

June 23, 2009

## Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation

### Potential Implications for Banks, Thrifts and Their Holding Companies

The Obama Administration introduced a white paper, *Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation*,<sup>1</sup> (the White Paper) on June 17, 2009, proposing significant and comprehensive regulatory reform in response to what the White Paper calls the “most severe financial crisis since the Great Depression.”

The White Paper offers targeted recommendations intended to address the following five key goals: (1) *promote robust supervision and regulation of financial firms*, (2) *establish comprehensive supervision and regulation of financial markets*, (3) *protect consumers and investors from financial abuse*, (4) *improve tools for managing financial crises*, and (5) *raise international regulatory standards and improve international cooperation*.

### Robust Supervision and Regulation of Financial Institutions

As part of the effort to strengthen and augment the existing regulatory framework, the White Paper recommends restructuring the federal financial regulatory system, including the formation of new agencies and coordinating bodies, a new consolidated bank regulator, and a more powerful Federal Reserve. A primary goal of the reforms proffered in the White Paper is to ensure the stability and strength of financial institutions, in part by imposing stronger, more consistent capital, liquidity and leverage requirements on *all* financial institutions, with higher standards applying to large, interconnected institutions. Significant elements of the restructuring include:

1. A new Financial Services Oversight Council (FSOC), chaired by the Secretary of the Treasury with the principal federal financial regulators<sup>2</sup> as members, would be responsible for improving information sharing and coordination among key federal regulatory agencies on policy development, supervision and identifying emerging systemic risks and regulatory gaps. The FSOC would have authority to require periodic and other reports from *any* U.S. financial institution, regardless of whether the institution is federally regulated. A subset of the council's membership would be responsible for determining whether to invoke resolution authority with respect to large, interconnected institutions.
2. New authority would be given to the Federal Reserve, granting it consolidated supervision over large, potentially “too-big-to-fail” institutions that could pose a threat to financial system stability—so-called Tier 1 Financial Holding Companies (FHCs)—regardless of whether such institutions own a bank or other depository institution. The White Paper proposes that this designation would

<sup>1</sup> For a copy of the White Paper, please click the following link: [http://www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf).

<sup>2</sup> The members, in addition to the Treasury Secretary, include the heads of the following: the Board of Governors of the Federal Reserve System, the National Bank Supervisor, the Consumer Financial Protection Agency, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, and the Federal Housing Finance Agency.

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be ultimately determined by the Federal Reserve, within legislative and regulatory guidelines, and need not be determined by specific asset levels. The Federal Reserve would consider recommendations by the FSOC. Federal Reserve supervision would extend to all FHCs, bank holding companies (BHCs) and *all* of their subsidiaries without taking into account whether such entities are otherwise regulated or U.S.-based.<sup>3</sup> The White Paper also recommends that any investment banks or their holding companies, subject to consolidated supervision, should be regulated by the Federal Reserve rather than by the Securities and Exchange Commission (SEC).

3. A new National Bank Supervisor, which would be a separate agency within the Treasury, would supervise all federally chartered depository institutions and all federal branches and agencies of foreign banks. The White Paper proposes eliminating the federal thrift charter and perceived “nonbank” bank loopholes—available to, among others, trust companies, credit card banks and industrial loan companies—that permitted owners of these institutions to avoid the limitations and requirements imposed on BHCs by the Federal Reserve.
4. An Office of National Insurance (ONI) would be established within the Treasury to address the lack of expertise within the federal government regarding the insurance industry and to develop a modern regulatory framework for insurance.
5. Advisers of hedge funds and other private pools of capital with a certain amount of assets under management would be required to register with the SEC under the Investment Advisers Act of 1940. Other recommendations include harmonization of investment adviser and broker-dealer regulation and imposing fiduciary duties on broker-dealers that “provide investment advice” to their customers.<sup>4</sup>
6. A new, independent Consumer Financial Protection Agency (CFPA) would have the authority to regulate and supervise consumer financial services and investment markets.
7. A new resolution regime, modeled after the existing Federal Deposit Insurance Corporation (FDIC) resolution authority for depository institutions, would be put in place for failing bank holding companies (including all FHCs) and Tier 1 FHCs if a disorderly resolution could have a serious adverse effect on the financial system or economy.

### Implications for the Banking Industry

- Tier 1 FHCs may be subject to “stricter and more conservative” capital, liquidity and risk management standards, may be subject to enhanced public disclosures and may be required to prepare and continuously update plans for their own resolution in the event of “severe financial distress.”
- The Federal Reserve may require subsidiaries of Tier 1 FHCs to be subject to more stringent prudential safeguards.
- Increased examination costs are likely to be a result of the new proposal.
- Increases in capital requirements—in particular, with respect to off-balance-sheet vehicles (e.g., structured investment vehicles, asset-backed commercial paper programs, and advised money market mutual funds)—are recommended. Former thrift holding companies would become subject to consolidated capital requirements as a result of the “conversion” to BHCs.

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<sup>3</sup> The White Paper acknowledges that allowing the Federal Reserve the power to obtain information or impose prudential restrictions on regulated subsidiaries that already have a primary supervisor—e.g., banks, broker-dealers, investment advisers, futures commission merchants and insurers—would require an amendment to the Gramm-Leach-Bliley Act’s provisions intended to provide for “functional regulation” of an FHC’s or a BHC’s regulated subsidiaries.

<sup>4</sup> It is unclear whether the White Paper proposes to impose a fiduciary duty on broker-dealers whose investment advice is “solely incidental” to their broker-dealer services.

- Banks and BHCs may see enhanced executive compensation requirements, including limitations on incentive compensation, golden parachutes and supplemental retirement packages.
- Shareholder “say on pay” may be required.
- New requirements for increased loan loss reserves are probable.
- Federal Reserve Act Section 23A and Section 23B “firewalls” are recommended to be enhanced: the White Paper proposes that covered transactions be required to be fully collateralized through the life of the transaction, that the restrictions may be applied to transactions between a bank and all private investment vehicles sponsored or advised by the bank, and that the Federal Reserve’s level of discretion to provide exemptions be limited.
- While there is likely to be concern about the elimination of the federal thrift charter, the White Paper proposes to permit nationwide de novo interstate branching for state and federal charters and the elimination of age requirements in connection with interstate bank acquisitions. Deposit caps would remain in place.
- The unitary thrift charter would be eliminated.
- In the “conversion” of thrifts to “banks,” credit concentrations and limits may be addressed.
- Companies owning trust companies, industrial loan companies, credit card banks and “nonbank banks,” if not already BHCs, would become BHCs.<sup>5</sup>

## Comprehensive Supervision of Financial Markets

The White Paper proposes greater regulation and robust reporting requirements on securitizations, as well as a requirement that issuers and sponsors retain a financial interest. The White Paper also proposes stronger regulation of credit rating agencies and comprehensive regulation and oversight with respect to all over-the-counter (OTC) derivatives and derivatives dealers, including capital requirements (in addition to those currently imposed by bank regulators) and required compliance with anti-manipulation and abuse rules. All OTC contracts should be traded through regulated centralized counterparties with standardized products that would be moved to regulated exchanges or other transparent electronic trading facilities. The proposal stresses the importance of harmonizing regulation of the securities and futures markets, especially in light of the growing derivatives market, and calls for the SEC and the Commodity Futures Trading Commission (CFTC) to make recommendations as to how to accomplish such harmonization. Finally, the White Paper advises granting new authority to the Federal Reserve to oversee payment, clearing and settlement systems and related activities.

### Implications for the Banking Industry

- Higher level of regulation of securitizations and asset-backed securities transactions, which may include retention of liabilities with respect to assets sold.
- Retention of credit risk will complicate compliance with loan-to-one borrower requirements.
- Consolidation of securitizations on balance sheets may result in higher capital requirements.
- Additional regulation of and limits on OTC transactions and requiring transactions to be cleared or traded on exchanges may impose additional strains on liquidity due to margin or collateral requirements, may increase trading costs due to brokerage fees, and may limit the ability to meet business, tax and accounting requirements for hedge treatment.

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<sup>5</sup> While it is clear that companies owning federally insured trust companies would become subject to the new regime, it is not clear whether Treasury proposes that non-federally insured trust companies would also be subject to it.

## Protection of Consumers and Investors

The CFPA would be created to protect consumers in the financial products and services markets, except for investment products and services already regulated by the SEC or CFTC. The primary objective of the CFPA is to protect consumers in the *credit*, *savings* and *payments* markets from unfair, deceptive and abusive practices. The CFPA would have rulemaking authority, as well as supervisory and enforcement authority, over all covered products and the institutions that issue, provide or service such products.

With the help of a Financial Consumer Coordinating Council (made up of federal and state consumer protection agencies), the White Paper suggests the CFPA should coordinate enforcement with the states and that the states should be able to “adopt and enforce *stricter* laws for institutions of all types, regardless of charter, and to enforce federal law concurrently with respect to institutions of all types, also regardless of charter.” The latter would seem to undermine the well-established preemptive authority that has been exercised by federal bank regulators when faced with state regulations and laws that impact the activities of federally chartered banks. The White Paper promotes improvements to the “transparency, fairness, and appropriateness” and higher standards for all consumer financial products and services providers. The Administration believes that the CFPA should apply consistent regulation to similar products.

The Administration proposes to enhance the role of the SEC. Particularly, the Administration believes that the SEC should be given expanded authority to promote transparency in disclosures to investors by requiring, for example, that prospectuses be given to investors *before* the sale so that the investor can make an informed decision at the point of sale. The Administration also proposes that the SEC should be given new tools to promote fair treatment of investors by establishing a “fiduciary duty for broker-dealers offering investment advice and harmonizing the regulation of investment advisers and broker-dealers.”

### Implications for the Banking Industry

- The White Paper’s consumer-oriented proposals will likely result in increased litigation risk from disclosures and new suitability standards.
- The White Paper proposes a new and high “reasonableness” standard for the sale or origination of bank products to consumers. The proposal states that the provider of a consumer financial product would be subject to administrative action, but not civil liability, if the reasonableness standard is violated.
- Examination costs will be increased due to the introduction of the new agency.
- Treasury may seek legislation to increase statutory damages for existing private rights of action.
- The White Paper also suggests that the government should do more to “promote ‘plain vanilla’ products” (such as traditional 30-year, fixed-rate mortgages) and that the CFPA should have the authority to “define standards” for those products and “require firms to offer them” with other lawful products.
- The CFPA may require banks and BHCs to acquire new technology to comply with new disclosure requirements.
- The White Paper recommends that “states should be the first line of defense” for supervisory and enforcement authority, and also recommends that states should be able to enforce the regulations promulgated by the CFPA, thus apparently eliminating the preemption defense previously enjoyed by national banks.
- The Administration proposes authorizing the CFPA to adopt regulations subject to the Administrative Procedure Act, including “disclosures or restrictions on contract terms or sales practices” that would apply to any covered providers of such products. Mortgage and consumer

lending, as well as deposit taking, would be subject to the regulations of the CFPB, in addition to more stringent state regulations of that activity.

- Duties of care, including a duty of best execution for mortgages and other similar products, by financial intermediaries and the elimination of certain compensatory arrangements for intermediaries (e.g., yield spread premiums) are recommended by the White Paper.
- A recommendation for enhanced disclosures for overdraft protection plans, including point-of-sale and ATM disclosures are included in the White Paper.
- The CFPB would enforce fair lending laws and the Community Reinvestment Act (CRA) and would be the entity to determine compliance with the CRA for purposes of merger clearance.
- Bank broker-dealers may be subject to new fiduciary standards of care.
- The White Paper recommends the elimination of mandatory arbitration provisions in consumer financial products and broker-dealer investment contracts.

## Tools for the Government to Manage Financial Crises

The White Paper suggests granting the U.S. government additional authority, modeled on the existing authority of the FDIC, to resolve potential failures of BHCs and Tier 1 FHCs if the failure could have serious consequences for the financial system or the economy. This authority would not replace the ability to pursue bankruptcy, but rather is based on the FDIC's current "systemic risk exception," which allows it to resolve institutions and not be subject to the typical least cost resolution standard when systemic financial stability is at stake. The White Paper recommends that the Treasury, after consulting with the President and having the recommendations of two-thirds of the board members of the FDIC and of the Federal Reserve, can require resolution of the institution; if the largest subsidiary by assets is a broker-dealer, then FDIC approval is not required and two-thirds of the SEC's commissioners must approve. The Treasury generally should appoint the FDIC as receiver or conservator, though the SEC could be appointed if the largest subsidiary of the failing institution is a broker-dealer. In the event the failing institution includes an insurer, the ONI will provide consultation to the Federal Reserve and FDIC boards on insurance-specific matters.

In order to improve accountability, the White Paper also proposes amending the Federal Reserve Act to require the Treasury Secretary's prior approval for the Federal Reserve to exercise certain emergency lending authority to any individual, partnership or corporation under "unusual and exigent circumstances."

### Implications for the Banking Industry

- The FDIC is proposed to have authority to obtain examination reports for BHCs and is further proposed to have back-up examination authority over BHCs.
- The source of payment of resolution costs of BHCs by the FDIC is not addressed.

## International Cooperation

The White Paper highlights the importance of reaching an international consensus in four core areas: (1) regulatory capital standards, (2) oversight of global financial markets, (3) coordinating supervision of internationally active financial firms, and (4) crisis management and prevention. The proposed reforms on international cooperation are intended to be consistent with U.S. commitments made as part of the G-20 process.

The Federal Reserve, in consultation with the Treasury, would develop rules to identify foreign financial institutions that should be Tier 1 FHCs, based on whether or not their U.S. operations pose a threat to

financial stability. The Federal Reserve could apply the criteria: (1) to the worldwide operations of the foreign institution, (2) only to the U.S. operations of the foreign institution, or (3) only to those operations of the foreign institution that affect the U.S. financial markets. In reaching its determination, the Federal Reserve should take into account the national treatment and equality of competitive opportunity for the foreign institutions based in the United States and U.S.-based institutions, as well as international agreements negotiated by the Executive Branch. Once designated, foreign institutions may be required to meet the same capital and management test as U.S. institutions, as is the case with current FHCs and their U.S. subsidiary banks or U.S. branches. How these rules would apply will be determined by the Federal Reserve in consultation with the Treasury.

The White Paper recommends that the Financial Stability Board (FSB) and U.S. authorities enhance the supervision of significant global financial institutions through the establishment and continued development of supervisory colleges consisting of the regulators of such institutions in various countries.

The White Paper supports the directive of the G-20 that the accounting standard setters quickly improve the standards for the valuation of financial instruments and reduce the complexity of financial instruments accounting. First, the White Paper recommends that the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) clarify and make consistent the application of fair value accounting standards, including the impairment of financial instruments, by the end of 2009. Second, the FASB and the IASB should improve accounting standards for loan loss provisioning and make it more forward-looking without sacrificing the transparency of financial statements. Finally, the White Paper recommends that the IASB and FASB make substantial progress by the end of 2009 toward developing a single set of high-quality global accounting standards, with the objective of achieving broad convergence of International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles, or GAAP, by the end of 2010, which is a necessary precondition under the SEC's proposed roadmap to adopt IFRS.

### Implications for the Banking Industry

- The White Paper encourages modifications and improvements in the risk weights applicable to trading books and securitized products in the Basel II framework.
- A supplemental ("simple, transparent, non-model based") leverage ratio is recommended.



*We will continue to monitor developments related to the regulatory reform initiatives affecting clients. If you have questions regarding this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorneys with whom you regularly work, or access our Regulatory Reform Task Force Resource Center website: [www.regulatoryreformtaskforce.com](http://www.regulatoryreformtaskforce.com).*

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