LAW360

Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Banking Regulation To Watch In 2013

By **Evan Weinberger**

Law360, New York (January 01, 2013, 4:27 PM ET) -- The banking industry could see its business change fundamentally in 2013 as banking regulators finalize key provisions of the Dodd-Frank Act that cover nearly every aspect of a bank's operations, including mortgages, capital requirements and proprietary trading.

“I think 2013 is really going to be a watershed year in bank regulation,” said Scott Anenberg, the co-head of Mayer Brown LLP's financial services regulatory and enforcement practice. “It's a pretty safe bet that virtually all of these major regulations are going to come out in final form during 2013.”

Here are five of the most important rules banks are bracing for in 2013.

The Qualified Mortgage Rule

The Consumer Financial Protection Bureau expects to complete its qualified mortgage rule by the end of January, which will require lenders to determine that a borrower is able to repay his or her mortgage before issuing a loan. And when that rule is done, it will have a profound effect on the way people borrow money to purchase homes, attorneys say.

“Anything that is not a qualified mortgage is not going to be available from a bank,” said Elizabeth McKeen, a partner with O'Melveny & Myers LLP.

The rule, which under the statute must be finalized by the end of January, will force lenders to delve more deeply into a borrower's finances, unless the borrower is applying for a high-quality loan. For the most part, mortgages with balloon payments and those that did not require a borrower to verify and document their income would not be considered qualified under the law.

Banks have been fighting a two-front battle over the qualified mortgage rule. They are at once battling for a broad definition of what will be considered a qualified mortgage, as well as a safe harbor provision to protect them from lawsuits and potential loan putback requests once the mortgages are packaged into securities.

“It may not matter how broad the definition is, because if I don't get a good, strong safe harbor I may not be interested in making those loans,” said Jeffrey Taft, a partner at Mayer Brown.

While there is general agreement on the need for a safe harbor in the qualified mortgage rule, there is not a consensus on how it should look.

A broad, nonprescriptive safe harbor could allow banks to have a certain amount of flexibility when challenged on the quality of mortgages they issued, some argue.

However, that leaves banks open to interpretation of the statute by both enterprising plaintiffs firms and judges. A more check-the-box approach would offer better protections, McKeen said.

"I do think that the brighter the lines can be, the more certainty you're likely to have. And that's better," she said.

The Qualified Residential Mortgage and Risk-Retention Rules

Dodd-Frank charged the Federal Reserve, the Federal Deposit Insurance Corp., the Office of the Comptroller of the Currency, the Federal Housing Finance Agency and the U.S. Department of Housing and Urban Development to craft rules that would require banks and other companies that securitize consumer loans to hold on to 5 percent of the securities once they are offered for sale.

The goal is to give banks and other companies an incentive to monitor the quality of the loans included in those securities by making them share in the risk after they hit the market.

Although the rule applies to all consumer loans, the banking industry has been focused on the definition of qualified residential mortgages that the regulators have been developing, the first to take effect. Any mortgage designated a QRM would not be subject to the risk-retention rules and would be far easier to securitize.

Regulators charged with writing the QRM standard have delayed finalizing the rule until after the CFPB wraps up its qualified mortgage provision. Dodd-Frank mandated that the QRM standard could not be tighter than the CFPB's qualified mortgage rule.

Without a firm, broad QRM definition, it is unlikely that private capital will return to the secondary mortgage market, which is dominated by Fannie Mae and Freddie Mac, said Bob Bostrom, a shareholder at Greenberg Traurig LLP and former Freddie Mac general counsel.

"Until there is certainty about risk retention and repurchases, no one is going to go near the space," he said.

The Volcker Rule

One of Dodd-Frank's most prominent provisions was the ban on proprietary trading known as the Volcker Rule. Named for former Federal Reserve Chairman Paul A. Volcker, the rule would also limit banks' investments in certain funds and will have exemptions for market making and hedging. The rule went into effect in July — but the problem is, there is still no actual rule.

The five regulators charged with writing it — the Fed, the FDIC, the OCC, the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission — have been battling over the definitions of market making and hedging, among other provisions.

With the regulators promising to finish the rule by the end of the first quarter of 2013, there is a danger that there may be several different versions to contend with.

That, in many minds, would be a worst-case scenario.

“I think most people think at the end of the day there will be a uniform rule because the alternative would simply be unworkable, particularly for banks that have broker-dealers in their structure,” Anenberg said.

However, regulators coming together on the strictest interpretation possible for the Volcker Rule would be no better for banks, said Donald Lamson, counsel at Shearman & Sterling LLP who helped craft the Obama administration's version of the rule while detailed to the U.S. Department of the Treasury in 2009 and 2010.

“That would curtail economic activity the most,” he said.

The Basel III International Banking Accords

Embedded in Dodd-Frank was a requirement that the Fed, the OCC and the FDIC implement the Basel III international banking accords' mandate that banks increase their capital holdings, but regulators have put off the controversial measures, promising to finalize them in 2013.

The 2010 Basel III agreements require depository institutions to hold up to 7 percent in Tier 1 capital — the type most able to absorb losses — against their risk-weighted assets. Although the agreements apply only to large internationally active banks, U.S. regulators proposed in June to extended the rules to all U.S. banks and thrifts with $500 million or more in consolidated assets.

After a flood of comments, including thousands from community banks that were not expecting that the rules would apply to them, and questions from Congress, the regulators said in November that they would not meet a Jan. 1 deadline for finalizing the rules. Instead, the rules will come out at some point in 2013.

“There's an inherent admission that what the regulators proposed wasn't workable,” Lamson said.

Most community banks already meet Basel III's prescribed capital levels, but they still argued that the way regulators propose to require them to account for that capital would make it difficult for them to continue their lending and other operations.

Specifically, they say that the proposed methods for calculating capital necessary to guard against the risks of nontraditional mortgages, among other provisions, would place an undue burden on them when the rules were supposed to only apply to global banks.

The regulators have already said that they plan to incorporate community bankers' concerns in the final rules, but it is unclear what, exactly, the changes will be.

While community bankers stand to benefit the most, the largest banks will also see some benefit as well.

“Even though it's the community banks that are maybe gaining the most traction on those issues under the standardized approach, like treatment of mortgage loans, many of those issues are also important to larger banks because they have to operate with those same rules as their … floor,” Anenberg said.

Enhanced Prudential Regulations: Dodd-Frank Act Sections 165 and 166

The Fed is expected in 2013 to finalize its rules for enhanced prudential regulation of bank holding companies, otherwise known as sections 165 and 166 of the Dodd-Frank Act. The package of rules include a broad rewriting of how banks should manage and monitor risks, as well as maintain liquidity and otherwise protect themselves.

The rules will cover both U.S. banks with $50 billion or more in assets, as well as foreign banks with U.S. branches. It is unclear, however, whether the Fed rules will apply to foreign banks with $50 billion in global operations or $50 billion in the U.S. alone.

Sections 165 and 166 rules are essentially the “federalization of corporate governance,” Bostrom said, laying out standards for everything from the makeup of a bank board of directors' risk committee and the qualifications for a chief risk officer to a bank's risk-based capital and liquidity requirements.

“It covers the gamut of supervisory activity and significantly increases it for those two categories of covered institutions,” he said.

The enhanced prudential regulations went into effect in July, but regulators have only finished a small portion of the vast requirements, notably the rules for stress testing. The Fed released its proposals for non-U.S. banks with $50 billion or more in assets operating in the United States in late December.

Many expect the Fed to release its enhanced rules in stages over the course of 2013.

“These are all segregated issues, and I think from the Fed's perspective it probably makes sense to pick away at these item by item rather than to roll out one huge regulation,” Paul Hastings LLP partner Kevin Petrasic said.

--Editing by Andrew Park.

All Content © 2003-2012, Portfolio Media, Inc.