

STRICTER STANDARDS SUPERVISION UNDER HOUSE FINANCIAL REFORM LEGISLATION (H.R. 4173)

In a January 8, 2010, client update we described generally the House passed financial reform legislation (H.R. 4173). This client alert focuses more closely on the House bill's provision requiring "stricter standards" for financial firms that threaten financial stability.

Oversight Council Designation of Companies Subject to Stricter Standards Replaces Federal Reserve Tier 1 FHC Designations

As described in our September 24, 2009, client alert concerning Tier 1 FHCs, the Treasury Department proposed that the Federal Reserve be given authority to identify and regulate as a Tier 1 FHC any company engaged in finance that it determined could pose a threat to financial stability if it experienced material financial distress during times of economic stress. The Federal Reserve would have had broad discretion to impose "enhanced" regulatory standards on such companies. This proposal was criticized for giving the Federal Reserve new authority when, in the view of many critics, the Federal Reserve had failed as a regulator in the lead up to the financial crisis.

The House bill gives the new Financial Services Oversight Council (the "Council") the authority to identify the financial companies that would be subject to "stricter standards" ("Stricter Standards Companies"). This authority covers any company engaged in finance that "could pose a threat" to financial stability or the economy because of its activities, regardless of whether that company or the economy came under financial stress. As we discuss below, the House bill added other factors the Council should consider that could lead to surprising results if the bill's language becomes law.

Oversight Council Control of Stricter Standards Limits Federal Reserve Independence in Establishing Standards

The Federal Reserve would still create and impose specific stricter standards. If the Council, however, found "grave" circumstances then it could override Federal Reserve standards and impose directly its own stricter standards on a Stricter Standards Company. Also limiting the Federal Reserve's control over the stricter standards, each member of the Council would be obligated twice a year to report to Congress whether it agreed "all reasonable steps" were being taken to "ensure financial stability and to prevent systemic risk that would negatively affect the economy." This would give each member the opportunity (and obligation) to report publicly any disagreement it might have with the standards being imposed by the Federal Reserve or with the Council's actions.

Broad Council Authority to Regulate or Prohibit a Practice or Activity That Threatens Financial Stability

The Council would also have the power to identify and require the Federal Reserve to develop stricter regulatory standards for (including prohibiting) any practice or activity the Council determined could create (or increase the risk of) liquidity, credit, or other problems among financial firms and “low-income, minority, or underserved communities” and “thereby” threaten financial or economic stability. Such standards would apply to all companies (not only Stricter Standards Companies) engaged in the identified activity or practice. Unlike with stricter standards, there is no express authority for the Council to impose directly its own standards in place of standards developed by the Federal Reserve for such identified practices or activities.

Composition of Council Does Not Ensure Bank Regulator Control

Treasury proposed that the Council be made up of the Treasury, Federal Reserve, OCC (or National Bank Supervisor, if it were created), OTS (or National Bank Supervisor, if it were created), FDIC, SEC, CFTC, CFPB, and FHFA. This was intended as an expansion of the existing President’s Working Group on Financial Markets (made up of Treasury, the Federal Reserve, the SEC, and the CFTC) in order to broaden the range of views and expertise represented.

The House bill would increase the breadth of representation on the Council by adding the federal regulator of credit unions (the NCUA) as a voting member and the new Federal Insurance Office, as well as a state banking regulator, a state insurance regulator and a state securities commissioner, as non-voting members. The Treasury Secretary would preside at Council meetings. Treasury’s proposal had no formal voting procedures for the Council, because the Council it proposed would have made recommendations and provided information. It would not have made regulatory decisions.

The expanded membership of the Council and allocation of voting power to actual federal regulators means only two (the Federal Reserve and OCC) of the ten (nine after the OTS ceases to exist*) voting members directly regulate large banks or their holding companies, the companies most likely to be designated Stricter Standards Companies. Given the evolution of the large investment banks into bank holding companies, none of the other voting members supervises the overall operations of large banking organizations.

The dynamics of the Council in action will determine whether the Council will issue designations or other decisions not desired by the Federal Reserve and OCC. The FDIC, which in practice supervises small banks, has been openly critical of Federal Reserve and OCC positions it considers favorable to large banks or disadvantageous to small banks. The NCUA has not been as prominent. The CFPB does not exist. If created, no one expects it to give much attention to large bank concerns.

* The House bill provides for the duties of the OTS to eventually be subsumed by the OCC, at which point the OTS will no longer be a member of the Council.

House Bill Details More Specific and More Severe Forms of Stricter Supervision

Barney Frank, Chair of the House Financial Services Committee and the main crafter of the House bill, has stated he intends a financial company's designation as a Stricter Standards Company to be a Scarlet Letter that companies would seek to avoid and, once gained, seek to remove. His intent seems to be fulfilled through the lengthy list of standards the House bill directs the Federal Reserve to consider, and in some cases requires it to impose, for Stricter Standards Companies.

The main section of the House bill listing, and establishing procedures for, Stricter Standards (Section 1104) is more than 42 pages long. It does not contain all the stricter standards the bill authorizes. Among the most interesting House additions to Treasury's concise list of required standards (such as stricter risk-based capital, leverage, liquidity, and risk management requirements) are:

- stress tests conducted quarterly by each Stricter Standards Company and annually by the Federal Reserve for each such Stricter Standards Company, in all cases using at least 3 scenarios (baseline, adverse, and severely adverse).
- required update of "rapid resolution" plan (i.e. "living will") after adverse or baseline stress test results indicate that the Stricter Standards Company is significantly or critically under-capitalized.
- an absolute GAAP leverage limit of 15 to 1.
- after 3 years, a limit on short term debt (including short term off-balance sheet exposures) for Stricter Standards Companies (although the Federal Reserve could grant exemptions and could defer imposing rules for 2 more years).

Among the more interesting additional actions the Federal Reserve is specifically authorized (but not required) to take are to:

- prohibit proprietary trading by any Stricter Standards Company.
- require any Stricter Standards Company to issue "contingent capital" debt that converts into capital when either the Stricter Standards Company fails to meet a capital or other prudential standard or the Federal Reserve determines financial stability requires such conversion.

Council has Separate Power to Mitigate Systemic Risk

In addition to these stricter standards, as a separate power to "mitigate systemic risk", the House bill would authorize the Council to require even a well capitalized Stricter Standards Company to sell or otherwise divest itself of any subsidiary or other asset, or cease any business, if the Council determined this were necessary to prevent or limit a "grave threat" to financial stability or the economy. This power could only be used with Treasury Secretary agreement for a required divestiture of more than \$10 billion. This is not part of the "prompt corrective action" requirements that authorize the Federal Reserve to require divestitures for Stricter Standards Companies that are not well capitalized.

Some House Bill Language Could Lead to Odd Results

While Chairman Frank's (and presumably the House's) desire to make Stricter Standards Company designation a Scarlet Letter and not a badge of honor seems clear in most parts of the House bill, other considerations reflected in the bill could lead to a different result.

The House bill seeks to emphasize the importance of protecting "low income, minority, and underserved" communities. Through a "manager's amendment" language was added to the bill that directs the Council to consider the importance of a company as a source of credit for low-income, minority, or underserved communities in deciding whether to apply stricter standards to that company. Does this mean the Council should not apply a Scarlet Letter to such a company even if the company would otherwise meet the criteria for applying stricter standards?

The "manager's amendment" also states the Council should consider the impact the failure of such a company would have on the identified special communities. This seems to suggest the Council should act to prevent failure by imposing stricter standards. But, if the Council is supposed to ensure such company remains in business to provide services to the special community, is the stricter standards designation intended as a Scarlet Letter to encourage the company to stop providing those services in order to remove the designation?

The directions to the Council for identifying financial activities or practices to prohibit or specially regulate could contain a similar issue. Is the Council really required to find a threat to financial stability *and* problems for a low-income, minority, or underserved community or is the Council supposed to find more easily a threat to overall stability if there are problems in such special communities?

While one might expect these wording problems would be corrected before any reform legislation becomes law, more problems will likely arise as other issues are identified by legislators who want their concerns reflected somewhere in the law. The concern that led to a large membership on the oversight Council (i.e. to expand the horizons of the smaller PWG) and the separate concern that led to more direct regulatory authority for that Council (i.e. to limit the Federal Reserve's autonomy) have together created the apparent anomaly (perhaps intended) that a group of regulators with little experience with large banking organizations has a large voting majority (3 to 1) over the only two members that supervise the overall operations of those firms.

House Bill Follow Treasury Proposal in Treatment of Commercial Companies and Foreign Firms

The House bill, like the Treasury proposal, would require a Stricter Standards Company engaged in commerce (i.e. in activities not considered "financial" under the BHCA) to form an intermediate bank holding company to hold its financial activities. As described in our September 24, 2009, client alert concerning Tier 1 FHCs, this would subject the intermediate holding company to affiliate transaction limits in dealing with commercial affiliates as if the entire intermediate holding company were a bank. The Federal Reserve could exempt a Stricter Standards Company from this onerous restriction and permit the relevant financial holding company to be treated as if it were a bank holding company, but only if the company on a consolidated basis were primarily involved in financial, not commercial, activities. This would permit such a company to operate like other non-bank holding companies

without commercial operations (such as insurance companies) that could be designated as Stricter Standards Companies.

The House bill follows Treasury's proposal in permitting the U.S. operations of foreign firms to be designated Stricter Standards Companies.

The House bill also follows the Treasury proposal in imposing special prompt corrective action and "dissolution" procedures on Stricter Standards Companies. We will review those issues in a separate client update.

If you would like to discuss any of the issues addressed in this Client Update or would simply like to find out more about Chapman, please contact Bob Lockner at lockner@chapman.com or Tim Mohan at mohan@chapman.com.

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