud | Bloomberg Law

*Citigroup Global Markets Realty Corp. v. Smith*, No. 3921/2008, 2011 BL 316999 (N.Y. Sup. Ct. Dec. 13, 2011)

- **A foreclosing party must own both the note and the mortgage to initiate foreclosure in New York.**
- **Citigroup failed to demonstrate unity of ownership when a note and a mortgage were assigned to different Citi entities.**

The New York Supreme Court for Kings County denied an application for an Order of Reference by Citigroup Global Markets Realty Corp. (Citigroup), finding that it had no standing to foreclose on the mortgage.

In December 2006 Howard Smith executed a note and mortgage in favor of American Bankers Conduit (ABC), which was secured by his property in Brooklyn, New York. The Mortgage Electronic Registration Systems (MERS) was named ABC's nominee in the mortgage. In January 2008, the mortgage was assigned by MERS to Citigroup. An undated endorsement to the note purported to transfer it, but named Citimortgage, Inc. (Citimortgage) as the endorsee rather than Citigroup. Smith defaulted and Citigroup initiated a foreclosure action.

In New York if a borrower fails to file an answer to a foreclosure action the lender must seek an Order of Reference, which appoints a Referee to determine the amount owed by the borrower to the lender. A request for an Order of Reference must be accompanied by an affidavit attesting to the borrower's default and showing the foreclosing entity's ownership of the note and mortgage. Citigroup sought an Order of Reference.

A lender may not foreclose in New York unless it owns both the note and mortgage secured by the real property. In *Bank of New York v. Silverberg*, 86 A.D.3d 274 (2nd Dep't, 2011), the appellate court concluded that an assignment of mortgage without the underlying debt transferred no interest to the acquiring entity. Here, as recounted above, the note was endorsed to Citigroup while the mortgage was assigned to Citimortgage. The court stated that Citigroup failed to explain the corporate relationship between it and Citimortgage. Consequently, the court concluded that Citigroup failed to show unity of ownership and, thus, it lacked standing to foreclose.

A lender may not foreclose in New York unless it owns both the note and mortgage secured by the real property.

The court also recognized that Smith, having failed to submit an answer to the foreclosure action, waived any standing objection he may have asserted. However, the court concluded that, despite a waiver of standing, Citigroup could not succeed without a showing of its ownership of the note. Therefore, the court denied Citigroup's request for an Order of Reference.

**Bloomberg News**

# JPMorgan, BofA Sued By Massachusetts Over Home Foreclosures

David McLaughlin | Bloomberg News

Dec. 1 (Bloomberg) – JPMorgan Chase & Co., Bank of America Corp. and Citigroup Inc. were among five banks sued by Massachusetts for allegedly conducting unlawful foreclosures and deceiving homeowners.

Massachusetts Attorney General Martha Coakley filed the lawsuit today against the three banks, as well as Wells Fargo & Co. and Ally Financial Inc., in state court in Boston. She accused the banks of engaging in unfair and deceptive trade practices in violation of state law.

"The stakes could not be higher at this stage of the game," Coakley said at a press conference in Boston. "The foreclosure crisis continues to be at the root of the economic mess that we find ourselves in and our inability to turn it around."

State attorneys general across the U.S. have been negotiating a possible settlement with the five banks that would resolve a probe into foreclosure practices that began more than a year ago following disclosures that faulty documents were being used to seize homes.

State and federal officials are aiming to reach a deal that would provide mortgage relief to homeowners and set requirements for the ways mortgage servicers conduct home foreclosures and interact with borrowers.

## 'Enforceable Relief'

Coakley today blamed the banks for failure to reach a deal, saying they hadn't offered "meaningful and enforceable relief" to homeowners for harm they have caused. With a settlement still out of reach more than a year after all 50 states announced their investigation into bank practices, Coakley said, she decided to file her lawsuit.

"They have had more than a year to show they've understood their role and the need to show their accountability for this economic mess, and they failed to do so," she said.

In September, California Attorney General Kamala Harris said she was withdrawing from the talks, saying a proposed settlement was "inadequate" and would allow too few California homeowners to stay in their homes.

John Stumpf, chairman and chief executive officer of San Francisco-based Wells Fargo, said in a CNBC interview today that he's disappointed the lawsuit was filed.

"We've worked hard to come to an agreement that I think would be good for the country and good for housing," he said. "We can work through that better together than working it out in court."

Marth Coakley, center, Massachusetts attorney general
Credit: Neal Hamberg/Bloomberg

Coakley said the banks moved to seize Massachusetts homes when they had no legal authority do so because they didn't hold the mortgage on the properties.

## 'In Good Faith'

Gina Proia, a spokeswoman for Detroit-based Ally, said its GMAC Mortgage unit, which was named as a defendant, will fight the lawsuit and has worked "in good faith" with Coakley's office during the past year to discuss mortgage servicing and ways to assist borrowers.

Iowa Attorney General Tom Miller, who is leading negotiations with the banks for the states, said today in a statement from his office that he's optimistic a settlement will be reached "on terms that will be in the interests of Massachusetts."

Coakley said the banks moved to seize Massachusetts homes when they had no legal authority do so because they didn't hold the mortgage on the properties. Failure to obtain valid mortgage assignments before foreclosure has affected titles to "hundreds, if not thousands, of properties" in the state, she said.

### 'Strung Along'

The banks also deceived and misled homeowners about loan modifications, the attorney general said in a statement. The servicers "often strung along borrowers for months" in trial modifications before rejecting their attempts to modify loans, according to Coakley.

Banks are also accused of engaging in "robosigning," in which foreclosure paperwork is signed without verification of the information in the documents.

Banks are also accused of engaging in "robosigning," in which foreclosure paperwork is signed without verification of the information in the documents. The practice was also used in the transfer of mortgages, Coakley said.

"If we do not do this, we are stuck in this downward spiral of more foreclosures in a way that is totally counterproductive to the economy," she said at the press conference.

The lawsuit also names Merscorp Inc., which runs a mortgage registry used by banks, as a defendant. According Coakley, the banks undermined the public land record system through the use of the registry, which tracks servicing rights and ownership interests in mortgage loans. Merscorp spokeswoman Karmela Lejarde said in an e-mail that the system complies with Massachusetts law.

### JPMorgan Disappointed

Tom Kelly, a spokesman for New York-based JPMorgan, said the bank is disappointed Massachusetts sued while settlement negotiations with state and federal officials continue.

"We continue to believe that collaborative resolution rather than continued litigation will most quickly heal the housing market and help drive economic recovery," Lawrence Grayson, a spokesman for Charlotte, North Carolina-based Bank of America, said in a statement.

Citigroup hasn't had time to review the lawsuit, Mark Rodgers, a spokesman for the New York-based bank, said in an e-mail. The company has been cooperating with the attorney general, he said.

The case is Commonwealth of Massachusetts v. Bank of America N.A., 11-4363, Suffolk County Superior Court (Boston).

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## Former FDIC Chief Bair Calls for Stiffer Rules on Leverage

**Yalman Onaran | Bloomberg News**

Dec. 7 (Bloomberg) – Former Federal Deposit Insurance Corp. Chairman Sheila Bair, in testimony to U.S. lawmakers, pushed for stiffer global limits on how much banks can borrow.

The leverage ratio adopted by the Basel Committee on Banking Supervision needs to be increased, Bair told the Senate Subcommittee on Financial Institutions and Consumer Protection. She also urged regulators to consider "starting over" on the language of the Volcker rule as the panel held a hearing today in Washington on "Wall Street megabank risk."

"Regulators' primary focus should be constraining absolute leverage through an international leverage ratio that is significantly higher" than the Basel Committee's proposed 3 percent standard, Bair said in her written testimony.

The European Union has wavered on implementing Basel's leverage ratio, saying it needs to study the potential impact before committing to it. The U.S. has had its own ratio for about two decades, which would be closely matched by the new Basel standard.

A Basel requirement exceeding 3 percent also would force U.S. banks to boost capital or sell assets. Although the leverage ratio sometimes refers to total assets over equity, Basel and U.S. regulations flip the equation around, talking about equity as a percentage of total assets.

### Different Risks

The leverage ratio caps bank borrowing based on total assets on the balance sheet, ignoring the riskiness of different holdings. Standard capital ratios allow less capital to be held against lower-risk assets, giving banks leeway that may allow them to underestimate risk, as they did with mortgage securities before the 2008 housing crisis.

Bair called for an international leverage ratio during the Basel committee's 2009 to 2010 discussions on new capital and liquidity standards. The committee brings together regulators and central bankers from 27 countries. Its rules aren't binding on member countries, which need to individually translate the internationally agreed standards into their own regulatory frameworks.

European banks are in worse condition than U.S. peers because capital regulation has been looser and banks more leveraged, Bair said in her testimony. The European banking system is "so fragile" that lenders facing sovereign bond losses can't raise capital from markets. The EU banks may have to rely on help from the European Central Bank, their governments or the International Monetary Fund, she said.

European banks are in worse condition than U.S. peers because capital regulation has been looser and banks more leveraged, Bair said in her testimony.

Sheia Bair, former chairman of the Federal Deposit Insurance Corp. (FDIC), speaks during a Senate Banking Committee hearing with Simon Johnson, professor at the MIT Sloan School of Management
Credit: Andrew Harrer/Bloomberg

### Options 'Not Pretty'

"The choices in Europe are not pretty," Bair said. "They can let a good portion of their banking system fail, or they can commit to massive financial assistance through a combination of ECB bond buying and loans and guarantees from the IMF and stronger euro zone countries. Frankly, I don't know which is worse."

Bair also criticized the complexity of the rules drafted by U.S. regulators to implement the Dodd-Frank Act's Volcker rule. The regulation aims to prevent banks from taking oversized risks with their own capital through trading and investing in hedge funds. Paul Volcker, the former Federal Reserve chairman who conceived the idea, also has been critical of the proposed rules for similar reasons.

"The regulators should think hard about starting over again with a simple rule based on the underlying economics of the transaction, not on its label or accounting treatment," Bair said. "If it makes money from the customer paying fees, interest and commissions, it passes. If its profitability or loss is based on market movements, it fails."

The new rules also should make bank executives "personally accountable" for monitoring compliance with the standards, Bair said in her testimony.

### 'Personally Accountable'

The new rules also should make bank executives "personally accountable" for monitoring compliance with the standards, Bair said in her testimony.

Asked by members of the Senate subcommittee whether Dodd-Frank had solved the too-big-to-fail issue, Bair said that the authority given to the FDIC to take over and shut down big banks will remove the government backing that the biggest firms have enjoyed for decades. Without that implicit support, shareholders of the banks should force them to break up, Bair said.

Simon Johnson, a finance professor at the Massachusetts Institute of Technology who also testified at the hearing, countered Bair, noting that Wall Street executives are still publicly saying they want to expand globally.

*With assistance from Bradley Keoun and Bob Ivry in New York.*

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# State Banks

## Permissible or Prohibited Activities

## Republic to End Refund Anticipation Loan Program

Blayne V. Scofield | Bloomberg Law

Republic Bancorp, Inc., Current Report (Form 8-K) (Dec. 9, 2011)

- **Republic agreed to terminate its program and pay a $900,000 civil money penalty as part of a settlement with FDIC.**
- **Republic's exit may shift the regulatory focus to nonbank providers of refund anticipation loans.**

On December 9, 2011 Republic Bancorp, Inc. announced that its wholly-owned subsidiary, Republic Bank & Trust Company (Republic), entered into an agreement with the Federal Deposit Insurance Corporation (FDIC) to resolve a dispute related to Republic's tax refund anticipation loan program. The Republic settlement is a victory for FDIC in its efforts to drive banks from the refund anticipation loan market.

> The Republic settlement is a victory for FDIC in its efforts to drive banks from the refund anticipation loan market.

### Bank Regulators Targeted Refund Anticipation Loan Providers

Republic was the sole remaining bank provider of refund anticipation loans. In 2010, JPMorgan Chase & Co. exited the market voluntarily. Shortly thereafter, federal banking regulators pressured three of the final four bank providers–HSBC Holdings Plc, River City Bank, and Ohio Valley Bank–into abandoning their refund anticipation loan programs. Since then, regulators prevented other banks from providing refund anticipation loans and actively advised consumers to avoid them due to high fees and interest rates.

### Republic Sanctioned; Challenged FDIC Enforcement Action

In early 2011, FDIC set its sights on Republic. On February 15, 2011 FDIC launched a surprise nationwide examination of Republic's refund anticipation loan practices. The exam included on-site inspections in 36 states of 250 tax preparers that participated in Republic's refund anticipation loan program. Based on the findings of its exam, FDIC concluded that Republic's refund anticipation loan program violated several federal laws and regulations. It ordered Republic to shutter its program and imposed a $2 million civil money penalty.

Republic contested the findings and conclusions, and sued FDIC in federal court. Republic claimed that FDIC's activities were an illegal effort to eliminate refund anticipation loans through enforcement rather than through proper rulemaking channels. It sought declaratory judgment and an injunction barring FDIC from using information obtained during the surprise examination in administrative enforcement proceedings.

For more background on the suit and FDIC's enforcement action, see Bloomberg Law Reports®–Banking & Finance, *FDIC Amends Notice of Charges Against Kentucky Bank* (May 12, 2011).


Credit: Via Bloomberg News. Editorial Use Only

### Settlement Ends Bank Involvement in Refund Anticipation Loans

While Republic did not admit wrongdoing, it agreed to pay a $900,000 civil money penalty and terminate its refund anticipation loan program at the end of the 2012 tax season. As part of the settlement, FDIC agreed to terminate its enforcement proceedings and Republic agreed to voluntarily dismiss its lawsuit. Neither the settlement nor Republic's dismissal is subject to judicial approval.

On a positive note for Republic, FDIC allowed it to continue offering other tax-related products, such as electronic refund checks, deposits, and prepaid debit cards. Although the settlement agreement required Republic to improve its oversight of the tax preparers that market its products to consumers, it did not otherwise limit the sales of these products.

### Effects of the Settlement

As a result of the Republic settlement, regulators have successfully purged the banking system of refund anticipation loans. This will likely have two effects. First, regulatory attention will shift to nonbank providers, such as Money Co. USA, Inc. (formerly known as Mo' Money Taxes), that offer similar products. These entities are currently regulated by states, but will fall within the federal Consumer Financial Protection Bureau's jurisdiction once it has a permanent director in place. Second, for banks, this may cause federal regulators to focus on similar products, like refund anticipation checks, which have come under fire from consumer groups for many of the same reasons as refund anticipation loans.

> A drawback of the settlement is that FDIC's aggressive information gathering tactics in this case will avoid judicial scrutiny.

A drawback of the settlement is that FDIC's aggressive information gathering tactics in this case will avoid judicial scrutiny. Republic accused FDIC of using the surprise exam to circumvent the formal discovery process set forth in its regulations, under which Republic would have received notice and an opportunity to object to FDIC's information requests. According to Republic, FDIC's actions deprived it of due process. Republic's claims would have presented an interesting test of the scope of FDIC's examination powers while a formal administrative proceeding is pending. As a result of the settlement, however, FDIC's approach will escape judicial review for now.

## Bloomberg News

# Death of Tax-Refund Loans Spurs Search for Successor Products

Richard Rubin | Bloomberg News

Dec. 15 (Bloomberg) – The tax-refund loan, once a profit source for banks and tax-preparation companies, is vanishing under pressure from federal bank regulators and consumer advocates. Tax filers' need for quick cash hasn't eroded, and the companies are looking for ways to capitalize on that market.

Companies including Kansas City, Missouri-based H&R Block Inc., the nation's largest tax-preparation chain, are turning to so-called refund-anticipation checks that let taxpayers without bank accounts take advantage of the speed of directly deposited tax refunds through an account established for the payment.

"There's always going to be demand, and I believe someone's going to come up with a product," said John Hewitt, the president, CEO and chairman of Liberty Tax Service Inc., a Virginia Beach, Virginia tax-preparation company. Liberty will offer loans to tax filers in at least six states with consumer-finance laws that allow it.

> Bank regulators at the Federal Deposit Insurance Corp. and the Office of the Comptroller of the Currency questioned whether refund loans were a safe product for banks and if they adequately protected consumers.

The shift away from tax-refund loans has occurred over the past few years. The Internal Revenue Service stopped telling tax preparers and banks whether refunds would be siphoned off to cover other debts. Bank regulators at the Federal Deposit Insurance Corp. and the Office of the Comptroller of the Currency questioned whether refund loans were a safe product for banks and if they adequately protected consumers.

The shrinking of the refund-loan industry culminated Dec. 8 when Republic Bancorp Inc., the last bank company to finance refund loans, announced a settlement agreement with the FDIC. London-based HSBC Holdings Plc and New York-based JPMorgan Chase & Co. had previously exited the business.

## Republic's Agreement

Under the settlement, Republic agreed to stop providing refund-anticipation loans after the 2012 tax season, pay a $900,000 penalty, drop litigation against the FDIC and submit to supervision of its tax-refund business.

Republic, which provides loans for Jackson Hewitt Tax Service Inc. and Liberty Tax, in 2010 earned $44.2 million, or 69 percent of its net income, from its tax business.

**Steven Trager, chief executive officer of Republic Bancorp**
Credit: Via Bloomberg News. Editorial Use Only

"With this settlement, we preserve a big chunk of this business going forward," said Steve Trager, chairman and CEO of Republic, based in Louisville, Kentucky.

The company charged $90 for a $1,500 loan and $30 for a refund-anticipation check, which is less risky for the bank. With a loan, tax filers receive the money up front and then repay it when their tax refunds arrive, often within two weeks.

With a refund anticipation check, taxpayers don't receive any money until the IRS issues the refund. Tax filers get their money faster than if they wait for a paper check from the IRS.

## Refund-Anticipation Checks

Last year, Trager said, Republic issued loans and other tax-related products, including refund-anticipation checks, for 3.5 million people.

Trager said he expects continued growth in the bank's tax business outside of loans.

"A lot of regulations apply to loans that don't apply to non-loans," Trager said. "Even though I disagree with anyone that says $90 is too much for the loan product, our adversaries had a lot of weapons when it comes to loans because there's a lot of regulation that relate to loans."

Consumer advocates have long maintained that refund-anticipation loans prey on workers applying for the earned income tax credit who are among the almost half of U.S. households that don't pay income taxes.

## 'Sharks Come Circling'

"These are low-income families with a lot of expenses and this is the one time of year that they see a significant chunk of money," said Chi Chi Wu, a staff attorney at the National Consumer Law Center. "The sharks come circling, and all the industries that want a piece of that money come in."

Wu said payday lenders and other companies may fill the void left by the end of refund anticipation loans, known as RALs.

"While RALs made by banks are gone, tax-time financial products aren't gone," she said, adding that her group is examining refund-anticipation checks and urging states to regulate them.

H&R Block isn't offering refund loans this year.

Gene King, a company spokesman, declined to comment for this story.

Phil Mazzini, who runs the company's retail tax business, told investors at a conference in New York Dec. 8 that Block's competitive disadvantage didn't hurt the company in 2011.

"Independents lost share for the first time in at least five years, as they lack the scale and the tools to combat the RAL loss," Mazzini said. The "low cost, no cash out of pocket RAC benefit is the key settlement product benefit, and that the higher-cost, faster-access-to-a-refund RAL benefit has become a distant second, especially given the shrinking IRS refund window."

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# Failed Insured Depository Institutions

## Failed Insured Depository Institutions – Fourth Quarter 2011

Blayne V. Scofield | Bloomberg Law

- Bank failures slowed in the fourth quarter as regulators closed 18 banks, down from 26 in the third quarter.
- Failed banks remained concentrated in the southeastern U.S.
- Receivership litigation against failed bank directors and officers, as well as appraisers and mortgage brokers, remained brisk.

### Overview[1]

In the fourth quarter of 2011, 18 insured depository institutions[2] failed. This is slower than the pace set in the first three quarters of the year–26 banks were closed in the first quarter, 22 were closed in the second quarter, and 26 were closed in the third quarter. Although this continues to represent a substantial departure from the late 90's and early 2000's when bank closures were rare, it is a distinct improvement over mid-2009 through mid-2010 when regulators closed 40 to 50 banks per quarter.

Despite this, there remain significant issues to contend with. The Office of the Comptroller of the Currency's (OCC) Deputy Comptroller for Special Supervision predicted an uptick in closures during the first quarter of 2012. In addition, 844 banks with total assets of more than $339 billion remained on FDIC's problem bank list. This could expose the banking industry to significantly more closures if the U.S. is adversely affected by financial problems in Europe or if a speculative bubble in agricultural real estate forms and bursts.

There were two noteworthy bank failures in the fourth quarter. In October, for the first time in its history, the Board of Governors of the Federal Reserve System (FRB) exercised its powers to close a bank–Colorado Community Capital Bank. Ordinarily, a bank is closed by its chartering authority (*i.e.*, the OCC or the applicable state regulator). In this case, however, FRB acted due to federal statutory requirements and a disagreement with Colorado regulators.

In November, FDIC took the unusual step of retaining approximately $15 million in deposits related to external litigation when it closed SunFirst Bank. The litigation reportedly involves a suit filed by the Federal Trade Commission against a Utah philanthropist with ties to the bank.

### State Statistics

For the year, the southeast dominated bank failures. Alabama, Florida, and Georgia were home to 38 of the banks, approximately 41 percent, that failed in 2011. These states accounted for approximately 40 percent of both the total assets and total losses to the Deposit Insurance Fund (DIF) from failed banks in 2011.

This trend appears likely to continue through 2012. According to FDIC's Quarterly Banking Report for third quarter 2011 (see Table IV-A), banks in FDIC's Atlanta region had the lowest return on assets (0.62 percent) and return on equity (5.16 percent) of any in the country. In addition, approximately 33 percent of the banks in the region were unprofitable, nearly ten percentage points higher than the next closest region, San Francisco, in which approximately 24 percent of banks were unprofitable.

**Number of Failed IDIs in 2011**

| | Jurisdiction | Number of Failed IDIs |
|---|---|---|
| 1. | Georgia | 23 |
| 2. | Florida | 13 |
| 3. | Illinois | 9 |
| 4. | Colorado | 6 |
| 5. | California | 4 |
| 6. | Arizona | 3 |
| 7. | South Carolina | 3 |
| 8 | Washington | 3 |
| 9. | Wisconsin | 3 |
| 10. | Alabama | 2 |
| 11. | Michigan | 2 |
| 12. | Minnesota | 2 |
| 13. | North Carolina | 2 |
| 14. | Oklahoma | 2 |
| 15. | Virginia | 2 |
| 16. | Indiana | 1 |
| 17. | Iowa | 1 |
| 18. | Kansas | 1 |
| 19. | Louisiana | 1 |

| | Jurisdiction | Number of Failed IDIs |
|---|---|---|
| 20. | Mississippi | 1 |
| 21. | Missouri | 1 |
| 22. | Nebraska | 1 |
| 23. | Nevada | 1 |
| 24. | New Jersey | 1 |
| 25. | New Mexico | 1 |
| 26. | Pennsylvania | 1 |
| 27. | Texas | 1 |
| 28. | Utah | 1 |
| | **TOTAL** | **92** |

### Total Assets of Failed IDIs in 2011

| | Jurisdiction | Assets of Failed IDIs[3] (in millions) |
|---|---|---|
| 1. | Georgia | $6,165.4 |
| 2. | Colorado | $5,881.2 |
| 3. | Florida | $4,205.2 |
| 4. | Alabama | $3,734.9 |
| 5. | New Mexico | $2,188.2 |
| 6. | Indiana | $1,994.4 |
| 7. | Illinois | $1,903.1 |
| 8 | Virginia | $1,068.6 |
| 9. | California | $953.1 |
| 10. | Washington | $864.8 |
| 11. | Michigan | $842.2 |
| 12. | South Carolina | $781.8 |
| 13. | Kansas | $538.1 |
| 14. | Wisconsin | $515.1 |
| 15. | Minnesota | $441.2 |
| 16. | Louisiana | $383.1 |
| 17. | Arizona | $372.4 |
| 18. | North Carolina | $366.3 |
| 19. | Missouri | $351.5 |
| 20. | Texas | $239.9 |
| 21. | Mississippi | $228.3 |
| 22. | Utah | $198.1 |
| 23. | New Jersey | $191.9 |
| 24. | Nevada | $135.1 |
| 25. | Oklahoma | $134.7 |
| 26. | Nebraska | $106.1 |
| 27. | Iowa | $91.6 |
| 28. | Pennsylvania | $46.8 |
| | **TOTAL** | **$34,923.1** |

### Estimated DIF Losses in 2011

| | Jurisdiction | Estimated DIF Losses[4] (in millions) |
|---|---|---|
| 1. | Georgia | $1,828.8 |
| 2. | Colorado | $1,300.0 |
| 3. | Florida | $672.1 |
| 4. | Illinois | $521.1 |
| 5. | Alabama | $435.0 |
| 6. | Virginia | $285.6 |
| 7. | Michigan | $270.6 |
| 8 | New Mexico | $260.0 |
| 9. | Washington | $185.4 |
| 10. | Indiana | $170.7 |
| 11. | California | $165.1 |
| 12. | South Carolina | $148.1 |
| 13. | Missouri | $118.3 |
| 14. | Kansas | $116.6 |
| 15. | North Carolina | $94.2 |
| 16. | Wisconsin | $83.8 |
| 17. | Arizona | $76.8 |
| 18. | Minnesota | $75.0 |
| 19. | Louisiana | $58.1 |
| 20. | Texas | $53.8 |
| 21. | Utah | $49.7 |

| | Jurisdiction | Estimated DIF Losses[4] (in millions) |
|---|---|---|
| 22. | Mississippi | $49.1 |
| 23. | Oklahoma | $46.6 |
| 24. | New Jersey | $45.8 |
| 25. | Nevada | $31.9 |
| 26. | Nebraska | $12.7 |
| 27. | Iowa | $12.0 |
| 28. | Pennsylvania | $11.0 |
| | **TOTAL** | **$7,177.9** |

## Primary Federal Regulator Statistics

The Federal Deposit Insurance Corporation (FDIC) was the primary federal regulator for approximately 70 percent of the banks that failed in 2011. It is the primary federal regulator for 62.4 percent of all U.S. banks.[5] Thus, FDIC had a disproportionately high number of banks that failed in 2011. However, as measured by total assets and losses to the DIF, FDIC's performance was favorable. The banks for which it was the primary federal regulator accounted for only 43.7 percent of total failed bank assets and 54.5 percent of losses to the DIF.

On the flip side of this analysis are federal savings associations. Only six of these institutions failed in 2011. However, they represented an outsized proportion of failed bank assets and losses to the DIF–21.5 percent and 14.1 percent, respectively. This is despite the fact that federal savings associations account for only 8.5 percent of all insured depository institutions.[6] The disproportionate contribution of federal savings to failed bank total assets and losses to the DIF in 2011 was driven largely by the failures of United Western Bank and Superior Bank. These were two of the largest bank failures in 2011 and both were federal savings associations.

### Number of Failed IDIs in 2011

| | Primary Federal Regulator | Number of Failed IDIs | Percent of Total |
|---|---|---|---|
| 1. | FDIC | 64 | 69.6% |
| 2. | OCC - National | 11 | 12.0% |
| 3. | FRB | 11 | 12.0% |
| 4. | OTS/OCC - Thrifts[7] | 6 | 6.4% |
| | **TOTAL** | **92** | **100.0%** |

### Total Assets of Failed IDIs in 2011

| | Primary Federal Regulator | Assets of Failed IDIs (in millions)[8] | Percent of Total |
|---|---|---|---|
| 1. | FDIC | $15,261.7 | 43.7% |
| 2. | FRB | $7,919.3 | 22.7% |
| 3. | OTS/OCC - Thrifts[9] | $7,501.3 | 21.5% |
| 4. | OCC - National | $4,240.8 | 12.1% |
| | **TOTAL** | **$34,923.1** | **100.0%** |

### Estimated Losses to the DIF in 2011

| | Primary Federal Regulator | Estimated DIF Losses (in millions)[10] | Percent of Total |
|---|---|---|---|
| 1. | FDIC | $3,912.3 | 54.5% |
| 2. | FRB | $1,663.3 | 23.2% |
| 3. | OTS/OCC - Thrifts[11] | $1,011.5 | 14.1% |
| 4. | OCC - National | $590.8 | 8.2% |
| | **TOTAL** | **$7,177.9** | **100%** |

## Selected Litigation Activity

The failure of a bank usually gives rise to a variety of litigation. FDIC may seek to recover losses to the DIF by filing suits against the parties associated with a failed bank–for example, its officers and directors, holding company, or vendors–alleging that their activities contributed to the bank's demise. In some instances, a failed bank may challenge its regulator's decision to close it. Creditors of a failed bank whose claims are denied by FDIC often challenge FDIC's determinations. Selected litigation from the fourth quarter of 2011 involving failed IDIs is summarized below.

### – Appraisers and Mortgage Companies

- FDIC suffered a setback in *FDIC v. LSI Appraisal Inc.*, 11-cv-00706 (C.D. Cal. Nov. 2, 2011) (Docket No. 35) (Washington Mutual). FDIC sued an appraisal company accusing it of negligence and breach of contract. The court dismissed FDIC's negligence claims. If the court's reasoning is adopted by other courts, this could impair FDIC's ability to recover against appraisers and participants in the mortgage origination process. For more information, see

Blayne V. Scofield, *Half of FDIC's Claims Against Appraisal Management Company Thrown Out in $154 Million Dispute*, Bloomberg Law Reports®–Banking and Finance (Nov. 10, 2011).

- FDIC continued to file suits accusing appraisers of using improper methods in conducting real estate appraisals for banks that eventually failed. *E.g.*, *FDIC v. Hollis Appraisals, Inc.*, No. 11-cv-01049 (M.D. Fla.) (filed Oct. 25, 2011) (First Federal Bank of North Florida).
- FDIC also continued to file suits against other participants in the mortgage origination process, accusing them of various improprieties in connection with mortgages held by banks that eventually failed. *E.g.*, *FDIC v. Clarion Title Company, Inc.*, 11-cv-14394 (S.D. Fla.) (filed Nov. 3, 2011) (AmTrust Bank, F.S.B.).

### – Authority to Close

- *United Western Bank v. OTS*, No. 11-cv-00408 (D.D.C.). The parties continued to squabble over discovery during the fourth quarter. As ordered by the court, OCC produced the administrative record related to the closure of United Western. However, the bank's attorneys accused OCC of improperly withholding more than 200 pages of materials.

### – Bankruptcy

- *In re Corus Bankshares Inc.*, No. 10-26881 (Bankr. N.D. Ill.). The bankruptcy court approved Corus's reorganization plan despite FDIC's objections. FDIC challenged the plan based on its claims to approximately $265 million of Corus's tax refunds.
- *In re BankUnited Financial Corporation*, No. 09-19940 (Bankr. S.D. Fla.). The bankruptcy court rejected FDIC's claim to certain tax refunds and held instead that the proceeds of the refunds were property of the bankruptcy estate.

### – Directors and Officers

- In *FDIC v. McCaffree*, No. 11-cv-02447 (D. Kans. 2011) (Docket No. 26) (The Columbian Bank and Trust Co.), the bank's directors and officers moved to stay the proceedings while an action in state court challenging the seizure of the bank is pending. The court rejected the motion, citing the statutory limitations in 12 U.S.C. § 1821(j) on judicial interference with receivership actions.
- FDIC announced that it settled its claims against three Washington Mutual executives for approximately $64 million. FDIC's suit against the executives reportedly sought $900 million in damages. According to the settlement agreement, insurers will pay approximately $39.6 million of the $64 million.
- In the fourth quarter, FDIC filed four new suits against directors and officers of failed banks: *FDIC v. Blackwell*, No. 11-cv-03423 (N.D. Ga.) (filed Oct. 7, 2011) (Alpha Bank); *FDIC v. Mahajan*, No. 11-cv-07590 (N.D. Ill.) (filed Oct. 25, 2011) (Mutual Bank); *FDIC v. Johnson*, No. 11-cv-05953 (W.D. Wash.) (filed Nov. 18, 2011) (Westsound Bank) and *FDIC v. Greenwood*, No. 11-cv-00337 (W.D.N.C.) (filed Dec. 29, 2011) (The Bank of Asheville).
- According to its website, FDIC has filed 17 suits to date against directors and officers in connection with the wave of failures that began in 2007 and has authorized litigation against officers and directors of 41 institutions that have failed.

### – Insurance

- FDIC filed a complaint against Lloyd's of London, *FDIC v. Syndicate 2003 at Lloyd's*, No. 11-cv-02083 (D. Ariz.) (filed Oct. 25, 2011) seeking $43.5 million in damages. FDIC accused Lloyd's of breaching a directors and officers liability policy in connection with the failure of First National Bank of Arizona and First National Bank of Nevada.

### – Securitizations/Securities Fraud

- FDIC filed at least three securities fraud suits against Wall Street banks in connection with the failure of Franklin Bank S.S.B. In its suits, FDIC accused the banks of making material misstatements regarding loans collateralizing certain mortgage-backed securities. *FDIC v. Morgan Stanley & Company LLC*, No. 11-cv-04184 (S.D. Tex.); *FDIC v. Morgan Stanley & Company LLC*, No. 11-cv-04187 (S.D. Tex.); and *FDIC v. Countrywide Securities Corporation*, 11-cv-04188 (S.D. Tex.) (filed Dec. 2, 2011).

[1] Data for this article: Bloomberg, L.P., FDIC.

[2] For purposes of this article, "insured depository institutions" (IDI) includes institutions whose deposits are insured by FDIC and excludes federally-insured credit unions. The terms "bank" and "insured depository institution" are used interchangeably in this article.

[3] The data was obtained from each IDI's Call Report or Thrift Financial Report as of the quarter immediately preceding its failure (*i.e.*, for IDIs that failed in the first quarter of 2011, the information is as of December 31, 2010, for IDIs that failed in the second quarter of 2011, the information is as of March 31, 2011, for IDIs that failed in the third quarter of 2011, the information is as of June 30, 2011, and for IDIs that failed in the fourth quarter of 2011, the information is as of September 30, 2011).

[4] FDIC issues a press release with respect to each failed IDI that contains, among other things, FDIC's estimate of the loss to the Deposit Insurance Fund (DIF) from the IDI's failure. "Estimated Cost to DIF" data was taken from FDIC's press release with respect to each failed IDI.

[5] As of September 30, 2011, FDIC reported that there were 7,436 FDIC-insured banks and that it was the primary federal regulator for 4,641 of these institutions.

[6] As of September 30, 2011, FDIC reported that there were 7,436 FDIC-insured banks. This includes 1,084 savings institutions. FDIC supervises 448 of these savings institutions. This implies that there are 636 federal savings associations currently supervised by OCC (and formerly supervised by the Office of Thrift Supervision (OTS)).

[7] Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the OTS was dissolved on July 21, 2011 and its

supervisory responsibilities for federal savings associations were transferred to OCC.

[8] The data was obtained from each IDI's Call Report or Thrift Financial Report as of the quarter immediately preceding its failure (*i.e.*, for IDIs that failed in the first quarter of 2011, the information is as of December 31, 2010, for IDIs that failed in the second quarter of 2011, the information is as of March 31, 2011, for IDIs that failed in the third quarter of 2011, the information is as of June 30, 2011, and for IDIs that failed in the fourth quarter of 2011, the information is as of September 30, 2011).

[9] Pursuant to the Dodd-Frank Act, the OTS was dissolved on July 21, 2011 and its supervisory responsibilities for federal savings associations were transferred to OCC.

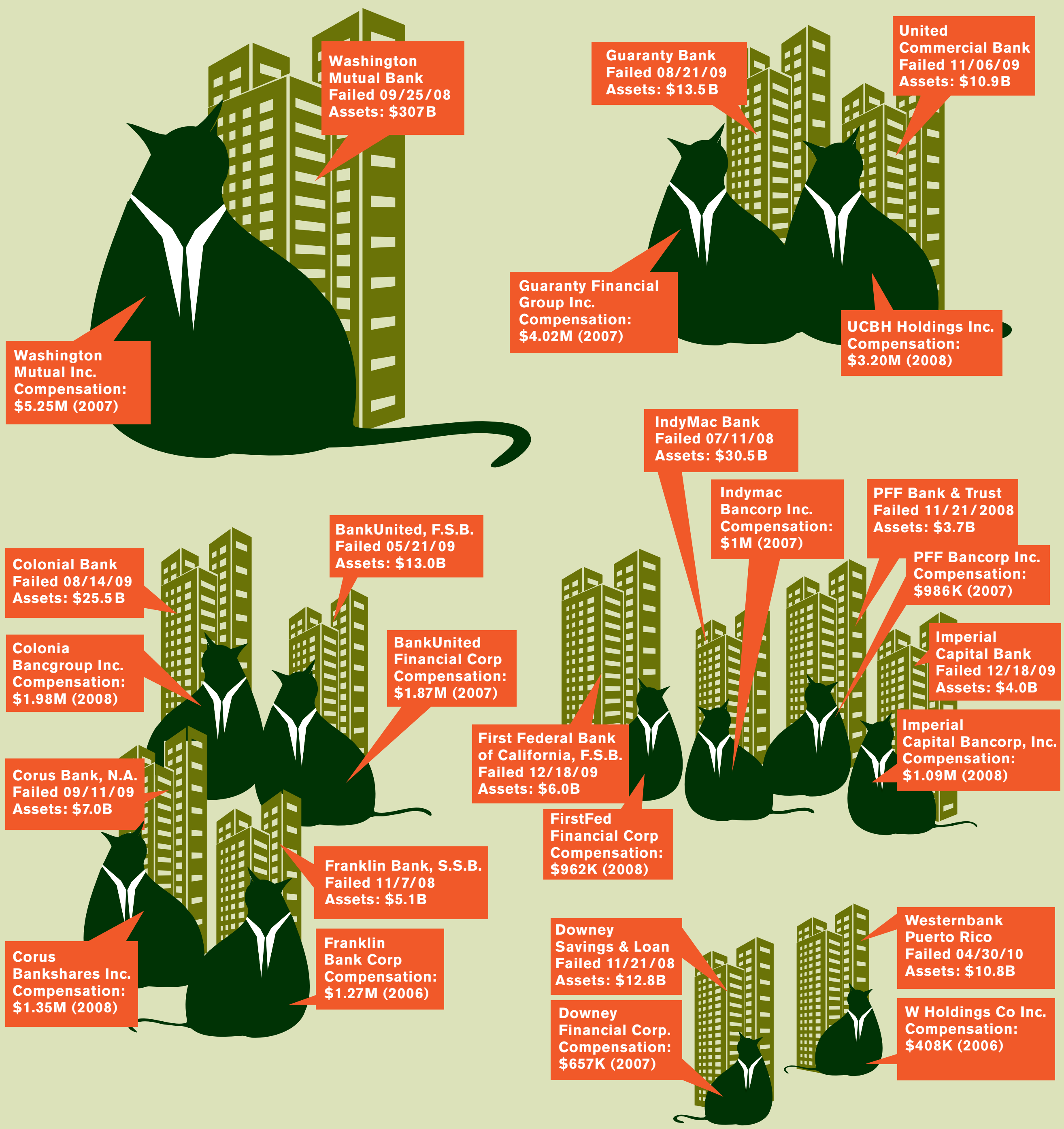
[10] FDIC issues a press release with respect to each failed IDI that contains, among other things, FDIC's estimate of the loss to the DIF from the IDI's failure. "Estimated Cost to DIF" data was taken from FDIC's press release with respect to each failed IDI.

[11] Pursuant to the Dodd-Frank Act), the OTS was dissolved on July 21, 2011 and its supervisory responsibilities for federal savings associations were transferred to OCC.

# BEFORE THEY FAILED

## CEO COMPENSATION PRIOR TO BANK FAILURE

In a two year period, between July 2008 and April 2010, 13 of the largest banks in the U.S. failed. CEOs of their bank holding companies (BHC) were often highly paid, even in the year prior to failure. Below is an illustration of the banks' total assets (in billions) at failure and the compensation of the CEO of their BHCs.




Source: SEC 

# Developments in Brief

## Regulatory Activity

## Selected Regulatory Activity for December 2011

### Releases

***Supervision and Regulation Proposals For SIFIs Announced.*** Sections 165 and 166 of the Dodd-Frank Act mandated that FRB strengthen the regulation and supervision of systemically important financial institutions (SIFIs). FRB's proposal sets forth measures for early remediation, single-counterparty credit limits, and stress tests. It also addresses implementation of risk-based capital, leverage, and liquidity requirements. Under the proposal, compliance is expected within a year after it is finalized. FRB seeks comments on the proposal, which must be submitted no later than March 31, 2012. Cheyenne Hopkins and Phil Mattingly, *Fed Compels Banks to Follow Tougher Risk Management Rules*, Bloomberg News (Dec. 20, 2011); Dakin Campbell, *Fed 'Punted' on Capital, Liquidity Limits in Dodd-Frank Plan*, Bloomberg News (Dec. 21, 2011); Board of Governors of the Federal Reserve System, Press Release (Dec. 20, 2011).

***CFPB Welcomes Whistleblowers.*** Those with knowledge of potential violations of federal consumer financial laws may now use email or a phone number to communicate their information to the CFPB. Online access to whistleblower tip submission is expected to be available early next year. CFPB seeks information about potential violations from current or former employees, contractors, vendors, and others. The Dodd-Frank Act provides some protection to current employees against termination or discrimination if they cooperate with CFPB, including providing information about potential consumer financial law violations, testifying about potential violations, filing lawsuits under a federal consumer financial law, or refusing to participate in a violation of federal consumer financial laws. Carter Dougherty, *U.S. Consumer Bureau Seeks Whistleblower Tips on Finance Rules*, Bloomberg Law (Dec. 15, 2011); Consumer Financial Protection Bureau, Press Release, *Consumer Financial Protect Bureau Begins Taking Whistleblower Tips* (Dec. 15, 2011).

***Credit Cards: Know Before You Owe.*** The CFPB announced a new "Know Before You Owe" initiative which will provide more guidance to consumers about credit card agreements. CFPB seeks to simplify credit card agreements and provide information to the consumer that is easier to understand. The proposed form of agreement is two pages and explains key features immediately in plain language. The proposal also attempts to standardize much of the legal language currently in many credit card agreements and streamline it by making it available online or in paper form by the issuer. CFPB seeks public opinion about the proposed agreement and plans to test it on customers of the Pentagon Federal Credit Union. Carter Dougherty and Roger Runningen, *U.S. Consumer Bureau Proposes Simplified Credit-Card Form*, Bloomberg News (Dec. 7, 2011); Consumer Financial Protection Bureau, Press Release, *Consumer Financial Protection Bureau Aims to Simplify Credit Card Agreements* (Dec. 7, 2011).

### Rulemakings

***CRA Threshold Updated By Agencies.*** The Community Reinvestment Act (CRA) defines small banks and savings associations and intermediate small banks and savings associations according to asset size of the institution. Federal banking regulators are required to adjust the asset size threshold for these institutions annually using the consumer price index (CPI). In the period ending November 30, 2011, the CPI increased 3.43 percent and, as a result, small banks and savings associations will now be defined as those institutions with assets that are less than $1.160 billion and intermediate small banks and savings associations will be those institutions with assets greater than $290 million and less than $1.160 billion, in each case determined as of December 31 of the prior two calendar years. These adjustments become effective on January 1, 2012. Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, Press Release, *Agencies Release Annual CRA Asset-Size Threshold Adjustments for Small and Intermediate Small Institutions* (Dec. 19, 2011).

***CFPB Releases Thirteen Interim Final Rules and Seeks To Streamline Regulations.*** The Dodd-Frank Act transferred rulemaking authority for federal consumer financial laws to CFPB from several federal agencies when it officially assumed responsibility on July 21, 2011. The republished regulations will include technical changes reflecting the transfer to CFPB and other conforming changes made by recent legislation, but no substantive differences. CFPB seeks recommendations from the public about changes to the inherited regulations that will streamline the rule and simplify or ease compliance. CFPB provided eight specific questions for which it seeks comments to address general reviews of the inherited regulations, specific instances for streamlining the regulations, and practical suggestions for easier compliance with the regulations. Comments are requested no later than March 5, 2012, with an additional 30 days to respond to comments posted by the deadline. It subsequently republished seventeen regulations: Regulations B, C, F, G, H, I, J, K, L, M, N, O, P, V, X, Z, and DD as interim final rules effective December 30, 2011, and requested comments on or before February 14 (Regulations C, F, I, N, and O), February 17 (Regulations G, H, M), and February 21 (Regulations B, J, K, L, P, V, X, and Z). Consumer Financial Protection Bureau, *Streamlining Inherited Regulations*, 76 Fed. Reg. 75825 (Dec. 5, 2011); Consumer Financial Protection Bureau, *Fair Debt Collection Practices Act (Regulation F)*, 76 Fed. Reg. 78121 (Dec. 16, 2011), *Disclosure Requirements for Depository Institutions Lacking Federal Deposit Insurance (Regulation I)*, 76 Fed. Reg. 78126 (Dec. 16, 2011), *Mortgage Acts and Practices–Advertising (Regulation N); Mortgage Assistance Relief Services (Regulation O)*, 76 Fed. Reg. 78130 (Dec. 19, 2011), *Home Mortgage Disclosure (Regulation C)*, 76 Fed. Reg. 78465 (Dec. 19, 2011), *S.A.F.E. Mortgage Licensing Act (Regulations G & H)*, 76 Fed. Reg. 78483 (Dec. 19, 2011), *Consumer Leasing (Regulation M)*, 76 Fed. Reg. 78500 (Dec. 19, 2011), Real Estate Settlement Procedures Act (Regulation X), 76 Fed. Reg. 78978 (Dec. 20, 2011), Fair Credit Reporting (Regulation V), 76 Fed. Reg. 79308 (Dec. 21, 2011), Equal Credit Opportunity (Regulation B), 76 Fed. Reg. 79442 (Dec. 21, 2011), Interstate Land Sales Registration Program (Regulations J, K, and L), 76 Fed. Reg. 79486 (Dec. 21, 2011), Privacy of Consumer Financial Information (Regulation P), 76 Fed. Reg. 79025 (Dec. 21, 2011), and Truth in Lending (Regulation Z), 76 Fed. Reg. 79768 (Dec. 22, 2011).

***Federal Banking Agencies Seek Comment on Market Risk Capital Rules.*** FRB, FDIC, and OCC announced a proposed rule addressing market risk capital rules. Under the Dodd-Frank Act, federal agencies must replace references to credit ratings in their regulations with alternate creditworthiness criteria. Under the proposed rule, creditworthiness determinations would vary depending on the instrument in question–market risk capital requirements for securitizations, sovereign debt, public sector debt, financial institution debt, and corporate debt would be calculated using risk-related financial data. The agencies proposed standards are expected to conform to the risk capital calculation method outlined by the Basel Committee on Banking Supervision. The agencies' request comments on the NPR no later than February 3, 2012. Carter Dougherty, *FDIC Seeks Comment on Alternatives to Ratings for Debt*, Bloomberg News (Dec. 7, 2011); Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, Press Release, *Agencies Seek Comment on Additional Revisions to the Market Risk Capital Rules* (Dec. 7, 2011).

## Testimony

***Mortgage-Backed Securities Legislation Discussed.*** Real estate finance industry insiders testified before the House Financial Services Committee about the Private Mortgage Market Investment Act (PMMIA), legislation intended to standardize the securitization process, provide uniform underwriting standards, and increase transparency for mortgage-backed securities' risks. Some viewed the legislation as a means to return private capital to the housing finance system. A few witnesses expressed the opinion that the government, and particularly government-sponsored enterprises, should reduce their role in the housing finance market. One witness voiced his concern that the legislation was unnecessary and that the market should form securitization standards, not the federal government. A hearing in early November addressing this legislation included testimony from the FHFA Director and other industry insiders. Hearing Before the House Committee on Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises, *"H.R.___, the Private Mortgage Market Investment Act, Part 2"* (Dec. 7, 2011).

Neal Wolin, U.S. deputy treasury secretary, left to right, Daniel Tarrullo, governor of the U.S. Federal Reserve, and Mary Shapiro, chairman of the U.S. Securities and Exchange Commission
Credit: Andrew Harrer/Bloomberg

***Regulators Address Progress of the Dodd-Frank Act Initiatives.*** Testimony by Neal S. Wolin (Treasury), Daniel K. Tarullo (FRB), Mary Schapiro (SEC), Gary Gensler (CFTC), Martin J. Gruenberg (FDIC), and John Walsh (OCC) addressed the progress made by their respective agencies to adopt regulations implementing the Dodd-Frank Act. Interagency efforts were outlined by the witnesses and each expressed the efforts the agencies have expended to comply with their requirements under the Dodd-Frank Act. Difficulties in meeting the deadlines set forth in the Dodd-Frank Act were acknowledged, but the witnesses testified about the reasons their agencies struggled with the deadlines–typically citing budgetary constraints and the desire for thorough and measured consideration of the proposals. Phil Mattingly, *Regulators Face Grilling by Congress on Volcker Rule, Dodd-Frank*, Bloomberg News (Dec. 6, 2011). Hearing Before the Senate Committee on Banking, Housing, and Urban Affairs, *Continued Oversight of the Implementation of the Wall Street Reform Act* (Dec. 6, 2011).

# Transaction Activity

## Selected Transaction Activity for December 2011

### Assets

***Banks Tussle over Archstone***. A legal fight has erupted over the sale of a minority stake in Archstone, an owner of luxury apartment buildings in the U.S. and Europe. The company is held by Lehman Brothers Holdings Inc. (currently in bankruptcy) which has a 47 percent stake, and Bank of America Corp. and Barclays Plc which control the other 53 percent. The three banks initially sought to sell the company outright but could not agree on timing. In response, Bank of America and Barclays agreed to sell half their interest to Equity Residential. Lehman exercised its contractual right to match Equity Residential's offer and filed a suit to block the Bank of America/Barclay sale. Linda Sandler, *Lehman Sues Barclays, Bank of America Over Archstone Deal*, Bloomberg News (Dec. 15, 2011).

***Citi Dumps Primerica Stake***. Citigroup Inc. disposed of the last of its holdings of life insurer Primerica Inc. Citi acquired Primerica in the late 1980s. Its divestment effort began in 2010 when it spun off Primerica in an initial public offering. In November 2011, Primerica reduced Citi's stake by repurchasing approximately 8.9 million Citi shares. On December 13, 2011, Citi and Primerica initiated a public sale of Citi's remaining shares. In divesting itself of Primerica, Citi follows other large financial institutions like Bank of America that have shed noncore assets to focus on primary business lines. Michael J. Moore and Donal Griffin, *Citigroup Sells Remaining Primerica Shares for $180 Million*, Bloomberg News (Dec. 13, 2011).

### Capital

***GE Awaiting FRB Verdict on Dividends***. GE Capital Corp. reportedly seeks to reinstate dividend payments in 2012. The company, GE's finance arm, halted divided payments in 2009 to preserve cash in the midst of the financial crisis. According to GE, GE Capital is projected to have nearly $50 billion in cash on hand by the end of 2012. GE Capital is subject to FRB oversight as a savings and loan holding company due to its ownership of a federal thrift, GE Capital Retail Bank (formerly known as GE Money Bank). FRB assumed responsibility for savings and loan holding companies earlier this year when the OTS was dissolved pursuant to the Dodd-Frank Act. Market analysts speculated that FRB would render its decision in the first half of 2012. Rachel Layne, *GE Investors Eager for Finance Unit Payment Await Fed Review*, Bloomberg News (Dec. 6, 2011).

### Mergers and Acquisitions

***First Niagara Taps Markets to Finance HSBC Purchase***. In July, First Niagara Financial Group announced that it agreed to purchase 195 New York and Connecticut branches from HSBC for approximately $1 billion. In November, the transaction cleared an important hurdle when the DOJ agreed not to object to the deal on antitrust grounds. Progress on the transaction continued in December as First Niagara tapped the capital markets to obtain the funds necessary to consummate the deal. It issued $450 million in new common stock, $600 million in perpetual noncumulative preferred stock (in two separate offerings), and $300 million in subordinated debt. First Niagara Financial Group, Inc., SEC Form 8-K (Dec. 14, 2011) (issuance of noncumulative perpetual preferred stock); SEC Form 8-K (Dec. 13, 2011) (issuance of subordinated debt); SEC Form 8-K (Dec. 12, 2011) (issuance of common stock); SEC Form 8-K (Dec. 7, 2011) (announcement of plan to issue $250 million in noncumulative perpetual preferred stock).


Credit: Doug Benz/Bloomberg

***Investor Seeks to Block BB&T-BankAtlantic Deal***. On November 1, BankAtlantic Bancorp Inc. announced an agreement to sell its subsidiary bank, BankAtlantic, to BB&T Corp. As part of the transaction, BankAtlantic Bancorp. will retain some loans and real estate held by the bank. On November 28, holders of BankAtlantic Bancorp's trust preferred securities sued to halt the sale, arguing that the proposed transaction violated the securities' governing documents. The trust preferred holders accused BankAtlantic Bancorp. of allowing BB&T to cherrypick its best assets, which would leave BankAtlantic Bancorp. with insufficient resources to repay its trust preferred obligations. The trust preferred holders also accused BB&T of tortious interference. *Hildene Capital Management LLC v. BankAtlantic Bancorp Inc.*, No. 7068-VCL (Del. Ch. Nov. 28, 2011) (Docket No. 1).

### Products

***Columbus Bank & Trust Terminates Green Dot Relationship***. Green Dot disclosed that Columbus Bank & Trust (CB&T) has taken steps to terminate the parties' relationship in October 2012 at the expiration of the agreement's initial term. CB&T currently issues Green Dot's Visa- and MasterCard-branded prepaid cards. The agreement between Green Dot and CB&T allows either party to terminate the agreement at that time without cause upon six months prior notice (see Section 23.1). In November, FRB approved Green Dot's acquisition of Bonneville Bank and, on December 8, Green Dot announced that it closed the transaction. The purchase of Bonneville Bank will allow Green Dot to issue its own prepaid cards without the assistance of a third party bank. Green Dot, Inc., SEC Form 8-K (Dec. 12, 2011).

***Goldman to Issue Index-Linked CDs***. Goldman Sachs Bank USA is reportedly planning to issue a certificate of deposit product linked to the Dow Jones Industrial Average (DJIA). This will be Goldman's first entry into the structured CD market. Structured CDs are FDIC-insured deposits. However, unlike plain vanilla CDs which pay a fixed interest rate, the yield on structured CDs is linked to an external factor, like commodity prices, foreign currencies, or, as in this case, a stock index. According to a preliminary prospectus, Goldman's CDs will yield the greater of 0.5 percent per year or an amount based on a formula tied to the DJIA. Because of their unusual yield mechanisms, structured CDs can present challenging Truth in Savings Act/Regulation DD disclosure issues for financial institutions. Matt Robinson, *Goldman Said to Start FDIC-Backed CDs Linked to Equities*, Bloomberg News (Dec. 9, 2011).

***Coakley Spooks Ally***. Earlier this month, Massachusetts Attorney General Martha Coakley accused Ally Financial, four other large banks, and MERS of engaging in unfair and deceptive foreclosure practices. The suit seeks civil damages of $5,000 per violation, attorneys fees, and corrective action. The day after the case was filed, Ally announced that it would cease purchasing mortgages in Massachusetts from its correspondent lenders and brokers, but will continue to originate mortgages in its own name. Ally did not explain why it apparently perceived greater risk in its wholesale mortgage activities compared to its direct lending activities. Dakin Campbell, *Ally Financial Will Halt Mortgage Purchases in Massachusetts*, Bloomberg News (Dec. 2, 2011). *See also* David McLaughlin, *Ally Should Be Investigated by Congress, Massachusetts Says*, Bloomberg News (Dec. 6, 2011).

# Index of Authorities