

Impact of the Dodd-Frank Act on Main Street

By: Peter G. Weinstock¹

On July 15, 2010 the Senate passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), which represents the most sweeping change to banking law since Congress adopted the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), if not before. FIRREA was the congressional action designed to "forever prevent" another banking catastrophe. Many statements from the late 1980s, such as the elimination of "too big to fail" ("TBTf"), have echoed in the debate over "systemically important" financial institutions. Hopefully, the Act's Financial Stability Oversight Council and the orderly liquidation authority over nonbanks that pose systemic risk will have more success than the FIRREA tools that were not effectively employed to prevent the subprime bubble.

This client alert does not cover the creation of the Bureau of Consumer Financial Protection, the "Volcker Rule," regulation of private fund investment advisers, derivatives and

¹ Peter Weinstock is practice group leader of the financial institutions corporate and regulatory section of Hunton & Williams LLP. Mr. Weinstock writes and speaks frequently on topics of interest to community bankers. You may contact him at (214) 468-3395 or pweinstock@hunton.com.

swaps or other matters that primarily impact the country's biggest banks or nonbank enterprises. These issues are addressed in other Hunton & Williams client alerts. We would be happy to discuss any of those matters. This client alert, however, is limited to issues that should resonate among "main street" bankers.

1. Leveling the Playing Field.

The focus of the capital purchase program under the Troubled Asset Relief Program ("TARP") and the Temporary Liquidity Guarantee Program ("TLGP"), as well as numerous other programs provided by the U.S. Treasury ("UST") and the Federal Reserve Board ("Federal Reserve") was to address systemic risk factors that followed in the wake of the bankruptcy of Lehman Brothers. The not-intended consequence of such programs was that consumers and businesses determined that the country's largest banks were TBTf. Consequently, such financial institutions have enjoyed a lower cost of funds than their industry compatriots who are perceived to lack a similar government bulwark. UST Secretary Geithner has commented of the Act that "these reforms will help level the playing field, allowing community banks to compete more fairly with the nation's largest financial firms."

The Act seeks to reduce, although it will not eliminate, this pricing disparity through three steps. First, the Act makes permanent the increase in the FDIC's deposit insurance coverage to \$250,000. Second, the Act extends through the end of 2012 the TLGP's protection for transaction account customers whose balances exceed the limit on deposit insurance. Third, the Act now allows financial institutions to pay interest on corporate transaction accounts.

For many community banks, paying interest on corporate deposits will represent a mixture of opportunity and cost. Some financial institutions may focus on their existing corporate transaction accounts and calculate the cost of paying interest as a pure expense item. While the expenses are easy to measure, what is harder to quantify is the opportunity to compete on a more even basis with larger financial institutions. Currently, as businesses grow, they migrate to larger banks that offer sweep accounts and other sophisticated programs that enable corporate treasurers to obtain some yield on their transaction accounts. Now, however, all financial institutions will be able to compete for such business.

2. Interchange Fees. The Act requires fees charged for debit card

transactions to be both “reasonable and proportional” to the cost incurred by the card issuer. Within nine months of the Act’s enactment, the Federal Reserve is to flesh out the meaning of such terms. The Federal Reserve must consider costs incurred by issuers for fraud prevention, but cannot consider other expenses incurred in connection with the authorization, clearance and settlement of electronic debit transactions unless such costs are specific or incremental to the transactions. Any debit card issuer that has, along with its affiliates, fewer than \$10 billion of assets will be exempt from the limit on interchange fees.

It is hard to see how exempt institutions will be able to maintain their existing fee structure. First, the competitive market will require that all fees be the same or merchants will migrate away from doing business with customers who hold debit cards issued by smaller issuers. Second, payment networks and issuers may no longer contract that all transactions be handled exclusively on one network. Instead, merchants will be allowed to route their transactions over any network. The Act also overrides issuer restrictions on merchant action to minimize fees paid, such as merchants providing discounts for cash transactions or establishing minimum transaction amounts for using debit cards.

The Act exempts debit or prepaid cards issued as part of federal, state or local government-administered payment programs. One year after the Federal Reserve’s regulations become effective, an issuer of such a card may charge overdraft fees

and a fee for the first withdrawal per month from an ATM.

Certain financial analysts have estimated that the costs of the changes to the interchange fees will be less than 3 percent of earnings for the TBTF banks and between 4 and 8 percent of earnings for other banks. Such estimates do not assume that financial institutions seek to recoup such revenue from changes in existing fee structures, benefits awarded under reward programs or incentives given to customers who use credit cards rather than debit cards. As Jamie Dimon, JPMorgan Chase & Co. CEO, noted, “If you’re a restaurant and you can’t charge for the soda, you’re going to charge more for the burger.”

3. Assessments. The Act changes the basis for assessments from a tax based on deposits to one based on assets. The assessment base will be based on average consolidated total assets of the financial institution minus its tangible equity. In the case of custodial banks and bankers’ banks, the FDIC must determine a consistent formula.

The minimum reserve ratio has been increased from 1.15 percent to 1.35 percent of deposits. The Deposit Insurance Fund (“DIF”) is to reach this ratio by September 30, 2020. Currently, the FDIC expects the DIF to reach 1.15 percent by March 31, 2017.

The Act places the burden of the assessments needed (to reach the required threshold) on institutions with total assets above \$10 billion. It is unclear whether the assets of sister banks of the same holding company will be aggregated for the purpose

of calculating what institutions are subject to such higher assessments.

The FDIC was required by law to pay dividends if the DIF exceeded 1.15 percent. This requirement arguably was counter-cyclical. The Act now removes this requirement. Going forward, the FDIC will have discretion of whether or not to pay dividends.

4. The Office of Thrift Supervision (“OTS”). It seems fair to say that few countries, if they were starting from scratch, would design a system of bank regulation that had as its end result our country’s myriad of federal bank regulatory agencies with overlapping authority over the same financial institutions. As discussed below, in the Act, Congress actually further expands regulatory duplication. The last remnant of the Obama administration’s original proposal to streamline and make more efficient jurisdiction over financial institutions that made it through the Congressional meat grinder concerns the fate of the OTS.

The Act provides for the elimination of the OTS as a separate regulatory body. The OTS is to be merged into the Office of the Comptroller of the Currency (the “OCC”). The Act establishes a deputy comptroller for federal savings banks. In contrast, the House bill had proposed a Division of Thrift Supervision housed within the OCC and a senior deputy comptroller.

The Act provides that all employees of the OTS would become employees of the OCC and the other federal bank regulator agencies, as the case may be, with similar seniority and positions to the extent available. The OCC would have the authority to adopt rules and regulations governing

federal savings banks and will have the same jurisdiction over federal thrifts that the OTS now possesses.

All orders, resolutions, determinations, agreements, regulations, interpretive rules, other interpretations, guidelines, procedures and other advisory materials that have been issued by the OTS will continue in effect after the date of transfer of authority and the demise of the OTS. The OCC and the other federal bank regulatory agencies, as the case may be, however, are to publish no later than the transfer date, the regulations of the OTS that each such agency intends to continue.

The Federal Deposit Insurance Corporation (the "FDIC") will continue to regulate and supervise state savings banks. The OCC, Federal Reserve and FDIC will consult with one another to discuss changes to OTS regulations, staffing and other matters. The federal bank regulatory authorities must publish any proposed changes to the OTS regulations by the transfer date.

The effective date for such transfers of authority would be one year after the date of enactment of the statute. The Secretary of Treasury, however, in consultation with the other federal bank regulatory authorities, including the OTS, can extend the time period for the transfer of authority, but not by more than 18 months after the date of enactment. Ninety days after the transfer date, the OTS and the position of director of the OTS are to be abolished.

5. The Fate of the Federal Savings Bank Charter and Thrift Holding Companies. The Act prohibits the OCC from granting any additional federal savings bank

charters. The existing 757 federal savings bank charters (at March 31, 2010) are grandfathered.

The Act continues the qualified thrift lender ("QTL") test. Unlike the current lax consideration given to the QTL test by the OTS, the Act strengthens enforcement. There will be dividend restrictions in the event a savings bank is not in compliance with the QTL test. Moreover, the failure to comply may be subject to civil money penalties, administrative action and other sanctions. The provisions of the House bill that proposed forcing a federal savings bank to convert to a national bank if it failed the QTL test were not adopted.

The Federal Reserve will regulate thrift holding companies and their nonbank subsidiaries. The 10(l) election under the Home Owners' Loan Act ("HOLA") that currently authorizes holding companies over state savings banks to elect to be regulated either by the OTS or the Federal Reserve is eliminated.

For the first time, thrift holding companies will now be subject to regulations related to capital requirements. In contrast, under existing law, thrift holding companies are not subject to any quantitative capital requirements or leverage limitations. The Federal Reserve's leverage and risk-based capital requirements, however, will not become applicable for five years. This delayed effectiveness is intended to enable thrift holding companies to deleverage as need be.

6. Financial Holding Companies.

For thrift holding companies that are engaged in activities that are financial in nature under the authority created by the Gramm-Leach-Bliley Act, the Act permits the Federal Reserve to

require that such activities be contained in an intermediate thrift holding company. Such intermediate holding companies, as well as financial holding companies (and not just their financial institution subsidiaries), will now be subject to the Federal Reserve's capital and management requirements.

7. Capital. Senator Collins proposed an amendment (the "Collins Amendment") that was incorporated into the Act requiring bank regulators to establish for holding companies minimum capital levels that are at least of the same nature as those applicable to financial institutions. In doing so, however, the Act requires that the Federal Reserve seek to make any capital requirements counter-cyclical, "so that the amount of capital required to be maintained by a company increases in times of economic expansion and decreases in times of economic contraction, consistent with the safety and soundness of the company."

All trust preferred securities ("TRUPs") issued by bank or thrift holding companies prior to December 31, 2009 (or mutual holding companies prior to May 19, 2010) continue to count as Tier I capital for holding companies with assets under \$15 billion at December 31, 2009. Starting on January 1, 2013, holding companies with assets above the \$15 billion threshold will deduct one-third of TRUPs a year for the following three years from Tier I capital. (The TRUPs will become Tier II capital.) Within 18 months, the GAO is to conduct a study of hybrid capital elements.

Holding companies that received funding under TARP will continue to be able to count such securities as Tier

I capital. The \$500 million Regulation Y small bank holding company exemption has been preserved.²

8. Source-of-Strength. The Act codifies the Federal Reserve's Source-of-Strength Policy Statement. Interestingly, while the Federal Reserve requires holding companies to serve as a source of financial and *managerial* strength, the statute only requires a holding company to serve as a source of financial strength to its subsidiary financial institutions. Thrift holding companies, as well as bank holding companies, are subject to the source-of-strength requirement. Commercial firms that own ILCs³ also are subject to the source-of-strength requirement.

9. Branching. The Act generally provides for the possibility of unlimited nationwide branching for all financial institutions, not just federal savings banks. Under the Act, national and state banks can branch into states on a de novo basis. As long as a bank domiciled in the host state would be allowed to branch, then an out-of-state financial institution could establish that branch. Once in a state, an out-of-state financial institution may establish additional branches within a state to the same extent as a commercial bank chartered in such state can do so.

The Act also fixes a quirk of the Riegle-Neal Act, by making it clear that a federal savings bank that becomes

² For a discussion of sources of available capital, see the [client alert that I co-authored with Mike Keeley dated March, 2009](#).

³ The Act preserves for the time being the ILC charter. The Federal Reserve is to study commercial ownership of ILCs. While the fate of the ILC is debated, ILCs owned by commercial firms are subject to limitations on their activities.

a commercial bank may continue to operate any branch that it operated immediately before becoming a bank.

10. Transactions with Affiliates. The Act provides that the borrowing or lending of securities (including a guaranty, acceptance, or letter of credit issued on behalf of a securities borrowing or lending transaction) will be a "covered transaction" under the Affiliates Act and Regulation W to the extent it causes a financial institution to have credit exposure to the affiliate. Similarly, a derivative transaction will be subject to restrictions on transactions with affiliates if it creates a credit exposure for the bank. The Federal Reserve may issue regulations or interpretations considering the effect of a netting agreement on the amounts outstanding and collateral coverage requirements. Exceptions for transactions with financial subsidiaries have been eliminated. All of these changes would take effect one year from the enactment of the Act.

11. Insider Transactions. The Act also requires a majority of a financial institution's disinterested directors to approve in advance of the purchase or sale of any asset to or from any Insider (as defined by Regulation O) if the amount of the transaction exceeds 10 percent of the financial institution's capital. The transaction also must be on an arm's-length basis. The Federal Reserve is to adopt regulations further fleshing out this requirement. It can be expected that the Federal Reserve will exclude from the "disinterested director" definition members of management and likely will exclude directors who represent institutional investors.

12. Holding Company Supervision.

The Act provides that the Federal Reserve examine nonbank subsidiaries of a bank or thrift holding company. To the extent possible, the Federal Reserve should rely on other agencies' examination reports and seek to avoid duplication of other agencies' examination activities. In addition, the Federal Reserve is to give notice to and consult with such agencies, including regulators of functionally regulated subsidiaries. The primary federal regulator of a financial institution is now entitled, under certain circumstances, to examine the holding company and its nonbank subsidiaries to the extent the Federal Reserve fails to do so. The primary regulator, however, must recommend any enforcement action to the Federal Reserve. Sheila Bair has said that the FDIC's back-up authority over holding companies will augment its back-up authority over financial institutions. Such back-up authority may assist in limited circumstances when one regulator fails to uphold its responsibilities. In most cases, however, rather than streamlining existing federal agency jurisdiction, the Act oftentimes adds to the clutter.

13. Preemption. The Act weakens the authority of the federal bank regulatory agencies to preempt state law rules and regulations. Essentially, Congress is rolling back federal preemption rules to that which existed before the bank regulatory agencies, at the behest of the industry, became more aggressive in finding preemption, and the Supreme Court backed up such findings. Congress does so by reinstating the standard embodied in the *Barnett Bank of Marion County, N.A. vs. Nelson* decision. Essentially, the OCC would need to determine

that there is substantial evidence of a conflict between the federal rule and the state rule, and that the OCC has previously adopted a substantive standard intended to address the activity in question. We separately will provide information regarding that standard. Subsidiaries of national banks will not be able to rely on preemption.

14. Deposit Cap. The Act includes savings associations and ILCs, as well as banks, in the nationwide deposit limitation. Thus, no acquisition of any financial institution, not just a commercial bank, can be approved if the effect of the acquisition would be to increase the acquiror's nationwide deposits to more than 10 percent of all deposits.

15. SARBOX. The Act exempts companies with less than \$75 million in market capitalization from the requirement to comply with the auditor attestation requirement for internal controls required by Section 404 of the Sarbanes-Oxley Act ("SARBOX").

16. Regulation D. Regulation D is most often used by smaller holding companies to raise capital in private placements. The issuance of securities is exempt from federal registration with the Securities and Exchange Commission ("SEC") if the offering is limited to 35 sophisticated purchasers and an unlimited number of "accredited investors." Accredited investors are either high earners or have net worths of a million dollars or more. The Act carves out the value of a home from the net-worth test. Moreover, the SEC is charged with evaluating whether to increase the income or net-worth thresholds over time and whether other changes are needed to protect investors. The effect of such changes

could be to limit a holding company's ability to raise capital quickly and without the cost of a SEC registration.

17. Restrictions on Conversions of Troubled Banks.

A financial institution may not convert its charter to the extent it has an existing administrative action unless:

- notice is provided to the financial institution's current regulator;
- the current regulator does not object to the conversion or the plan to address the significant supervisory matters;
- the new regulator ensures the plan is implemented; and
- in the case of an enforcement action issued by a State Attorney General, the financial institution commits to comply with such action.

18. Legal Lending Limit. Congress had considered applying the lending limit applicable to national banks to state banks. In other words, state banks would be subject to a lending limit of 15 percent of capital and reserves as the base rule applicable to any loans to one borrower. This provision did not make its way into the Act.

19. Excessive Compensation. The Act provides that the "appropriate federal regulators" must establish standards prohibiting, as an unsafe and unsound practice, any compensation plan of a bank holding company or other "covered financial institution" that provides an Insider or other employee with "excessive compensation" (undefined) or could lead to a material financial loss to such firm. A "covered financial institution"

includes investment advisers, broker dealers, credit unions and any other entity that the appropriate federal regulators jointly deem to be covered. The appropriate "federal regulators" are all federal bank regulatory agencies plus the National Credit Union Administration board, the SEC and the Federal Housing Finance Agency.

In establishing such standards, the appropriate federal regulators will consider the safety and soundness standards regarding compensation that the FDIC issued in response to the Federal Deposit Insurance Corporation Improvement Act of 1991. The Federal Reserve has previously had the authority to regulate compensation at the holding company level. This authority was eliminated by the Riegle-Neal Act. The Act now provides even more such authority.

The Act requires companies with securities listed on national securities exchanges to require that all boards have compensation committees composed of members independent of the issuer. Certainly, most compensation committees are currently so populated under the best practices that arose following SARBOX. It is likely that the national securities exchanges will mandate independence tests for compensation committee members similar to existing tests for audit committee members, which tests are more strict than the overall requirements for a determination of board independence.

The Act furthermore requires the compensation committee to consider whether committee advisers are independent. These advisers include not just compensation consultants, but also legal counsel and accountants.

The Act also requires national securities exchanges to prohibit the listing of company equity securities if the company's compensation policies do not include "claw back" provisions if compensation were paid that should not have been in light of information subsequently uncovered. Although these compensation provisions govern firms listed on national security exchanges, it is highly likely that the bank regulatory authorities will adopt them either as best practices or as compensation standards in regulation for all financial institutions.⁴

20. Fair Lending; Regulatory Burden.

The Act contains numerous

⁴ Other compensation provisions of the Act are discussed in separate [Hunton & Williams client alerts](#).

provisions that will enhance the regulatory burden and challenge the compliance officers of financial institutions. For instance, the federal bank regulatory agencies have already ramped up enforcement of fair lending laws.⁵ The Act requires financial institutions to inquire whether a small business loan applicant is a woman-owned or minority-owned enterprise. The financial institution will be required to retain for three years information such as the number of the application, the date on which the application was received, the type and purpose of the loan, the amount of credit applied for, the type of action taken, the applicant's census track, the gross annual revenue of the applicant, and the race, sex

⁵ [See my client alert dated June, 2010.](#)

and ethnicity of the principal owners of the applicant. The purpose for such data collection is "to facilitate enforcement of fair lending laws." Accordingly, financial institutions should consider developing pricing models to ensure that there is clearly no disparate pricing or approval of such credits.

The work of the federal regulatory agencies will result in future further substantive changes. The Act provides for literally hundreds of regulations, studies and reports. Nonetheless, this summary will provide a good foundation of the current key topics primarily of concern to "main street" financial institutions and their holding companies.

Hunton & Williams Offices

Atlanta

Bank of America Plaza, Suite 4100
600 Peachtree Street, NE
Atlanta, Georgia 30308-2216
(404) 888-4000

Austin

111 Congress Avenue, Suite 1800
Austin, Texas 78701-4068
(512) 542-5000

Bangkok

34th Floor, Q. House Lumpini Building
1 South Sathorn Road
Thungmahamek, Sathorn
Bangkok 10120 Thailand
+66 2 645 88 00

Beijing

517-520 South Office Tower
Beijing Kerry Centre
No. 1 Guanghai Road
Chaoyang District
Beijing 100020 PRC
+86 10 5863 7500

Brussels

Park Atrium
Rue des Colonies 11
1000 Brussels, Belgium
+32 (0)2 643 58 00

Charlotte

Bank of America Plaza, Suite 3500
101 South Tryon Street
Charlotte, North Carolina 28280
(704) 378-4700

Dallas

1445 Ross Avenue, Suite 3700
Dallas, Texas 75202-2799
(214) 979-3000

Houston

Bank of America Center, Suite 4200
700 Louisiana Street
Houston, Texas 77002
(713) 229-5700

London

30 St Mary Axe
London EC3A 8EP
United Kingdom
+44 (0)20 7220 5700

Los Angeles

550 South Hope Street, Suite 2000
Los Angeles, CA 90071-2627
(213) 532-2000

McLean

1751 Pinnacle Drive, Suite 1700
McLean, Virginia 22102
(703) 714-7400

Miami

1111 Brickell Avenue, Suite 2500
Miami, Florida 33131
(305) 810-2500

New York

200 Park Avenue
New York, New York 10166-0091
(212) 309-1000

Norfolk

500 East Main Street, Suite 1000
Norfolk, Virginia 23510-3889
(757) 640-5300

Raleigh

One Bank of America Plaza Suite 1400
421 Fayetteville Street
Raleigh, North Carolina 27601
(919) 899-3000

Richmond

Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, Virginia 23219-4074
(804) 788-8200

San Francisco

575 Market Street, Suite 3700
San Francisco, California 94105
(415) 975-3700

Washington

1900 K Street, NW
Washington, DC 20006-1109
(202) 955-1500

If you have questions about this legislation or other matters of corporate law, please contact:

[Peter G. Weinstock](mailto:pweinstock@hunton.com)

(214) 468-3395

pweinstock@hunton.com

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