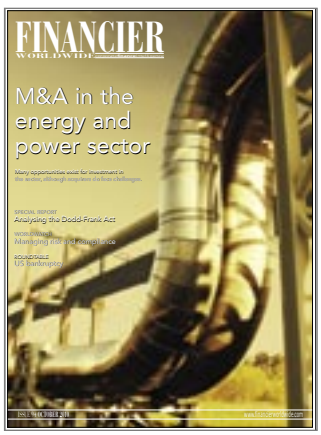
SPECIAL REPORT

SQUIRE SANDERS | LEGAL COUNSEL WORLDWIDE

ANALYSING THE DODD-FRANK ACT



REPRINTED FROM:
OCTOBER 2010 ISSUE

FW MAGAZINE

FINANCIER WORLDWIDE corporatefinanceintelligence

SPECIAL REPORT

Analysing the Dodd-Frank Act

FINANCIER WORLDWIDE corporatefinanceintelligence

Select provisions of the Dodd-Frank Act affecting banks

BY JAMES J. BARRESI AND AARON A. SEAMON

This article provides a general overview of select areas of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the 'Act') that directly impact banks, thrifts and their respective holding companies. Areas of focus include: (i) bank capital and leverage requirements; (ii) deposit insurance reforms; (iii) the 'Volcker Rule'; (iv) amendments effecting the regulation of depository institutions and holding companies; and (v) consumer financial protection.

The Act provides a general framework for financial reform and mandates the adoption of hundreds of rules, regulations and studies. It is difficult to predict with specificity the Act's impact until such regulatory action is complete. However, financial institutions should begin to plan now for the considerable financial, legal, and compliance costs triggered by the Act, not to mention the need for some institutions to spin off or discontinue certain business lines. The Act and regulations will also have a significant impact on certain borrowers, who should also begin to plan for its implementation.

Bank capital and leverage requirements

Section 171 of the Act, commonly referred to as the Collins Amendment, mandates significant changes with respect to leverage and risk-based capital requirements.

The Collins Amendment requires Federal regulators to establish minimum capital and leverage standards by January, 2012 that are no less stringent than the standards applicable to US insured depository institutions. The Federal Reserve Board (FRB) is also required to establish additional capital and leverage standards for systemically significant nonbank financial companies and bank holding companies with more than $50bn in consolidated assets, and may also impose contingent capital requirements for such firms after further study. A variety of additional GAO studies with respect to capital are also required, any of which may have an impact on final rulemaking.

Final rulemaking will also be significantly impacted by the capital standards recently announced by the Basel Committee on Banking Supervision as part of Basel III. Once implemented by participating nations and fully phased-in, the Basel III standards will require affected institutions to increase common equity from 2 percent of risk-weighted assets for adequately capitalised institutions to 4.5 percent, plus a 'conservation buffer' of up to 2.5 percent of additional common equity or other loss-absorbing capital. The conservation buffer could be drawn upon during times of stress, subject to restrictions on earnings distributions. The Tier 1 capital requirement will increase from 4 percent for adequately capitalised institutions to 6 percent, for a total Tier 1 capital requirement of 8.5 percent, inclusive of the common equity 'conservation buffer,' described above. An additional 'countercyclical buffer' of common equity or other loss-absorbing capital may also be required during favourable economic times, within a range of 0 to 2.5 percent. Additional non-risk-based leverage ratio requirements are also required by Basel III, supplementing the risk-based measures described above. The Basel Committee continues to work on additional measures for systemically important financial institutions, which may include a combination of additional capital requirements, surcharges, contingent capital and bail-in debt measures. Stricter adjustments with respect to the risk-weighting of assets are also expected, which may further increase the amount of capital needed to meet the new ratios described above. Any regulations implemented in response to the Collins Amendment will inevitably include features from Basel III as finally adopted.

Institutions with complex capital structures are likely to find that planning in light of the Collins Amendment and Basel III will be complicated and require significant strategic analysis. One key effect of the Collins Amendment will be the exclusion of trust preferred securities (TPS) as a component of Tier 1 capital, subject to certain exceptions, grandfathering and phase-in provisions. Affected institutions should begin to evaluate the terms of existing TPS issuances, focusing on whether early redemption is permitted, and if not, whether any exceptions may permit early redemption nonetheless, such as upon a change in law or regulation that affects capital treatment. TPS issuances that include replacement capital obligations should also be evaluated to determine whether additional equity capital must be issued before any redemption occurs. The Federal Reserve may also require the issuance of additional equity in order to permit a particular redemption of TPS.

Many institutions may need to obtain more costly forms of capital, retain more earnings and/or reduce balance sheet assets in order to comply with the increased capital standards resulting from the Collins Amendment and Basel III. In addition to creating stability and limiting risk, increased capital requirements are likely to result in reduced earnings and lower returns on equity as institutions work to ensure they meet or exceed any new requirements. This may affect borrowers and their access to and cost of capital, among other things.

Deposit insurance reform

The Act includes a variety of provisions related to FDIC deposit insurance. Of particular note is Section 331(b) of the Act, which directs the FDIC to amend its regulations to base deposit insurance assessments on insured depository institutions' average consolidated total assets rather than deposit base, with certain exceptions. This change is likely to have a greater impact on larger depository institutions that are more reliant on non-depository sources of funding. This revised assessment methodology may incentivise institutions to shrink their balance sheets.

Other provisions include increasing the minimum designated reserve ratio to no less than 1.35 percent, permanently increasing maximum deposit insurance to $250,000, and insuring certain qualifying noninterest bearing transaction accounts for a two-year period beginning on 31 December 2010.

Amendments affecting depository institution and holding company regulation

One of the primary purposes of the Act was to provide regulators with enhanced regulation, examination and enforcement powers over depository institution affiliates, including functionally regulated subsidiaries, in an effort to better detect systemic risk. The foregoing is just one aspect of the many technical, and in some instances overlapping, changes applicable to the regulation of depository institutions, related holding companies and their affiliates. These measures are expected to increase the time and expense associated with ongoing bank regulatory compliance, with such expense likely passed on to customers. As with other provisions of the Act, extensive rulemaking will be necessary prior to final implementation.

Volcker Rule

The Volcker Rule (Section 619 of the Act) generally prohibits any 'banking entity' from engaging in proprietary trading, or sponsoring or investing in a hedge fund or private equity fund. Systemically important nonbank financial companies are also required to maintain additional capital and comply with certain other quantitative limits. The Volcker Rule is subject to a variety of technical exceptions and ▸▸

extended phase-in period (becoming effective two years after enactment, with a two year transition period beginning upon the issuance of transition rules by the FRB). These restrictions will require extensive planning with respect to how organisations should best divest themselves of affected businesses. These divestitures may also result in possible acquisition opportunities for non banking-entity organisations who are not otherwise subject to the Act.

The Volcker Rule will have a substantial impact on larger, more complex banking organisations with extensive securities trading businesses and investment subsidiaries. For many institutions, business lines that are subject to the Volcker Rule have been among the most profitable in recent years, and exiting or modifying such business lines may significantly reduce earnings as well as risk.

Consumer financial protection provisions

The Act includes a variety of provisions with respect to consumer financial protection that will meaningfully affect most commercial banking organisations. The Act also imposes new and significant limits on the Federal preemption of state consumer financial protection laws and enforcement.

Hotly debated at the time of enactment, Title X of the Act establishes the Bureau of Consumer Financial Protection within the FRB and concentrates significant rulemaking supervision and enforcement authority within this new Bureau. The Bureau has exclusive authority and power over consumer financial protection matters for depository institutions with over $10bn in assets. The Bureau will also have a role in regulating smaller institutions with respect to consumer financial protection matters, subject to rulemaking by the Bureau, although supervision of and enforcement against smaller institutions will largely remain with existing regulators. A variety of institutions and activities are exempted from the Bureau's authority, such as registered broker-dealers, persons regulated by the CFTC, persons regulated by state insurance regulators, etc.

The Act also provides that state consumer protection law is preempted by Federal law only to the extent state law "prevents or interferes with" the exercise by a national bank of its powers, as determined by the Office of Comptroller of the Currency (OCC) on a case-by-case basis, which requires a determination by the OCC, based on substantial evidence and subject to judicial review. State law is also preempted by Federal law if it would have a discriminatory effect on national banks or is otherwise preempted by another Federal law. Preemption protections are also removed for subsidiaries, affiliates or agents of national banks that are not national banks themselves. State attorneys-general are empowered to bring actions against federally-chartered depository institutions to enforce regulations proscribed by the Bureau under Title X, and private parties are not precluded from enforcing applicable rights under Federal or state law.

While subject to further rulemaking (and various effective dates) the foregoing provisions may have far reaching and lasting consequences for national banks and other federally chartered depository institutions, requiring compliance with respect to state consumer financial protection laws not previously contemplated. By scaling back Federal preemption, institutions that operate in multiple states may find themselves subject to a variety of new and possibly inconsistent state consumer financial protection standards, resulting in increased enforcement risk and regulation by state attorneys-general. Affected institutions will need to carefully monitor subsequent rulemaking with respect to these measures, and evaluate business activities within their geographic footprint to ensure compliance.

Conclusion

The Act represents sweeping reform of the financial services industry and it will have wide-ranging consequences. Some of these consequences will be positive, some will be negative and many will be unintended. It is difficult to predict consequences with specificity until regulations and rules are promulgated. It is clear, however, that the Act will have a major impact on most financial institutions, including core elements of the business strategy of many. The Act may also be expected to have a significant, if indirect, impact on commercial customers, who are well-advised to carefully monitor how these important regulatory developments affect their sources of capital. ■

James J. Barresi is a partner at Squire, Sanders & Dempsey L.L.P. He can be contacted on +1 (513) 361 1260 or by email: jbarresi@ssd.

James J. Barresi chairs the firm's global Financial Services Practice Group. He advises financial institutions and finance companies, private equity funds and hedge funds in corporate and commercial finance matters, mergers and acquisitions and complex investment transactions. Mr. Barresi has substantial experience in the acquisition of troubled financial institutions and distressed companies and in managing exposure to troubled financial institutions.

Aaron A. Seamon is a principal at Squire, Sanders & Dempsey L.L.P. He can be contacted on +1 (614) 365 2759 or by email: aseamon@ssd.com.

Mr. Seamon is a member of the firm's Financial Services Practice Group and co-leads its capital markets practice segment. He brings considerable capital formation expertise to clients in a variety of industries, and has assumed leading roles in structuring and implementing numerous public and private offerings of debt, equity and hybrid securities. He also regularly advises financial services firms on a broad range of corporate and commercial matters, including securities law compliance, mergers, acquisitions and disposition transactions, bank capital and regulatory compliance and corporate governance matters.