The Dodd-Frank Act: Things to Know AND Risks to Avoid

Executive Summary

Enacted in 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was introduced as a new law in the financial services landscape. Financial services are now subject to new regulatory requirements as well as increased legal penalties and consequences for non-compliance with the various components of this Act. The Dodd-Frank Act demands somewhat immediate action provides the framework for future implementations of the different parts of the Act. This white paper provides a summary of the parts of the Dodd-Frank Act that everyone in financial services should know, and lists the risks to be avoided.

Introduction: Quick Review of the Dodd-Frank Act

In response to the demise of several financial institutions and the Recession, the Dodd-Frank Act calls for significant reform inspired regulations. Named after the two legislators who led the authorship of the regulation, the Dodd-Frank Act was introduced March 15, 2010 by Senator Chris Dodd to the United States Senate. It was passed by the Senate five days later. Revised by Congressman Barney Frank on June 30, 2010, the Dodd-Frank Act was approved by the House and signed into law by President Obama on July 21, 2010. Some of the provisions were implemented immediately while others will be imposed in the future.

This new regulation is designed for the following expressed purposes:

- Regulate financial markets
- Help reduce likelihood of another future economic crisis
- Provide additional and enhanced consumer protection
- Reduce abusive lending and mortgage practices
- Impose increased penalties for non-compliance

What Should You Know?

With over 2,300 pages and 16 reform areas, the Dodd-Frank Act can be intimidating. First there is denial, then anger, then...How can we shortcut to acceptance and finally mastery of the new regulations – to the extent that we feel fluent in the detail and spirit of the Act. And ultimately, adjusted to the point that the Dodd-Frank Act does not confuse or alter strategic trajectory?

Simply put, what should we know right now?

Bank Regulation

Enhancing regulation over banks is one of the main goals of the Dodd-Frank Act. Banks are faced with revisions to older regulations as well the task of implementing procedures to comply with new regulations. In its efforts to overhaul certain bank regulations and more closely monitor and prevent another future "too-big-to-fail" epidemic of the financial system, the Dodd-Frank Act has imposed several components:

- The Federal Reserve can require banks to increase their reserve requirements if they feel another "too big to fail" situation appears to be developing.
- The Act outlays process and enforcement to control and oversee inherently risky business endeavors engaged in by financial service institutions:
  - Imposing heightened liquidity and capital requirements on large bank holding companies and significant nonbanks when deemed necessary.
  - Establishing the Financial Stability Oversight Council (FSOC) which will monitor what risks are impacting the financial industry. The FSOC:
    - Has the authority to provide direction to regulatory agencies on addressing any such identified risks.
    - Will oversee non-bank financial companies.
  - The Act increases bank supervision, including establishing corrective action programs for large bank holding companies.
  - The Act gives Federal agencies the ability to respond to a potential crisis involving non-depository financial companies, such as placing them into a receivership structure, in a timely manner,
  - The Act imposes capital requirements for holding companies that are at least as strict as capital requirements for depository institutions.
  - The Act implements strength requirements for savings and loan holding companies, as well as for banks.
  - The Act implements securities regulation changes.
  - The Act increases enforcement actions against non-bank subsidiaries, such as mortgage affiliates, for failing to comply with rules and regulations, as well as for engaging in abusive practices.
  - The Act provides authority to liquidate failing financial companies which are posing a significant threat to overall financial stability of the financial systems.
  - The Act implements a timely process for implementing a bank shutdown if deemed necessary as a result of lack of money or insolvency.
  - The Act restructures the prevue of regulatory agencies through:
    - Eliminating the Office of Thrift Supervision (OTS);
    - Reallocating savings and loan holding company supervision to the Fed;
    - Moving Federal savings institution supervision to the OCC; and
    - Moving State savings institution supervision to FDIC.

New Rulemaking and Multiple Effective Dates

The Dodd-Frank Act is not designed to be implemented all at once, but rather to have different rules and provisions to be enacted at various times. In fact, many of the provisions within the Dodd-Frank Act have delayed effective dates that are contingent on various other factors for that specific rule. It is important that financial institutions recognize the increase litigation risk as a result of these current and impending new rules and their effective dates.

Heightened Regulation of Mortgages

The financial industry (including banks, non-banks, mortgage companies, and servicing companies) is faced with a large increase in regulations that govern its members' actions. Specifically, the Dodd-Frank Act requires a certain amount of risk retention for mortgage loan securitizes, an increase in detailed mortgage loan-related disclosures to consumers, and that every effort be made by mortgage originators to provide services that are in accordance with the best interests of the consumer. The provisions of the Dodd-Frank Act significantly increase the regulation of mortgage lending and servicing by banks and nonbanks.

Agencies Given New Authorities

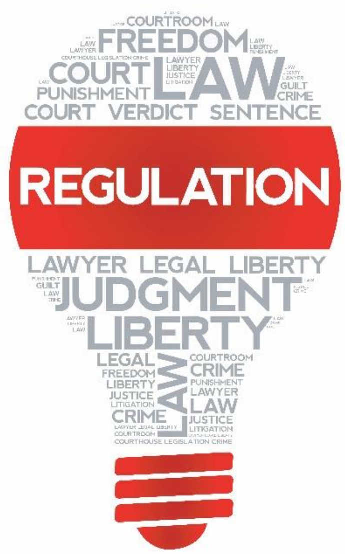
Through the Dodd-Frank Act government agencies, specifically the Board of Governors of the Federal Reserve and Federal bank regulatory agencies, have been granted new governance authorities to monitor the financial systems of the U.S. The extended authorities allow these government agencies to:

- Assume full control of financial companies which pose significant risks to financial systems,
- To require nonbank financial companies and large bank holding companies (with total consolidated assets equal to or in excess of $50 billion) to assume certain controls to mitigate the risk they may present to financial systems, and
- To continuously monitor financial systems and take the necessary steps to mitigate risks that would impact the financial system's safety and soundness.

Volcker Rule and Investing Activities

A rule within the Dodd-Frank Act deals specifically with investing activities. The rule, known as the Volcker Rule, outlines several restrictions and requirements as they pertain to investing activities. These include:

- Requiring registration of hedge funds and private equity advisors
- Prohibition of banks from performing certain operations for their own profit, such as owning, investing, or sponsoring hedge funds, or private equity funds
- Implementing restrictions on proprietary trading
- Implementation of sponsoring and investment limits on private equity funds and hedge funds, subject to certain conditions
- Requiring the forwarding of some swap activities to affiliates if the bank involved receives Federal assistance
- Requiring divestiture of existing funds that are non-compliant with the Volcker Rule
- Permitting trading if it is deemed necessary for the bank to operate.
- Implementation of acquisition restrictions that would prevent a bank from having over 10 percent of the control over the consolidated aggregate liabilities of all banks



Derivatives' Effects

Clearinghouses are required to be established to provide the public transparency of derivative trades. The Commodity Futures Trading Commission (CFTC) or the SEC is required to monitor and regulate those derivatives considered the riskiest. However, not all derivatives are regulated in accordance to the Dodd-Frank Act. Exemptions were given to banks, certain energy companies and hedge funds. Additionally, The Dodd-Frank Act expands coverage of Section 23A of the Federal Reserve Act to consider credit exposure as it relates to additional transactions. This includes derivative transactions.

Insurance

Under the Treasury Department, the creation of the Federal Insurance Office (FIO) would provide an agency with the ability to obtain insurance industry information, identify insurance companies which posed risks to the insurance system, as well as ensure minorities have affordable insurance available.

Credit Rating Agencies

As a result of some credit rating agencies misleading investors with higher-than-actual value mortgage-backed securities and derivatives, the Office of Credit Rating ("OCR") at the Securities and Exchange Commission was created to monitor and regulate credit rating agencies. Credit rating agencies may be required to submit their rating systems to the OCR for review. If the OCR finds that a credit rating agency is providing misleading reviews, that credit rating agency can be decertified.

"The provisions of the Dodd-Frank Act significantly increase the regulation of mortgage lending and servicing by banks and nonbanks"

Consumer Protection

The best interest of consumers is also a main objective of the Dodd-Frank Act. Heightened consumer protection from unfavorable business practices by banks becomes the responsibility of the newly created Consumer Financial Protection Bureau (CFPB). The CFPB's focus is extensive with many responsibilities toward consumer protection. However, these responsibilities do not include oversight and enforcement powers related to the Community Reinvestment Act (CRA).

The creation of the CFPB is intended to:

- Consolidate several existing consumer protection responsibilities currently under the prevue of other government agencies.
- Provide oversight for nonbank, mortgage industry services and depository institutions that exceed $10 billion in assets
- Implement new consumer protection provisions for other regulatory agencies for those institutions that have less than $10 billion in assets.
- Work jointly with large bank regulators in the prevention of abusive practices against consumers.
- Reform mortgage lending in regards to predatory lending and the abilities for the consumer to repay their obligations.
- Provide comprehensible information and language in mortgage disclosures to consumer
- Provide oversight regarding consumer loans, payday loans, debit cards, and credit cards
- Provide oversight to credit reporting agencies
- Provide enhanced credit scoring information to consumers
- Provide consumer hotline for consumers to report issues with financial service providers that they may encounter
- Restructure the preemption determinations of Federally-chartered depository institutions in regards to State intervention.

Whistle Blower Provisions

Safe haven provisions are provided to those individuals who may have information regarding security violations. To increase its efforts in minimizing insider trading and corruption, a whistle-blower provision has been implemented by the Dodd-Frank Act which may provide for financial rewards and incentives for those who come forward and provide such information.

Risks to Avoid

Trying to understand and implement the Dodd-Frank Act can be trying for financial institutions. Financial institutions already face challenges to remain compliant with many other regulations. So what you do to help ensure you are proactive in abiding by the Dodd-Frank Act? Financial institutions, regardless of size, purpose, or business, should be aware of certain risks which ultimately could derail their efforts to comply with the Dodd-Frank Act. This list is not all-inclusive, but rather lists some general risks that financial institutions should make efforts to avoid.

POLICIES & PROCEDURES

Failing to establish policy, procedures, and processes that serve the best interests of consumers

Failing to develop and implement the policy and procedures for each new rule or provision outlined in the Dodd-Frank Act

ACCOUNTABILITY

Failing to establish Dodd-Frank Act roles and responsibilities to personnel

MONITORING

Establishing and/or performing inadequate monitoring of the institution's lending practices as well as the behavior of its lending personnel

Inadequately monitoring and identifying risks that could impose significant threats

DECISION MAKING

Failing to involve the Board and Senior Management in the decision-making process regarding efforts for compliance of the Dodd-Frank Act

Failing to take appropriate steps to mitigate significant risk

PREPARATION

Failing to recognize and plan accordingly for new regulations imposed by the Dodd-Frank Act, including acknowledging their effective dates

AUDITS

Failing to enhance the internal audit program or requiring an external audit program, to examine and review for compliance of the Dodd-Frank Act

Conclusion

Regulation like Sarbanes Oxley and The Dodd-Frank Act to some seem overdue and to others excessively reactionary. Without a doubt, this type of regulation imposes a new burden on businesses. The successful firms will understand the regulation the best they can, open a dialogue with the regulators, integrate the new regulations into its processes so that the achievement of objectives is not affected and perhaps even enhanced. The Dodd-Frank journey is not designed to be a short one. Understanding its requirements is the first step. It is no longer relevant to the success of your organization to debate the confluence of politics, economic events or social phenomena that washed this Act ashore and changed the rules of the game. The first steps are not denial and anger, rather they are study and understand...Then, implement and eventually fold into the success of your organization.

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ABOUT CONTROL SOLUTIONS INTERNATIONAL

Financial Institutions Regulatory Compliance

Our team of Financial Institution Regulatory Compliance (FIRC) experts have been assembled to address nearly every regulatory challenge faced by firms within the Banking, Non-bank Mortgage and Insurance industries. Companies from every industry recognize the importance and challenge of facilitating compliance with changing regulations while growing or maintaining profit levels and value.

Today, financial institutions face a unique and demanding regulatory environment. Recent events behoove financial institutions to transparently demonstrate that they are not only compliant but have the right people, processes and systems in place to ensure compliance with regulations is sustainable. We are dedicated to helping organizations identify, remediate, monitor, and manage regulatory compliance risks in addition to coordinating your organization's people, processes and technologies to improve effectiveness and help manage costs.

References:

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