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The Dodd-Frank Wall Street Reform and Consumer Protection Act: Impact on Mortgage Businesses

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I. Introduction

A. The Dodd-Frank Act: Landmark Financial Legislation

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[1] is landmark legislation that represents the most profound restructuring of financial regulation since the Great Depression. With the primary goal to "restore responsibility and accountability in our financial system to give Americans confidence that there is a system in place that works for and protects them," the Dodd-Frank Act will have broad impact on the financial services industry for years to come.

Born out of the financial crisis that erupted in early 2008, the Dodd-Frank Act, composed of a series of new laws, is, in the aggregate, breathtaking in its scope. Particularly significant is that the new law: 1) creates the Bureau of Consumer Financial Protection ("BCFP"), a new independent consumer watchdog agency housed within the Federal Reserve Board ("FRB"), 2) grants to the U.S. Department of the Treasury, Federal Deposit Insurance Corporation ("FDIC") and the FRB broad new powers to seize, close and wind down "too big to fail" financial (including non-bank) institutions in an orderly fashion, 3) establishes a new Financial Stability Oversight Council ("FSOC"), charged with identifying and responding to emerging risks throughout the financial system, composed primarily of federal financial services regulators and chaired by the Secretary of the Treasury Department, 4) restructures the federal regulatory jurisdiction over banks and their parent companies, and abolishes the Office of Thrift Supervision ("OTS"), 5) adopts new federal oversight of the insurance industry, 6) adopts new standards and rules for the mortgage industry, 7) adopts new bank, thrift and holding company regulation, 8) adopts new federal regulation of the derivatives market, 9) adopts the so-called Volcker Rule, substantially restricting proprietary trading by depository institutions and their holding companies, 10) imposes requirements for "funeral plans" by large, complex financial companies, 11) establishes new regulation of the securitization market through "skin in the game" and enhanced disclosure requirements, 12) establishes new regulation of interchange fees, 13) establishes new and enhanced compensation and corporate governance oversight for the financial services industry, 14) provides enhanced oversight of municipal securities, 15) provides a specific framework for payment, clearing and settlement regulation, 16) adopts new federal hedge fund regulation, 17) adopts new fiduciary duties and regulation of broker dealers, investment companies and investment advisors, 18) tasks the federal banking agencies with adopting new and enhanced capital standards for all depository institutions, 19) significantly narrows the scope of federal preemption for national banks and federal thrifts, and 20) places a moratorium on ownership of industrial loan banks by non-financial companies.

Furthermore, the Dodd-Frank Act provides broad and substantial delegations to various federal agencies the task of implementing its many provisions through regulation. Hundreds of new federal regulations addressing all of the major areas of the new law will be required, ensuring that federal rules and policies in this area will be further developing for years to come.

B. The Dodd-Frank Act: Impact

The Dodd-Frank Act profoundly impacts all major segments of the financial services industry, including 1) banks, 2) thrifts, 3) bank, financial and savings and loan holding companies, 4) mortgage businesses that include mortgage brokers, mortgage bankers and direct lenders, 5) insurance companies, 6) industrial loan companies and their parent companies, 7) investment company, broker-dealer and investment advisor firms, 8) hedge funds and private equity funds, and 9) payment systems companies.

This Stay*Current* bulletin addresses the impact of the Dodd-Frank Act on mortgage businesses. As the provisions of the Dodd-Frank Act broadly impact the mortgage industry, the term “mortgage business” is intended to be interpreted broadly to encompass a broad range of industry participants, including state-licensed mortgage brokers and lenders, state and federally chartered banks and thrifts with mortgage operations, and mortgage servicers.

II. Discussion

Spanning numerous titles, the Dodd-Frank Act contains various provisions designed to increase accountability for a broad range of participants in the mortgage industry by imposing minimum standards and providing enforcement mechanisms that are intended to limit subprime and predatory lending, and to bring mortgage-related businesses that previously have been largely unregulated within the supervision of the new BCFP. Specifically, the provisions in the Dodd-Frank Act that potentially have the greatest impact on mortgage businesses are:

A. Title X, which creates a new federal regulator, the BCFP, that will have broad powers to regulate the offering and provision of consumer financial products and services under the federal consumer financial laws. Among its supervisory responsibilities, the BCFP will supervise mortgage businesses that are otherwise not subject to supervision by the federal banking agencies by requiring reports, conducting periodic examinations, and imposing registration, recordkeeping and other requirements on these entities. For depository institutions with total assets of $10 billion or less, primary supervision and enforcement authority with respect to federal consumer financial laws will remain with the prudential regulator; however the BCFP is authorized to require reports from these entities.

B. Title XIV, which imposes sweeping new laws and minimum standards governing the details of mortgage loan origination and requiring extensive rulemaking, which greatly increases the compliance burden and risk of noncompliance for mortgage businesses.

C. Subtitle D of Title IX, which prescribes rulemaking mandates for risk-retention provisions that require mortgage originators and securitizers to retain a portion of the credit risk for any asset, including residential mortgage assets, that a securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party, subject to exceptions and exemptions.

D. Title I, which establishes the FSOC, a new advisory panel that has the authority to designate significant nonbank financial companies as requiring supervision and enhanced regulation by the FRB. For large mortgage businesses that, until now, have been subject to limited federal reporting requirements, the information-gathering functions of the FSOC may entail substantially increased reporting and information collection burdens for these entities.

Each of these significant provisions of the Dodd-Frank Act are addressed below, followed by an action plan outlining applicable considerations and next steps.

A. Bureau of Consumer Financial Protection

Title X of the Dodd-Frank Act is entitled the “Consumer Financial Protection Act of 2010” (“CFP Act”).

The CFP Act establishes the BCFP, a new federal consumer watchdog agency. The BCFP’s primary purpose is to implement and enforce federal consumer laws and regulate various aspects of consumer financial products and services to protect consumers. Generally, the BCFP will have broad rulemaking authority with respect to a wide array of consumer financial laws and will have supervisory and enforcement authority over nonbank financial companies offering consumer financial products or services, including mortgage-related businesses, as well as large banks, savings associations, and credit unions with over $10 billion in assets “and any affiliate thereof.”

Given that the BCFP’s broad powers affect many types of financial institutions, the discussion in this section focuses only on the BCFP’s impact on mortgage businesses with respect to their mortgage-related products and services. A more comprehensive discussion of the BCFP is available at Paul Hastings Stay*Current*—The Dodd-Frank Act: The Bureau of Consumer Financial Protection.

Rulemaking Authority

The BCFP will have broad rulemaking authority with respect to all financial institutions, including mortgage companies and depository institutions that offer financial products and services to consumers. It will also have authority to issue rules under existing consumer banking statutes, which are defined in Section 1002(12) as “enumerated consumer laws” that include, *among others*:

- the Equal Credit Opportunity Act (“ECOA”);[2]
- the Homeowners Protection Act of 1998 (“HOPA”);[3]
- the Fair Debt Collection Practices Act (“FDCPA”);[4]
- the Home Mortgage Disclosure Act of 1975 (“HMDA”);[5]
- the Home Ownership and Equity Protection Act of 1994 (“HOEPA”);[6]
- the S.A.F.E. Mortgage Licensing Act of 2008 (“S.A.F.E. Act”);[7]
- the Real Estate Settlement Procedures Act of 1974 (“RESPA”);[8] and

- the Truth in Lending Act ("TILA").[9]

Exclusive rulemaking authority with respect to the laws enumerated above will reside with the BCFP, along with other statutes and any rule or order of the BCFP that meet the definition of a "Federal consumer financial law." A "Federal consumer financial law" is defined as "the provisions of this title [the CFP Act], the enumerated consumer laws, the laws for which authorities are transferred under subtitles F [Transfers of Functions and Personnel; Transitional Provisions] and H [Conforming Amendments], and any rule or order prescribed by the [BCFP] under this title, an enumerated consumer law, or pursuant to the authorities transferred under subtitles F and H. The term does not include the Federal Trade Commission Act."

The BCFP may also prescribe rules applicable to a covered person or service provider identifying certain acts or practices as unlawful, unfair, deceptive, or abusive in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service.

A "covered person" is broadly defined and means—

(A) any person that engages in offering or providing a consumer financial product or service; and

(B) any affiliate of a person described in subparagraph (A) if such affiliate acts as a service provider to such person.

In general, a "service provider" means any person that provides a material service to a covered person in connection with the offering or provision by such covered person of a consumer financial product or service, including a person that—

(i) participates in designing, operating, or maintaining the consumer financial product or service; or

(ii) processes transactions relating to the consumer financial product or service (other than unknowingly or incidentally transmitting or processing financial data in a manner that such data is undifferentiated from other types of data of the same form as the person transmits or processes).

However, the term ''service provider'' does not include a person solely by virtue of such person offering or providing to a covered person—

(i) a support service of a type provided to businesses generally or a similar ministerial service; or

(ii) time or space for an advertisement for a consumer financial product or service through print, newspaper, or electronic media.

Section 1023 places a control on the BCFP's seemingly unlimited rulemaking authority by providing that, on the petition of any member agency of the FSOC (see the discussion in Section II.D below), the FSOC may set aside a final regulation prescribed by the BCFP, or any provision thereof, if the FSOC decides that the "regulation or provision would put the safety and soundness of the [U.S.] banking system or the stability of the financial system of the [U.S.] at risk." A decision by the FSOC to issue a stay of, or set aside, any regulation of the BCFP pursuant to this authority shall be made only with the affirmative vote of at least 2/3 of the FSOC's members then serving.

Additional powers of the BCFP include the ability to exercise enforcement powers provided under Subtitle E to "prevent a covered person or service provider from committing or engaging in an unfair, deceptive, or abusive act or practice under [f]ederal law in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service."

Supervision and Enforcement Authority

The BCFP will supervise "nondepository covered persons," which include any covered person who "offers or provides origination, brokerage, or servicing or loans secured by real estate for use by consumers primarily for personal, family, or household purposes, or loan modification or foreclosure relief services in connection with such loans." The category of "covered persons" that will be subject to the supervision of the BCFP pursuant to this section will be defined in a rulemaking that the BCFP shall engage in within 1 year after the "designated transfer date," as described below.

The BCFP will also supervise large banks, savings associations, and credit unions, which include any covered person that is either an insured depository institution or credit union with total assets of more than $10 billion "and any affiliate thereof." For depository institutions with total assets of $10 billion or less, primary supervision and enforcement authority with respect to federal consumer financial laws will remain with the prudential regulator. However, the BCFP is authorized to require reports from these entities, which can potentially create a new burden for such entities.

The BCFP shall have several functional units, one of which will be established for the purpose of collecting and tracking complaints. The functions of the new unit will include establishing a single, toll-free telephone number, a website, and a database or utilizing an existing database to facilitate the centralized collection of, monitoring of, and response to consumer complaints regarding consumer financial products or services. The Director of the BCFP shall coordinate with the FTC and other federal agencies to route complaints to such agencies, where appropriate.

While a majority of the provisions governing the BCFP's general powers in Subtitle B of Title X become effective on the "designated transfer date," Section 1022 (with respect to the BCFP's rulemaking authority), Section 1024 (with respect to supervision of nondepository covered persons), and Section 1025(e) (with respect to simultaneous and coordinated supervisory action with respect to large banks, savings associations, and credit unions) are effective as of the date of enactment of the Dodd-Frank Act.

Transfer of Consumer Financial Protection Powers from Other Agencies

Between 180 days and 12 months (which may be extended for an additional 6 months) after enactment of the Dodd-Frank Act, each of the FRB, OCC, OTS, FDIC and NCUA are required to transfer its "consumer financial protection functions" to the BCFP. The Department of Housing and Urban Development ("HUD") and Federal Trade Commission ("FTC") are also required to transfer certain consumer protection functions to the BCFP. In the case of HUD, such transferred functions will only relate to the RESPA,[10] the S.A.F.E. Act,[11] and the Interstate Land Sales Full Disclosure Act.[12] The BCFP may only enforce a rule that is prescribed under the FTC Act with respect to an unfair or deceptive act or practice to the extent that such rule applies to a covered person or service provider with respect to the offering or provision of a consumer financial product or service as if it were a rule prescribed by the BCFP under Section 1031 of Title X.

The date that such transfer of consumer financial protection functions from the various agencies to the BCFP will take place is the “designated transfer date,” which is the date that the Secretary of the Treasury (in consultation with the other agencies) will designate in a Federal Register notice that will be published within 60 days after enactment of the Dodd-Frank Act. As prescribed in Section 1062 of the Act, the “designated transfer date” will not be earlier than 180 days but generally no more than 12 months after enactment of the Dodd-Frank Act, and may be extended up to an additional 6 months past the 12 month general deadline if the Treasury Secretary provides to the “appropriate committees of Congress” certain documentation including a written determination that the 12 month deadline is not feasible for an orderly implementation of the transfer of consumer financial protection functions of the various agencies to the BCFP and an explanation for why an extension is necessary.

Preemption

Subtitle D of Title X addresses the applicability of state consumer financial laws to federally chartered depository institutions and their subsidiaries, affiliates and agents.[13] A “state consumer financial law” is defined as “a [s]tate law that does not directly or indirectly discriminate against national banks and that directly and specifically regulates the manner, content, or terms and conditions of any financial transaction (as may be authorized for national banks to engage in), or any account related thereto, with respect to a consumer.” Specifically, Subtitle D provides that subsidiaries and affiliates of national banks and federal thrifts may no longer be preempted from state consumer financial laws that are otherwise preempted for the subsidiary’s parent that is a national bank or federal thrift. This change in law substantially affects the operations of mortgage businesses that are conducted through operating subsidiaries of national banks or federal thrifts. For a more comprehensive discussion on the impact of the repeal of the availability of preemption for operating subsidiaries of national banks and federal thrifts, as well as applicable considerations, *see* Paul Hastings Stay*Current*—The Dodd-Frank Act: Impact on Federal Preemption for National Banks and Federal Thrifts.

An area of concern with respect to the impact of the Act’s repeal of preemption for operating subsidiaries of national banks and federal thrifts is whether such change in law would affect the eligibility of mortgage loan originators who are employees of an operating subsidiary of a national bank or federal thrift in qualifying for federal registration under the S.A.F.E. Act.[14] The S.A.F.E. Act requires all residential mortgage loan originators to be either state licensed or federally registered with a nationwide registry, obtain a unique identifier, and maintain this registration.[15] Federal registration is valid for national coverage while employees subject to state licensing requirements must submit to the state-by-state licensing regime based on the state(s) in which the employee operates. The S.A.F.E. Act treats employees of depository institution subsidiaries the same as employees of the depository institution, if the subsidiary is “owned and controlled by the depository institution” *and* “regulated by a Federal banking agency.”[16] While the Dodd-Frank Act amends the S.A.F.E. Act to transfer the responsibilities of the Federal banking agencies, with respect to developing and maintaining the system for registering employees of Federal banking agencies, to the BCFP (to become effective on the designated transfer date), the amendments do not otherwise alter the requirements for loan originators in qualifying for federal registration.[17] Therefore, employees of operating subsidiaries of depository institutions including national banks and federal thrifts would still continue to qualify for federal registration pursuant to the statutory criteria. However, because the Act provides that preemption of state consumer financial laws is no longer available for operating subsidiaries of national banks and federal thrifts, we note that it is possible for a federally registered loan originator who is an employee of an operating subsidiary of a national bank or federal thrift to nevertheless be required to comply with state licensing and registration requirements under the S.A.F.E. Act, in addition to his or her federal registration. Whether a federally registered mortgage loan originator employed by an operating subsidiary of a national bank or federal thrift will be required to comply with state licensing and registration requirements will likely depend on applicable state law and a potential determination by the BCFP to avoid duplicative federal/state registration requirements.[18]

B. Mortgage Reform

Title XIV to the Dodd-Frank Act is known as the "Mortgage Reform and Anti-Predatory Lending Act" ("Mortgage Reform Act").

As one of the more voluminous titles in the Dodd-Frank Act, the Mortgage Reform Act contains sweeping new laws and minimum standards for the mortgage industry, to be followed by what will likely be hundreds of implementing regulations. The regulations can generally be expected to be prescribed in final form within 18 months of the designated transfer date (see the discussion in Section II.A above), to take effect not later than 12 months after the date of issuance of the final rules.

Subtitle A of the Mortgage Reform Act is entitled "Residential Mortgage Loan Origination Standards." Provisions in this subtitle are targeted towards mortgage originators, for example, by eliminating certain financial incentives for making a subprime loan, including eliminating yield spread premiums and providing that "no mortgage originator may receive from any person and no person shall pay to a mortgage originator, directly or indirectly, compensation that varies based on the terms of the loan (other than the amount of the principal)." For any mortgage loan, mortgage originators also generally "may not receive from any person other than the consumer and no person, other than the consumer, who knows or has reason to know that a consumer has directly compensated or will directly compensate a mortgage originator may pay a mortgage originator any origination fee or charge except bona fide third party charges not retained by the creditor, mortgage originator, or an affiliate of the creditor or mortgage originator."

Regulations to be prescribed under this subtitle will also prohibit mortgage originators from steering any consumer to a residential mortgage loan that the consumer lacks a reasonable ability to repay or that has predatory characteristics or effects, such as equity stripping, excessive fees, or abusive terms. Such regulations shall also prohibit mortgage originators from steering any consumer from a residential mortgage loan for which the consumer is qualified that is a "qualified mortgage" (as defined below) to a residential mortgage loan that is not a qualified mortgage. Additionally, regulations promulgated under this subtitle are expected to prohibit mortgage originators from mischaracterizing the credit history of a consumer or the residential mortgage loans available to a consumer; mischaracterizing or suborning the mischaracterization of the appraised value of the property securing the extension of credit; or if unable to suggest, offer, or recommend to a consumer a loan that is not more expensive than a loan for which the consumer qualifies, discouraging a consumer from seeking a residential mortgage loan secured by a consumer's principal dwelling from another mortgage originator.

Mortgage lenders and brokers who violate the prohibitions in Subtitle A may be held accountable for up to three times "the total amount of direct and indirect compensation or gain accruing to the mortgage originator in connection with the residential mortgage loan involved in the violation" and attorneys' fees.

Subtitle B of the Mortgage Reform Act amends TILA to provide certain minimum standards that must be met by creditors for all residential mortgage loans. In general, no creditor may make a residential mortgage loan unless the creditor makes 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, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments.

A safe harbor is provided for mortgages that meet the definition of a "qualified mortgage," which seeks to carve out certain high-quality mortgages where the borrower is less likely to be surprised by increased payments and find himself or herself unable to pay. Specifically, TILA is amended to provide that the term "qualified mortgage" means any residential mortgage loan—

(i) for which the regular periodic payments for the loan may not—

  (I) result in an increase of the principal balance; or

  (II) except as otherwise provided, allow the consumer to defer repayment of principal;

(ii) except as otherwise provided, the terms of which do not result in a balloon payment, where a 'balloon payment' is a scheduled payment that is more than twice as large as the average of earlier scheduled payments;

(iii) for which the income and financial resources relied upon to qualify the obligors on the loan are verified and documented;

(iv) 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 and takes into account all applicable taxes, insurance, and assessments;

(v) 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 5 years, and a payment schedule that fully amortizes the loan over the loan term and takes into account all applicable taxes, insurance, and assessments;

(vi) that complies with any guidelines or regulations established by the Board relating to ratios of total monthly debt to monthly income or alternative measures of ability to pay regular expenses after payment of total monthly debt, taking into account the income levels of the borrower and such other factors as the FRB may determine relevant and consistent with the purposes described in the paragraph that allows the FRB to revise, add to, or subtract from criteria in this list that define a "qualified mortgage";

(vii) for which the total points and fees (as defined) payable in connection with the loan do not exceed 3 percent of the total loan amount;

(viii) for which the term of the loan does not exceed 30 years, except as such term may be extended pursuant to FRB rulemaking, such as in high-cost areas; and

(ix) in the case of a reverse mortgage (except for the purposes of subsection (a) of section 129C of TILA, to the extent that such mortgages are exempt altogether from those requirements), a reverse mortgage which meets the standards for a qualified mortgage, as set by the Board in rules that are consistent with the purposes of this subsection.

The definition of "qualified mortgage" set forth in this subtitle is also significant for purposes of determining what constitutes a "qualified residential mortgage" that would allow originators and securitizers of certain residential mortgage assets to be exempt from the risk retention requirements imposed under Title IX of the Dodd-Frank Act. See the discussion in Section II.C below.

Consumers are provided with a defense against foreclosure for lenders and mortgage brokers who do not comply with these new standards. The defense can be invoked in any action for foreclosure or other debt collection of a residential mortgage loan and provides for a right of recoupment or setoff as described in TILA, which includes damages, an amount equal to two times the finance charge charged on the loan, and attorneys' fees.

The section also prohibits prepayment penalties for any adjustable rate mortgage and other mortgages that do not meet the definition of a "qualified mortgage" and provides for a phase-out of prepayment penalties on qualified mortgages. In addition, the section prohibits mandatory arbitration clauses in mortgage agreements, although this prohibition is lifted for agreements entered into after a controversy has arisen. Loans providing for negative amortization are prohibited unless the creditor makes certain disclosures to the consumer and, in the case of a first-time homebuyer, provides documentation that proves the borrower received counseling from a counselor certified by HUD. Finally, this subtitle amends TILA to provide that additional disclosures are required to be communicated to borrowers with connection with certain mortgage loan transactions.

Mortgage lenders are required to notify borrowers with hybrid adjustable rate mortgages six months before the mortgage resets or adjusts to a variable rate with an estimate of their new rate and payment along with the options the borrower has (*e.g.*, refinancing) to alleviate the effects of the rate increase.

Mortgage lenders also must disclose the maximum a consumer might have to pay under a variable rate mortgage and to warn customers that their payments will vary based on interest rate changes.

Subtitle C is entitled "High Cost Mortgages" and revises the thresholds for identifying loans that qualify for higher standards under the HOEPA. It expands federal protections for high cost loans by lowering the interest rate, point, and fee thresholds that define high cost loans. It also restricts high-cost mortgage lending by prohibiting terms such as balloon payments and excessive late fees in high-cost mortgages and by requiring pre-loan counseling for the borrower prior to extending a high-cost mortgage loan.

Subtitle D establishes the "Office of Housing Counseling" within HUD which will coordinate and implement housing counseling programs for both home ownership and rental housing. The Office of Housing Counseling will implement a media campaign focusing on housing counseling: will establish a toll-free hotline and website; will issue housing counseling grants to HUD-approved housing counseling providers; and requires HUD to update the mortgage information booklet.

Subtitles E and F pertain to "Mortgage Servicing" and "Appraisal Activities," respectively. Mortgage servicing requirements are modified to require increased disclosures to consumers and stricter written request provisions under RESPA. Section 1461 amends TILA to require a creditor, when extending a closed-end first mortgage, to establish an escrow or impound account for the payment of taxes and insurance, ground rents, and any other required periodic payments or premiums with respect to the property or the loan terms, subject to exceptions. Servicers should also take note that Subtitle E amends RESPA to significantly decrease the response times within which a servicer of a federally related mortgage loan must respond to borrower inquiries. Section 1464 provides for the prompt crediting of home loan payments. Servicers must credit a payment to the borrower's account as of the date of receipt, unless the delay in crediting the borrower's account would not result in a fee or any negative information reported to a credit reporting agency. In addition, appraisals are required before a lender can make a high-cost mortgage, and lenders must provide copies of appraisal reports obtained in connection with a mortgage transaction before the closing date on the property.

C. Risk Retention Rules for Securitizers and Originators of Asset-Backed Securities

Title IX to the Dodd-Frank Act provides improvements to the asset-backed securitization process and calls for joint rulemaking within 270 days of enactment of the section by the OCC, FRB, FDIC ("Federal banking agencies"), the Securities and Exchange Commission ("SEC"), the Secretary of HUD and the Federal Housing Finance Agency ("FHFA") that, among other things, will most significantly require "any securitizer to retain an economic interest in a portion of the credit risk for any residential mortgage asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party." Final rules shall become effective 1 year after they are published in the Federal Register. Substantially similar regulations will also be issued within the same timeframe for all asset classes other than residential mortgages, however only the Federal banking agencies and the SEC will engage in such rulemaking. Where a securitizer purchases assets from an originator, the Federal banking agencies and the SEC will have the discretion to allocate risk retention requirements between a securitizer and an originator, although we note that it is unclear how this allocation among securitizers and originators will affect the rulemaking with respect to residential mortgage assets because only the Federal banking agencies and the SEC were given power to exercise such discretion, and not HUD or the FHFA.

Section 941 prescribes certain minimum guidelines and standards for the agencies in their tasked rulemaking, however leaves a lot of room for the details with respect to credit risk retention to be hashed out by the agencies pursuant to their collective discretion in the regulations. Most significantly, Section 941 imposes on the agencies a minimum standard to require by rulemaking, a securitizer to retain—

(i) not less than 5% of the credit risk for any asset—

(I) that is not a qualified residential mortgage that is transferred, sold, or conveyed through the issuance of an asset-backed security by the securitizer; or

(II) that is a qualified residential mortgage that is transferred, sold, or conveyed through the issuance of an asset-backed security by the securitizer, if 1 or more of the assets that collateralize the asset-backed security are not qualified residential mortgages; or

(ii) less than 5% of the credit risk for an asset that is not a qualified residential mortgage that is transferred, sold, or conveyed through the issuance of an asset-backed security by the securitizer, if the originator of the asset meets the underwriting standards prescribed by the agencies.

The term "securitizer" is defined as—

(A) an issuer of an asset-backed security; or

(B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.

The term "originator" is defined as a person who—

(A) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and

(B) sells an asset directly or indirectly to a securitizer.

A blanket exemption from the risk retention requirement is provided for "qualified residential mortgages," which will be jointly defined by the agencies responsible for the rulemaking with respect to residential mortgage assets, however the definition can be "no broader than" the definition of "qualified mortgage," as Congress defined elsewhere in the Dodd-Frank Act amending TILA (see the discussion on Title XIV of the Dodd-Frank Act in Section II.B above).

Additional exemptions, exceptions and adjustments with respect to the risk retention requirements are expected to follow in the required rulemakings. For example, a total or partial exemption may be provided for the securitization of: an asset issued or guaranteed by the U.S., or an agency thereof; or certain securities that include those issued or guaranteed by any State (or political division thereof) of the United States, or any public instrumentality of a State or territory that is exempt from the registration requirements of the Securities Act of 1933 by reason of section 3(a)(2) of that Act, or a security that is a qualified scholarship funding bond pursuant to the Internal Revenue Code of 1986.[19]

Additional details that remain to be seen in the regulations include:

(i) the permissible forms of risk retention for purposes of Section 941;

(ii) the minimum duration of the risk retention required under Section 941;

(iii) special rules with respect to commercial mortgages;

(iv) appropriate standards for retention of an economic interest with respect to collateralized debt obligations, securities collateralized by collateralized debt obligations, and similar instruments collateralized by other asset-backed securities;

(v) separate rules for securitizers of the different asset classes established by the agencies; and

(vi) underwriting standards to be established by the Federal banking agencies that specify the terms, conditions, and characteristics of a loan within the asset class that indicate a low credit risk with respect to the loan.

With the open issues and details that remain to be spelled out in the regulations, we expect that the industry will be very actively involved in the rulemaking process during the public comment period.

The risk retention regulations to be prescribed by the various agencies under Section 941 will likely be shaped by a report that the FRB is required to furnish to Congress within 90 days after enactment of the Dodd-Frank Act. The report shall furnish the results of a study that the FRB is required to perform in coordination and consultation with the OCC, OTS, FDIC, and SEC, with respect to the combined impact on each individual class of asset-backed security affected by the new rules, including the effect that the credit risk retention requirements have on increasing the market for federally subsidized loans. The report shall also include statutory and regulatory recommendations for eliminating any negative impacts on the continued viability of the asset-backed securitization markets and on the availability of credit for new lending that is identified by the study.

The risk retention provisions in Section 941 will be carried out in various phases. First, the FRB will produce the results of an inter-agency study in a report that will be provided to Congress within 90 days after enactment of the Dodd-Frank Act; second, the required rulemakings will be undertaken within 270 days after Section 941 is enacted; finally, the risk retention requirements prescribed by the regulations will become effective pursuant to the following timeframes: (a) for securitizers and originators of asset-backed securities backed by residential mortgages, 1 year after the date on which the final rules are published in the Federal Register; and (b) for securitizers and originators of all other classes of asset-backed securities, 2 years after the date on which the final rules are published in the Federal Register.

D. Financial Stability Oversight Council

Title I of the Dodd-Frank Act is known as the “Financial Stability Act of 2010” (“Financial Stability Act”).

The Financial Stability Act establishes the FSOC, a panel composed of the following voting members: the Secretary of the Treasury, who shall serve as Chairperson of the FSOC, the Chairman of the FRB, the OCC, the Director of the BCFP, the Chairman of the SEC, the Chairperson of the FDIC, the Chairperson of the Commodities Futures Trading Commission (“CFTC”), the Director of FHFA, the Chairman of the NCUA, and an independent member appointed by the President, by and with the advice and consent of the Senate, having insurance expertise. The FSOC will also be comprised of non-voting members.

The purposes of the FSOC are to monitor potential threats to the financial system and to provide for more stringent regulation of nonbank financial companies and financial activities that the FSOC determines, based upon consideration of risk-related factors, pose risks to the financial stability of the U.S.

The FSOC may determine, on a nondelegable basis and by a 2/3 vote that includes an affirmative vote by the Secretary of the Treasury, that a U.S. nonbank financial company should be supervised by the

FRB and shall be subject to "prudential standards" if the FSOC determines that "material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability" of the U.S. Upon making such a determination, the FSOC shall submit a report to Congress that details the FSOC's reasons for making such a determination, and the nonbank financial company at issue will generally have an opportunity for notice and hearing prior to a final determination, unless the FSOC invokes an emergency exception. Final determinations made by the FSOC may be subject to judicial review. Within 180 days after the date of the FSOC's final determination, the nonbank financial company must register with the FRB.

Other authorities of the FSOC include the ability to make recommendations to the FRB for imposing enhanced capital, leverage, liquidity, and risk management requirements for large, complex companies that pose risks to the U.S. financial system. The FRB is empowered to take certain mitigatory actions in addressing risks to financial stability, including the ability to prevent a merger or consolidation, or with a 2/3 vote from the FSOC, approve a decision by the FRB to require a large, complex company to divest itself of some of its assets if it poses a grave threat to the U.S. financial system. However, the FRB's ability to require divesture under this authority may only be invoked as a "last resort."

A new Office of Financial Research ("OFR") is established, through which the FSOC may require the submission of periodic and other reports from any nonbank financial company or bank holding company ("BHC") for the purpose of assessing the extent to which a financial activity or financial market in which the nonbank financial company or BHC participates, or the nonbank financial company or BHC itself, poses a threat to the financial stability of the U.S.

Whenever possible, the Council (through the OFR) shall coordinate with other agencies such as a primary regulator before requiring the submission of reports to mitigate the reporting burden on institutions. For large mortgage businesses that until now have been subject to limited federal reporting requirements, this information-gathering function of the FSOC may impose substantially increased reporting and information collection burdens.

Finally, the FRB is authorized to impose more stringent supervisory requirements in regulating large BHCs with total consolidated assets of at least $50 billion and significant nonbank financial companies that have been designated by the FSOC as requiring prudential regulation and supervision by the FRB. The enhanced prudential standards that will be applied to these entities include risk-based capital requirements and leverage limits (as determined to be appropriate), liquidity requirements and overall risk management requirements. These entities will also be required to submit "funeral plans" that detail the entity's plan "rapid and orderly resolution in the event of material financial distress or failure."

III. Action Plan

Mortgage businesses that include mortgage brokers, mortgage bankers, and direct lenders will be well-served to have an action plan in response to the various provisions of the Dodd-Frank Act that impact the mortgage industry. We recommend that this action plan include the following considerations:

1) Closely monitor the progress of rulemakings required under the Dodd-Frank Act, particularly with respect to Title XIV, which will require as much lead time as possible for

planning and implementation purposes. For example, once the definition of "qualified residential mortgage" is finalized, consider the feasibility of tailoring the underwriting criteria for future mortgages to meet the regulatory standards to qualify for the exemption from the risk-retention requirements.

2) Conduct periodic compliance audits once changes are implemented to ensure compliance with these new regulations.

3) Perform a business impact analysis with respect to the anticipated risk retention requirements. Determine whether the assets you originate and/or securitize are eligible for an exemption, and if not, whether an exemption should be sought during the notice and comment period for the rulemaking.

4) For nonbank mortgage companies, assess the relative merits of becoming affiliated with a depository institution, keeping in mind that preemption from state consumer financial laws will no longer be available to operating subsidiaries of national banks and federal thrifts.

5) For mortgage companies that are currently operating subsidiaries of a national bank or federal thrift, consider the costs and benefits to the business of rolling the company's mortgage operations directly into the national bank or federal thrift parent, so as to preserve the organization's potential ability to rely on preemption. This option involves an assessment of the benefit of being able to rely on federal preemption versus the risk to the parent of no longer being able to conduct such activities through a separately incorporated entity. National banks and federal thrifts considering this option will have at least 6 months (180 days to be exact), and generally up to 12 months, but no more than 18 months at the maximum, after enactment of the Dodd-Frank Act before the preemption provisions affecting the activities of operating subsidiaries of national banks and federal thrifts take effect.

To view other thought leadership pieces on how this landmark legislation and the myriads of implementing regulations will affect your industry, please follow this link.

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (enacted on July 21, 2010). The general effective date of the Dodd-Frank Act is July 22, 2010.

[2] 15 U.S.C. §§ 1691 *et seq*.

[3] 12 U.S.C. §§ 4901 *et seq*.

[4] 15 U.S.C. §§ 1692 *et seq*.

[5] 12 U.S.C. §§ 2801 *et seq*.

[6] 15 U.S.C. § 1601 note.

[7] 12 U.S.C. §§ 5101 *et seq*.

[8] 12 U.S.C. §§ 2601 *et seq*.

[9] 15 U.S.C. §§ 1601 *et seq*.

[10] 12 U.S.C. §§ 2601 *et seq*.

[11] 12 U.S.C. §§ 5101 *et seq*.

[12] 15 U.S.C. §§ 1701 *et seq*.

[13] Section 1045 amends the National Bank Act ("NBA") to specify that neither the NBA nor Section 24 of the Federal Reserve Act may be construed as preempting, annulling or otherwise affecting the application of any state law to any subsidiary, affiliate or agent of a national bank, other than one that is a national bank. Interestingly, the additional category of "agent" was added to Section 1045, which was intended to clarify in the NBA that preemption no longer applies to non-bank entities (*i.e.*, a "subsidiary, affiliate, or agent" of a national bank that is not chartered as a national bank); however the term "agent" was not included in Section 1044, which is the operative provision that provides that state consumer financial laws specifically apply to such entities. For more discussion on the preemption provisions of the Dodd-Frank Act, *see* Paul Hastings Stay*Current*–The Dodd-Frank Act: Impact on Federal Preemption for National

Banks and Federal Thrifts.

[14] 12 U.S.C. §§ 5101 *et seq*.

[15] 12 U.S.C. § 5103.

[16] 12 U.S.C. § 5102(7). *See* page 13 of draft final rule, as approved by the FDIC on November 12, 2009, *available at* http://www.fdic.gov/news/board/2009nov12no8.pdf.

[17] *See* Section 1100 of the Dodd-Frank Act.

[18] For example, for states that have adopted without modification the Model State Law as proposed by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators, an exemption from state licensing requirements is provided for "registered mortgage loan originators." This category of persons exempted from the licensing and registration requirements of the state law encompasses mortgage loan originators who are employees of depository institutions and their operating subsidiaries who are already registered with and maintain a unique identifier through the Nationwide Mortgage Licensing System and Registry. Given that the preemption provisions of the Dodd-Frank Act apply only to the "subsidiaries and affiliates" of national banks and federal thrifts, rather than the subsidiaries of other types of depository institutions, *e.g.*, state chartered banks, the application of a state law that implements the S.A.F.E. Act to a mortgage loan originator who is an employee of an operating subsidiary of a national bank or federal thrift would likely have a discriminatory impact on national banks and thrifts, as employees of subsidiaries of state chartered depository institutions may continue to be subject only to the federal registration requirements as implemented by the Agencies. *See* page 10, fn. 12 of draft final rule, as approved by the FDIC on November 12, 2009, *available at* http://www.fdic.gov/news/board/2009nov12no8.pdf (noting that employees of depository institutions and their subsidiaries "acting within the scope of their employment are subject only to the Federal registration requirements of the S.A.F.E. Act as implemented by the Agencies through this rulemaking.").

[19] 26 U.S.C. §§ 1 *et seq*.