

FINANCIAL INSTITUTIONS ALERT

NEWS FOR THE CLIENTS AND FRIENDS OF BASS, BERRY & SIMS PLC

Financial Reform's Impact on Community Banks

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On July 21, 2010, President Obama signed into law comprehensive financial regulatory reform legislation, known as the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). This new statute has been heralded as the most significant financial legislation since the New Deal. However, as its title indicates, many of its most far reaching and fiercely debated provisions will primarily impact "Wall Street" and the nation's largest financial institutions and are substantively irrelevant to most community banks. These include:

- Provisions regulating derivative transactions and the so-called "Lincoln Rule" for banks engaged in derivatives trading activity;
- The Financial Stability Oversight Council and the enhanced supervision of "systemically significant" institutions;
- The FDIC's new receivership authority over systemically significant institutions; and
- New registration and regulation of hedge funds and the "Volker Rule" limitations on proprietary trading by banks.

However, community banks (which for purposes of this alert means banks under \$10 billion in total assets, the cutoff in several statutory sections) did not dodge all of the congressional bullets, and the legislation contains several provisions that will impact "Main Street" banks. Below are some of these key provisions:

Deposits and Deposit Insurance

The statutory changes most likely to be beneficial to community banks are changes to assessments for federal deposit insurance, which, rather than being based on U.S. account deposits, will be based on the difference between average assets and average tangible equity. This change shifts the burden of assessments toward larger institutions which utilize significantly higher levels of non-deposit and off-shore funding for their assets. Furthermore, while the minimum reserve ratio for the federal deposit insurance fund will increase from 1.15 to 1.35 percent over a 10-year period, the FDIC must offset the effect of this increase on institutions with less than \$10 billion in assets, presumably with higher assessment rates on those institutions over \$10 billion in assets.

The Act made permanent the increase from \$100,000 to \$250,000 in the maximum FDIC deposit insurance and credit union share insurance, retroactive to January 1, 2008. The Act also temporarily extends, from December 31, 2010 to December 31, 2012, unlimited deposit insurance of noninterest bearing transaction accounts. Unlike the Transaction Account Guarantee Program, which remains in effect until December 31, 2010, the two-year unlimited coverage will not require payment of a special guarantee fee, and will not be available to low-interest NOW or IOLTA accounts. Finally, effective July 21, 2011, interest will be permitted to be paid on demand deposit accounts, including corporate checking accounts. Taken together, these deposit changes represent significant positive legislative changes long sought by community banks.

Consumer Financial Protection Bureau

The provision of the Act which drew the most criticism from the banking industry was Title X, which transfers most of the consumer financial protection responsibilities currently handled by the federal banking agencies and the Federal Trade Commission to the Bureau of Consumer Financial Protection (the "CFPB"). The CFPB is established as part of the Federal Reserve Board, but is substantially independent of it (i.e. it is an independent bureau within an independent agency). It is given broad rulemaking and interpretative power over essentially all federal consumer financial statutes, including:

- Alternative Mortgage Transaction Act
- Equal Credit Opportunity Act
- Fair Credit Billing Act
- Fair Credit Reporting Act (with exceptions)
- Fair Debt Collections Practices Act
- Gramm-Leach-Bliley Act privacy provisions
- Home Mortgage Disclosure Act
- Home Ownership and Equity Protection Act
- Real Estate Settlement Procedures Act
- S.A.F.E. Mortgage Licensing Act
- Truth in Lending Act

Importantly, community banks are exempted from the direct examination and supervision authority of the CFPB and will continue to be examined and supervised for compliance with federal consumer statutes by their primary federal bank regulator. Banks, thrifts and credit unions with over \$10 billion in assets, mortgage loan originators, servicers and brokers, real estate appraisers and settlement companies, debt collectors and debt management companies, payday lenders and pawn brokers are all made subject to the CFPB's examination and supervisory authority. The date when the banking agency consumer protection functions are

transferred to the CFPB ("transfer date") will be selected and announced by the Secretary of the Treasury by or before September 17, 2010. The transfer date must be between 180 days and 18 months of the July 21, 2010 enactment date of the Act.

Community banks will be primarily impacted by the CFPB's regulatory and interpretative authority, including its authority to prescribe rules to ensure that consumer financial products are fully and accurately described to consumers, and its authority to declare an act or practice to be "unfair, deceptive or abusive." Although similar to the banking agencies' current UDAP authority, the new threat of the CFPB determining that certain consumer product terms are "abusive" acts or practices, coupled with a likely activist CFPB staff, will probably generate additional regulatory concerns and initiatives that must be faced by community bankers. Furthermore, the CFPB has broad monitoring and information gathering powers that will impact bankers once the new agency is up and running.

Compliance Changes

Preemption of State Consumer Protection Laws: The Act imposes new limits on the preemption of state consumer financial laws that relate to national banks. For national banks, a state consumer financial law is preempted only if: (1) its application would have a discriminatory effect on national banks as compared to state-chartered banks; (2) it is determined (by a court or the Comptroller on a case-by case basis) to prevent or significantly interfere with the exercise of a national bank's powers (the *Barnett Bank* standard); or (3) it is preempted by another federal law.

The preemption provisions may eliminate some of the current advantages to the national bank and the federal thrift charter for banks with operations in multiple states or with consumer operations in subsidiaries. However, state banks too will face more risk of state law-based consumer protection provisions, since state banks usually have obtained the benefit of national bank preemption nullifications of state consumer financial laws through the operation of state "wild card" statutes. The Act specifically provides that if a state law offers more consumer protection, and does not otherwise conflict with the comparable federal statute, it is not preempted.

Mortgage Lending: Title XIV of the Act (The Mortgage Reform and Anti-Predatory Lending Act) was a 200-page addition that was added relatively late in the legislative process, and thus received less attention (and has more opportunity for unexpected consequences) than many other provisions. The Act mandates that lenders verify a mortgage borrower's ability to repay the loan and requires consideration of certain factors, such as credit score, income and debt-to-income ratio, in making that decision. In addition, it prohibits mortgage originators from being paid compensation that varies based on the terms of the loan, other than the principal amount, effectively prohibiting yield spread premiums. Other forms of steering incentives are also prohibited, with mortgage originators being limited to either receiving a fee from the borrower, or if the borrower does not pay any upfront payment of discount or origination points, from the lender, but not both.

Several of the Act's provisions are tied to a statutorily-defined "qualified mortgage," which is generally defined as any residential mortgage loan:

- For which the income and financial resources of the borrower have been verified;

- In the case of a fixed rate loan, for which the underwriting process is based on a payment schedule that fully amortizes the loan over the loan term, taking into account all applicable taxes, insurance and assessments;
- In the case of an adjustable rate loan, for which the underwriting is based on the maximum rate permitted under the loan during the first five years, and a payment schedule that fully amortizes the loan over the loan term taking into account all applicable taxes, insurance and assessments;
- For which total points and fees do not exceed 3 percent of the total loan amount;
- That does not allow for negative amortization or deferral of principal payments; and
- That does not allow for a balloon payment that is more than twice as large as earlier scheduled payments.

For mortgage loans that are not qualified mortgages, a consumer will be able to raise a violation of the ability to repay as a defense by way of recoupment or set off to any foreclosure or collection action, without regard to the statute of limitations for civil violations in the Truth in Lending Act. A similar defense to collection and foreclosure actions can be raised for violation of the anti-steering prohibitions. Mortgage loans that are not qualified mortgages may not provide for a prepayment penalty, and the prepayment penalties that may be charged on qualified mortgage loans are limited to fixed rate loans that meet certain APR standards and then only at reducing percentages over the first three years of the loan.

The Act contains numerous other substantive prohibitions or limitations in mortgage lending, such as prohibitions on pre-dispute arbitration and on certain credit insurance, increased disclosures for negative amortization loans, new notices for hybrid adjustable rate loans, significant changes to high-cost mortgage provisions, and limitations on force-place insurance. Because the mortgage provisions are amendments of the Truth in Lending Act and because of the delay in the transfer of consumer financial authority to the CFPB, most of the initial regulations for the mortgage lending provisions will be promulgated by the Federal Reserve Board.

Capital and Expansion

The Act includes several provisions that will impact community bank strategic choices, such as capital and expansion.

BHC Capital, Trust Preferreds and CPP Securities: Prior to the passage of the Act, federal banking law imposed minimum capital levels on banks through the prompt corrective action requirements, and BHC capital standards were imposed by "guidelines" adopted by the Federal Reserve Board. The Act now imposes capital requirements on holding companies that are required by statute to be at least as severe as those imposed on banks under current federal banking regulations. Trust preferred and cumulative preferred securities will no longer be deemed Tier 1 capital for holding companies, but CPP securities (cumulative and non-cumulative preferred and subordinated debt) issued to the U. S. Treasury and trust preferred securities issued by holding companies with under \$15 billion in assets at December 31, 2009 will be grandfathered. All new issuances of trust preferred securities will be classified as Tier 2

capital for bank holding companies above \$500 million in assets. Small bank holding companies with less than \$500 million in assets will continue to be exempt from holding company capital requirements.

Source of Strength: The Act provides a statutory basis for the Federal Reserve Board's long time regulation (which court decisions have questioned) that a BHC must serve as a source of financial strength for its depository institution subsidiary. "Source of financial strength" is statutorily defined to mean "the ability of a company that directly or indirectly controls an insured depository institution to provide financial assistance to such insured depository institution in the event of the financial distress of the insured depository institution." The interaction between the source of strength requirement and the 5 percent of assets limitation for holding company guarantees of bank capital plans under the prompt corrective action process may be dealt with when the federal banking agencies jointly issue final rules within one year of passage to carry out this new section.

Interstate Branching: The Act amends the Riegle-Neal Act to allow national and state banks to establish *de novo* interstate branches at any location where a bank based in that state could establish a branch. This provision is effective immediately to permit branching between Tennessee and nearby states, such as Georgia, Mississippi, Arkansas, Missouri and Kentucky which previously did not permit *de novo* branching by Tennessee banks.

Conversions: The Act prohibits conversions of national banks to state banks, and limits conversions of state banks to national banks, at any time when the banks are subject to enforcement orders including a cease and desist order, or memorandums of understanding. If a state bank wishes to convert to a national bank, the conversion is permitted only if the agency that would be the appropriate federal banking agency after conversion notifies the authority that issued the cease and desist order submits a plan to the authority that issued the order which addressed the problem "in a manner consistent with the safe and sound operation of the institution;" and the authority which issued the order does not object within 30 days.

Other Bank Operational Changes

Insider Asset Purchases: Title VI of the Act broadens the limitations on affiliated transactions by placing new restrictions on insured depository institutions' asset purchases from insiders and giving the Fed, subject to prior consultation with the Office of the Comptroller of the Currency ("OCC") and FDIC, rule making authority over these asset restrictions. Additionally, derivatives are now included within the scope of credit for which member banks must negotiate on market terms.

Lending Limits: Effective one year after the Office of Thrift Supervision's ("OTS") responsibilities are transferred to the OCC, Title VI of the Act broadens the definition of loans as defined in the National Bank Act to include credit exposure created by repos and derivative transactions, which are defined as "a contract, agreement, swap, warrant, note or option that is based, in whole or in part, on the value of any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices or other assets." Effective 18 months after the OTS' responsibilities are transferred to the OCC, insured state banks may only engage in derivative transactions if the law with respect to lending of the state chartering the bank takes into consideration credit

exposure to derivative transactions. Thus failure to amend a state lending limit statute will effectively prohibit state banks from engaging in any repos, swaps or option transactions.

Regulation of Federal Thrifts and Thrift Holding Companies: Title III of the Act abolishes the OTS and transfers federal thrift regulation to the OCC, thrift holding company regulation to the Federal Reserve Board and federal jurisdiction over state savings associations to the FDIC. For the first time, thrift holding companies will have minimum capital requirements.

Future Regulations

Over the next two years, federal banking agencies and the new agencies established by the Act, such as the CFPB, will be required to adopt numerous regulations and interpretations to implement the Act. As a result, the nation's financial institutions will face substantial new regulatory issues and challenges.

Bass, Berry & Sims PLC's Financial Institutions Group specializes in advising and assisting financial institutions in their dealings within a complex banking environment. We have represented numerous financial institutions, and their holding companies, in public and private equity and debt offerings, including participation in the United States Department of the Treasury's Capital Purchase Program; counseled financial institutions in mergers and acquisitions; and advised boards of directors of financial institutions concerning director liability and regulatory issues. From small community banks and thrifts in Tennessee and Kentucky, to large publicly held banks and insurance companies and their holding companies, we counsel our financial institution clients on a broad range of federal and state regulatory matters.

If you have any questions regarding the issues addressed in this *Financial Institutions Alert* please feel free to communicate with any of the attorneys in our Financial Institutions Group listed below.

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