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Dodd-Frank Wall Street Reform and Consumer Protection Act

Issues For Community Banks

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The Big Questions:

- What's Important?
- What's Not Important?

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What's Not Important?

- The Things That Don't Affect You...

Examples:

- The Financial Stability Oversight Council
- The designation of “Systematically Important Financial Institutions” (“SIFI’s”)
- Living Wills
- Office of Financial Research
- Wall Street Transparency and Accountability
- ETC.

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Q: What's Important?

A: Those provisions that will immediately impact your operations, your product offerings and your bottom line.

Examples:

- The Bureau of Consumer Financial Protection (BCFP)
- Fair Lending Enforcement
- Dodd-Frank Act impact on M & A / and Branching
- The impact of Dodd-Frank on the future of Housing Finance

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The BCFP

- Effective July 21, 2011
- Richard Cordray nominated as Director
- Rule writing and revision authority for virtually all consumer protection laws and regulations

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Priority No. 1 – Fair Lending Enforcement

- The BCFP has created its own Fair Lending Law Enforcement Division
 - Staffed by lawyers, statisticians, and examiners
 - With wide-ranging examination authority
- It will work in concert with the Justice Department
 - Which has its own Fair Lending Enforcement Division
 - And receives direct referrals from the three bank regulatory agencies (FDIC, OCC, & Federal Reserve)

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Priority No. 1 – Fair Lending Enforcement (Continued)

- But its chief impact will be on the actions of the FDIC, the OCC and the FED
 - An MOU for the regulators
 - Requires them to refer any detected pattern or practice of discrimination to the Justice Department with notice to the BCFP
 - Gives the BCFP final say in the content of the Enforcement Action

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Areas of Fair Lending Examination and Enforcement: (FDIC, OCC & FED)

- Primarily
 - Loan Underwriting
 - Loan Pricing
- Loan Underwriting:
 - Seeking to impose control over the use of discretion by loan officers and underwriters
 - Looking for well-defined criteria for underwriting of loans
 - Looking for well-defined (and limited) exceptions to underwriting criteria
 - Closely reviewing your loan policies for the above

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- Loan Pricing:
 - Seeking similar limits on the use of discretion in pricing by loan officers and underwriters
 - Looking for well-defined pricing criteria
 - Looking for well-defined (and limited) exceptions to pricing criteria
 - Also closely reviewing your loan pricing policies, guidelines and practices

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- The use of statistical analysis
 - Now common practice by the regulatory agencies, the Justice Department and (soon) the BCFP
 - Presently relies on:
 - HMDA data analysis
 - Analysis of unsecured loans to female borrowers
 - Likely to be expanded to
 - Increase HMDA data reporting
 - Include small business loans to minorities and females

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Actions to Take

- Review and revise your loan underwriting policies and procedures
- Review and revise your loan pricing policies and procedures
- Implement an effective monitoring program to track the above
- Consider doing a statistical analysis of your current loan data
 - Know before the examiners know!

The Impact of Dodd-Frank on Housing Finance

- The Mortgage Reform and Anti-Predatory Lending Act
 - Residential Mortgage Loan Origination Standards
 - Limits on MLO compensation
 - Prohibition on steering incentives
 - Minimum standards for mortgages
 - Ability to repay
 - Safe harbor and rebuttable presumption of compliance
 - Amendments to liability provisions
 - High-Cost mortgages

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- The impact on the Asset-Backed Securitization Process
 - The Qualified Mortgage vs. The Qualified Residential Mortgage
 - Will liquidity concerns require more loans to be QM or QRM?

- The Future Role of the Federal Government in Housing Finance
 - The future of Fannie and Freddy – completely unknown
 - The impact on the national economy?
 - The role of the community bank in filling any void?
 - An opportunity?

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A Closer Look

- The Mortgage Reform and Anti-Predatory Lending Act
 - Applies to a newly defined “Residential Mortgage Loan”
 - Def:** Any consumer loan secured by a dwelling (other than HELOCs)
 - Prohibits compensation tied to terms of a loan
 - Prohibits steering of loans to products where compensation is greater or costs to the consumer are higher

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Minimum Standards for “Residential Mortgage Loans”

- Similar to 2008 rules for higher-priced mortgage loans – but apply to significantly larger number of loans
- Requires reasonable and good faith determination that the consumer has a reasonable ability to repay the loan – verified and documented
- Ability to repay determination
 - Must take into account:
 - Credit history
 - Current income
 - Expected income
 - Current obligations
 - DTI
 - Employment status, and
 - Other financial resources

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The “Qualified Mortgage”

- Either a safe harbor or a rebuttable presumption of compliance
- Creditor or assignee may presume compliance if the loan is a “Qualified Mortgage”
- A “Qualified Mortgage” is one which
 - Does not feature negative amortization
 - Does not feature a balloon payment
 - Verifies and documents income and financial resources
 - For fixed-rate loans – uses fully amortizing payment, taking into account insurance and taxes
 - For adjustable-rate loans – uses the maximum rate permitted in the first 5 years and a payment schedule that fully amortizes over the term of the loan
 - Complies with DTI, etc. guidelines from the FED
 - Total points and fees do not exceed 3%
 - Term does not exceed 30 years

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Exceptions to Definition of Qualified Mortgage

- Smaller loans
- A balloon loan – provided creditor meets all of the other requirements and the creditor operates primarily in rural and underserved areas

- Other Provisions

- Restrictions on prepayment penalties
- Prohibition on single premium credit insurance
- Prohibition on Arbitration Agreements
 - Residential Mortgage Loans and
 - HELOCS
- Expanded Civil Liability
 - Penalties doubled from maximum of \$1,000 to \$2,000
 - Penalties for class action liability is doubled to \$1,000,000

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Q: How will the above impact your loan portfolio?

Q: How will the combined effect impact the economy?

Q: Can we find a silver lining? An Opportunity?

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Capital Issues in the Era of Dodd-Frank

September 21, 2011

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Dodd-Frank Era and the Resulting Regulatory Environment

- New challenges and uncertainties lead to:
 - Many banks consider raising additional capital;
and
 - New opportunities for mergers and acquisitions

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How Much Capital is Enough Capital?

- Individual Capital Directives
 - While capital adequacy regulations have not explicitly been changed, regulators have not hesitated to encourage or require individual banks to raise additional capital
 - Individual capital directives may be the new normal
 - Old capital guidelines could be viewed as a minimum as regulators require additional capital on a case by case basis
- Expansion plans require additional capital consideration

Raising additional capital

- Current environment mandates higher level of caution and planning in raising capital
- Uncertainty in the regulatory environment and fear among investors make valuation even more difficult than in the past
 - Certain uncertainties:
 - Enhanced and unpredictable regulatory environment lead to increased and unpredictable compliance costs
 - Interest rate risk and risks involved in seeking to increase fee income
 - Macroeconomic fears

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Finding the Right Price

- By law, the board of directors has ultimate responsibility for setting the price
- Underpricing can lead to excessive dilution of current shareholders
- Overpricing can lead to an unsubscribed offering
- Look at individually negotiated transactions, if any
- Obtaining a valuation is not generally required, but it can be a good guide for the bank's board of directors in setting the price

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Finding the Right Price

- Bottom line:
 - At what price is the bank willing to sell stock?
 - At what price is the bank capable of selling stock?

Who Will Buy the Stock?

- Does your bank have preemptive rights or other obligations to current shareholders?
 - Even without preemptive rights, a bank may want to allow current shareholders to purchase their proportionate share.
- Does the bank want to limit the offering to accredited investors?
 - Offering to unaccredited investors increases the issuer's disclosure obligations
 - Most offers of holding company stock are made pursuant to Regulation D Rule 506 which allows sales to up to 35 unaccredited investors so long as appropriate disclosures are made

What is an Accredited Investor?

- In general, an accredited investor is an investor that the SEC deems to be capable of investing in a private venture without the benefit of reports of the type a public company would file

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What is an Accredited Investor?

- A bank, insurance company, registered investment company, business development company, or small business investment company;
- An employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5 million;
- A charitable organization, corporation, or partnership with assets exceeding \$5 million;
- **A director, executive officer, or general partner of the company selling the securities;**
- **A business in which all the equity owners are accredited investors;**
- **A natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds \$1 million at the time of the purchase;**
- **A natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; or**
- A trust with assets in excess of \$5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.

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Limitation of Accredited Investor Status by Dodd-Frank

- An individual can qualify as an accredited investor by income or net worth (\$1 million)
- Dodd-Frank amended the net worth measure so an investor's primary residence is now excluded from net worth

Other considerations in selling stock

- Common or preferred
 - Preferred may be less dilutive, but caution should be exercised to make sure that preferred would be considered Tier 1 capital when issued
- Is the issuer a bank or a holding company?
- Does the issuer have sufficient authorized shares to issue new stock?
 - If not, an amendment to the articles of incorporation would be required, and such an amendment would require shareholder approval and, possibly, regulatory approval
- Make sure any sales of stock to insiders are on arms length terms
- Sales of stock are heavily regulated by the SEC and state securities commissions
 - Any sale of stock is either registered, exempt, or illegal

New Adjustments and Opportunities

- Banks needing capital may consider alternative means of raising capital such as institutional investors, attractive preferred shares, or warrants
 - Beware of holding company thresholds when selling large chunks of stock to a single investor
 - Ongoing warrants can create ongoing disclosure obligations
- Banks with capital on hand or the ability to raise capital may have good opportunities for acquisitions

Going Forward

- Expect an increase in merger and acquisition activity
 - Counter: Dodd-Frank’s introduction of de novo interstate branching could reduce some appetite for M&A activity
- Banks should consider what this could mean for their business
 - Even if your bank isn’t a target or an acquirer, many of your competitors will be one or the other

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Bureau of Consumer Financial Protection and Unfair, Deceptive and Abusive Acts or Practices

UDAAP

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Sources of Enforcement Authority

- Section 5 of the FTC Act
- Section 8 of the Federal Deposit Insurance Act
- Dodd-Frank Wall Street Reform and Consumer Protection Act

Dodd-Frank gives the BCFP authority to write regulations applicable to banks and others

To identify and prohibit

- Illegal acts
- Unfair, deceptive, or abusive acts or practices in connection with consumer financial products or services

Definitions

- FTC Act defines unfair or deceptive very broadly
- Unfair-Act or practice may be found unfair where:
 - It causes, or is likely to cause, substantial injury to consumers
 - Injury is not reasonably avoidable by consumers themselves
 - Injury not outweighed by counterveiling benefits to consumers or to competition

Definitions (Cont.)

- Deceptive – representation, omission or practice is deceptive if:
 - It is likely to mislead a consumer
 - The consumer is acting reasonably under the circumstances
 - The act or omission is material (it is likely to affect the consumer's conduct, such as the decision to purchase a product or service)

Definitions (Cont.)

- Act or practice may be unfair, deceptive or both
 - Prohibited if either unfair or deceptive
- May also be a simultaneous violation of other laws and regulations (for example, Truth in Lending, Truth in Savings, Equal Credit, Fair Housing Act, FCRA, Privacy)

Definitions (Cont.)

- Abusive – definition will depend on BCFP regulations
- Bureau's authority to issue those regulations subject to confirmation of Director
- D-F Act sets only very broad limits on Bureau's authority

Definitions (Cont.)

- Bureau has no authority to declare act or practice abusive unless it:
 - Materially interferes with consumer’s ability to understand a term or condition, or
 - Takes unreasonable advantage of:
 - Consumer’s lack of understanding of material risks, costs or conditions of product or service, or
 - Consumer’s inability to protect his/her own interests in selecting or using the product or service, or
 - Reasonable reliance by consumer on a covered person to act in the consumer’s interest

How will the BCFP define “abusive”?

Former U.S. Supreme Court Associate Justice Potter Stewart famously said that while he was unable to define “pornography”, "[I know it when I see it.](#)"



Enforcement

- Currently, a high priority with the agencies, BCFP will continue emphasis
- “UDAPs are illegal; can cause significant injury to consumers; erode consumer confidence; and present significant credit and asset quality risks...”*
- Corrective action may include discontinuance of act or practice, restitution, MOU or C&D, and civil money penalties
- Significant violations may result in downgrade of compliance and CRA ratings and the bank’s risk management rating.

* FDIC Compliance Manual, p. VII-1.1, June, 2011

Higher Risk Areas

- Rewards programs – rewards checking
- Mortgages – subprime, reverse mortgages, mortgage brokerage services
- Credit cards – secured and subprime cards, “rent a BIN” arrangements, third-party marketing activities
- Overdraft programs
- Prepaid debit cards
- Refund anticipation and payday loans
- Loan collection activities
- Products targeted to the elderly or financially less sophisticated
- Insurance and investment services

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Risk Management

- Review consumer complaints and resolution procedures
- Marketing and advertising – Pre-clear for misleading, inaccurate or incomplete information
- Third party service providers – credit cards, pre-paid debit cards, marketing services and promotional activities.

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Risk Management (Cont.)

- Loan collection activity – internal collections and use of outside debt collectors
- New products and new third party affiliations
- Use of internal reports – chargebacks and fee refunds
- Look closely at ODP Programs – FDIC, OCC OD Guidance
- Strong overall compliance management system

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More Dodd-Frank Issues

- Repeal of Regulation Q
 - Effective July 21, 2011 - permits payment of interest on demand deposits
 - Section 334 of Dodd-Frank provides unlimited deposit insurance coverage for demand deposits that are non-interest bearing between December 31, 2010 and December 31, 2012
 - If an account is converted to interest paying, the customer must be notified that the account will no longer receive unlimited coverage

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- Future BCFP regulations will require reporting for small business loans to minorities and females – Section 1071
 - Required data will include:
 - Application number/date
 - Type and purpose of the loan
 - Amount of credit applied for and amount approved
 - Action taken
 - Census tract in which the business is located
 - Gross annual revenue of the business
 - Race, sex and ethnicity of the owners
 - Any additional data the BCFP determines is helpful

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- Amendments to the Home Mortgage Disclosure Act – Section 1094
 - Future BCFP regulations will require additional data to be reported on HMDA-LAR
 - Age
 - Total points and fees
 - Difference between the APR and a benchmark established by the BCFP
 - Length of prepayment penalty
 - Value of real property securing the loan
 - Length of introductory rate period for ARM loan
 - Presence of interest-only or negative amortization periods
 - Term of the loan
 - Channel through which the application was received;
 - Other items BCFP may designate

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Arbitration

- Section 1028 of Dodd-Frank gives the BCFP authority to restrict, limit or prohibit the use of pre-dispute arbitration agreements in consumer contracts
- Would apply to the arbitration agreements banks currently use in consumer loan transactions and deposit account agreements
- Would not void existing arbitration agreements
- Would not prohibit pre-dispute arbitration agreements in a commercial context
- Won't take place until a Director of the BCFP is confirmed

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