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ALERT

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Senate Banking Committee Approves Changes to Dodd-Frank on Party-line Vote

On May 21, 2015, the Senate Banking Committee approved by a 12-10 vote a financial regulatory reform package developed by the Committee's Chairman, Richard Shelby (R-AL) that includes the most significant changes to Dodd-Frank since the law was enacted nearly five years ago, including:

- Raising the asset threshold that automatically subjects banks to enhanced prudential standards from the Federal Reserve from $50 billion to $500 billion, while giving regulators authority to decide which banks with assets between $50 and $500 billion should be subject to the tougher requirements;
- Allowing for most loans that lenders hold in portfolio to be classified as qualified mortgages ("QMs") for the purpose of determining their compliance with the Consumer Financial Protection Bureau's ("CFPB") Ability-to-Repay Rule;
- Increasing the amount of loans that are eligible to be considered QMs by excluding from the points and fees calculation any escrow payments the lender charges the borrower for future insurance payments;
- Changing the process used by the Financial Stability Oversight Council ("FSOC") to designate non-bank financial firms systemically important financial institutions ("SIFIs") to improve transparency and provide firms an opportunity to make changes to prevent them from being designated SIFIs or to shed their existing SIFI status; and
- Increasing from $10 billion to $50 billion the bank asset threshold that triggers direct examinations by the CFPB, though the banks would still be subject to examination by their primary regulator for compliance with CFPB rules.

Background information on enhanced prudential standards from the Federal Reserve, the CFPB's Ability-to-Repay Rule, and the Financial Stability Oversight Council is provided below.

Moderate Democrats hold key to passage in Senate

The 12-10 vote was along party lines. Republicans supported Chairman Shelby's package, arguing it would provide regulatory relief to community and regional banks that would boost the economy. But, Democrats opposed it, saying it went too far in rolling back provisions of Dodd-Frank put in place to prevent another financial crisis. Senator Sherrod Brown (D-OH), the top Democrat on the Banking Committee, led an unsuccessful effort by Democrats to replace Shelby's bill with a narrower measure that would have provided relief to smaller banks and credit unions without the broader changes in bank regulation included in Shelby's bill. Republicans voted it down.

Chairman Shelby hoped the Banking Committee's four moderate Democrats – Jon Tester (D-MT), Mark Warner (D-VA), Heidi Heitkamp (D-ND), and Joe Donnelly (D-IN) – would vote for his bill. Shelby even included provisions to win their support. But, the four senators voted against the bill, expressing frustration they were not given an opportunity to help draft it. By voting against Shelby's bill, however, they likely increased their leverage to negotiate changes with Chairman Shelby before the bill goes to the Senate floor.

This is because it takes 60 votes to overcome a Democratic filibuster and pass legislation in the Senate. But, Republicans only have a 54-seat Senate majority. So, Chairman Shelby needs the support of the four moderate Democrats on the Banking Committee. If he can persuade them to come his way by moderating the regulatory package's changes to Dodd-Frank, Shelby stands a good chance of picking up the support of other moderate Democrats on the Senate floor, giving him the votes he needs to advance the package in the Senate.

However, if Chairman Shelby fails to win over the moderate Democrats on the Banking Committee, or he goes too far in making changes to win their support, costing Republican votes, the regulatory package is unlikely to have enough support to secure 60 votes in the Senate. In that case, Senate Majority Leader Mitch McConnell (R-KY) is not likely to bring the package up for a vote and it could be stalled, perhaps indefinitely.

This would leave Chairman Shelby the option of trying to pass changes to Dodd-Frank as part of must pass legislation, most likely FY 2016 appropriations. But, this option would be much more limited because appropriations riders are often difficult to pass – particularly if they threaten passage of the underling appropriations bill. Moreover, the House and Senate Appropriations Committees would determine which changes to Dodd-Frank would be included in FY 2016 appropriations, if any.

Shelby expected to negotiate with Democrats over the summer

At the May 21st Banking Committee markup, Chairman Shelby said, "This is Round One. It's a good start. We've raised the level of debate on this and there are four, five, six Democrats that might be able to work with us on this committee. This is the beginning of some serious negotiations."

Thus, over the summer, Chairman Shelby is expected to negotiate with Democrats on the Banking Committee to make some changes to provisions in the regulatory package that alter Dodd-Frank and other parts of the legislation that Democrats may oppose such as those that make changes to the Federal Reserve.

One of the possibilities for compromise is the regulatory package's $500 billion bank asset threshold that would automatically trigger enhanced prudential supervision by the Federal Reserve, but leave in the hands of regulators the decision whether to subject banks with assets between $50 billion and $500 billion to the stricter federal oversight.

Both Republicans and Democrats on the Banking Committee want to help small and medium-sized banks in their states that engage in traditional banking activities and were not considered instrumental to the financial crisis. The difficult question is where to draw the line on asset size to automatically trigger enhanced prudential requirements from the Federal Reserve.

It appears there may be a middle ground between the $50 billion bank asset threshold in Dodd-Frank and the $500 billion bank threshold that Chairman Shelby included in his regulatory package. For example, during the Banking Committee markup, Senator Brown said, "I do agree that some banks above $50 billion shouldn't be regulated like Wall Street megabanks." Brown said he was interested in a proposal from Federal Reserve Governor Daniel Tarullo for raising the $50 billion bank asset threshold in Dodd-Frank to $100 billion.

Another potential compromise that Chairman Shelby could negotiate with Democrats is dropping or modifying language in the regulatory package that exempts banks with assets between $10 billion and $50 billion from direct exams by the CFPB. The language was added by an amendment offered by Senator Pat Toomey (R-PA). The only Democrat who voted for it was Senator Joe Donnelly.

Democrats view the CFPB as one of the most significant reforms included in Dodd-Frank and they are unlikely to support Shelby's bill if it contains Senator Toomey's amendment. However, if the language is removed or perhaps modified, this could make it easier for Chairman Shelby to persuade some Democrats on the Committee to support the package on the Senate floor.

While Chairman Shelby's bill and the alternative proposed by the Democrats may not have addressed all of the issues faced by community and regional banks, they are indicative of ongoing efforts by both Democrats and Republicans to find a bi-partisan legislative compromise to ensure that Dodd-Frank reasonably provides safe guards for systemic risk without an undue burden on the banking community, and more importantly, without unwarranted restrictions on the overall market's access to credit.

Enhanced prudential standards from the Federal Reserve

Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") directs the Board of Governors of the Federal Reserve System ("Board") to establish prudential standards for bank holding companies with total consolidated assets of $50 billion or more and for nonbank financial companies that FSOC has determined will be supervised by the Board in order to prevent or mitigate risks to U.S. financial stability that could arise from the material financial distress or failure, or ongoing activities of, large, interconnected financial institutions.

Last year, the Board released a final rule adopting amendments to Regulation YY to implement certain of the enhanced prudential standards required to be established under Section 165 of Dodd-Frank for bank holding companies and foreign banking organizations with total consolidated assets of $50 billion or more. The enhanced prudential standards include risk-based and leverage capital requirements, liquidity standards, requirements for overall risk management (including establishing a risk committee), stress-test requirements, and a 15-to-1 debt-to-equity limit for companies that FSOC has determined pose a grave threat to financial stability.

The amendments also establish risk-committee requirements and capital stress-testing requirements for certain bank holding companies and foreign banking organizations with total consolidated assets of $10 billion or more. The rule does not impose enhanced prudential standards on nonbank financial companies designated by FSOC for supervision by the Board. See Federal Register Volume 79, Issue 59 (March 27, 2014).

CFPB's Ability-to-Repay Rule

Truth In Lending Act ("TILA") Section 129C, as added by Sections 1411, 1412, and 1414 of Dodd-Frank, generally requires creditors to make a reasonable good faith determination of a consumer's ability to repay a mortgage loan and creates a presumption of compliance for certain loans designated as "qualified mortgages." On Jan. 10, 2013, the CFPB released a final rule implementing the ability-to-repay requirement of Dodd-Frank. The rule requires a lender to determine based on documented and verified information that at the time a mortgage loan is made, the borrower has the ability to repay the loan. Failure to make such a determination could result in a lender having to pay damages to the borrower who brings a lawsuit claiming that the lender did not follow the ability-to-repay rule.

The final rule provides multiple ways for a lender to comply, one of which is by originating a qualified mortgage. To receive QM status, a loan must meet certain underwriting and product-feature requirements. For example, the lender has not allowed the borrower to take on monthly debt payments in excess of 43 percent of pre-tax income; has not charged more than 3 percent in points and origination fees; and has not issued a risky or overpriced loan like negative-amortization, balloon, 40-year or interest-only mortgage. If a loan is a QM, then the lender receives a presumption of compliance for legal purposes.

The type of presumption of compliance that a QM receives depends on the rate of the loan. If the loan is a higher-priced mortgage (the mortgage's rate exceeds the average rate for a prime mortgage by more than 1.5 percentage points for a purchase), the lender receives a rebuttable presumption of compliance. If the QM is not a higher-priced mortgage, then the lender receives a safe harbor. So long as the mortgage meets the QM standards, the lender is considered to have complied with the ability-to-repay rule.

Financial Stability Oversight Council

Dodd-Frank established a new regulatory framework to address financial market instability. Included in this framework was the creation of the Financial Stability Oversight Council. FSOC is composed of the heads of the agencies that regulate financial institutions and markets, including: Department of Treasury, Federal Reserve Board, Office of the Comptroller of the Currency; Consumer Financial Protection Bureau;

Securities and Exchange Commission, Federal Deposit Insurance Corporation; Commodities Future Trading Commission, Federal Housing Finance Agency; National Credit Union Administration; and Insurance expert (appointed by the president).

FSOC was created to address some of the perceived regulatory weaknesses that may have contributed to the magnitude of the financial crisis of 2008. These perceived weakness included identification of risks to the financial system as a whole; lack of coordination among financial regulators; inadequate supervision of large, complex financial institutions; and instabilities that might result from the failure or bankruptcy of a non-bank financial institution. FSOC has the ability to classify ("designate") certain non-banks as systemically important financial institutions, which subject them to enhanced prudential standards from the Federal Reserve.

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This *GT Alert* was prepared by **Alan Slomowitz, Nanette Aguirre**, **Tim Hutchinson, and Albert Wynn**. Questions can be directed to:

> Alan Slomowitz | +1 202.533.2318 | slomowitza@gtlaw.com
> Nanette Aguirre | +1 212.801.6549 | aguirren@gtlaw.com
> Tim Hutchinson | +1 202.530.8512 | hutchinsont@gtlaw.com
> Albert Wynn | +1 202.530.8531 | wynna@gtlaw.com
> Or your Greenberg Traurig attorney

Albany
+1 518.689.1400

Amsterdam
+31 (0) 20 301 7300

Atlanta
+1 678.553.2100

Austin
+1 512.320.7200

Boca Raton
+1 561.955.7600

Boston
+1 617.310.6000

Chicago
+1 312.456.8400

Dallas
+1 214.665.3600

Delaware
+1 302.661.7000

Denver
+1 303.572.6500

Fort Lauderdale
+1 954.765.0500

Houston
+1 713.374.3500

Las Vegas
+1 702.792.3773

London*
+44 (0) 203 349 8700

Los Angeles
+1 310.586.7700

Mexico City+
+52 (1) 55 5029 0000

Miami
+1 305.579.0500

New Jersey
+1 973.360.7900

New York
+1 212.801.9200

Northern Virginia
+1 703.749.1300

Orange County
+1 949.732.6500

Orlando
+1 407.420.1000

Philadelphia
+1 215.988.7800

Phoenix
+1 602.445.8000

Sacramento
+1 916.442.1111

San Francisco
+1 415.655.1300

Seoul∞
+82 (0) 2 369 1000

Shanghai
+86 (21) 6391.6633

Silicon Valley
+1 650.328.8500

Tallahassee
+1 850.222.6891

Tampa
+1 813.318.5700

Tel Aviv^
+972 (0) 3 636 6000

Tokyo¤
+81 (0)3 3216 7211

Warsaw~
+48 22 690 6100

Washington, D.C.
+1 202.331.3100

Westchester County
+1 914.286.2900**West**

Palm Beach
+1 561.650.7900