May 24, 2010

FINANCIAL INSTITUTIONS DEVELOPMENTS

Major Provisions of Senate Financial Reform Bill

The financial reform bill passed by the U.S. Senate would vest the Federal bank regulators with an unprecedented level of control over the shape and strategic direction of the U.S. financial services industry. Many key initiatives of the bill appear to be driven more by populism than sound regulatory policy and stray from the fundamental objective of more effective regulation. This is evidenced by the fact that many of the key provisions appear to have been drafted in haste and lack critical details, deferring much of the definition and implementation to the Federal regulators. Some of the major provisions of the bill are discussed below.

The Financial Stability Oversight Council

The Senate bill abolishes the Office of Thrift Supervision and transfers oversight of savings and loans and their holding companies to the other Federal bank regulators. At the same time, it also adds a number of new regulatory bodies to a financial regulatory system already frequently criticized for being balkanized. Most notably, the bill creates the Financial Stability Oversight Council, which is dedicated to identifying and responding to emerging risks throughout the financial system. The Council is chaired by the Secretary of the Treasury and includes the Federal Reserve Board, the SEC, CFTC, OCC, FDIC, Federal Housing Finance Agency, a new Consumer Financial Protection Bureau and an independent member with insurance expertise appointed by the President.

Significantly, the Council can require, with a two-thirds vote, that a nonbank financial holding company be regulated by the Federal Reserve if its failure would pose a threat to the financial stability of the U.S. This provision represents a dramatic expansion of Federal Reserve authority. As a result, large nonbank financial companies – such as insurance companies, investment firms and finance companies – would for the first time potentially fall within the regulatory ambit of the Federal Reserve. Federal Reserve regulation of bank holding companies is qualitatively different from other types of financial regulation as it is organization-wide and sweeps in all legal entities in the holding company structure, even those located offshore. In contrast, the regulation of insurance companies, broker-dealers, mutual fund companies and finance companies currently focus on specific licensed subsidiaries and provide for nominal, if any, regulation of the parent company and affiliates. In addition, the "goal posts" in Federal Reserve supervision are not always clearly spelled out in written regulations, but also incorporate horizontal reviews of peer institutions (i.e., a best practices review) and judgments as to what constitutes safe and sound practices.

The bill also directs the Council to make recommendations to the Federal Reserve regarding rules for capital, leverage, liquidity, risk management and other requirements for bank holding companies and covered nonbank financial companies that become stricter as companies grow in size and complexity. As a result, these rules would be skewed against the largest, most complex banks and may be substantially different for smaller community banks. In extreme cases, if the Federal Reserve determines that a large bank holding company or a systemically important nonbank financial company poses a "grave threat" to the financial stability of the U.S., the Federal Reserve can, with a two-thirds approval by the Council, require the company to terminate an activity, or impose limitations on it. The Federal Reserve can also direct the company to sell assets, even those held off-balance sheet, to unaffiliated third parties.

Consumer Financial Protection Bureau

The bill also creates the Consumer Financial Protection Bureau, an independent regulatory body led by a director appointed by the President and confirmed by the Senate. The Bureau would be authorized to develop consumer protection rules for both bank and nonbank companies that offer consumer financial products and services, which are widely expected to be tougher than those in place currently. Virtually all of the consumer financial protection functions of the Federal Reserve, OCC, Office of Thrift Supervision, FDIC, Federal Trade Commission, National Credit Union Administration and the Department of Housing and Urban Development would be transferred to the Bureau. Consistent with the bill's overall theme of making regulation tougher for the larger banks, the Bureau would also have the authority to examine and enforce regulations for banks and credit unions with assets over $10 billion (and their affiliates) and all mortgage-related businesses (lenders, servicers and mortgage brokers) and large nonbank financial companies, such as large payday lenders, debt collectors and consumer reporting agencies. Banks with assets of $10 billion or less would be examined by the appropriate bank regulator. The Bureau would be housed in and have a dedicated budget paid for by the Federal Reserve but, importantly, would not be accountable to the Federal Reserve.

During the legislation process, the creation of such a Bureau met with strong industry opposition. Under the proposed regulatory scheme, the extensive Federal regulations that currently govern consumer finance would remain in place. The Bureau would have the ability to craft new regulations to supplement the current regulatory framework. In addition, the bill empowers states to craft even tougher regulations by making clear that the regulations issued by the Bureau are intended to serve only as a "floor." In recent months, Congress has been highly critical of the Federal bank regulators – asserting that they were not sufficiently assertive in protecting consumers. In view of this, the new Bureau is expected to be highly active.

Concentration Limits

The legislative efforts to revive Glass-Steagall's separation of investment banking from commercial banking as well as to break up the largest financial institutions were not successful. However, there are a number of provisions in the bill intended to make it more difficult for the largest institutions to expand through a combination of outright prohibitions and economic disincentives. The bill requires that bank holding companies with assets of $50 billion or more as well as systemically important nonbank financial companies obtain Federal Reserve approval prior to acquiring a wide range of financial companies with consolidated assets of $10 billion or more. These bank holding companies and nonbank financial companies also may not acquire or merge with any other company if the total consolidated liabilities of the acquiring financial company upon consummation of the transaction would exceed 10% of the aggregate consolidated liabilities of all U.S. financial companies. The methodology of defining and calculating the aggregate consolidated liabilities is left unstated and would be determined by the Federal Reserve at a later date. Perhaps most significantly, as noted above, capital, liquidity and other requirements are expected to become increasingly tougher as companies grow in size and complexity, potentially providing a powerful disincentive against aggressive expansion.

The Volcker Rule

In many respects, the bill grants an enormous amount of discretion to the Federal regulators, particularly the Financial Stability Oversight Council and the Federal Reserve. However, the bill deems certain activities as wholly inappropriate for bank holding companies. The Volcker rule requires the regulators to implement regulations for banks, their affiliates and holding companies, to prohibit proprietary trading, investments in and sponsorship of hedge funds and private equity funds. None of these activities have gained broad acceptance as material causes of the recent financial crisis. Despite the enormous potential impact on the financial service industry of the Volcker rule, it is almost alarmingly short with circular definitions and defers many of the hard questions to the Federal bank regulators. For example, the rule sidesteps the critical question of what constitutes "proprietary trading." A flat ban on proprietary trading in theory would require investments to be held indefinitely. Instead, the bill defines it as purchasing or selling a wide range of financial instruments "for the trading book" (which is not defined) or any other portfolio designated by the Federal bank regulators.

Derivatives

The provisions of the bill relating to regulation of the swaps market provide for a new regulatory regime that would grant the SEC and CFTC with authority to regulate over-the-counter derivatives. The bill requires central clearing and exchange trading for derivatives that can be cleared and requires margin for uncleared trades. In addition, capital requirements would be imposed on swap dealers and major swap participants. While these provisions should go a long way toward decreasing the amount of credit risk associated with derivatives, the bill at the same time requires banking organizations to move their derivatives businesses from their subsidiary banks – ironically their most creditworthy and regulated entities – to less regulated nonbank affiliates.

Next Steps

Senate and House leaders have indicated that they plan to convene a conference shortly to reconcile the differences between the Senate bill and the version passed by the House in December. The process will provide industry representatives with an opportunity to continue their lobbying efforts – although significant changes appear unlikely in the current political environment. Once the bill becomes law, a number of Federal regulators will commence a myriad of lengthy rule-making processes during which additional industry input will be possible. Many of the key decision makers during the rule-making process are or soon will be appointees of the current Administration. Administration appointees include not only the Treasury Secretary and the Federal Reserve Chairman, but also the Comptroller of the Currency (Comptroller Dugan's term expires this August), the FDIC Chairman (Chairman Bair's term expires in June 2011), the Director of the Consumer Financial Protection Bureau and the Federal

Reserve Vice Chairman for Supervision (a newly created position designated by the President focused on supervision and regulation).

Edward D. Herlihy
Richard K. Kim
Lawrence S. Makow