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At the outset of 2010, many questions concerning what Congress will accomplish in the financial services policy arena remain unanswered. The following provides our view on how the 2010 mid-term elections will impact the financial policy debate, as well as a summary of where things stand on four key issues to be addressed in the year ahead.

2010 Congressional Elections – Effect on Financial Services Policy

State of Play

The special election this week in Massachusetts, in which a Republican won in a historically Democratic stronghold, is evidence of the increasing vulnerability of Democrats in the upcoming November elections. The Democrats have lost their super-majority in the Senate, and their 18 vote majority in the chamber could erode more than previously projected. Senate Majority Leader Harry Reid (D-NV) faces a very difficult re-election campaign in a state with the most home foreclosures per capita in the nation. There are also Senate races in 2010 in three of the four states most affected by foreclosures: Florida, Illinois, and Ohio. This pressure, compounded with polling which shows that Americans still believe Wall Street has not paid enough of a “price” for the financial crisis, presents a challenging environment not only for candidates, but also for the financial services industry, which will see increased attacks on it as the November elections approach.

Conversely, Senate Banking Chairman Christopher Dodd’s (D-CT) recent decision not to seek re-election could create a less politically charged financial regulatory reform debate in the Senate Banking Committee, as Senator Dodd will no longer be the most vulnerable Democrat facing re-election. Senators Dodd and Shelby are more likely than ever before to reach consensus on a bill. If financial regulatory reform legislation is passed, we expect the House Financial Services and Senate Banking Committees to shift their attention to the ongoing foreclosure problems and the future of the government-sponsored enterprises.

With the economy still front and center, President Obama recently announced a proposal to limit the size and trading activities of financial institutions as a means to reduce systemic risk. Former Federal Reserve Chairman Paul Volcker has advocated in favor of such steps to reduce risk, and the proposals are intended to be included in the larger overhaul of the financial regulatory system, as discussed below. There will be increased political pressure on the Administration to

alleviate the struggles of Main Street America through the creation of jobs and stabilization of the housing market.

These facts, in tandem with the impasse over health care reform, could cause financial regulatory reform to be front and center over the next several months, as the Administration tries to re-tool the health care plan in this new political environment.

What to Watch for in 2010

- ⇒ Will unemployment change direction and dip below 10% or will it continue to rise? If unemployment goes down, the politically charged atmosphere around financial and housing reform will decline. If unemployment rises, then there is greater potential for increasing partisanship as the November elections approach.

- ⇒ Will the economy go into a double dip, putting pressure on the White House to replace members of its economic team before the November elections, or will post-election fallout cause a change of leadership?

Financial Regulatory Reform

State of Play

The largest financial services issue in Congress in 2010 is the proposal to fundamentally re-regulate the financial service industry. Chairman Dodd is poised to spend at least the first half of 2010 trying to replicate House Financial Services Committee Chairman Barney Frank's (D-MA) success in writing and then passing sweeping financial regulatory reform legislation. The Senate Banking Committee continues to work on the language that will constitute its regulatory reform package, which the Committee hopes to mark up before the President's Day recess in February. President Obama is conducting meetings with leaders from both chambers, urging swift passage of the legislation.

After the Senate passes its bill, the challenge of reconciling the Senate and House versions into legislation that can pass in both chambers could result in delaying final passage of financial regulatory reform legislation until sometime later in the year. Although the Democrats have lost their super-majority in the Senate, they retain an 18-vote majority and Senate Banking Committee Chairman Dodd continues to work with Ranking Member Shelby on a bipartisan bill. On December 11, 2009, the U.S. House of Representatives approved the "Wall Street Reform and Consumer Protection Act" (H.R. 4173). Democratic Members widely supported the legislation (223 – 27) while Republican Members unanimously rejected the bill (0 – 175). The House bill includes a number of provisions which, among other things, expand the authority of the Federal Reserve; establish a new federal systemic risk regulator; provide the FDIC with resolution authority to wind down failing financial firms; create a new Consumer Financial Protection Agency; provide greater oversight of credit rating agencies; increase regulation of the insurance industry; expand investor protection; enhance regulation of investment advisers; and expand regulation of executive compensation practices.

As noted earlier, the Senate Banking Committee is currently working on its own financial regulatory reform proposal, using Chairman Dodd's "Restoring American Financial Stability Act of 2009" discussion draft as its starting point. Generally, the discussion draft was well received by Democratic Senators and criticized by Republican Senators.

To achieve his desired goal of bipartisan legislation, Chairman Dodd asked Committee Members to voluntarily form two-Member working groups to address concerns regarding specific aspects of the proposed legislation. The groups are: prudential regulation (Chairman Dodd and Ranking Member Richard Shelby (R-AL)), consumer financial protection (Chairman Dodd and Ranking Member Shelby), resolution authority for failed financial firms (Senators Mark Warner (D-VA) and Bob Corker (R-TN)), executive compensation and corporate governance (Senators Charles Schumer (D-NY) and Mike Crapo (R-ID)), and regulation of the over-the-counter derivatives markets (Senators Jack Reed (D-RI) and Judd Gregg (R-NH)).

Despite media reports that Chairman Dodd is willing to pass legislation that does not create a new independent Consumer Financial Protection Agency, there does not appear to be any final agreement on the matter. While there have been discussions between Senate Banking Committee Members and staff about such a proposal, at this time, the Democrats (and the Obama Administration) seem likely to push for its inclusion.

Further, the Financial Crisis Inquiry Commission (FCIC), a bipartisan panel charged with examining the causes of the current financial and economic crisis in the United States, recently completed two days of hearings in Washington. During these sessions, the CEOs of Goldman Sachs, JPMorgan Chase, Morgan Stanley, and Bank of America, along with FDIC Chairman Bair, SEC Chairman Schapiro, and Attorney General Holder, discussed the primary factors behind the financial crisis. The FCIC was ordered to report its findings to Congress, the President, and the general public by December 15, 2010.

What to Watch for in 2010

- ⇒ In the Senate, how real is the spirit of bipartisanship? Will the two parties work together to produce legislation or will Democrats be forced to go it alone? Does Ranking Member Shelby see a "*Dodd-Shelby-Frank Act*" as part of his legislative legacy?
- ⇒ How will the legislation address concerns over the Federal Reserve's authority? Will Chairman Frank's proposed expansion of Federal Reserve's authority prevail or will Chairman Dodd's more restrictive proposal stripping the Federal Reserve of banking regulatory authority win approval?
- ⇒ What will happen to the "too big to fail" banks? Will resolution authority be given to the FDIC? Will the Glass-Steagall Act be reinstated? Will other punitive measures be taken to reflect the current populist tone in Washington?

Foreclosure Mitigation

State of Play

This year will be critical for the housing industry, including borrowers in distress. We see two primary factors impacting the ability of consumers to obtain foreclosure relief: (1) the ability and willingness of their mortgage servicer to engage in loss mitigation techniques through loan modifications or short sales; and (2) the impact of economic conditions on homeowners' property values and their ability to afford their mortgage payments.

Today, the Obama Administration released information evidencing its Home Affordable Modification Program (HAMP) was involved with over 800,000 active trial modifications, although only a fraction of the trial modifications (66,000) had resulted in permanent loan modifications at that time. The HAMP program has made slow progress as the number of active and permanent modifications has gradually increased each month since the program's inception. At the end of 2009, the Administration gave mortgage servicers an extra 30 days to convert eligible trial modifications. This was deemed necessary due to the difficulties both mortgage servicers and homeowners are experiencing in organizing the documentation necessary to substantiate the modification. As the HAMP program continues to evolve, both the Administration and Capitol Hill will be looking at potential next steps, including a move toward principal reduction and a viable short refinance program.

On April 5, 2010, borrowers will have access to another program that will incentivize mortgage servicers to permit short sales – the Treasury's Home Affordable Foreclosure Alternatives Program (HAFAP). HAFAP will compensate mortgage servicers for permitting short sales as an alternative to foreclosure for borrowers who do not otherwise qualify for a loan modification under HAMP.

Notwithstanding progress towards meaningful loss mitigation assistance, certain factors may weigh down the housing industry during 2010. First, some economists believe the Federal Reserve will increase interest rates during 2010. An increase in interest rates will adversely impact borrowers who have adjustable rate mortgage loans, raising the potential for a new segment of borrowers to have difficulty affording their mortgage payments. Second, it is anticipated that an increasing number of borrowers who hold payment option-ARM mortgage loans will have their loans recast, resulting in significantly higher mortgage payments. These borrowers will be especially vulnerable to interest rate increases. Third, the first-time homebuyer tax credit will not be available to borrowers that enter into a real estate sales contract on or after May 1, 2010, potentially reducing the number of eligible purchasers in an already constrained market. Each of these factors could potentially reverse the stabilizing trend in the housing market, causing a further drop in home value for already equity-strapped homeowners and increasing the number of individuals requiring loss mitigation assistance.

What to Watch for in 2010

⇒ Will the Administration add principal reduction to its HAMP program?

⇒ Will the "willingness to pay" overcome "ability to pay" as the problem to fix?

- ⇒ Will the housing market go into a double dip?
- ⇒ Will additional legislation be considered and enacted to address the housing crisis?
- ⇒ Can the Administration's stimulus package outrun the housing overhang?

Housing-GSE Reform

State of Play

The future of the government-sponsored mortgage giants Fannie Mae and Freddie Mac, along with the Federal Home Loan Banks, has remained uncertain for several years. We expect this uncertainty to continue well into 2010. However, we do expect Congress and the Obama Administration to actively discuss narrowing the mission and size of the GSEs, increasing federal oversight of their activities, and reducing federal financial support for their operations. It is expected that the Department of the Treasury will be completing its own report and set of proposals for the Administration to consider related to GSE reform.

Though housing and mortgage finance played a significant role in the financial market meltdown in 2008, and several members of the Senate would like to advance GSE reform legislation, we do not expect the current financial services regulatory reform legislation to include such comprehensive reform.

First, Congress' keen interest in significantly reining in and revamping Fannie Mae and Freddie Mac predates the 2008 financial crisis. Second, Congress has already passed significant GSE reform legislation, namely the "Housing and Economic Recovery Act of 2008" (HERA) that merged the Office of Federal Housing Enterprise Oversight (OFHEO) and the Federal Housing Finance Board into the newly established Federal Housing Finance Agency (FHFA) and granted the FHFA substantial new powers over the GSEs. Third, any legislation reducing the GSEs' still critical role in promoting home ownership and stabilizing the U.S. residential MBS markets will be controversial, especially at a time when the residential housing markets remain in desperate shape in many parts of the country and the GSEs are playing an increasingly important role in the current environment. Many economists believe that now is not the time to curtail the federal government's role in – or indirect financial support for – the critical U.S. housing sector.

What to Watch for in 2010

- ⇒ Will the Administration's preliminary report propose continuing the federal government's direct financial support for Fannie Mae and Freddie Mac? Will a cap on the size of the balance sheet of both entities be proposed, especially given Congress' recent desire to prevent the creation of financial institutions that are too big to fail? Will this proposal also call for substantial reforms to the Home Loan Bank System, including reducing the number of Home Loan Banks and/or limiting their activities, size, or membership criteria?
- ⇒ Who will the Administration appoint as the new permanent Director of the Federal Housing Finance Agency (FHFA)?

⇒ Will leading members of the Senate Banking Committee or the House Financial Services Committee introduce their own legislative proposals to tackle GSE reform or will they wait for the Obama Administration to take the lead on this controversial issue?

Tax: Issues Impacting Financial Services and Housing

State of Play

As we move into 2010, we expect that Congress and the Administration will continue to focus intently on tax issues. First, as a result of the recession, the credit crisis, TARP and stimulus spending, the Federal deficit is at record levels. Also, there remain numerous provisions in the tax code that expired at the conclusion of 2009 that need to be extended. Furthermore, at the end of 2010 the “Bush tax cuts” (income tax rates, dividends and capital gains) are scheduled to expire. Lastly, there remains talk of raising the issue of fundamental tax reform and tax fairness issues. All of these issues exist in an environment where unemployment is at 10% and potentially rising. Therefore, raising revenue to offset expiring provisions, reduce deficits or for other purposes is particularly difficult.

Having said that, in the financial services space, there is a growing sense on Main Street that Wall Street has gotten the US into the economic mess it has been in and that Wall Street should pay. This has translated into numerous ideas that are currently floating around Washington. The Administration has recently indicated its support for an idea that will charge a “fee” to the major banks to recoup any anticipated losses to the taxpayer as a result of the TARP program. This program, called the “Financial Crisis Responsibility Fee,” is currently being designed and is expected to be included in the President’s budget proposal in February. It is reported that it will be a 10 year program and raise nearly \$100 billion, according to a fact sheet released by the Obama Administration on January 14, 2010.

Additionally, the House of Representatives in 2009 passed a surtax on executive compensation bonuses. Recently, legislation has been introduced in the Congress that would impose a high surtax specifically on Wall Street bonuses. This mimics the 50% tax on bonuses that is being imposed in the UK on the companies that are paying the bonuses to employees in the UK. Lastly, there is still talk of the imposition of a securities transaction tax.

All of these “taxes on Wall Street” are rooted in a populist uproar across the country that is expected to grow to a more fevered pitch after Wall Street bonuses are announced and disclosed over the coming weeks. Given the very tenuous political environment, particularly for the Democrats, it can be expected that many Members of Congress will join in that populist chorus.

In addition to these Wall Street tax proposals, several tax proposals were enacted in 2009 that affect both businesses and individuals, such as the expanded homebuyer and net operating loss credits. Taxpayers that can benefit from the expanded credits may claim these credits during this year’s tax filing season.

Other issues to Watch for in 2010

⇒ Carried Interest: Several proposals for the taxation of carried interest income have been introduced, including a proposal that was a part of the “Tax Extenders Act of 2009,” which

passed the House in December. While this proposal is viewed primarily as affecting private equity fund managers, carried interest is also utilized in real estate and oil and gas investments. The Senate Finance Committee has yet to introduce its version of carried interest legislation. Also, the language included by the Administration in the Treasury's Green Book offered a broader carried interest proposal than those put forth by Congress, and it remains to be seen what the eventual carried interest bill will entail. As of this writing, the carried interest proposal remains quite controversial in the Senate and we do not expect its passage as a revenue raiser for the extenders bill. The one caveat is that the "anti-Wall Street" fervor could roll over to the carried interest issue.

⇒ International Tax Reform: Senate Finance Committee Chairman Max Baucus (D-MT) and House Ways and Means Committee Chairman Charles Rangel (D-NY) have both alluded to international tax reform that will be undertaken this year. A number of proposed reforms to the international tax regime appeared in various bills and in the Treasury's Green Book. Some of the more controversial proposals, such as certain provisions in Senator Carl Levin's (D-MI) "Stop Tax Haven Abuse Act," appear to have lost momentum; however, as revenue is needed for various initiatives, it is possible that Congress will embrace these proposals in the future. In addition, the "Tax Extenders Act of 2009" (which has already been passed) includes proposals to curb tax abuses by U.S. persons who hide money offshore. It will be important to monitor the Senate's version of the tax extenders bill and to identify which proposals will be included in the comprehensive international tax reform that is expected to begin in 2010.

We hope this gives you a fresh and helpful reset in the New Year. If you have any questions, please feel free to contact any member of the Patton Boggs Financial Services Practice Group.

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