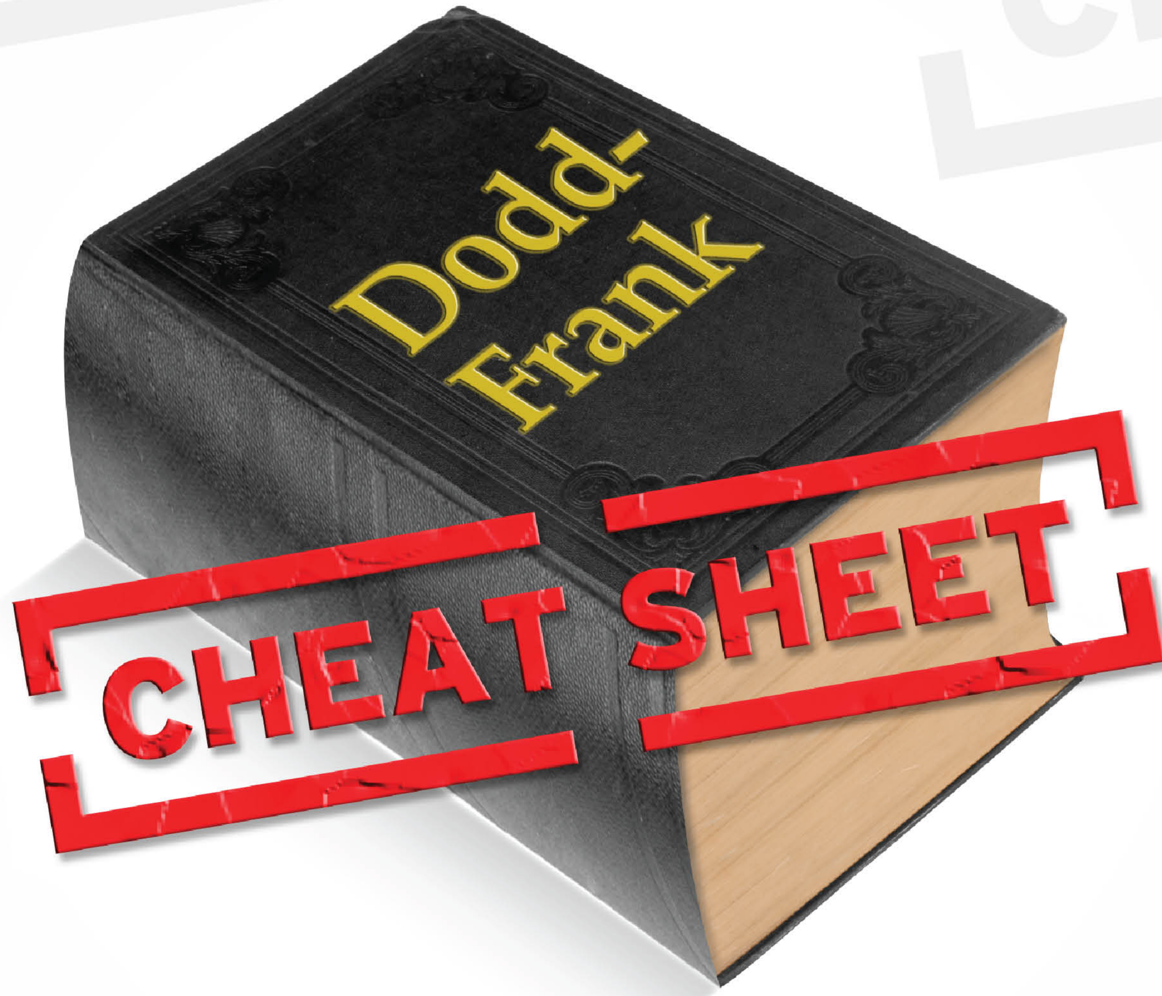

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InformationWeek
Financial Services

Editor's Letter

Dodd-Frank Wall Street Reform and Consumer Protection Act

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The Complete Works of Dodd-Frank (Abridged)

Weighing in at slightly less than 1,000 pages, the Dodd-Frank Wall Street Reform and Consumer Protection Act is not at the top of most people's reading list. Much of the legislation is written in legalese and typical Congressional jargon. It's dense, confusing, complicated and often boring (as the editors of the InformationWeek Financial Services group reminded me whenever they had the chance). So when I was asked recently by a CIO if we read the entire law, I responded: "Well, someone had to do it."

Our mission was to dissect Dodd-Frank to figure out what's important and what isn't. The goal was to compile a shortened version — a cheat sheet, if you will — for readers who want to know more about the law but simply don't have the time to sit down and read the massive, historic document.

Make no mistake: Dodd-Frank is important — the most important piece of financial legislation since Reg NMS, Check 21 or Solvency II, at least — and, occasionally, eye-opening. The law touches on all parts of financial services and will change the way that many types of financial products are bought, sold and traded.

So here is the InformationWeek Financial Services **Dodd-Frank Cheat Sheet** from the editors of *Advanced Trading, Bank Systems & Technology, Insurance & Technology* and *Wall Street & Technology*. The end product is a relatively brief 39-page document. For those of you who aren't attorneys or Congressional legislators, the Cheat Sheet distills Dodd-Frank down to its essential implications, providing layman's definitions of the rules, information about the law's impact on technology, important deadlines, additional resources and more.

While the Cheat Sheet isn't a substitute for reading the entire legislation (just as "Cliffs Notes" aren't a substitute for reading "Hamlet"), it will help executives get up to speed on the new requirements. Happy reading.

Greg MacSweeney
Editorial Director
InformationWeek Financial Services

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Of the 16 Titles contained in the nearly 1,000-page Dodd-Frank legislation, Title I is the most straightforward and arguably the least controversial. Title I establishes two new bodies to share insight and information across the disparate arms of the U.S. financial services industry — the Financial Stability Oversight Council (FSOC) and the Office of Financial Research (OFR), which fall under the supervision of the U.S. Treasury Department.

Essence of Title I

The aim of these two new bodies is to form an agency that will be responsible — for the first time — for looking at the overall systemic risk in the nation's financial institutions. The government (namely the Treasury), Wall Street, and the banking and insurance sectors have operated within their own regulatory silos for decades. Now, with the creation of the FSOC, the regulatory leaders of those silos will meet frequently to discuss the strengths and vulnerabilities of their particular silos.

The FSOC's Role: The FSOC will be headed by the Secretary of the Treasury. The other members will include the chairman of the Federal Reserve; the Comptroller of the Currency; the director of the Bureau of Consumer Financial Protection; the chairpersons of the SEC, FDIC and CFTC; the director of the Federal Housing Finance Agency; and the chairman of the National Credit Union Administration Board. The final member is an appointee of the President of the United States (with the advice and consent of the U.S. Senate). The committee's makeup is historic in that members of non-banking institutions will be at the same table with traditional bank regulators.

According to industry observers, the FSOC would be able to look at, for example, the hedge fund sector on one hand, and the insurance and banking sectors on the other. The new regulatory body would be in a position to identify a developing pattern of suspicious or worrisome behavior in the markets and to take steps to correct the problem or reduce the risk to the market participants and the entire market itself. For example, the members of the FSOC could identify the early development of a bubble or a margin spreading to an unusual degree and take steps to rectify it.

It is also the responsibility of the FSOC to issue a report to Congress that describes the health of the United States' financial system. Each member will attest that the federal government is taking all steps to attain and sustain financial stability and keep systemic risk in check, or provide additional measures that need to be implemented.

FSOC's Power: The FSOC has quite a bit of authority. It has the authority to impose on the Systemically Important Financial Institutions — also known as SIFIs or "Too Big to Fail" banks — additional capital, liquidity and other forms of regulatory restraints that are designed to cure the systemic problem(s) that it has identified. The FSOC also may compel any bank or nonbank financial institution with assets of more than $50 billion to submit certified reports of the firm's financial condition, its systems for monitoring

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and controlling risk, and transactions with subsidiaries that are regulated by banks; and disclose company activities that could have a disruptive impact on financial markets or the overall financial stability of the country.

The FSOC does not have a set schedule for meetings. On January 18, 2011, it released a number of documents pertaining to the U.S. financial markets, including a study and set of recommendations on how to implement the Volcker Rule, the subset of Title VI of Dodd-Frank that prohibits U.S. firms from investing their own funds in investment schemes in order to avoid any conflict on their clients' behalf. This report is 81 pages long and includes 10 recommendations to effectively implement the Volcker Rule against proprietary trading. The recommendations include requiring banks to sell or wind down all proprietary trading desks, requiring banks to implement robust compliance, and requiring firms to perform quantitative analysis to detect prop trading without provisions for safe harbors.

The OFR's Role: The Office of Financial Research was created to improve the quality of the industry's data for more robust and sophisticated analysis of the nation's financial system and to make regular reports to Congress.

The cornerstone of the OFR's mandate is to oversee and create standards for data that can reveal a firm's fiscal health and the entire industry's risk exposure. The OFR will establish a data center "to standardize, validate and maintain the data necessary to help regulators identify vulnerabilities in the system as a whole, and a research and analysis center to conduct, coordinate and sponsor research to support and improve regulation of financial firms and markets."

Symbology Requirements: The OFR also will push financial services firms to create a standard symbology for trades. Currently there are different methods and protocols for representing a trade from firm to firm. The OFR will mandate a single method of symbology so that regulators and market participants know who has participated in a trade and who owns what stock and particular piece of risk. Firms finally will have a way of creating an understandable set of symbologies for derivatives or non-standard esoteric swaps, for example.

Impact on IT

Investment firms will have to get their ever-growing volumes of data in order, something that has either vexed or bored them for decades. Not only are there different ways of representing a trade from firm to firm, there often are multiple ways a firm will represent a trade within its own enterprise. Investment firms will be pushed to meet and agree on data symbology standards within the coming two years — or face the prospect of the government setting the rules for the industry.

Future of Title I

Although industry observers predict that the current Republican-led House of Representatives will push for some scaling-back of the sweeping Dodd-Frank legislation, few think that the authority or provisions of Title I—Financial Stability will be altered much from their original charter. ■

Title II—Orderly Liquidation Authority

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Title II attempts to relieve taxpayers of future "too big to fail" bailouts by establishing rules that would require large financial firms that are deemed systemically important to be taken over by the FDIC if they become financially unstable.

Essence of Title II

Title II was constructed to allow for the orderly liquidation of unstable companies deemed systemically important. If a company is facing bankruptcy but is considered by regulators to be too big to fail, that company would be subject to an "Orderly Liquidation Authority," or OLA.

This statute requires that the OLA pave the way for the Federal Deposit Insurance Corp. (FDIC) to seize control of a financial firm whose collapse could topple the nation's financial system, which was the case during the AIG fiasco. Under this arrangement, taxpayers will be protected from ever having to bail out a firm considered too big to fail.

Legal experts point out that there are several steps that must be taken before the OLA is able to begin liquidation proceedings. First, the FDIC and Federal Reserve Board of Governors — either of their own volition or at the behest of the Secretary of the Treasury — must recommend the appointment of the FDIC as a receiver of a financial company. Before making such a recommendation, those agencies must consider the following eight criteria:

1. Whether the firm is in danger of default.
2. The impact the firm's default could have on the U.S. economy.
3. The impact the firm's default could have on low-income, minority or underserved communities.
4. Recommendations on actions to be taken under the OLA.
5. An evaluation of whether a private sector alternative can prevent the firm from defaulting.
6. An explanation for why a bankruptcy filing would be inappropriate.
7. An evaluation of the impact FDIC receivership may have on the firm's creditors, counterparties, shareholders and other market participants.
8. An evaluation of whether the firm satisfies the definition of a financial company.

After determining whether a firm meets these criteria, the OLA will decide if a firm is in default if any of the following have occurred:

1. A bankruptcy case has begun, or is likely to commence.
2. The firm has incurred, or is likely to incur, losses that will deplete virtually all of its capital.
3. A firm's assets are likely to be less than its obligations to creditors.
4. The firm is unable — or likely to be unable — to meet its obligations during normal business operations.

In the case of a broker-dealer, the SEC and Federal Reserve Board (FRB) will consult with the FDIC before making a recommendation to the Secretary of the Treasury about whether it should be placed into FDIC receivership.

Once the FDIC is allowed to step in, it assumes complete control of the liquidation process. Legal experts note that under Dodd-Frank, the FDIC supplants a role typically reserved for courts in bankruptcy cases: It is allowed to

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oversee the sale or transfer of assets or a merger with another firm without shareholder approval.

In order to allow the FDIC to carry out the liquidation of a financial firm, the OLA will set aside money in an Orderly Liquidation Fund. That money, which will be held at the Treasury, can be accessed only when the FDIC's plan for liquidation is approved by the Treasury Secretary.

The law mandates that taxpayer funds not be used for this matter. Instead, the Orderly Liquidation Fund will come from eligible financial companies — including banks with assets of $50 billion or more and nonbank financial firms that are supervised by the FRB. Those firms will pay a risk-based assessment fee if they fall under the category of an "eligible financial company."

In determining how much a firm will pay out, regulators will take its size and total value into account — the bigger a company's size and risk, the greater its fee will be. Companies that currently fall beneath $50 billion in total value would be subject to this fee in the future if they crossed that threshold.

Impact on IT

This statute does not directly impact IT.

Key Dates

The provisions of Title II became effective on July 22, 2010. The OLA became effective immediately following Dodd-Frank's passage and currently is available if a firm experiences financial difficulty. However, legal experts point out that the FDIC is required to issue rules that it deems necessary in order to implement the OLA, but lawmakers have not issued deadlines for these. ■

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Title III—Transfer of Powers to the Comptroller of the Currency, the Corporation, and the Board of Governors

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Title III abolishes the Office of Thrift Supervision (OTS) and divides the OTS' responsibilities among the Federal Reserve, FDIC and the Comptroller of the Currency. Title II also raises the insured level of FDIC deposits to $250,000.

Essence of Title III

Title III transfers the OTS' authority over holding companies to the Federal Reserve, its authority over state savings associations to the FDIC, and its authority over other thrifts to the Office of the Comptroller of the Currency (OCC). Subtitle C requires that the FDIC permanently increase the amount of deposits insured by the FDIC from $100,000 to $250,000. It also requires the FDIC to maintain a reserve ratio of at least 1.35 percent of insured deposits, up from 1.15 percent.

Fair Employment: Another subtitle (Section 342 of Subtitle D) of Title III impacts banks' hiring policies. It requires each financial regulatory agency to set up an Office of Minority and Women Inclusion that will be responsible for all matters relating to diversity in management, employment and business activities for that agency and the financial institutions it oversees. Each of these offices will have a director whose job will be to develop standards for equal employment opportunity.

These directors are also charged to increase participation of minority-owned and women-owned businesses in the agencies' programs and contracts. The most interesting aspect of this section to banks is this office's mandate to assess the diversity policies and practices of entities regulated by the agency — meaning, of course, financial institutions. Banks will want to make sure their hiring policies can stand up to examination and that they are making some efforts to recruit minorities and women.

Each office must submit to Congress an annual report on how well it's done at using minority- and women-owned contractors and hiring minority and female employees.

Impact on IT

This title doesn't have any obvious direct impact on bank IT departments. However, the fresh scrutiny of recruiting and hiring policies and practices could extend to IT departments, requiring banks to at least try to increase the number of women and minority IT staff members.

Future of Title III

The OCC and the Federal Reserve Bank have begun reviews of all of the OTS' regulations regarding savings associations and analyses of any differences in policies. The OCC and Fed are in the process of considering how to integrate the OTS' regulations into their regulations. This process is expected to include certain changes that would be effective as of the July 21, 2011, transfer date and to continue in phases after the transfer date. Any substantive changes proposed affecting savings associations will be published in the Federal Register.

Key Dates

Dodd-Frank transfers authority for supervision of savings and loan holding companies and their non-depository subsidiaries from the OTS to the FRB effective July 21, 2011. The transfer of OTS employees must occur no later than 90 days after July 21, 2011. ■

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The portion of Title IV that has the greatest and most widespread impact on the industry is the new registration requirements for almost all funds (except venture capital funds) so regulators can easily obtain adequate information and data to determine if a fund poses a systemic risk to the industry.

Essence of Title IV

Most of Title IV focuses on new registration requirements for advisers and funds, while expanding the definition of "adviser" to include almost all funds and advisers, except for venture capital funds. The law aims to safeguard the structure of the financial markets from systemic risks, although most experts acknowledge that investment advisers and funds were generally not the primary cause of the most recent financial crisis.

Since regulators heretofore have not had insight into private funds because they were not required to register, this law requires all managers of private funds to register. The registration of funds will increase new recordkeeping and reporting requirements and costs for fund managers and will subject the funds to more scrutiny and oversight from regulators. Advisers and funds with assets of more than $100 million will be required to register with the SEC. The SEC is shifting the regulatory burden of monitoring smaller advisers to the states so the SEC can focus on regulating larger investment advisers. This portion of Title IV stems from the failure of the SEC to detect a few highly publicized frauds (*think:* Bernie Madoff) committed by larger investment advisers.

In addition, any adviser or fund that is not required to register with a local state and manages assets of more than $25 million will be required to register with the SEC.

Reporting: Section 204 "Collection of Systemic Risk Data; Reports; Examinations; Disclosures" is the portion of Title IV that will most directly impact compliance and reporting technology and procedures at advisers. Advisers will need to record the following (but not necessarily file with the SEC):

- The amount of assets under management.
- Counterparty credit risk exposure.
- Trading and investment positions.
- The fund's valuation policies and practices.
- Types of assets held.
- The use of leverage (including off-balance-sheet leverage).
- Other information the SEC deems necessary.

While the law doesn't specify how often an adviser will have to file these reports (and they may not have to file them "regularly" at all), Dodd-Frank does make it clear that the firms need to maintain the records and have the records ready in case the SEC comes knocking. In fact, the law stipulates that advisers should be able to make the records available "without undue effort, expense, or delay" when the SEC makes a request. However, Title IV does require the SEC to issue rules requiring the filing of reports. The SEC will determine these rules in the near future.

For many advisers, this level of reporting will be completely new, since many were not required to report to the SEC pre-

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viously or, if they were, the reporting was not as extensive.

Information Sharing: Information that is shared with the SEC must be shared with the Financial Stability Oversight Council if the FSOC considers the data necessary for assessing the systemic risk of a private fund. The information will be kept confidential, unless the FSOC deems it necessary to share the information with Congress or another federal agency.

Many financial services executives have raised concerns that proprietary information contained in the data could be used to "reverse engineer" a trading strategy or to discover investment tips. Title IV does have specific rules meant to protect proprietary information, including "sensitive, nonpublic information." This type of information could include: the investment or trading strategies of the investment adviser; analytical or research methodologies; trading data; computer hardware or software containing intellectual property; and any additional information that the SEC determines to be proprietary.

Custody: Title IV also allows, but does not require, the SEC to implement rules to require advisers to take steps to safeguard assets over which the adviser has custody by using independent public auditors to verify the assets in the fund. This rule also aims to protect investors from another Madoff-style fraud.

Accredited Investor: The threshold for the accredited investor standard is also changed by Title IV. (Accredited investors are generally higher-net-worth investors who are permitted to invest in certain types of higher-risk investments.) The threshold was modified so that an individual is no longer permitted to include the value of his or her primary residence in determining whether he or she meets the $1 million net-worth test. Previously, individuals were able to include the value of their homes, but that became problematic when the real estate market declined rapidly. The SEC will review this threshold four years after the enactment of Dodd-Frank.

Impact on IT

The technology organizations for financial advisers that are impacted by Title IV will need to drastically increase reporting capabilities. Getting a handle on data across the organization will be required, since the SEC will be looking for enterprisewide exposures to risky counterparties, not risk metrics by account.

Risk management and risk analytics capabilities will be in demand as well, as advisers will need to pinpoint potential risks before the SEC demands the reports. For firms that have just registered for the first time, the cost of compliance with Title IV should not be underestimated. Staffing, technology and new compliance workflow (processes) will need to be implemented or enhanced to meet the new requirements.

Key Dates

- Title IV of Dodd-Frank will go into effect one year after the date of enactment (July 21, 2010).
- The Government Accountability Office (GAO) will conduct a study to determine the feasibility of having self-regulatory organizations (SROs) oversee private funds/advisers. This report also is due within one year of the date of enactment.
- The GAO also must conduct a study that is due in summer 2011 that focuses on the cost of compliance with the Custody Rule. ■

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Title V establishes the Federal Insurance Office that will gather information from insurance companies in order to spot potential gaps in insurance regulation that may harm consumers.

Essence of Title V

Title V of the Dodd-Frank Act establishes the Federal Insurance Office (FIO), a body, run by a director appointed by the Secretary of the U.S. Treasury, that is intended to study and share information about the insurance industry rather than regulate the industry. The FIO has no regulatory powers, strictly speaking, but does have the authority to request information from financial institutions and to report to the Secretary of the U.S. Treasury with recommendations about addressing any gaps in insurance regulation that could harm consumers or contribute to a systemic risk in the U.S. financial system.

Title V applies to all lines of insurance except health insurance, long-term care (except when bundled with life insurance) and crop insurance, which are exempt from this legislation.

Among the most important powers accorded to the FIO within Title V is the authority to gather information from insurance companies. This has raised concerns that insurers will have additional compliance concerns resulting from FIO data calls.

Like much of Dodd-Frank, the ultimate impact of Title V is hard to assess. Insurance industry observers worried that a zealous FIO director might seek to maximize the Office's power. Those concerns have been muted by Republican congressional gains in the 2010 midterm elections and the emergence of Michael McRaith, head of the Illinois Department of Insurance, as the Obama administration's choice for the post. However, until a director is officially appointed and starts to act, many aspects of Title V and the FIO remain undefined.

The greatest fear on the part of some insurance industry players is that the FIO will precipitate some kind of dual regulatory system in conjunction with state-based regulation. Others within the industry favor federal regulation of some parts of the insurance industry.

Impact on IT

Any effect of Title V on insurance organizations will not materialize until the FIO has surveyed the existing sources of information. However, carriers may be faced with new federal demands for data reporting. That possibility should be seen in the context of other demands being shaped by regulatory efforts such as Solvency II and increased reporting demands by rating agencies. Insurers that are moving to enterprise risk management or governance, risk and compliance (GRC) capabilities and consolidated financial reporting should be able to meet the new demands. Those that are not moving in this direction are likely to be caught short by worst-case scenarios emanating from Title V and the FIO.

Future of Title V

The biggest change to the FIO in the near future will be its emergence from the abstract into the concrete upon the appointment of a director. Again, insurers have feared that an aggressive director might expand the new

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agency beyond its congressional mandate. However, both a general change of tone politically and the danger that Dodd-Frank funds may be cut make it less likely that a more aggressive director will be appointed.

In fact, news has emerged that Michael McRaith, head of the Illinois Department of Insurance, is the Obama administration's choice for FIO director. As a state regulator himself, McRaith has collegial ties to the National Association of Insurance Commissioners — the state regulators. In addition, because of his understanding of the industry and the state regulatory system, he is a reassuring choice for insurers. Factions in the industry that oppose federal regulation believe that McRaith is unlikely to expand the authority of the FIO beyond its original mandate. At press time, however, McRaith's appointment had not been made official.

Key Dates

Title V requires the director of the FIO to conduct a study on how to modernize the insurance regulatory system and to submit a report to Congress no later than 18 months from enactment (i.e., Jan. 2012). As noted above, as of early March 2011, a director of the FIO was yet to be appointed.

Title V also requires the director of the FIO to submit a report on any inconsistencies or redundancies in state regulation to the president and the Committees on Financial Service and Ways and Means in the House, and the Senate Banking, Housing and Urban Affairs and Finance committees, on or before Sept. 30 of each calendar year, beginning in 2011. The FIO is on the same timetable for reports to the same parties on any other information deemed relevant by the Director or requested by the committees. ■

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Title VI of the Dodd-Frank Act, commonly known as the "Volcker Rule," prevents banking institutions from participating in speculative investments, such as proprietary trading and sponsoring or investing in hedge funds.

Essence of Title VI

Title VI makes amendments to the Bank Holding Company Act of 1956, which prevents bank holding companies from performing business or acquiring controlling rights to nonbank businesses. Essentially, the Volcker Rule aims to prevent banking entities from partaking as principals in risky types of investments that contributed to the financial crisis. Title VI does, however, allow for some of those activities to continue, providing they take place on behalf of a customer.

The Financial Services Oversight Council (FSOC) in its January 2011 "Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships With Hedge Funds & Private Equity Funds," reported that several banking entities have either shut down or are in the process of shutting down business units dedicated to proprietary trading. For example, New York-based JPMorgan Chase announced in August 2010 that it was closing its proprietary trading desk, while New York-based Goldman Sachs reportedly took steps in February 2011 to close down its Global Macro Proprietary Trading desk.

The FSOC also made 10 recommendations to regulators:

1. Require banking entities to sell or wind down all impermissible proprietary trading desks.
2. Require banking entities to implement a robust compliance regime, including public attestation by the CEO of the regime's effectiveness.
3. Require banking entities to perform quantitative analysis to detect potentially impermissible proprietary trading without provisions for safe harbors.
4. Perform supervisory review of trading activity to distinguish permitted activities from impermissible proprietary trading.
5. Require banks to implement a mechanism that identifies which trades are customer-initiated.
6. Require divestiture of impermissible proprietary trading positions and impose penalties.
7. Prohibit banks from investing in or sponsoring a hedge fund or private equity fund, except on behalf of trust, fiduciary or investment advisory customers.
8. Prohibit banking entities from engaging in transactions that would allow them to "bail out" a hedge fund or private equity fund.
9. Identify "similar funds" that should be brought within the scope of the Volcker Rule prohibitions in order to prevent evasion of the intent of the rule.
10. Require banks to publicly disclose permitted exposure to hedge funds and private equity funds.

The Federal Reserve mandate, paired with the FSOC recommendations, makes a path to compliance with the Volcker Rule fairly clear. And a solid first step is to initiate the elimination of proprietary trading desks and to cease participation in trading activity and investment or sponsorship of hedge funds and private equity funds. In instances where a banking institution is partaking in these types of investments on behalf of a customer, the regulators will

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most likely require the financial institution to prove it.

Additional Compliance Requirements: The FSOC's January 2011 study provides the clearest glimpse of how the specific rules might shape up. It is up to the regulators to prohibit proprietary trading and to identify and maintain its definitions of prohibited investments. From the banks' perspective, analytics and quantitative metrics will play a significant role in complying with the Volcker Rule. To help identify whether trading activities are within the boundaries, the FSOC recommends regulators require financial institutions to supply:

- Revenue-based metrics
- Revenue-to-risk metrics
- Inventory metrics
- Customer-flow metrics

In addition to the emphasis on metrics, regulators might require banks to establish internal compliance programs to safeguard against prohibited investments. Further, when hedge fund investments are initiated on behalf of a customer, regulators might propose that banks report on the nature and amount of those investments.

Possible Penalties: Should a financial institution break the rules, regulators might require immediate termination of illegal trading activities as well as the liquidation of the investment. Other penalties could include regulatory supervision to increase oversight of a bank's investment activity, increased capital charges or monetary penalties.

The FSOC acknowledges that most risk management and supervisory measures will be built on what's already in existence, though there will be additional oversight to prevent proprietary trading and investment in hedge funds and private equity funds.

Impact on IT

Title VI clearly will impact IT, though banks — depending on their size and scope of investment operations — will be affected in different ways. The FSOC hasn't yet established how banks will be required to report data, but data warehousing, core systems and risk analytics, as well as maintaining clean, consistent data, will be imperative under Title VI.

The Future of Title VI

Rep. Spencer Bachus (R-Ala.), Chairman of the House Financial Services Committee, along with others in Congress have spoken out against the Volcker Rule as recently as March 2011. The Federal Reserve's February 2011 final rule on the Volcker Rule did not address the application of the rule to non-U.S.-based financial institutions or to banks that also operate as insurance companies.

Key Dates

The Federal Reserve confirmed on Feb. 9, 2011, that banks would have two years to comply with the Volcker Rule, which will become effective on July, 21, 2012, or one year after the final regulations are issued by the regulatory agencies, whichever comes first, making Title VI one of first pieces of Dodd-Frank to have a definitive timeline to execution. Upon the Volcker Rule's effective date, institutions can be granted up to three one-year extensions on a case-by-case basis. ■

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Title VII is intended to bring regulation and transparency to OTC derivatives trading. The law will radically change how broker-dealers, mutual funds, hedge funds and end users trade and clear derivatives. Regulators are pushing for electronic trading of OTC derivatives and central clearing of standard swaps contracts to reduce risk.

The third leg of Title VII is focused on organizing swaps data repositories. The repositories will contain information on trades and will enable regulators to view how risk is shifting through the markets.

Essence of Title VII

While the derivatives section of Dodd-Frank is among the most complex and detailed, there are five areas you need to know about: jurisdiction, registration, execution, clearing and reporting.

Jurisdiction: The SEC is given jurisdiction over security-based swaps, including single-name swaps, and the CFTC is given jurisdiction over almost every other swaps product, including commodity-based swaps and index products that contain at least nine components. Under the law, both regulators are charged with harmonizing their rules to the extent possible. However, there is no requirement that their rules be identical.

In addition, although not part of Title VII, Title XVI of Dodd-Frank specifically states that swaps are not subject to section 1256 requirements of the IRS. This should be a relief to firms, as section 1256 would require investors to report gains or losses on swaps at the end of each year.

Registration: Firms must register with the regulators as either swaps dealers, major swaps participants or end users. This means that a swaps dealer, usually a broker-dealer that makes a market in swaps, must register with either, or both, regulators (depending on the asset class). Capital and collateral requirements will be more tightly regulated. A swaps dealer designation is specific to a category of swaps, so an entity can be required to register with regard to its activities in one type of swap and not in others.

In part, the law is meant to prevent a non-regulated firm such as AIG Financial Products, which was an off-balance-sheet subsidiary of insurer AIG, from participating in the swaps market to the extent that it did without posting collateral.

Any entity that is not a swaps dealer could be a major swaps participant if that firm has a substantial position in swaps. Large asset managers such as Pimco or BlackRock are going to be considered MSPs. The criteria for determining which entities are MSPs includes the number of counterparties with which they do business. If a firm has one counterparty, it's probably not an MSP; but if it has 24 to 40 counterparties, then it probably is. However, there is an exemption from registration for non-financial companies hedging commercial risk. For example, a heating oil company that purchases swaps to hedge its exposure to oil prices could be declared an end user.

All of the large hedge funds and dealers are going to have to register with both the CFTC and SEC.

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Clearing: Any swap that is determined by the regulators and clearinghouses to require clearing must be submitted for clearing to a derivatives clearing organization (DCO). Swaps trades will be guaranteed by the clearinghouse to eliminate exposure to counterparty risk.

It's up to regulators to decide which instruments are clearable, and not everything will be mandated for clearing. Studies estimate that about 60 percent to 70 percent of the swaps contracts will be cleared. Through the rules proposal process, regulators will set the criteria for determining which kinds of swaps are clearable. The major central clearinghouses are CME, ICE Trust, LCH.Clearnet and IDCG.

There are industry concerns, however, that regulators are going to instruct clearinghouses on which products they must clear. Regulators are concerned that exemptions may create loopholes for participants to avoid regulation.

Execution: Cleared swaps contracts in the U.S. must be traded on a registered venue, either an exchange or a swap execution facility (SEF), a term coined by Congress, to bring the $600 trillion OTC swap market onto regulated venues. Exchanges, clearinghouses and interdealer-brokers are expected to set up SEFs. CFTC Chairman Gary Gensler has said he expects 30 to 40 SEFs to register, but analyst firm Tabb Group estimates the number is closer to 20 or 30. Industry participants are worried that SEFs will fragment the swaps market.

Most interdealer-brokers (IDBs) will be among the big winners as they are expected to register as SEFs since they already handle the majority of dealer-to-dealer OTC derivatives trading. Some IDBs, such as ICAP, have already launched electronic trading capabilities in swaps. Independent platforms (including Bloomberg, Tradeweb, MarketAxess, etc.) and new entrants also will register as SEFs.

Though regulators are pushing for clearing and electronic trading of swaps, there is no mandate for electronic trading as there is in the equities markets, according to Tabb Group senior analyst Kevin McPartland. Since the SEF definition indicates that orders can be taken over any form of interstate commerce, voice trading is permitted if the trade is entered into a machine afterwards. A block trade in swaps can be negotiated over the phone and entered into an electronic system after the fact, says McPartland. Anything that is mandated for trading that is not a block will be traded over an electronic platform, he adds.

Data Reporting: The CFTC and SEC will require real-time public reporting — meaning as soon as technologically practical — following trade execution for swaps that are subject to mandatory clearing requirements. Essentially, the real-time reporting requirements apply to all swaps executed on a registered SEF or a designated contract market (DCM) or exchange, and those swaps executed bilaterally between counterparties that are termed off-facility swaps. Information on swaps trades will be reported to swaps data repositories, or SDRs.

Dodd-Frank allows for competition among multiple SDRs, according to industry sources. Some of the main contenders are the Depository Trust and Clearing Corp., which operates the Trade Information Warehouse; and the International Swap Dealers Association (ISDA), which has defined TriOptima, owned by ICAP, as its swaps data repository. While the CFTC is not looking to limit the number of repositories, it is unclear how regulators will monitor the collected data for systemic risk. Some par-

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ticipants caution that multiple repositories will prevent regulators from seeing all the swaps transactions.

Data reporting is one of the more contentious issues to come out of the swaps reform rules. Dealers have expressed concern over public reporting of block trades to SDRs, saying it could leave them less time to hedge their positions.

Real-time data reporting will create more price transparency by giving institutions a record of the last sale while enabling regulators to see how risk is shifting through the markets. Regulators want to create a ticker for swaps, similar to TRACE in the corporate bond market, where the price for every transaction is reported publicly.

Impact on IT

The industry is going to make tremendous investments in technology for the derivatives space. The markets that were historically voice traded are becoming more electronic. Firms will need connectivity to the central clearinghouses and to multiple swap execution facilities. The biggest impact is going to be on the dealers. According to estimates by Tabb Group, top-tier dealers together will spend about $217 million, while second- and third-tier dealers will spend $169 million in aggregate, updating their systems and processes for central clearing. Top-tier dealers will spend another $165 million in total, and second- and third-tier dealers will spend $124 million more, on execution automation. A lot of buy-side firms and hedge funds will look to the dealers and prime brokers to provide the infrastructure they need to clear and trade swaps.

In addition to accessing a clearinghouse, firms will need a front-end trading system to find the best price and a back-end system to capture the trade information. They also will need to do risk management on their counterparties, and they will need to monitor their own trading activity in order to ensure compliance. In addition, they will need middle-office software to monitor for trade breaks and to make corrections on electronic trades.

Large asset managers on the scale of Pimco, BlackRock or DE Shaw will need to make investments in technology to ensure that their systems are able to maintain control over the information flow for trading and clearing swaps. Hedge funds may want to build their own trading systems. But the vast majority of buy-side firms will rely on their dealers for connectivity to clearinghouses. Another option is to go through service providers such as MarkitServ and Bloomberg, which likely will provide connectivity to clearing facilities.

Key Dates

While Dodd-Frank provides a comprehensive framework for regulation of OTC derivatives, most of the rules are not yet finalized. Swaps dealers and major swaps participants (MSPs) must be registered with the appropriate regulator within one year of Dodd-Frank's enactment, regardless of whether they are banks. But the CFTC and SEC will be writing hundreds of rules to implement Dodd-Frank, which also requires the regulators to conduct studies to create the rules. As of late January 2011, the CFTC was half-way through the rule-making process.

Broker-dealers have complained that the July 15, 2011, deadline for Dodd-Frank is unreasonable. In terms of timelines for implementing the new derivatives rules, there's a lot of focus on getting the clearing infrastructure and electronic execution infrastructure in place first. Some U.S. clients are pushing for the mid-July date for getting the clearing piece in place; there is speculation that the electronic trading capabilities on SEFs will come later. ■

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At 20 pages long, Title VIII of the Dodd-Frank Act is one of the shorter sections of the finance reform bill. It aims to mitigate the dangers posed by entities deemed systemically important. Also known as the "Payment, Clearing and Settlement Supervision Act of 2010," this section of Dodd-Frank gives regulatory agencies broader powers over financial market utilities.

Essence of Title VIII

Title VIII was constructed to solve the problems in settlement, clearance and payment processes with which market regulators struggled during the global market crash of 2008. Under the statute, the recently constructed Financial Stability Oversight Council will determine whether certain payment, clearing or settlement activities are systemically important. If they're deemed as such, the SEC, the CFTC and the Governors of the Federal Reserve system could gain new authority over financial activities that are conducted at the retail and institutional levels.

As with many other parts of Dodd-Frank, however, there continues to be a lack of clarity from regulators on exactly what makes an entity systemically important. The rule does appear to augment Title VII, which looks to bolster regulation of the swaps market by pushing derivatives trades onto central clearinghouses, a structure that is designed to eliminate risks taken between counterparties in swaps deals. Title VIII takes this a step further by placing clearinghouses under the watch of regulators; since they're taking on risk that was traditionally exclusive between counterparties on a deal, the clearinghouses are likely to be classified as systemically important.

In determining whether an entity is systemically important, regulators are likely to gauge its interdependence and exposure to other firms and the total value of transactions that it processes. Investment firms, broker-dealers and hedge funds managing $150 million or more in assets, wire clearinghouses, debit and credit card networks, and the automated clearing network are among the types of firms that potentially face unprecedented oversight if their activities are deemed systemically important.

Financial Market Utilities: Regulators also are in the process of determining whether such firms may fall under the umbrella of financial market utilities. According to the statute, a financial market utility is any entity that manages a multilateral system for the purpose of transferring, clearing or settling payments, securities or other transactions involving the transfer of funds between institutions.

The Criteria: In order to determine whether a financial market utility is systemically important, the Financial Stability Oversight Council will take five elements into account:

1. The total monetary value of transactions processed by the financial market utility or carried out through payment, clearing or settlement activity.
2. The total exposure of the financial market utility or institution engaged in payment, clearing or settlement activity to its counterparties.
3. The relationship and interdependence between financial market utilities.

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4. The impact that the collapse of a financial market utility could have on critical markets and the financial system as a whole.
5. Any other factors that the Financial Stability Oversight Council determines to be important.

Additional Authority: Title VIII also calls upon the SEC, CFTC and Federal Reserve Board to set risk management standards for designated financial market utilities, and to set standards for how financial institutions will conduct payment, clearing and settlement of transactions. In setting those standards, the regulatory bodies will have to take international standards into account.

Legal experts say this is part of a push by regulators to develop some uniformity around how markets around the world will resolve clearance and settlement issues. The standards set by the Bank for International Settlements Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) will be the primary sources for U.S. regulators when setting risk management standards for payment, clearing and settlement activities.

Impact on IT

Legal experts note that when it comes to IT, Title VII will directly impact Title VIII. The number of swaps trades is expected to see a sharp increase due to Title VII, which holds potentially dramatic implications for the clearinghouses under Title VIII. Clearinghouses will need to develop adequate technology to be able to process OTC products, which are vastly different from futures and equities, both of which have traditionally been centrally cleared. Clearinghouses also will need to build mechanisms that can calculate end-of-day pricing.

Market experts note that Title VIII will impact members of clearinghouses and their clients. Firms will need to be able to build an infrastructure that can take swaps trades conducted on swap execution facilities and funnel them to the clearinghouses. Such an infrastructure does not exist at this point.

Future of Title VIII

Much about Title VIII is still to be determined as regulators sort out what makes a financial market utility systemically important. And then, once something is found to be systemically important, regulators will have to determine the appropriate course of action to curb systemic risk. Experts point out that broker-dealers, investment firms and hedge funds are watching the implementation of this rule carefully as the SEC, CFTC and FRB have gained newfound authority to alter market functions.

Key Dates

By July 21, 2011, the CFTC, SEC and Board of Governors will have submitted a joint report to the Senate giving their recommendations on how to improve:

1. The consistency of the SEC's and CFTC's oversight of clearinghouses.
2. Risk management conducted by clearing entities.
3. How regulators oversee risk at clearing entities and the impact those risks can have on the nation's financial system. ■

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The most important aspect of Title IX is that it aims to bring transparency to financial firms by requiring them to further disclose compensation, and provide "say on pay" votes to shareholders and details on all incentive-based compensation programs. Title IX also aims to encourage and protect corporate whistleblowers.

Essence of Title IX

As part of its drive to provide more transparency and reduce risk, the SEC is expanding its disclosure requirements for proxy statements. Regulators also want to limit incentives for employees of capital markets firms to take excessive or inappropriate risks by cutting back on some of the practices that are believed to have contributed to the financial crisis — including firms handing out to bankers large up-front bonuses on deals that eventually went bad.

Say on Pay: Proxy Statements must include a resolution on whether a non-binding "say on pay" vote will occur every one, two or three years. The "say on pay" vote must subsequently be presented at least every three years, and the vote on the frequency of the "say on pay" vote must be presented at least every six years.

Internal Pay: Firms must disclose the median total annual compensation of all employees other than the chief executive officer, the total annual compensation of the CEO, and the ratio of those two amounts.

Hedging: Companies must disclose whether employees or directors are allowed to purchase financial instruments designed to hedge or offset any decrease in the market value of equity securities they hold.

Incentive-Based Compensation: Each financial institution with assets of more than $1 million must disclose to the appropriate federal regulator the structures of all incentive-based compensation arrangements to determine whether any employee, director or principal shareholder has been handed excessive compensation, fees or benefits.

Regulators will also be looking to see whether a firm's compensation structure could lead to material financial loss to the organization. There are no requirements to report the compensation of particular individuals, or for a firm that does not have an incentive-based payment structure to disclose its compensation agreements.

Whistleblower Program: In the aftermath of the Madoff scandal, which saw the SEC come under fire for failing to "listen" to a whistleblower's repeated warnings that Bernard Madoff was operating a Ponzi scheme, the Dodd-Frank Act sets forth new whistleblower provisions meant to encourage employees to report securities law violations to the SEC. Whistleblowers who provide information that leads to a successful SEC enforcement will receive 10 percent to 30 percent of the monetary sanctions above $1 million and are also protected against any form of retribution from their own firms.

Impact on IT

Firms need to invest in better infrastructure, enterprise risk tools, extractor tools and reporting systems so that they can boost their data quality and come up with clear

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and accurate data. Business analytics technology is necessary and includes enterprise resource planning (ERP) systems, data management/repository software, risk modeling tools, and compliance applications that can also be used as strategic tools.

When it comes to the whistleblower provisions in Title IX, firms will want to boost their compliance programs and processes to ensure that employees are more inclined to report violations internally than to the SEC. Supporting technology includes enterprisewide risk management platforms, real-time advanced analytics, compliance systems with continuous monitoring of accounts, and surveillance systems that can detect market manipulation and insider trading.

Future of Title IX

Investment Adviser Examinations: A study mandated by the Dodd-Frank Act found that the number and frequency of examinations of registered investment advisers has seriously declined over recent years. This is in part due to an explosion in the number of registered investment advisers and a decrease in examiners. The SEC expects its resources to remain seriously limited and for the number of advisers to continue to grow. As a result, it is looking at different options that would enable the industry to be subjected to more examinations. Options include levying a tax on the securities industry so that it can "self-fund" more frequent examinations as well as recruit more examiners; and recommending that a self-regulating body such as FINRA carry out the examinations.

Fiduciary Standards: In a study commissioned under the Dodd-Frank Act whose findings were released in January 2011, the SEC noted that while investment advisers and broker-dealers are regulated extensively under different regulatory regimes, many retail investors do not understand the distinction and are confused by the roles of investment advisers and brokers and are unsure of their protections when they receive advice about securities. As a result, the SEC has recommended the adoption of a uniform fiduciary standard for broker-dealers that is as stringent as the standard currently applied to investment advisers.

It remains to be seen whether these recommendations will actually lead to the adoption of a new fiduciary standard. Two SEC commissioners have already voiced their opposition, explaining that they weren't necessarily opposed to creating a common fiduciary standard for brokers and advisers, but that the SEC must do more analysis to show that the change wouldn't harm investors. ■

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The establishment of the Bureau of Consumer Financial Protection is the main stipulation outlined in Title X.

Essence of Title X

Title X establishes a consumer watchdog organization, the Consumer Financial Protection Bureau, or CFPB, to monitor the financial services industry for unfair and abusive practices and set rules governing consumer financial products, including bank credit and debit cards, home mortgages, private student loans, payday loans, and overdraft loans. The CFPB will enforce the 18 existing laws governing consumer finance — including Reg Z (Truth in Lending), Reg E (which governs electronic fund transfers) and Reg DD (Truth in Savings) — that are currently enforced by seven different regulatory agencies.

In addition to implementing and enforcing federal consumer financial laws, the CFPB will review business practices to ensure that financial services providers are following the law; monitor the marketplace and take action to make sure markets work as transparently as they can for consumers; and establish a toll-free consumer hotline and website for complaints and questions about consumer financial products and services. It has already begun compiling a database of customer complaints gathered from other enforcement agencies and bank customers themselves.

Why It's Important: The CFPB will have broad powers to create and enforce new consumer financial protection laws. The acting head, Harvard professor Elizabeth Warren, aims to protect consumers from financial "tricks" and "traps." She has said her two initial priorities will be mortgages and credit cards. Some banks fear that the burden of changing their products, systems and processes to accommodate new consumer-friendly rules could absorb all of their IT resources for a long time, pushing other important technology changes to the back burner.

Who Should Pay Attention: Technically, the CFPB will have direct and primary authority to examine only depositories over $10 billion for consumer protection compliance, with some oversight over non-depositories such as mortgage-related businesses, payday lenders and private student loan providers. However, observers say the Bureau's new rules will be imposed on banks of all sizes, although small banks will continue to be examined by their current regulators.

In January 2011, the CFPB signed an agreement with the Conference of State Bank Supervisors pledging to coordinate and cooperate in the supervision of providers of consumer financial products and services. This means there will be more cops on the beat enforcing the Bureau's new rules.

Some say this also means the death of federal preemption — national banks will have to comply with state laws. Some state Attorney Generals have been itching to go after national banks operating in their states. "Not to be cynical, but as states become more budget conscious, you'll see more action," one Washington insider observes. "They'll be able to get settlements."

Additional Responsibilities: The CFPB also is required by Title X to create reports and conduct studies on

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consumer-related products such as reverse mortgages, private education loans, and credit scores — across the board, not just for the over-$10-billion banks. It is also required to come up with disclosure and process requirements for small-business loan data collection and electronic funds transfers.

While Title X is 99.99 percent focused on the new consumer protection bureau, it makes one random detour: It requires the Treasury Department to study options for shutting down Fannie Mae and Freddie Mac. This, of course, is a huge topic; if Fannie and Freddie were shut down, it would have profound impact on any bank that originates mortgages. This issue is likely to get bogged down in a political quagmire and be unresolved for years.

Penalties: Dodd-Frank authorizes the Bureau to charge up to $1 million a day for egregious violations of consumer financial law, an amount that would quickly put many banks out of business. However, some existing banking laws carry a $1 million daily maximum penalty that has never been imposed. There tends to be a negotiation of the fine, with mitigating and aggravating factors considered.

Impact on IT

Although the new consumer rules haven't been drafted yet, they will force banks to make changes to all of the software and systems that touch affected consumer products and services. Some IT areas likely to be affected include:

Data management: The Bureau is calling for increased transparency for banks, which will require many banks to step up their data governance and data quality efforts. Many large banks' IT shops are already working on data integration projects, but they may also need to invest in new data scrubbing and reporting tools.

Project management: Multiple projects, interdependencies and changing priorities will make program and project management harder for banks. Several large banks reportedly are considering setting up a Project Management Office dedicated to the changes coming from the CFPB.

Profitability measurement: Some observers believe that as new rules affect profitability (such as the Fed's proposed 12-cent limit on debit card interchange fees), banks will need to create or buy tools that can handle multi-dimensional, risk-adjusted profitability metrics so that they can reassess product profitability, perhaps repricing or dropping products that new rules put into the red.

Mortgage technology and processes: Housing finance reform and foreclosure reform are hot topics throughout Washington this year. The CFPB is likely to write rules for mortgage documentation. Elizabeth Warren told Newsweek she wants to create a one-page mortgage-shopping document that would detail the monthly payment, the required cash at closing and how long it will take to pay off the loan. Because of ongoing mortgage servicing and foreclosure issues, banks may also be required to track mortgage documents, maintain underlying mortgage data and prove that they're not using "robosigners" to speed up foreclosures, among other things.

Product inventories: It would behoove banks to take inventory of their own consumer products to see if they pass a basic "smell test" of fairness. When they launch a new product, they should perform tests to determine who is using them, how the products are being used and

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how risk is being managed. Of course, fairness is in the eye of the beholder. “Abusive practices don’t necessarily look abusive until they get the spin from one side or the other,” one commenter observes.

Unintended Consequences: If the Bureau is extremely aggressive with its rules for banks, the cost of bank services could rise for consumers — already, some banks are experimenting with checking account fees to make up for lost debit card interchange fee income. Because of abuses targeted to a small number of people (abuses that cannot be condoned, of course), all consumers could end up paying a higher cost for credit and other financial products and services.

Future of Title X

All of the actual rules are still to be determined. For instance, the CFPB is working on credit card and mortgage disclosure requirements. Divisions of the agency are looking into:

1. revolving debt and credit cards;
2. mortgages and installment loans, such as student loans;
3. payments and deposits;
4. credit reporting; and
5. debt collection.

The CFPB also will review services for people who don’t have a bank account, Warren told the Associated Press recently. “I anticipate a lot of change in this area,” she said.

Key Dates

The Bureau officially opens for business July 21, 2011. However, staffers under acting head Elizabeth Warren already are gathering consumer complaints, and Warren has begun floating ideas for new rules, such as one calling for the one-page mortgage document.

In addition, duplication between the Real Estate Settlement Procedures Act (RESPA) disclosures and Truth in Lending disclosures are part of the reason mortgage documents tend to be 150 pages long or more. Warren has said that she might propose that Congress make some modifications to those laws to eliminate duplicate provisions to get to that one-page mortgage document she covets. ■

BANK SYSTEMS & TECHNOLOGY

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Title XI amends the Federal Reserve Act, adding a position to the Federal Reserve's Board of Governors and additional oversight measures to ensure emergency lending actions conducted by the Fed are justified.

Essence of Title XI

Title XI adds checks and balances to the Federal Reserve System. It amends the Federal Reserve Act — the legislation that established the Federal Reserve System when President Woodrow Wilson signed it into law in 1913. In doing so, it creates a new position on the Fed's Board of Governors, limits the Fed's authority to provide emergency lending and adds more Government Accountability Office (GAO) oversight of the Federal Reserve in the form of audits.

The new presidentially appointed position created under Title XI is Vice Chairman for Supervision. Part of that job description is to serve as an adviser to the board as well as to develop policy recommendations. The Vice Chairman also will make semiannual reports to Congress.

Part of the GAO's role in auditing the Federal Reserve System is to identify practices that led to the financial crisis while studying the process in which the Fed appoints its directors and the system's effectiveness in representing public interest. The GAO is also tasked with examining the Fed's emergency lending practices.

Meanwhile, Title XI sets stricter rules for the Federal Reserve System that would shore up emergency lending practices and prevent insolvent institutions from receiving funding. Basically, if the borrower is bankrupt, falls under Title II (Liquidation Authority) of Dodd-Frank, or is undergoing any other state or federal insolvency proceeding, that institution is considered insolvent and therefore unable to receive emergency funding.

Any emergency lending program proposed by the Federal Reserve Board would need approval from the Secretary of the Treasury. If the Fed initiates an emergency lending program, it has one week to report to Senate and Congressional hearings:

- the justification for assistance.
- the identity of those receiving assistance.
- the date, amount and form in which any assistance was distributed.

In addition, the Fed must provide the Treasury, Congress and Senate the value of collateral held against the loan, the terms and conditions, and the expected cost to tax payers.

Impact on IT

Title XI is aimed internally at the Fed and how it distributes loans to businesses. As such, it has no direct IT impact on banks.

Future of Title XI

The Federal Reserve on Dec. 1, 2010, posted transaction data on its website covering its emergency lending during the financial crisis. Two days later, it created an "Audit" link, connecting to GAO audit reports, the Fed's annual audited financial statements, reports to Congress, and other information. The Vice Chairman of Supervision, who will serve a four-year term, has yet to be appointed by the president. ■

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Title XII aims to set up a microloan and small-loan program for low- to moderate-income individuals, protect borrowers from predatory lenders, establish a way for lower-income individuals to have bank accounts and encourage organizations to work with banks to deliver financial counseling to individuals.

Essence of Title XII

The "Improving Access to Mainstream Financial Institutions Act of 2010," or Title XII of Dodd-Frank, sets guidelines under which financial products such as small-dollar, short-term loans can be made available to people who otherwise might not have access to them. Title XII sets a framework under which banks can model a microloan system similar to those that have been successful in serving developing countries, but to do so domestically and by a federally insured financial institution. The act primarily seeks to accomplish several things:

- Giving low- to moderate-income individuals the ability to borrow a small amount of money (up to $2,500) through a bank.
- Protecting borrowers from predatory lenders that offer small-dollar loans at high interest rates.
- Open up bank accounts to people who have traditionally existed outside of banking by promoting new and accessible types of accounts.
- Set a framework for organizations to deliver financial counseling and education.

Background: While the microloan concept has existed for some time, it hasn't been widely accepted as a business unit within American banks. Some organizations, such as nonprofit Kiva, have opened up microfinance in developing countries, where entrepreneurial people with low to moderate incomes can apply for small-value loans for business ventures. In the U.S. model outlined by Title XII, this same concept could be used to provide loans to qualified individuals who need access to funds they might otherwise be limited from obtaining because of their incomes. It is meant to provide a low-cost alternative to more costly loans, such as those provided by payday lenders or pawnshops.

The FDIC in 2009 concluded a pilot program to promote small-dollar loans at three Illinois banks. At the end of the two-year pilot program, the FDIC reported that most bankers indicated that the small loans were useful in building long-term, profitable relationships with new customers.

In the FDIC study, many small or community banks in suburban locations indicated the importance of building partnerships with nonprofits and other community organizations that could refer or even qualify potential customers for participation in a small-dollar loan program. Title XII refers to these groups as community development financial institutions. To promote these sorts of programs among banks, Title XII also could provide incentives such as grants establishing loan-loss reserve funds for institutions willing to participate, as well as technical assistance grants for community development financial institutions or partnerships to help maintain small-dollar loan programs.

Any potential small-dollar loan program funding will require an application from a bank or institution.

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From a technical perspective, a small-dollar loan program could require some work toward the creation of a system that allows banks to easily process applications. The requirements, however, wouldn't be much different from any other loan or credit application, save for the fact that the loans are meant to serve an unbanked or underbanked population that may not have previously had a relationship with a traditional bank. To that end, credit scoring, analytics and risk management could play a significant role in loan approvals. Banks and community development financial institutions participating in such programs will be required to file annual reports.

Key Dates

There was no date given on which the Secretary of the Treasury is to act on Title XII; Improving Access to Mainstream Financial Institutions gives the Secretary the authority to establish the aforementioned programs. ■

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Title XIII aims to have all money returned to the government from TARP, the stimulus and the takeovers of Fannie Mae and Freddie Mac put to use to pay down the deficit. The Pay It Back Act also requires the Secretary of the Treasury to report to Congress every six months on the amounts received from the sale of TARP-related assets.

Essence of Title XIII

Title XIII of the Dodd-Frank bill, The Pay It Back Act, is fairly straightforward. Introduced by Senators Michael Bennet (D-Colo.), Scott Brown (R-Mass.) and Jon Tester (D-Mont.), the bill's major thrust is to use the returns from the Emergency Economic Stabilization Act (aka "TARP," or "the bailout"), the American Recovery and Reinvestment Act (the "stimulus"), and the Housing and Economic Recovery Act (which put Fannie Mae and Freddie Mac under government conservatorship) to reduce the budget deficit.

The first meaningful section amends the bailout by reducing the amount of funds made available under the bailout from $700 billion to $475 billion. It also prevents TARP funds from being reallocated after they're repaid — a provision in the original bill — instead mandating that returns be used for deficit reduction. (This is a theme that's repeated throughout the bill.)

Title XIII also requires the Secretary of the Treasury to report directly to Congress the amounts received back from sales of TARP-purchased assets (and applied to the deficit) every six months. This extends a provision in the original bailout bill that gave the authority over those funds to the Treasury.

Where the Industry Is Now: According to ProPublica, a nonprofit investigative journalism group, $416.5 billion was allocated by TARP. Of this, banks have returned to the Treasury $234.8 billion in repayments and $34.5 billion in other revenue (from dividend payments, interest payments and/or stock warrants).

Fannie and Freddie: The Housing and Economic Recovery Act of 2008 (HERA) amended the Fannie Mae and Freddie Mac charters to allow the Treasury to purchase "any obligations and other securities issued by the corporation[s]." Pay It Back further amends those provisions by mandating that any proceeds from the resale of those obligations and securities be used for deficit reduction.

It also requires the director of the Federal Housing Finance Agency (FHFA) — which was created by HERA — to submit a report to Congress on how the agency plans to "support and maintain the nation's vital housing industry, while… [guaranteeing] that the American taxpayer will not suffer unnecessary losses." The FHFA has not sent an official report to meet this requirements, but a spokesperson told UBM TechWeb that a letter sent Feb. 2, 2010, "covers topics that will be consistent with what will be in the report." The Act does not set a deadline.

According to ProPublica, the Treasury has allocated $115.8 billion to Fannie and Freddie. There is no cap on the amount that these organizations could receive. None of this has been paid back, but $16.4 billion has been

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returned to the Treasury through dividends.

Stimulus Funds: The last component of the Pay It Back Act deals with funds made available by the stimulus. The stimulus allows either the governor of a state or the legislature of a state to request and accept funds. Funds that are not accepted by either of these bodies are to be rescinded and used for deficit reduction; they cannot be allocated for any other purpose. The same is true if the federal government itself withdraws funding offered to a state.

Impact on IT

None. Unless you count using calculators to figure out how much you can afford to pay the government back.

Future of Title XIII

It's unlikely that this fairly straightforward legislation will be altered. Its inclusion in the broader financial reform bill was bipartisan, and the current political climate is anti-bailout and, at least on the majority Republican side, anti-stimulus as well. Reducing the deficit is a hot topic in Washington, and this provides some mechanism to do so.

Key Dates

All the stimulus money must be obligated to, or assigned to, states by Dec. 31, 2012. The President, however, can waive this requirement. ■

Top 10 Recipients of TARP cash under the Capital Purchase Program:	
Bank of America	$45 billion*
Citigroup	$45 billion *
JPMorgan Chase	$25 billion
Wells Fargo	$25 billion
Goldman Sachs	$10 billion
Morgan Stanley	$10 billion
PNC	$7.6 billion
US Bancorp	$7 billion
SunTrust	$4.85 billion
Capital One	$3.55 billion

*Includes an additional $20 billion each under the Targeted Investment Program

Top 5 Recipients of CPP cash that have not paid back any funds:	
SunTrust	$4.85 billion
Regions Financial Corp.	$3.5 billion
KeyCorp	$2.5 billion
CIT	$2.33 billion
Marshall & Isley	$1.715 billion

Other amounts of note:

AIG has received $68 billion, of which $9.6 billion has been paid back.

GM has received $50.7 billion, of which $22.7 billion has been paid back.

Chrysler has received $10.75 billion, of which $2.2 billion has been paid back.

Source: ProPublica

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Title XIV directly addresses the abuses that contributed to the subprime mortgage meltdown and subsequent foreclosure crisis. The portions of Title XIV that will have the most direct impact on banks and other lenders are Subtitles A, B, C and E, which are designated as the Enumerated Consumer Law and will be administered by the new Consumer Financial Protection Bureau (see Title X). Although the CFPB will handle the bulk of Title XIV's administration, the Department of Housing and Urban Development (HUD) will be an active player, too.

Many of the provisions within Title XIV are amendments or updates to existing regulations, such as Regulation Z (Truth in Lending Act, TILA), the Home Ownership and Equity Protection Act (HOEPA) and the Real Estate Settlement Procedures Act of 1974 (RESPA). Generally, Title XIV sets increased disclosure requirements around the origination of residential mortgage loans and specifies new criteria for creditors to originate mortgage loans. It also restricts certain lending activities around certain high-cost residential mortgage loans.

Essence of Title XIV

Residential Mortgage Loan Origination Standards (Subtitle A): Section 1401 provides updated definitions and related requirements around compensation and amends the TILA to define the term mortgage originator, or mortgage broker. It applies tougher requirements to originators' loan underwriting actions for what it terms "qualified mortgages," amending TILA in Section 1402 to mandate that consumers "are offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay the loans and that are understandable and not unfair, deceptive or abusive."

Notes Stephen F.J. Ornstein, a partner with law firm SNR Denton, "This gets back to the grass roots of sound underwriting" after the abuses and lax standards that led to the subprime mortgage crisis. "It tries to ensure that those that make loans are properly licensed; clamps down on brokers who would steer borrowers to more expensive loans because of improper incentives; imposes minimum standards for mortgages [with] very rigorous income verification requirements; [and] also clamps down in terms of loans that were deemed to be predatory."

Violations of the "ability to repay" standard, or a mortgage that has excessive fees or abusive terms, may be raised as a foreclosure defense by a borrower against a lender without regard to any statute of limitations. It bars mortgage lenders and brokers from giving or receiving compensation that varies based on the terms of the loan (other than the amount of the principal).

Minimum Standards for Mortgages (Subtitle B): In defining minimum underwriting standards, Section 1411 puts the burden on the creditor to make "a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan" before granting a mortgage loan. The basis for determination of ability to repay a residential mortgage

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loan includes the consumer's credit history, current income, expected income, current obligations, debt-to-income ratio or the residual income the consumer will have after paying non-mortgage debt and other mortgage-related obligations, employment status, and other financial resources other than the consumer's equity in the dwelling or real property that secures repayment of the loan.

The safe harbor and rebuttable presumption section defines qualified mortgages. Section 1414 specifies that residential mortgage loans that are not qualified mortgages may not contain prepayment penalties, and that the limitations apply to prepayment penalties connected with qualified mortgage loans.

Another TILA amendment calls for new consumer disclosures for variable-rate loans; further, "the creditor, assignee or servicers" is/are required to furnish borrowers with a monthly statement setting forth "in a conspicuous and prominent manner" the principal balance, interest rate, the ARM reset date, a description of the prepayment penalties to be charged (if any), and the late fees and servicer's contact information.

High-Cost Mortgages (Subtitle C): Expanding the definition of a high-cost mortgage, Title XIV also expands the scope of the Home Ownership and Equity Protection Act, the primary federal anti-predatory lending law. Currently HOEPA applies only to refinances of loans with points and fees and/or interest rates in excess of certain thresholds.

Section 1431 specifies that coverage would be expanded to purchase money loans and home equity lines of credits. According to a summary from the law firm SNR Denton, this is significant "because few originators knowingly make loans subject to HOEPA." It also creates a new HOEPA points and fees threshold and specifies triggers. As a consequence of the expanded definition and coverage, the law firm says, "fewer non-prime loans will be made available to lesser-served communities."

Office of Housing Counseling (Subtitle D):
The "Expand and Preserve Home Ownership Through Counseling Act" creates a new Office of Housing Counseling that will exist within HUD. The Office's director has primary responsibility within HUD for consumer-oriented homeownership and rental housing counseling, which may include research, regulation, and administration of requirements related to housing counseling.

This subtitle also instructs the HUD secretary, in consultation with other Federal agencies responsible for financial and banking regulation, to establish a database to track foreclosures and defaults on mortgage loans for one- through four-unit residential properties.

Among the counseling procedures outlined in Section 1443 are establishment of standards for materials and forms used by organizations involved in housing counseling; certification of software programs that can be used by consumers to evaluate different residential mortgage loan proposals; and development of multimedia campaigns intended to make "potentially vulnerable consumers aware" that they should get objective homeownership counseling before making this kind of financial commitment. The HUD secretary also is directed to make financial assistance and grants available to HUD-approved counseling agencies and state housing finance agencies.

HUD also is directed to conduct "an extensive study of

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the root causes of default and foreclosure of home loans" and to establish and maintain a database of information on foreclosures and defaults on mortgage loans; this is to be done by HUD and the CFPB, in consultation with the Federal agencies responsible for regulation of banking and other financial institutions involved in residential mortgage lending and servicing.

Although these initiatives are intended to help consumers, they are likely to add costs to the mortgage process — and those costs likely will be passed on to the public. "It's going to cost borrowers more money to get a loan," says Marianne Lamkin, associate partner, Capco. "The costs of compliance … are not free."

Mortgage Servicing (Subtitle E):
This concerns rules involving escrow and settlement procedures for people who are having trouble repaying their mortgages, and also makes amendments to the Real Estate Settlement Procedures Act (RESPA) of 1974. Creditors must create an escrow account for the payment of taxes, hazard insurance, mortgage insurance, and required periodic payments or premiums associated with mortgage loans. This account is mandated when it is specifically required by state or federal law; when a loan is made, guaranteed, or insured by state or federal government; or when a transaction is secured by a first mortgage or lien. It must remain in existence for a minimum of five years and until the account has sufficient equity to not require mortgage insurance. Creditors are required to provide a disclosure notice, including information about applicable fees or costs associated with the non-establishment of such an account, to consumers who waive escrow services.

In another TILA amendment, Section 1464 specifies that payments made on home loans must be processed as of the date of receipt, unless delay of crediting doesn't result in any charge to the consumer or in a negative credit report (in which case it can be credited after five days).

Appraisal Activities (Subtitle F): This part of Title XIV addresses the role of property appraisals in the granting of mortgages (and, by implication, the role of improper appraisals in the subprime crisis). TILA is amended in Section 1471 to specify that in general, creditors may not extend credit in the form of high-risk mortgages to any consumers without first obtaining a written appraisal of the property to be mortgaged prepared in accordance with the section's requirements, including a physical property visit and a second appraisal where warranted. Lenders are obligated to report to the applicable state appraiser-certifying and -licensing agency any violations (or suspicion of violations) of compliance with the Uniform Standards of Professional Appraisal Practice.

Subtitle F also defines standards for the automated valuation models used to estimate collateral value for mortgage lending purposes. Additionally, the GAO is directed to conduct a study of the effectiveness and impact of various appraisal methods, valuation models and distribution channels.

Mortgage Resolution and Modification (Subtitle G):
This part relates to the Home Affordable Modification Program (HAMP) created by the Treasury Department in 2008 in response to the financial crisis as part of the Emergency Economic Stabilization Act. The HUD Secretary is charged with developing a program to ensure protection of current and future tenants and at-risk multifamily properties. The Secretary may coordinate this

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with the Secretary of the Treasury, the FDIC, the Fed, the Federal Housing Finance Agency and any other federal government agency deemed appropriate.

Section 1482 requires every mortgage servicer participating in the program to provide each borrower under a mortgage whose request for a mortgage modification under the program is denied with all borrower-related and mortgage-related input data used in any net present value (NPV) analysis performed in connection with the mortgage. This data must be provided to the borrower at the time of the denial. The Treasury Secretary also is directed to establish a web site that explains NPV calculations, and also to develop a website to explain HAMP and associated programs that also provides an evaluation of the impact of the program on home loan modifications.

This could create "a firestorm" (and additional costs) in terms of potential complaints and consumer challenges to banks, according to Capco's Lamkin, as banks and consumers are not necessarily using the same information or calculations to determine loan-worthiness. On the other hand, the stricter requirements may cause some prospective candidates to "self select" out of the process, Lamkin says.

Miscellaneous Provisions (Subtitle H): Here Congress goes on the record stating "the importance of government-sponsored enterprises reform to enhance the protection, limitation and regulation of the terms of residential mortgage credit" and that "significant structural reforms of Fannie Mae and Freddie Mac are required." Congress also commissions the GAO to study current inter-agency efforts to reduce mortgage foreclosure and rescue scams and loan-modification fraud.

Impact on IT

Even though the responsibility for administering many of Title XIV's requirements fall on government agencies, banks' IT organizations will be tasked with responding to numerous reporting, data gathering, transaction processing and compliance issues. Notes Capco's Lamkin, "On the servicing side, this rule shortens the amount of response time to qualified written requests." Previously, the servicer had 20 days to simply send an acknowledgment letter, and then 60 days to resolve the complaint. Now the response time is five days and 20 days for resolution (with extension options). The systems that issue automated response letters will have to be updated. Similarly, there's not a lot of time for banks to implement new reporting systems related to exceptions or escrow.

Key Dates

The regulations are to be prescribed in their final form before the end of the 18-month period that begins on the designated transfer date (no earlier than 180 days nor later than 12 months from the date the Mortgage Reform and Anti-Predatory Lending Act is enacted, extendable to no later than 18 months after enactment).

The provisions of Title XIV become effective within 12 months after the CFPB's designated transfer date.

New TILA criteria for loan origination and high-cost mortgages become effective six months following enactment. ■

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The portion of Title XV that has the most relevance to financial institutions has to do with restrictions on U.S. approval of loans to other countries issued by the International Monetary Fund (IMF). In addition, Title XV requires the SEC to create rules that require disclosures about trade in conflict minerals originating in or near the Democratic Republic of the Congo; reporting of coal and mine safety information; and disclosure of payments by resource-extraction issues. Also included in Title XV is a call for a study on core deposits and brokered deposits, and an assessment of the effectiveness of federal inspectors general.

Essence of Title XV

Title XV is a grab bag of proposals and requirements. To a great extent it appears to have been a way for members of Congress to weigh in on issues — many not even financial services-related — in which they had a particular interest (for example, in Section 1502, the exploitation and trade of "blood diamonds" and other conflict minerals to fund conflict in the Democratic Republic of the Congo; or, in Section 1503, mine safety conditions).

Another influence appears to have been the European debt crisis and questions it has raised about what entity should provide the funds when a developed country requires a bailout.

The IMF-related provisions direct the U.S. Executive Director at the IMF to evaluate any proposal for a loan to a country if either the amount of the country's public debt exceeds the country's GDP, or if the country isn't eligible for assistance from the International Development Association. If either of these indicators suggests the proposed loan is unlikely to be repaid in full, the U.S. Executive Director at the IMF must oppose the proposal. Essentially, this would make it more difficult for the IMF to provide aid to a developed country. However, it is not clear yet whether the Obama administration or future administrations would even follow this requirement — not to mention whether the requirement is constitutional.

Community banks stand to benefit from Section 1506, which calls for a study by the FDIC to evaluate the definitions of core deposits and brokered deposits (bank deposits solicited by a third-party broker, often for an amount slightly below $100,000, so the interest and principal both are covered by deposit insurance), and what the implications are in terms of banks' insurance premiums. One way community banks compete with larger institutions is by offering higher interest rates; those deposits often are designated as brokered. However, the difference between core and brokered deposits makes a difference from an asset/liability management standpoint. FDIC policy has discouraged acceptance of brokered deposits by charging an FDIC insurance premium if such deposits exceed a specified percentage. It also has very broadly interpreted the definition of a brokered deposit.

In light of the recent financial crisis FDIC policy has created some risk vulnerabilities for community banks. According to Larry Taylor, managing principal, Capco,

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"Essentially what Congress is doing is laying the groundwork for some changes to assist some of the community banks, so they can avoid having some of their deposits designated as brokered."

Impact on IT

There appears to be virtually no direct technology impact of the relevant provisions of Title XV on financial institutions.

Key Dates

Not later than one year after the date of Dodd-Frank's enactment, a report must be submitted to the Senate's Committee on Banking, Housing and Urban Affairs and the House of Representatives' Committee on Financial Services on the results of the study of core and brokered deposits "that includes legislative recommendations, if any, to address concerns arising in connections with the definitions of core deposits and brokered deposits." ■

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Title XVI essentially is an extended definition of 1256 Contracts. It outlines when certain swaps are required to report under section 1256 of the IRS code.

For more information about 1256 Contracts, see Title VII—Wall Street Transparency and Accountability, on page 15 of this document. Title VII focuses on derivatives trading.

For your easy reference, here is the entirety of Title XVI from the Dodd-Frank Act:

TITLE XVI—SECTION 1256 CONTRACTS
SEC. 1601. CERTAIN SWAPS, ETC., NOT TREATED AS SECTION 1256 CONTRACTS.

(a) IN GENERAL—Subsection (b) of section 1256 of the Internal Revenue Code of 1986 is amended—
(1) by re-designating paragraphs (1) through (5) as subparagraphs (A) through (E), respectively, and by indenting such subparagraphs (as so re-designated) accordingly,
(2) by striking '"For purposes of"' and inserting the following: "(1) IN GENERAL—For purposes of," and
(3) by striking the last sentence and inserting the following new paragraph:
"(2) EXCEPTIONS—The term 'section 1256 contract' shall not include — (A) any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract, or (B) any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement."
(b) EFFECTIVE DATE—The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

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Additional Resources

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DOCUMENTS & OTHER LINKS:

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