

THE REGULATORY REFORM MARATHON

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The Obama Administration is currently on the legislative leg of the regulatory reform marathon that began earlier this year with the release of its [Rules of the Road](#) and continued with its [White Paper on Financial Regulatory Reform](#). The Obama Administration released last week its legislative text to implement many elements of the White Paper. Overall, the Administration's proposed legislation hews closely to the White Paper, though it provides important details in a number of areas where the White Paper was more general. The proposal would expand the Federal Reserve's powers to include those of a systemic risk regulator, and create a new interagency Financial Services Oversight Council to assist the Federal Reserve in its new mission.

No sooner had the proposed legislation been released, however, than critics began to pull apart the proposals in commentary and through counterproposals. FDIC Chairman Sheila Bair criticized aspects of the proposal to appoint the Federal Reserve as systemic risk regulator, and SEC Chairman Mary Schapiro argued that a council of federal regulators, on which the SEC would have a seat, should have enhanced authority. The House Republicans proposed their own regulatory reform legislation, which contained a number of alternative proposals, including to limit the Federal Reserve's authority to overseeing monetary policy, to transfer all of the Federal Reserve's current regulatory authority to a new financial institutions regulator, and to fundamentally reform Fannie Mae and Freddie Mac. House Financial Services Committee Chairman Barney Frank argued that the federal thrift charter should not be abolished, even if the OTS were merged into the OCC in the form of a new national bank supervisor.

As of the writing of this memorandum, the outcome of US financial regulatory reform is uncertain and predictions about what will become law, and at what pace, are perilous. We believe that US financial regulatory reform will now be enacted incrementally. The only certainty is that the legislative reform agenda will continue to be crowded and that legislative text once proposed will be recycled in the great echo chamber of Washington.

This memorandum, which builds on the analysis in the Davis Polk memorandum on the White Paper, [A New Foundation for Financial Regulation?](#), discusses the Obama Administration's proposed legislation and the Republican counterproposal. Davis Polk is monitoring new developments in this area and will issue newsflashes and memoranda from time to time.

Consolidated Supervision and Regulation of Tier 1 FHCs

The Administration's approach to systemic risk regulation is to create a robust new framework to supervise and regulate "large, highly leveraged, and substantially interconnected financial companies." The goal of this framework is to mitigate the threats that these companies can pose to financial stability.

Overall, the Administration's proposal did a good job answering many of the questions that remained open after the release of the White Paper. While retaining a very broad definition of Tier 1 FHC, the proposed legislation would provide a reasonable amount of *ex-ante* legal certainty about who is in and who is out, and what that would mean.

This legal certainty will not please everyone. Critics have argued that designating firms as Tier 1 FHCs will institutionalize them as "too big to fail," creating another class of institutions like Freddie Mac and Fannie Mae that have funding advantages over their competitors because of the implicit support of the US government. The Administration has responded by arguing that any funding advantages will be offset by the costs of enhanced capital, liquidity and other requirements that will be imposed on Tier 1 FHCs, and that it is not possible to impose these enhanced requirements on systemically important institutions unless there is some mechanism for identifying who they are. FDIC Chairman Bair has taken a "third way" in this dispute. Without objecting to the identification of Tier 1 FHCs or their subjection to enhanced regulation, she has argued that the "too big to fail doctrine" must end. She proposes a new resolution regime that would narrow or eliminate the systemic risk exception for open (as opposed to closed) assistance for Tier 1 FHCs.

One of the key policy disagreements in the domestic debate revolves around the role of the Federal Reserve as the sole or lead systemic risk regulator. The Administration's proposal reflects its decision to make the Federal Reserve solely responsible and accountable for systemic risk regulation and supervision, with assistance from the Financial Services Oversight Council. This aspect of the proposed legislation has had many critics, including Senate Banking Committee Chairman Christopher Dodd, Senate Banking Committee Ranking Minority Leader Richard Shelby, FDIC Chairman Bair and SEC Chairman Schapiro. Some of these critics expressed concern about concentrating too much power in the hands of the Federal Reserve and reducing the influence of other federal agencies such as the FDIC and the SEC. Many of these critics would place systemic risk authority in the hands of a council made up of a variety of federal regulators, including the SEC and the FDIC. The House Republicans would go a step further and transfer the Federal Reserve's current regulatory authority to a new single financial institutions regulator, while limiting the Federal Reserve's mission to monetary policy.

US and non-US Financial Companies

- A “United States financial company” would be a “bank holding company or **any other company**” organized under US law that is engaged in whole **or in part**, directly or indirectly, in “activities **in the United States** that are **financial in nature**.”
- A “foreign financial company” would be a “bank holding company or **any other company**” organized under non-US law that is engaged in whole **or in part**, directly or indirectly, including through a US branch, in “activities **in the United States** that are **financial in nature**.”

Possible Tier 1 FHCs

- Any of the financial institutions that were subject to the Supervisory Capital Assessment Program
- Any large, highly leveraged and interconnected US or foreign hedge fund because trading is financial in nature
- Any large, highly leveraged and interconnected US or foreign automobile, merchandising or other commercial company, if engaged in any financial activity in the US, such as providing consumer credit

But not:

- Any company engaged exclusively in nonfinancial activities in the US, such as a company engaged solely in automobile manufacturing, merchandising or other commercial activities

Defining Tier 1 FHCs

The Administration’s legislative proposal would define a Tier 1 FHC as a “United States financial company” or a “foreign financial company” that is designated as a Tier 1 FHC by the Federal Reserve. As shown in the adjacent sidebar, the proposal would define the range of US and non-US financial companies that could be designated as Tier 1 FHCs very broadly.

Because the Administration would add these definitions to the Bank Holding Company Act of 1956, the term “financial in nature” would presumably be understood to mean those activities that are defined, from time to time, as financial in nature under the Bank Holding Company Act. Similarly, the term “company” would presumably reflect the definition of that term in the Bank Holding Company Act.

These definitions would give the Federal Reserve broad discretion to designate almost any large, highly leveraged or interconnected company as a Tier 1 FHC, provided it is engaged in at least some financial activities. There is no requirement that a company be predominantly engaged or even substantially engaged in financial activities. Any financial activities will do. Only a company that is exclusively engaged in nonfinancial activities is entirely insulated from being designated as a Tier 1 FHC. The lower sidebar provides examples of the types of companies that could be designated Tier 1 FHCs if they met the size, leverage and interconnectedness tests.

This definition of Tier 1 FHC, combined with the Federal Reserve’s definition of “financial in nature,” could lead to some counterintuitive results. For example, it would preclude the Federal Reserve from designating as a Tier 1 FHC any company that is engaged exclusively in real estate investment or management, commodities trading or other activities that are not considered to be “financial in nature” under the Bank Holding Company Act, unless the Federal Reserve expands the definition of “financial in nature” to include those activities.

Mechanism for Designating Firms as Tier 1 FHCs

The proposal also includes a mechanism for the Federal Reserve to designate, by regulation or order, which US and foreign financial companies are Tier 1 FHCs. The list of Tier 1 FHCs would vary from time to time as some firms are added to the list and some are deleted from the list, depending on whether they continue to satisfy the criteria for Tier 1 FHC status.

The standards for designating a financial company as a Tier 1 FHC differ based on whether the company is a US or non-US company. A foreign financial company can only be designated as a Tier 1 FHC based on its impact in the United States. In addition, the Federal Reserve would be prohibited from designating any foreign financial company as a Tier 1 FHC unless it has “**substantial assets or operations in the United States**.”

- A “United States financial company” can be designated as a Tier 1 FHC if the Federal Reserve determines that “material financial distress at the company could pose a threat to **global or United States** financial stability or the **global or United States** economy during times of economic stress.”
- A “foreign financial company” can only be designated as a Tier 1 FHC if the Federal Reserve determines that “material distress at the company could pose a threat to **United States** financial stability or the **United States** economy **taking into consideration the principles of national treatment and equality of competitive opportunity.**”

The Federal Reserve’s designation of US financial companies as Tier 1 FHCs would be based on:

- the amount and nature of the company’s financial assets
- the amount and types of the company’s liabilities, including the degree of reliance on short-term funding
- the extent of the company’s off-balance sheet exposures
- the extent of the company’s transactions and relationships with other major financial companies
- the company’s importance as a source of credit for households, businesses and state and local governments
- the company’s importance as a source of liquidity for the financial system
- the recommendation, if any, of the Financial Services Oversight Council
- any other factors the Federal Reserve deems appropriate

The factors for making these determinations also differ depending on whether the company is a US or non-US company. The sidebar lists the factors that the Federal Reserve would consider in determining whether a US financial company is a Tier 1 FHC. The proposed legislation provides that the Federal Reserve, in consultation with Treasury and the Financial Services Oversight Council, would prescribe regulations containing these criteria and any others it deems appropriate.

The factors for identifying a foreign financial company are similar, except that:

- financial assets are limited to the company’s US financial assets;
- liabilities are limited to those used to fund the company’s US activities and operations;
- off-balance sheet exposures are limited to US-related off-balance sheet exposures;
- transactions and relationships are limited to those with other major US financial companies; and
- households, businesses and governments are limited to US households, businesses and state and local governments.

Similarly, the G-20 has tasked the Financial Stability Board with establishing supervisory colleges to identify systemically important cross-border firms. As a practical matter, the Federal Reserve would have to coordinate with these international efforts when designating a foreign financial firm as a Tier 1 FHC.

The designation of a company as a Tier 1 FHC would be reviewed annually and could be rescinded by the Federal Reserve. The Federal Reserve would be required to consult with the primary federal regulator for any company’s subsidiaries before designating a company as a Tier 1 FHC or rescinding such a designation.

The Federal Reserve's information gathering and related authority would be limited to financial companies with at least

- \$10 billion in assets
- \$100 billion in assets under management or
- \$2 billion in gross annual revenue

For foreign companies, the thresholds would be limited to amounts "in the United States."

Under the Federal Reserve's current regulations, a bank is generally

- **"well capitalized"** if it meets certain minimum risk-based capital ratios and, in the case of a foreign banking organization, with deference to how international capital guidelines are implemented by home country supervisors
- **"well managed"** if it received satisfactory composite and management ratings at its most recent examinations and, in the case of a foreign banking organization, based mainly on their US operations

The proposed legislation provides companies with a right to notice and an opportunity to be heard before being designated as a Tier 1 FHC or having such designation rescinded. Upon the company's receipt of a final order or regulation designating it as a Tier 1 FHC, the company would have 180 days to register as such with the Federal Reserve. The Federal Reserve, in its discretion, may extend both the registration deadline and the deadline for compliance with Tier 1 FHC standards. An emergency exception allows the Federal Reserve to waive or modify the notice and hearing requirements where such action is "necessary or appropriate to prevent or mitigate threats posed by the company to financial stability."

The Federal Reserve would be aided in the designation process by information collection and examination authority. The information gathering and related authority would be limited to the institutions described in the top sidebar. The proposed legislation would require that the Federal Reserve coordinate with the company's primary federal regulator to determine if the requested information is available from or could be obtained by that regulator. Each relevant federal agency is authorized to provide requested information to the Federal Reserve. The Federal Reserve would also have the authority to conduct an examination of any US financial company where the collected information proved insufficient to enable a determination of whether a Tier 1 FHC designation is warranted.

Enhanced Prudential Standards

As expected, the proposed legislation would establish standards that are more stringent than those applicable to bank holding companies and would include stricter risk-based capital requirements, leverage limits, liquidity requirements, and overall risk management requirements. The Federal Reserve would consult with the Financial Services Oversight Council regarding proposed regulations or guidance adopting, implementing or revising material prudential standards for Tier 1 FHCs.

The proposed legislation specifies, however, that at all times after registration a Tier 1 FHC will be required to satisfy the tests to be considered well capitalized and well managed. The adjacent sidebar summarizes the Federal Reserve's current definitions of "well capitalized" and "well managed" for bank holding companies. The Federal Reserve would have the power to adapt those definitions for Tier 1 FHCs, adding a consolidated leverage limit and possibly resulting in higher minimum capital ratios. Since there is no consolidated regulatory framework that imposes capital requirements on the holding companies of insurance companies, the proposed legislation could result in a new layer of capital requirements for any such holding company designated as a Tier 1 FHC.

This adds to the debate about whether Tier 1 FHC status will cause such firms to be competitively advantaged or disadvantaged by enhanced capital requirements.

In setting prudential standards for Foreign Tier 1 FHCs, the Federal Reserve would be required to give due regard to the principles of national treatment and equality of competitive opportunity. While Foreign Tier 1 FHCs' liquidity requirements will be limited to liquidity requirements for operations in the United States, the remaining standards are not so limited. In particular, Foreign Tier 1 FHCs would be required to comply with leverage capital limits. Under current law, the Federal Reserve has not required foreign banking organizations to satisfy any minimum leverage capital ratio in order to qualify as a financial holding company or to acquire a US insured depository institution. Instead, it has relied almost entirely on risk-based capital ratios, with leverage ratios only factoring into a general review of capital equivalency. The leverage ratio will also be addressed at the Basel Committee and is expected to be supported there.

The proposed legislation provides flexibility for the Federal Reserve, in prescribing prudential standards, to differentiate among Tier 1 FHCs. This "categorization and tiering" would be based upon consideration of risk, complexity, financial activities, financial activities of subsidiaries, and any other factor deemed appropriate to the Federal Reserve.

Under the Republicans' proposal, responsibility for establishing prudential standards would remain with an institution's primary federal regulator. These standards would be subject to the review of a newly proposed Market Stability and Capital Adequacy Board, which would make recommendations to functional regulators.

The term "functionally regulated subsidiary" means any:

- National bank and federal branch or federal agency of a foreign bank, for which the National Bank Supervisor would be the federal regulatory agency
- State-chartered bank, other than a member bank of the Federal Reserve System, and insured State branch of a foreign bank, for which the FDIC is the federal regulatory agency
- Savings association
- Broker or dealer registered with the SEC
- Investment company registered with the SEC
- Investment adviser registered with the SEC
- Futures commission merchant, commodity trading advisor and commodity pool operator registered with the CFTC

Back-up Authority for Functionally Regulated Subsidiaries of Tier 1 FHCs

As expected, the proposed legislation provides the Federal Reserve with back-up authority to prescribe more stringent prudential standards not only for holding companies but also for functionally regulated subsidiaries of Tier 1 FHCs. Therefore, the subsidiaries are also subject to the Federal Reserve's back-up reporting, examination and enforcement authority, potentially rendering oversight by the functional regulators largely duplicative.

- Before issuing regulations applicable to specific categories of functionally regulated subsidiaries, the Federal Reserve would be required to consult with the appropriate federal regulator for such subsidiaries.
- Federal Reserve orders regarding functionally regulated subsidiaries would be authorized only where:
 - the Federal Reserve has reasonable cause to believe the subsidiary poses a threat to financial stability,
 - the relevant federal regulator had been so notified in a writing, and

The Federal Reserve may require reports from a Tier 1 FHC and its subsidiaries about:

- the company's financial condition
- the company's systems for monitoring and controlling risks
- transactions by the company with depository institution subsidiaries
- the extent to which activities and operations pose a threat to financial stability
- compliance by the company or its subsidiaries with provisions of the proposed legislation and other law under the Federal Reserve's jurisdiction

A Tier 1 FHC would be required to submit periodic reports to the Federal Reserve on its:

- Plan for rapid and orderly resolution
- The nature and extent of its credit exposure to other Tier 1 FHCs
- The nature and extent to which other Tier 1 FHCs have credit exposure to it

The Federal Reserve would be required to use:

- Reports already provided to federal or state regulators
- Externally audited financial statements and other publicly reported information and
- Examination reports of Tier 1 FHCs and their functionally regulated subsidiaries already prepared by federal or state regulatory authorities

- the Federal Reserve has not received notification that the federal regulator has commenced the recommended supervisory action.

While the Administration's White Paper referenced liquidity "stress testing" and assessment of capital adequacy under stress scenarios, the proposed legislation does not mandate these actions. Instead, the Federal Reserve would have the discretionary authority to implement any of them, in consultation with the Financial Services Oversight Council.

Credit Concentration Limits

The proposed legislation would require the Federal Reserve to prohibit each Tier 1 FHC from having credit exposure, including on derivatives and credit default swaps, to any single unaffiliated company (or group of related companies) that exceeds 25% of the Tier 1 FHC's capital stock and surplus, or a lower amount to be specified by the Federal Reserve. The proposed legislation does not include any exceptions for fully or partially secured credit exposure, but the Federal Reserve would have the authority to exempt any transactions, in whole or in part, from the definition of credit exposure. The concentration limits called for under the proposed legislation would be subject to a 3-year transition period, along with a potential 2-year extension at the Federal Reserve's discretion.

Reporting and Examination Requirements

The proposed legislation gives the Federal Reserve broad authority to require reports from and to conduct examinations of a Tier 1 FHC and all of its subsidiaries. This would elevate the Federal Reserve as the only regulator with broad oversight over and deep knowledge of a range of institutions. The Federal Reserve's examination authority would extend to each US Tier 1 FHC and its subsidiaries and to any US subsidiary, branch, or agency of a Foreign Tier 1 FHC.

The proposed legislation authorizes the Federal Reserve to require, by regulation, periodic public disclosure by Tier 1 FHCs. There is no detail provided on what this public disclosure would entail. Nor is there any explanation of the interaction of this disclosure with the existing securities law disclosures applicable to most Tier 1 FHCs.

The proposed legislation would also give the FDIC broad access to any examination report produced by the Federal Reserve for a Tier 1 FHC or one of its subsidiaries. The FDIC would have back-up examination authority over Tier 1 FHCs, if it recommends an examination of a particular Tier 1 FHC and the Federal Reserve does not initiate such an examination.

Enforcement Authority of the Federal Reserve

The enforcement provisions of the proposed legislation extend certain provisions of the Federal Deposit Insurance Act, Sections 8(b) through 8(n), which apply to bank holding companies and their non-bank subsidiaries, to

Sections 8(b) through 8(n) of the Federal Deposit Insurance Act provide authority to:

- issue cease-and-desist orders
- require affirmative corrective action
- impose limitations on activities or functions
- apply to US district courts for injunctions to enforce outstanding notices or orders
- remove or suspend parties from office
- prohibit further participation by a party in any manner in the company's conduct or affairs
- impose civil money penalties

Tier 1 FHCs and their non-bank subsidiaries. This means that Tier 1 FHCs that have not otherwise been subject to the enforcement authority of the Federal Reserve would become subject to its enforcement authority in the same manner as a bank holding company.

Enforcement actions against a functionally regulated subsidiary would remain in the hands of the subsidiary's primary federal regulator. The Federal Reserve would only be permitted to initiate supervisory action or enforcement proceedings against a functionally regulated subsidiary if, after making a written recommendation, the primary federal regulator failed to initiate such action or proceedings.

Activities Restrictions

The draft legislation requires all Tier 1 FHCs to conform their non-banking activities to those that are permissible for a financial holding company under the Bank Holding Company Act. The non-banking activities that are permissible under the Bank Holding Company Act are generally limited to those that are financial in nature, incidental to a financial activity or complementary to a financial activity. The Bank Holding Company Act also permits certain qualifying foreign banking organizations to engage in any activity as long as it is conducted entirely outside the United States. The proposed legislation would extend these exemptions to all Foreign Tier 1 FHCs as if they were foreign banking organizations.

The proposed legislation would generally provide newly designated Tier 1 FHCs with a 5-year transition period within which to become compliant. During this 5-year grace period, they could continue to conduct non-conforming activities and retain non-conforming investments.

In the case of a US Tier 1 FHC that is “predominantly” engaged in nonfinancial activities, however, the proposed legislation would require it to restructure itself within 90 days after being designated as a Tier 1 FHC so that all of its financial activities are held through a single intermediate holding company. The legislation does not define “predominantly” for this purpose or provide any relief if such restructuring causes adverse tax consequences or is otherwise very costly to achieve within the 90-day period.

In the case of a US Tier 1 FHC that is “predominantly” engaged in nonfinancial activities, however, the proposed legislation would require it to restructure itself within 90 days after being designated as a Tier 1 FHC so that all of its financial activities are held through a single intermediate holding company.

The Federal Reserve would be able to immediately treat such an intermediate holding company as a Tier 1 FHC for purposes of its registration, prudential standards, reporting, public disclosure, examination

and enforcement authority. Such an intermediate holding company would also be treated as a member bank for purposes of the restrictions on transactions with affiliates under Sections 23A and 23B of the Federal Reserve Act.

This would create a competitive disadvantage for such Tier 1 FHCs because Sections 23A and 23B only impose limits on transactions between the insured depository institution subsidiaries of bank holding companies and their affiliates, and not on transactions by non-insured depository institution financial companies and their affiliates.

As a practical matter, a company that is predominantly engaged in nonfinancial activities would almost certainly find it impossible or undesirable to conform its activities to those that are permissible for financial holding companies if it were designated a Tier 1 FHC, unless the Federal Reserve dramatically expanded the range of permissible activities. As a result, such a company would have little choice but to terminate or divest its financial activities within the 5-year grace period in order to escape being designated as a Tier 1 FHC. The requirement that it segregate its financial from nonfinancial activities within 90 days after being designated a Tier 1 FHC is an implicit recognition that this will be its only practical course of action.

Limitations on Acquisitions

Under the proposed legislation, all Tier 1 FHCs would be subject to the restrictions on investments in insured depository institutions and bank holding companies that apply to bank holding companies under Section 3 of the Bank Holding Company Act. These restrictions would include the requirement to obtain the Federal Reserve's prior approval before making an investment in 5% or more of any class of voting securities of a US insured depository institution or bank holding company, thereby leveling the playing field between bank holding companies and Tier 1 FHCs that are not bank holding companies. Companies that are not bank holding companies or foreign banking organizations subject to the Bank Holding Company Act are generally required to obtain the Federal Reserve's prior approval only if they acquire "control" of a US insured depository institution or bank holding company.

The proposed legislation would also add a new factor for the Federal Reserve to consider in all Section 3 applications, whether they are filed by a Tier 1 FHC or any other applicant. The Federal Reserve would be required to "take into consideration the extent to which the proposed acquisition, merger, or consolidation would result in greater or more concentrated risks to the stability of the United States financial system or the economy of the United States." This would give the Federal Reserve authority to deny an application if it believed the proposed investment or acquisition would make the applicant too large or interconnected for the economic well-being of the United States.

The proposed legislation would also impose prior notice requirements on certain acquisitions of voting shares of large non-bank companies by a Tier 1 FHC that do not currently apply to regular financial holding companies. In particular, Tier 1 FHCs would be required to provide the Federal Reserve with advance written notice, pursuant to notice procedures set forth in the Bank Holding Company Act, before acquiring direct or indirect ownership or control of any voting shares of any company engaged in non-banking activities with \$10 billion or more in consolidated assets. The only exceptions to this prior notice requirement would be investments permitted by Section 4(c) of the Bank Holding Company Act, including Section 4(c)(6)'s exemption for 5% or less of voting shares, or made pursuant to the authority to engage in "underwriting, dealing in or making a market in securities" contained in Section 4(k)(4)(E) of the Bank Holding Company Act.

In reviewing any prior notice under this provision, the Federal Reserve would be required to consider the standards that currently apply to non-banking acquisitions that require prior approval under Section 4. The proposed legislation would also add a new factor to be considered – namely, whether the proposed acquisition "would result in greater or more concentrated risks to global or US financial stability or the global or US economy." But unlike the similar change to Section 3, this factor would not apply to all Section 4 applications, but only to applications for large non-banking acquisitions by Tier 1 FHCs. The proposed legislation would also require the Federal Reserve to deny any proposed acquisition requiring prior notice by a Tier 1 FHC if it is not well capitalized and well managed before and after the proposed acquisition.

The proposed legislation would also subject each Tier 1 FHC to the Depository Institutions Management Interlocks Act as though it were a bank holding company. This would limit the ability of a Tier 1 FHC to have directors and management who serve on the boards of, or serve as directors of, other Tier 1 FHCs and bank holding companies.

Regulating Foreign Tier 1 FHCs

Under the proposed legislation, the Federal Reserve and the Treasury Secretary would be required to consult with foreign counterparties and through multinational organizations to reach agreement to extend comprehensive and robust prudential supervision and regulation to all systemically important financial companies. This is the same concept endorsed by the G-20 in its [Declaration on Strengthening the Financial System](#). In regulating and supervising Foreign Tier 1 FHCs, the Federal Reserve is instructed by the proposed legislation to take into account the extent to which such companies are subject to comparable standards to those applicable to US Tier 1 FHCs.

If the Federal Reserve determines that a condition, practice or activity of a Foreign Tier 1 FHC does not comply with applicable law or regulation or otherwise threatens financial stability, the Federal Reserve, after notice and

an opportunity for a hearing, would be authorized to order the Foreign Tier 1 FHC to terminate the activities of any branch, agency or subsidiary in the United States. This is a significant power that would allow the Federal Reserve to order the termination of activities by a Foreign Tier 1 FHC that is not a bank holding company or is not otherwise regulated as such. Furthermore, the Federal Reserve would be permitted to deny any opportunity for a hearing upon a determination that expeditious action is necessary to protect the public interest.

Prompt Corrective Action for Tier 1 FHCs

The proposed legislation provides a detailed prompt corrective action regime for Tier 1 FHCs. The legislative proposal is largely imported into the Bank Holding Company Act from the Federal Deposit Insurance Act and mirrors the majority of the provisions applicable to depository institutions. However, as described below, the proposed prompt corrective action regime for Tier 1 FHCs deviates substantially from the Federal Deposit Insurance Act's approach to critically undercapitalized depository institutions by creating an involuntary bankruptcy regime to deal with such troubled Tier 1 FHCs.

The broad mandate provided by the legislation, like the Federal Deposit Insurance Act in respect of depository institutions, instructs the Federal Reserve to "take prompt corrective action to resolve problems" of any US Tier 1 FHC. In establishing the framework for its prompt corrective action regime, the proposed legislation introduces four key capital categories.

Generally, the relevant capital measures are the prudential standards that will be applicable to Tier 1 FHCs, including a leverage limit and a risk-based capital requirement. We expect that these capital measures will incorporate the concept of "critical capital" which reflects the current focus on tangible equity. The Federal Reserve is also authorized to establish additional relevant capital measures and to rescind those that are no longer appropriate. The proposed legislation assumes away the difficulty of devising capital standards for Tier 1 FHCs in widely divergent businesses.

Undercapitalized Tier 1 FHCs

The proposed legislation provides for prompt corrective action for undercapitalized Tier 1 FHCs that substantially mirrors the Federal Deposit Insurance Act's provisions for undercapitalized insured depository institutions.

An undercapitalized Tier 1 FHC will be required to submit an acceptable capital restoration plan to the Federal Reserve within a reasonable time to be established by regulation. Failure to submit a capital restoration plan or failure to implement the plan in any material respect will cause an undercapitalized Tier 1 FHC to become subject to the regime applicable to significantly undercapitalized Tier 1 FHCs.

Four key capital categories:

- Well capitalized,
- Undercapitalized,
- Significantly undercapitalized, and
- Critically undercapitalized.
- The Administration has eliminated all references to the Federal Deposit Insurance Act's "adequately capitalized" category
- Each of the four categories that is retained is defined by reference to a "required minimum level," which is to be established by the Federal Reserve by regulation, with respect to each relevant capital measure

Membership of the Administration's Proposed Financial Services Oversight Council:

- Treasury Secretary, who shall serve as the Chairman of the Council
- Chairman of the Board of Governors of the Federal Reserve System
- Comptroller of the Currency, and then, Director of the National Bank Supervisor
- Director of the OTS (temporary)
- Director of the Consumer Financial Protection Agency
- Chairman of the SEC
- Chairman of the CFTC
- Chairman of the FDIC
- Director of the Federal Housing Finance Agency

Membership of the Republicans' Proposed Market Stability and Capital Adequacy Board:

- Treasury Secretary, who shall serve as Chairman
- Chairman of the Federal Reserve Board of Governors
- Chairman of the SEC
- Chairman of the FDIC
- Chairman of the CFTC
- Chairman of the Financial Institutions Regulator
- Director of the Federal Housing Finance Agency (temporary appointment)
- Five private members of the Board to be appointed by the President and confirmed by the Senate

Significantly Undercapitalized Tier 1 FHCs

The prompt corrective action regime proposed for significantly undercapitalized Tier 1 FHCs also generally mirrors the Federal Deposit Insurance Act's corresponding provisions. The proposed legislation would provide the Federal Reserve with significant authority to affect the composition and compensation of management of a significantly undercapitalized Tier 1 FHC.

Tier 1 FHCs in Unsafe or Unsound Condition

Under the proposed legislation, the Federal Reserve would be authorized to impose strict requirements on any Tier 1 FHC that is determined to be in an unsafe or unsound condition or to be engaging in unsafe or unsound practices. Upon such a determination with respect to a well capitalized Tier 1 FHC, the Federal Reserve would be authorized to impose capital distribution restrictions upon the Tier 1 FHC and to subject the Tier 1 FHC to any of the actions available pursuant to the prompt corrective action regime for undercapitalized Tier 1 FHCs.

Mandatory Bankruptcy for Critically Undercapitalized Tier 1 FHCs

The proposed legislation disregards the Federal Deposit Insurance Act's treatment of critically undercapitalized institutions and proposes an entirely distinct regime.

Within 90 days of a Tier 1 FHC becoming critically undercapitalized, the Federal Reserve would be required to file a petition for bankruptcy against the Tier 1 FHC under the Bankruptcy Code or require the Tier 1 FHC to file a petition for bankruptcy under the Bankruptcy Code. The Bankruptcy Code would also be amended by the proposed legislation to authorize the Federal Reserve to institute an involuntary case against a Tier 1 FHC on the grounds that the Tier 1 FHC is critically undercapitalized.

These provisions would presumably be overridden if, as discussed in the section on Resolution Authority below, the Treasury Secretary made a determination that the resolution of the particular Tier 1 FHC would be systemically disruptive and that resolving the Tier 1 FHC under the proposed new resolution power would be preferable. But the proposed legislation does not clearly explain the interplay between these mandatory bankruptcy provisions and the proposed resolution authority.

Financial Services Oversight Council

The Administration's proposed legislation for the creation of a Financial Services Oversight Council gives the Council a largely advisory role without any enforcement authority to carry out its mission. The Republicans' proposed legislation calls for the creation of a Market Stability and Capital Adequacy Board, which would have a similar purpose to the Council. The Republicans' proposal would provide for a different membership structure and would expressly limit the Board's enforcement authority.

Powers and Duties of the Council

As monitor:

- Request and collect financial data from any US financial firm for risk-assessment purposes
- Receive information from other federal regulators
- Receive from the Federal Reserve information collected related to its role as systemic risk regulator
- Provide an annual report to Congress
- Meet at least quarterly, with as many additional meetings as the Chairman deems necessary
- Appoint special advisory committees

As administrator:

- Consult, where appropriate, with other agencies to carry out its mandate and to appoint special advisory committees, which may include non-Council members, to assist in carrying out its functions

As advisor:

- Consult on regulations and standards where the Fed is required to take certain actions, including prescribing rules for the designation of Tier 1 FHCs
- Make recommendations to the Federal Reserve for Tier 1 FHCs and Systemically Important Payment, Clearing and Settlement Activities
- Consult with Congress on financial regulation and recommend improvements to the financial markets and investor confidence
- The Treasury Secretary, as Chairman, to advise the President on the Council's operations

The limited powers of the Council, combined with the ability of the Federal Reserve to override it, will likely be the subject of continued criticism by those who seek to strengthen the Council and provide checks against the proposed power of the Federal Reserve as the systemic risk regulator.

As previously proposed, Treasury would provide the Council with its permanent staff. Combined with the Treasury Secretary's chairmanship, this continues to suggest a role for Treasury as "first among equals" on the Council.

In keeping with the White Paper, the Administration's legislative proposal provides for the Council's main responsibilities to include a monitoring function, an administrative function and an advisory function. It also provides the Council a role in coordinating rulemaking and enforcement actions, which may call into question the individual agencies' independence.

The Republicans' Proposal

The Republicans' proposal would also create a Market Stability and Capital Adequacy Board to observe the entire financial system and to identify systemic risks. The Board, which is explicitly denied any enforcement authority, would primarily monitor the interactions of various sectors of the financial system and identify risks with the potential to endanger the safety and soundness of the system.

In addition to regulators, the Market Stability and Capital Adequacy Board would include 5 private, Presidentially appointed members with no more than 3 private members from the same political party. One of the 11 Market Stability and Capital Adequacy Board positions would be reserved for an individual who has served as a state insurance commissioner or supervisor. The Market Stability and Capital Adequacy Board would be empowered to review certain insurance industry data in coordination with state regulators, a task assumed by the Office of National Insurance under the Administration's proposal (see "Office of National Insurance" below).

Resolution Authority

The Administration's proposed legislation establishing a federal resolution authority for bank holding companies and Tier 1 FHCs is virtually identical to the Administration's proposed legislation for systemically important financial companies released on March 25, 2009. Both are modeled on the specialized bank insolvency regime contained in Sections 11 and 13 of the Federal Deposit Insurance Act. The discussion below assumes familiarity with the Administration's original proposal, which is discussed in Davis Polk's memorandum, [Treasury's Proposed Resolution Authority for Systemically Significant Financial Companies](#), March 30, 2009. We will simply note the few differences between the two proposals and discuss the major outstanding issues.

Covered company:

- **All defined as “covered bank holding companies”:** Any bank holding company, Tier 1 FHC or any of their subsidiaries other than an excluded subsidiary, as to which a systemic determination has been made.
- **Tier 1 FHCs:** As noted above, a Tier 1 FHC can include any systemically important US or foreign company that is engaged directly or indirectly in any financial activity, including hedge funds, automobile, merchandising or other commercial companies, if they engage in any financial activity such as providing consumer credit.
- **Excluded subsidiaries** means any insured depository institution, SEC-registered broker-dealer or insurance company subsidiary.
- **Systemic risk determination** means a determination made by the Treasury Secretary on the eve of bankruptcy that resolving the covered company under the Bankruptcy Code would produce serious adverse effects on financial stability or economic conditions in the US and resolving the company under the proposed resolution authority would avoid or mitigate such adverse effects.

The House Republicans have rejected the concept of replacing the Bankruptcy Code with a resolution authority based on Sections 11 and 13 of the Federal Deposit Insurance Act. Their proposal would create a new Chapter 14 of the Bankruptcy Code to govern the resolution of insolvent non-bank financial institutions, regardless of size or systemic importance.

The Administration’s New Proposal for Resolution Authority

The Administration’s new proposal has only four material differences from its March proposal:

- A far broader definition of the companies that could be subject to the resolution authority (compare sidebar in this memorandum to sidebar on page 9 of Davis Polk’s memorandum, [Treasury’s Proposed Resolution Authority for Systemically Significant Financial Companies](#), March 30, 2009);
- The creation of a fund that would require bank holding companies and Tier 1 FHCs to bear the costs of providing any assistance to or otherwise resolving any covered company;
- A provision requiring the conservator or receiver of a covered company to coordinate with the appropriate foreign financial authorities regarding the resolution of any foreign subsidiary; and
- Only the FDIC or the SEC (and not the CFTC) could be appointed conservator or receiver of a covered company, and the SEC could only be appointed where the largest subsidiary of a covered company is an SEC-registered broker or dealer.

The fund that would be established to bear the costs of providing any assistance to or otherwise resolving any covered company would be called the Bank Holding Company Fund. The FDIC would be able to capitalize the fund by issuing debt securities to the Secretary of the Treasury and depositing the proceeds in the fund. The FDIC would have the power to recover the amount of any funds expended in connection with exercising the resolution authority by imposing assessments on bank holding companies and Tier 1 FHCs with non-FDIC assessed liabilities (e.g., excluding insured deposits) of more than \$10 billion as of the end of the previous calendar quarter. The FDIC, in consultation with the Federal Reserve, would be required to promulgate regulations to govern the fund.

The Republicans’ Proposal for Failed Non-Bank Financial Institutions

As noted above, the House Republicans have rejected the concept of replacing bankruptcy with a resolution authority based on Sections 11 and 13 of the Federal Deposit Insurance Act. Instead, the Republicans would create a new Chapter 14 of the Bankruptcy Code that would apply to the reorganization of non-bank financial institutions. A non-bank financial institution is defined as “an institution the business of which is engaging in financial activities that is not an insured depository institution.” What

Highlights of Republicans' Proposed New Chapter 14:

- **Consultation.** A non-bank financial institution may not be a debtor and a creditor may not commence an involuntary case under Chapter 14, unless it consults with the institution's functional regulator, the Market Stability and Capital Adequacy Board and any agency that administers a resolution regime for an affiliate that is excluded from the Bankruptcy Code (*e.g.*, the FDIC with respect to an insured depository institution).
- **Trustee.** If court determines that trustee is warranted, US Trustee must appoint a trustee from a list of qualified, disinterested persons provided by the Market Stability and Capital Adequacy Board, subject to court approval.
- **Automatic Stay.** Upon motion by the non-bank financial institution and with the approval of the Market Stability and Capital Adequacy Board or the bankruptcy court, protected contracts can be made subject to the automatic stay.
- **Liquidation.** A Chapter 14 reorganization can be converted to a Chapter 7 liquidation under the normal standards that apply to such conversions.

constitutes financial activities is not defined in the proposal and thus may be open to interpretation.

Cases administered under new Chapter 14 would be subject largely to the reorganization provisions of Chapter 11, with the exception of certain changes that purport to streamline the reorganization of a non-bank financial institution and reduce the adverse effects the reorganization may have on the larger financial system. Certain key provisions of proposed new Chapter 14 are highlighted in the sidebar.

The Republicans' proposal would also amend Section 364 of the Bankruptcy Code to prevent the United States from providing financing to an entity that operates its business under the protection of the Bankruptcy Code. Presumably, this would preclude the United States from providing debtor-in-possession financing.

Open Issues

Aside from its rejection by the House Republicans, the Administration's proposal leaves a lot of questions unanswered, including the following:

- **Changing the Rules of the Game on the Eve of Bankruptcy.** How can it ever be systemically less disruptive to change the "rules of the game" on the eve of bankruptcy from the Bankruptcy Code to the new resolution regime, since that change alone would seriously disrupt the reasonable expectations of customers, creditors, counterparties and other stakeholders who have very different rights under the Bankruptcy Code and the Federal Deposit Insurance Act on which the new resolution law is modeled?
- **Key Changes in the "Rules of the Game":**
 - Under FDIC policy, contingent claims (*e.g.*, under guarantees) are not provable;
 - *Ipsa facto* clauses are not enforceable;
 - All contracts can be repudiated, not merely executory contracts;
 - Security interests are avoidable, even if taken more than 90 days before insolvency and even if new value is given at the time the security interest is taken.
- **Legal uncertainty.** Because there is so little case law, legal commentary and FDIC guidance on certain key legal issues under the Federal Deposit Insurance Act, in the absence of a legislative mandate to promulgate clarifying rules under the proposed new resolution authority, creditors, counterparties and other stakeholders will find it extremely difficult to manage their credit risks to bank holding companies or Tier 1 FHCs if they might be resolved under the new resolution regime instead of the Bankruptcy Code. This

legal uncertainty could substantially increase the cost of credit to bank holding companies and Tier 1 FHCs. It is also substantially more harmful in the cross-border environment in which many Tier 1 FHCs operate.

- **What is the object of the proposed resolution law?** If one of its central goals is to give the government power to resolve systemically important financial groups like Bear Stearns, Lehman Brothers or AIG over which the government did not have resolution authority during the financial crisis, how is excluding the insurance or SEC-registered broker-dealer affiliates of such groups consistent with furthering that goal?

Because the new resolution authority is highly technical, the Administration should consider putting together a working group of public and private sector legal experts under the Bankruptcy Code and the Federal Deposit Insurance Act in order to make sure that the new resolution authority will do more good than it does harm.

Federal Reserve Emergency Authority

The Administration's proposed legislation would amend Section 13(3) of the Federal Reserve Act to require the Treasury Secretary's prior written approval to authorize the extension of credit by the Federal Reserve in "unusual and exigent circumstances" to individuals, partnerships, or corporations. This approval would supplement the existing requirement of approval by 5 or more members of the Federal Reserve Board. The change is intended to satisfy important legislative constituencies by placing some measure of accountability alongside the broad expansion of the Federal Reserve's power.

The Republicans' proposal would place further restrictions on the Federal Reserve's emergency authority. In using its emergency powers under Section 13(3), the Federal Reserve would be required to make the credit broadly available to entities within the market sector for which such authorization was being made. This presumably means that Section 13(3) could be used for programs like TALF, but not to provide financial assistance to individual firms as was done for AIG. The Republicans' proposal would also permit Congress, after notification from the Treasury Secretary, to reject the authorization of emergency powers through an expedited joint resolution process. If Congress enacts the joint resolution into law, the Federal Reserve would have 180 days from the date of authorization to discontinue and unwind the emergency facility.

The New National Bank Supervisor

Merger of OCC and OTS

The Administration's proposed legislation would merge the OCC and OTS into a new federal government agency called the National Bank Supervisor.

National Bank Supervisor

- To be housed in Treasury
- Would conduct prudential supervision and regulation of all federally chartered depository institutions and federal branches and agencies of foreign banks
- Would be headed by a single Director appointed by the President and confirmed by the Senate for a term of 5 years
- The Treasury Secretary would be responsible for appointing the Deputy Director
- The National Bank Supervisor Fund, supported by money received by the National Bank Supervisor, including fees from regulated institutions, would be used to pay for expenses
- Treasury would be permitted to invest excess amounts from the fund into debt guaranteed by the US government

Republicans' Proposed Financial Institutions Regulator

- Would be divided into a Federal Banking Division and State Banking Division
- Would inherit all the powers, duties and authority vested in the OCC and OTS
- Would take over the supervisory and regulatory functions of the Federal Reserve and FDIC
- Would include the National Credit Union Administration as a distinct entity
- Would include an Office of Consumer Protection to exercise all of the authority granted by the Consumer Credit Protection Act and to regulate consumer protection

The National Bank Supervisor would have the same duties and powers with respect to national banks and federal savings associations that had previously rested with the OCC and the OTS. The FDIC would become the primary federal regulator of state-chartered savings associations. All thrift holding companies would become bank holding companies subject to the Federal Reserve's jurisdiction and be required to conform their activities to the restrictions contained in the Bank Holding Company Act after a transition period described in more detail below.

The transfer of authority to the National Bank Supervisor and the FDIC would take effect one year after enactment of the legislation, unless the Treasury Secretary were to submit a written explanation to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services asking for an extension of no more than 6 months. The OCC and OTS would be abolished 90 days after the transfer took place.

The Republicans' proposed legislation for regulation and supervision of banks differs significantly from the Administration's proposed legislation. The legislation proposed by Republicans would abolish the OCC and OTS and establish a newly created Financial Institutions Regulator. The Republicans' proposed legislation would transfer all authority of the Federal Reserve and the FDIC to regulate depository institutions to the Financial Institutions Regulator, as described in the sidebar below. In contrast, the Administration's legislation would preserve the supervisory role of the Federal Reserve and the FDIC and would leave the National Credit Union Administration untouched.

In sharp contrast to the White Paper's proposal and the Administration's recently introduced legislation that would create a separate Consumer Financial Protection Agency, the Republican legislation would establish an Office of Consumer Protection within the Financial Institutions Regulator.

Restrictions on Switching Charters

The Administration's proposed legislation would restrict the ability of state banks to switch charters, but in contrast to the White Paper it does not propose to place restrictions on conversions of national banks into state banks or to further reduce the differences in the substantive regulations and supervisory policies applicable to national banks, state member banks and state nonmember banks. Under the proposal, the National Bank Supervisor would not be permitted to approve the conversion of a state bank to a national bank association during any period of time in which the state bank is subject to a cease and desist order, memorandum of understanding or other enforcement action entered into or issued by a state bank supervisor, the FDIC, the Federal Reserve or a Federal Reserve Bank. This legislation would reduce opportunities for regulatory arbitrage as well as ensure more effective monitoring and management of troubled banks.

Elimination of the Federal Thrift Charter

The Administration's legislation would eliminate the federal thrift charter. By contrast, while the Republicans' proposal would eliminate the OTS, it would not eliminate the thrift charter.

Under the Administration's proposed legislation, within 6 months of enactment, every existing savings association would be required to notify the OTS of its election to become one of four permissible entities:

- a national bank;
- a mutual national bank;
- a state-chartered bank; or
- a state-chartered savings association.

Within one year of enactment, each savings association would be converted into one of those entities, with federal savings associations being converted by operation of law into national banks or mutual national banks if they had not made elections or if their applications to become a state-chartered bank had not yet been approved. The OCC and the appropriate state banking agency would be permitted to impose such conditions on those new charters that they determined, in their sole discretion, were appropriate to assure safe and sound operation. The OTS and National Bank Supervisor would also be prohibited from chartering any new federal savings associations. In addition, effective one year after enactment, all state savings associations, cooperative banks, homestead associations and building and loan associations would be treated as state banks for purposes of federal banking law.

Following the 1-year conversion period, all thrifts would either be converted into national banks or, for those choosing to become state-chartered entities, would be treated as banks under the Bank Holding Company Act. As a result, thrift holding companies, which otherwise were not subject historically to the regulation of the Federal Reserve or the provisions of the Bank Holding Company Act, would find the regulatory regime under which they made their investments dramatically changed. This would be especially true for grandfathered unitary thrift holding companies, which were not previously subject to any activities restrictions, and which would be required during a transition period to conform their activities to those that are permissible under the Bank Holding Company Act.

Finally, the proposed legislation would limit federal regulation of state banks. Unless the Director of the National Bank Supervisor, the Federal Reserve, or the FDIC were to find that federal regulation was necessary to assure safety and soundness, none of them would be permitted to adopt or enforce any regulation that contravened the corporate governance rules prescribed by state law, or regulation, for state banks.

As part of the transition plan, converted entities will:

- have a 3-year transition period to hold non-conforming assets, engage in non-conforming activities, and proceed with loans that would otherwise be limited by statute;
- have a 5-year phase-in schedule to limit the “rapid expansion” of new powers in excess of the authorization of the Home Owners’ Loan Act and its implementing regulations relating to activities restricted by statute, e.g., activity that is subject to limits based on percentage of assets; and
- for all contracts and agreements, succeed to all the rights and obligations of the prior savings associations.

Transition Provisions

The elimination of the thrift charter would, of course, be a dramatic change to the US banking industry. As a result, the proposed legislation would give federal thrifts and state savings associations that convert into banks a 3-year transition period, beginning on the date of enactment, to hold nonconforming assets and engage in nonconforming activities that they were lawfully permitted to engage in prior to conversion – that is, assets that may not be held by, and activities that are not permissible for, national or FDIC-insured state banks, such as the investment powers of certain state savings associations and savings banks. The appropriate federal banking agency would be permitted to impose conditions, through regulation or order, on nonconforming activities or assets, and grant no more than two 1-year extensions from the 3-year period as it determines, in its sole discretion, to be appropriate to assure the safe and sound operation of the bank.

In addition, because under the thrift charter, thrifts historically have been subject to limitations on their activities that were not applicable to national and FDIC-insured state banks (such as the asset restrictions imposed by the qualified-thrift-lender test, which requires thrifts to maintain certain concentrations in mortgage and consumer assets), the proposed legislation provides a phase-in schedule for federal thrifts and state savings associations that convert to banks to exercise the expanded bank powers. The phase-in period depends on whether the historical limitation was based on a percentage of assets (such as the qualified-thrift-lender restrictions), or whether the historical limitation was an amount previously imposed by statute.

With respect to the former, the proposed legislation sets out a comprehensive phase-in schedule detailing permissible percentage increases over the 5-year period, subject to the bank’s receiving an exemption from the appropriate federal banking agency. Five years after the enactment of the legislation, the activities of such converted banks would be the same as national banks. For the phase-in schedule for activities limited in amount by statute, the proposed legislation would permit the appropriate federal banking agency to increase the permissible level of such activities by regulation or order.

The Administration’s legislation also deals with the implications of branches and agencies of depository institutions that become banks or are treated as banks once the legislation is enacted. Any depository institution that is a savings association at the date of the legislation’s enactment and becomes a bank before one year from the date of enactment or is treated as a bank pursuant to the legislation, and any depository institution or bank holding company that acquires that depository institution, may continue, after the depository institution becomes or commences to be treated as a bank, to operate any branch or agency that the savings association was operating as a branch or agency or was in the process of establishing on the date of enactment.

Expansion of Interstate Branching

In conjunction with eliminating the thrift charter, which allowed thrifts to enjoy the unrestricted ability to branch across state lines, the proposed legislation eliminates the remaining restrictions on interstate branching by national and state banks. Currently, many states require interstate entry only through the acquisition of an existing bank and prevent *de novo* branching into their states, or impose a minimum age requirement on in-state banks that can be acquired by an out-of-state banking firm.

The legislation proposes that the Director of the National Bank Supervisor have the power to approve an application by a national bank to establish and operate a *de novo* branch in a state in which the bank does not maintain a branch if the law of the state where the branch is located, or is to be located, would permit establishment of the branch if the national bank were a state bank chartered by such state. The legislation would remove the current limitation on interstate branching that requires that the host state have a law that applies equally to all banks and expressly permits all out of state banks to establish *de novo* branches in that state.

Similarly, the legislation would allow the FDIC to approve an application by an insured state nonmember bank to establish and operate a *de novo* branch in a state other than the bank's home state. In this way, the Administration's legislation expands the opportunities for interstate branching. As expected, the legislation would keep intact all consumer protections and deposit concentration caps with respect to interstate banking. Nevertheless, the relaxation of interstate branching rules opens the door to a greater expansion of national banking and the development of much larger banks, which could favor strong regional and superregional banks. As a result, one of the concerns that state regulators and others have voiced about this is that in extending the thrift charter's interstate branching rules to national and state banks and eliminating state-level restrictions on interstate branching, important checks on the scope of nationwide banking will be eliminated.

Expansion of Bank Holding Company Regulation

In one of the more significant aspects of its proposal, and as expected, the Administration's legislation would eliminate the ability for a holding company to own an insured depository institution subsidiary that is not a "bank" within the meaning of the Bank Holding Company Act – such as a savings association, industrial loan company, credit card bank, trust company and grandfathered non-bank bank – without being regulated as a bank holding company. The companies that continue to own such depository institution subsidiaries would become bank holding companies that would be required either to conform their activities to the non-banking activity restrictions of the Bank Holding Company Act or to divest control over such depository institution subsidiaries within a temporary transition period to be determined by the Federal Reserve. As described in the sidebar on the next page, the

A company that would be required to become a bank holding company by operation of law must:

- register as a bank holding company with the Federal Reserve within 90 days of the date of enactment of that act
- for any such company, the Federal Reserve may grant temporary exemptions or provide appropriate temporary relief to permit such company to implement measures necessary to comply with the requirements under the Bank Holding Company Act

proposed legislation does not provide any class grandfather relief, but only a quite short – when compared to the other transition periods in the legislation – transition period for compliance.

There is likely to be substantial opposition to these proposed changes. There is no evidence that any of these depository institutions, or the ability to own any of them without being treated as a bank holding company, had anything to do with causing the financial crisis, despite the assertion in the factual findings of the Administration's proposed legislation.

In addition to expanding the supervisory and regulatory authority of the Federal Reserve, the expansion of bank holding company regulation would have an enormous effect on those companies – insurance companies, commercial companies owning industrial loan companies, in particular – that currently control exempt insured depository institutions. Bank holding company supervision and regulation subjects such companies to the requirement to conform their non-banking activities to activities “closely related to banking,” or, if the companies elect “financial holding company” status, to activities financial in nature or incidental or complementary to a financial activity; to the imposition, at the holding company level, to the Federal Reserve's requirement that bank holding companies be a “source of strength” to their subsidiary depository institutions; to Federal Reserve capital standards and supervision and regulation; and to the Federal Reserve's enforcement powers under Section 8 of the Federal Deposit Insurance Act, among other supervisory burdens. Taken together, this heightened regulation will provide an extremely strong incentive to the divestiture of previously-exempt insured depository institutions, especially by commercial companies that own industrial loan companies and industrial banks.

The proposed legislation does not provide any grandfathering relief for any company that acquired one of these depository institutions in the past. Thus, the legislation will have an adverse retroactive effect, and not merely an adverse prospective effect. Worst hit will be holding companies, including grandfathered unitary thrift holding companies and commercial companies that use industrial loan companies or credit card subsidiaries to provide consumer finance, that have relied on the exemption for years if not decades.

Enhanced Standards for All Banks and Bank Holding Companies

The Administration's legislation builds on the White Paper's proposals for heightened capital and other prudential standards for all banks and bank holding companies, providing further details on certain proposals and introducing entirely new proposals that aim to provide more stability and strength to the banking system.

Heightened Regulatory Requirements for Financial Holding Companies

Bank holding companies wishing to qualify as a financial holding company under the Bank Holding Company Act would be required to satisfy well capitalized and well managed tests on a consolidated basis, not just at the level of their subsidiary insured depository institution. Consequently, the legislation would modify the authority of the Federal Reserve to issue regulations and orders to carry out the purposes of the Bank Holding Company Act to specifically include regulations relating to capital levels of bank holding companies.

Enhanced Supervisory and Regulatory Power of the Federal Reserve

The Administration's proposed legislation would remove the limitations on the Federal Reserve's ability to require reports from, examine, or impose higher prudential requirements or more stringent activity restrictions on the functionally regulated or depository institution subsidiaries of bank holding companies. The ability of the Federal Reserve to examine functionally regulated subsidiaries is broadened under the Administration's legislation by removing a number of conditions that were previously required for the Federal Reserve to make such examinations. The legislation further broadens the Federal Reserve's power by eliminating provisions that restrict the focus of the Federal Reserve's examinations of bank holding companies. The legislation would also require that the Federal Reserve use reports that have been required to be provided to other federal or state regulatory agencies, information that is required to be reported publicly and externally audited financial statements, to the fullest extent possible.

Enhanced Restrictions on Banks and Bank Holding Companies

Restrictions on Transactions with Affiliates

The legislation would expand the reach of Sections 23A and 23B of the Federal Reserve Act, extending those sections' restrictions to new types of transactions and eliminating certain statutory exemptions, while also limiting the Federal Reserve's discretion to provide exemptions from the statutes' reach.

The proposed legislation would redefine "affiliate" for purposes of Sections 23A and 23B so as to apply existing federal restrictions on affiliate transactions to any investment fund with respect to which a member bank or affiliate thereof is an investment adviser (clarifying that the investment adviser role is not limited by the definition of "investment adviser" in the Investment Company Act of 1940). This differs slightly from the language in the White Paper which proposed expanding the definition of "affiliate" to include investment vehicles sponsored or advised by the relevant insured depository institution.

In addition, the proposed legislation would require credit transactions between banks and their affiliates to be fully collateralized at all times, as opposed to merely at the time at which the credit transaction was entered

Under the proposed legislation, the definition of a "covered transaction" would be expanded to include:

- debt obligations, in addition to securities, issued by an affiliate as collateral security for a loan or extension of credit to any person or company;
- securities borrowing and lending transactions with an affiliate to the extent that the transactions create credit exposure for the member bank to the affiliate; and
- current and potential future credit exposure to an affiliate in derivative transactions with that affiliate.

into, thus requiring banks to post additional collateral over time if the market value of the collateral declined.

The proposed legislation also would eliminate certain exemptions relating to transactions between banks and their financial subsidiaries (which are deemed to be bank affiliates for purposes of Sections 23A and 23B). Covered transactions between a bank and an individual financial subsidiary would no longer be exempt from Section 23A's 10% of capital and surplus restriction for transactions with any one affiliate. In addition, a financial subsidiary's retained earnings would be included in the calculation of the amount that a bank had invested in the securities of such a financial subsidiary (thus increasing the amount of the covered transaction for purposes of the 10% limit). These changes would clearly provide incentives for banking organizations to conduct substantial "financial in nature" activities outside of the bank chain.

Finally, mirroring the White Paper proposal, the legislation would limit the Federal Reserve's discretion to provide exemptions from the coverage of Sections 23A and 23B. The Federal Reserve would not, by regulation or order, be permitted to grant an exemption from the statutory requirements unless the Federal Reserve had obtained the concurrence of the Chairman of the FDIC; and, with respect to a transaction involving an individual national bank, both the Director of the National Bank Supervisor and the Chairman of the FDIC.

Stricter Standards for Bank Acquisitions

The Administration's proposal includes new stricter standards for acquiring bank shares or assets. In considering whether to allow a proposed acquisition, merger or consolidation, the Federal Reserve would be required to consider the additional criterion of whether such proposed transaction would result in greater or more concentrated risks to the stability of the US financial system or the US economy.

In a significant departure from current bank holding company rules, the legislation would give the Federal Reserve the authority to approve an application of a bank holding company to acquire control of, or acquire all or substantially all of the assets of, a bank located in another state only if the bank holding company is well capitalized and well managed. This is a higher standard than the current requirement that such bank holding companies merely be "adequately" capitalized and managed. Furthermore, the legislation would also amend the Federal Deposit Insurance Act so that the responsible agency may approve an application for an interstate merger transaction only if it determines that the resulting bank will continue to be well capitalized and well managed upon consummation of the transaction, which again is a higher standard than the existing "adequately" capitalized and managed.

For purposes of lending limits between a national banking association and a person, the term “derivative transaction” means:

- Any transaction that is a contract, agreement, swap, warrant, note, or option
 - Based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices or other assets.

Fee Assessments

- Fees assessed by the National Bank Supervisor on national banks with less than \$10 billion in consolidated total assets must not exceed average fees assessed by the state for examinations on state banks of similar size.
- The proposed legislation does not provide a basis for the Federal Reserve or the FDIC to impose any new fees on community banks.
- The legislation would subject all banks, regardless of their charter, size or complexity, whose assets total more than \$10 billion, to the same fee assessment framework.
- The Federal Reserve and the FDIC would assess fees on state member banks and state nonmember banks, respectively, at rates that are identical to the rate that is assessed by the National Bank Supervisor.
- Any fees collected by the FDIC that are not used to defray the cost of examination are to be deposited into the Deposit Insurance Fund.

Limitations on Transactions with Insiders

While not proposed in the White Paper, the legislation would limit the ability of the Federal Reserve, by regulation, to make exceptions to what constitutes an “extension of credit” for purposes of the prohibition on a member bank’s ability to extend credit to its insiders. The Federal Reserve would not be permitted to exempt credit exposure arising from a derivative transaction, a repurchase agreement, reverse repurchase agreement, securities lending transaction or securities borrowing transaction between the member bank and the person.

In a related measure, the proposed legislation would prohibit an insured depository institution from purchasing an asset from, or selling an asset to, one of its executive officers, directors or principal shareholders or any related interest of such person unless the transaction is on market terms, and, if the transaction represents more than 10% of the institution’s capital stock and surplus, the transaction must be approved in advance by a majority of the institution’s board of directors without interested directors participating in the approval. The legislation gives the FDIC the authority to prescribe rules to implement these requirements.

Preemption of State Lending Limits; Enhanced Lending Limits

The proposed legislation would require all insured depository institutions to comply with national bank lending limits as if they were national banks, thus preempting state lending limits to the extent they are inconsistent with national bank lending limits.

The legislation would also expand the definition of “loans and extensions of credit” in the national bank lending limits to include credit exposure to a person arising from a derivative transaction (see top sidebar for definition of derivative transaction), repurchase agreement, reverse repurchase agreement, securities lending transaction or securities borrowing transaction between the national banking association and the person.

New Fee Assessments

The proposed legislation introduces a new element for reducing regulatory arbitrage by requiring that the Federal Reserve, FDIC and the National Bank Supervisor adopt joint rules on bank regulatory fees. The assessment of fees was not discussed in the White Paper proposal but is in line with the White Paper’s and the legislation’s overall emphasis on harmonizing the regulation of banks. The legislation prescribes asset-based fee assessments to fully defray the costs of examination and the agency’s operations, with lower fees to be assessed on national banks that have less than \$10 billion in consolidated total assets, and higher fees to be assessed on banks with more than \$10 billion in consolidated total assets.

The proposed asset-based assessment arrangement is also responsive to the view increasingly expressed in recent months that the community and

Key Payment, Clearing and Settlement Terms

- **“Designated activity”**: any payment, clearing or settlement activity that the Federal Reserve determines to be systemically important.
- **“Designated financial market utility”**: any financial market utility that the Federal Reserve determines to be systemically important.
- **“Financial market utility”**: any legal entity other than a natural person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and such entity.
- **“Financial institution”**: a depository institution, branch or agency of a foreign bank, organization operating under Section 25 or 25A of the Federal Reserve Act, credit union, broker, dealer, investment company, investment adviser, insurance company, futures commission merchant, commodity trading adviser, commodity pool operator or company engaged in activities that are financial in nature or incidental to a financial activity.
- **“Financial transactions”**: funds transfers, securities contracts, contracts of sale of a commodity for future delivery, forward contracts, repurchase agreements, swap agreements, foreign exchange contracts, financial derivatives contracts, and any similar transaction.
- **“Payment, clearing or settlement activity”**: any activity carried out by one or more financial institutions to facilitate the completion of financial transactions (as defined above), which activities may include calculation and communication of unsettled obligations between counterparties, netting of transactions, provision and maintenance of trade, contract or instrument information, management of risks and activities associated with continuing obligations, transmittal and storage of payment instructions, movement of funds, final settlement of obligations and similar functions.

national retail banks are the victims of the financial crisis and should not pay the same fees as larger banks.

Systemically Important Payment, Clearing and Settlement Systems

Payment, clearing and settlement systems may be the least romantic portion of the US financial system. Yet it is hard to imagine any segment of the US financial system that has the potential to be more systemically important. If any major operator of one of these systems failed or experienced a serious disruption, financial transactions around the country and the globe could grind to a halt.

One way to measure their systemic importance is to consider the mind-boggling volumes of transactions that the operators of some of these systems process. According to data posted on the Federal Reserve’s website, the average volume of dollar transfers processed by the Fedwire Funds Transfer System was approximately \$3 trillion per day in 2008. Assuming 250 business days per year, this translates into \$750 trillion per year. Yet only a fraction of the dollar payments made through the US and international banking system are processed through Fedwire. A substantial and largely unmeasurable volume of additional transactions is processed on the books of banks themselves or directly between correspondent banks, without going through Fedwire.

The securities settlement system processes similar volumes of securities transactions. According to data posted on the Federal Reserve’s website, the average volume of US government and agency securities transactions processed by the Fedwire Securities Service was \$1.6 trillion per day or \$419 trillion per year in 2008. Similarly, the Depository Trust Company, the principal US securities settlement system for US corporate securities, reported processing \$455 trillion of securities transactions in 2008. A substantial, and largely unmeasurable, volume of additional transactions is processed on the books of banks, brokers and other securities intermediaries, or directly between securities intermediaries, without going through Fedwire or DTC.

International securities settlement systems, mainly Euroclear and Clearstream, also process foreign and international securities transactions for US investors. Euroclear, the largest settlement system for internationally traded securities, reported a processing volume of €560 trillion in 2008, including transactions for US investors.

In light of the systemic importance of payment, clearing and settlement systems, it is not surprising that the Administration has proposed that the Federal Reserve should have additional authority over these institutions as part of its overhaul of the regulation of systemically important financial companies.

Systemic Importance

- “[A] situation where the failure of or a disruption to the functioning of a financial market utility or the conduct of a payment, clearing, or settlement activity could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the financial system.”

The criteria used to determine systemic importance are:

- The aggregate monetary value of transactions processed by the financial market utility or carried out through the payment, clearing, or settlement activity;
- The relationship, interdependencies, or other interactions of the financial market utility or payment, clearing, or settlement activity with other financial market utilities or payment, clearing, or settlement activities;
- The effect that the failure of or a disruption to the financial market utility or payment, clearing, or settlement activity would have on critical markets, financial institutions, or the broader financial system;
- The recommendation, if any, of the Financial Services Oversight Council; and
- Any other factors that the Federal Reserve deems appropriate.

The proposed legislation introduces several new terms, some of which are used in place of existing concepts. Certain newly defined terms are set out in the sidebar on the previous page.

The proposed legislation would principally give the Federal Reserve authority to set risk management standards for both systemically important financial market utilities and the conduct of systemically important payment, clearing and settlement activities by any financial institution. Most financial institutions conduct some form of payment, clearing or settlement function for their customers, including street name settlement, wire transfers, clearing bank operations and tri-party repurchase facilities. In addition, some of these institutions conduct these activities on a “multilateral” basis. Any bank, broker, insurance company or other financial institution that is not otherwise systemically important could have its payment, clearing and settlement business subject to the Federal Reserve risk management oversight if the business is found to be systemically important.

Designation of Systemic Importance

The Federal Reserve would have the authority to determine whether a financial market utility or payment, clearing, or settlement activity is, or is likely to become, systemically important, and has the authority to rescind that determination. In making this determination, the Federal Reserve must:

- consider the criteria set forth in the sidebar;
- consult with the Financial Services Oversight Council and the relevant primary regulator;
- provide advance notice;
- allow time for written comments; and
- conduct a hearing upon request.

However, the Federal Reserve may dispense with these procedures if it determines that emergency action is necessary to prevent or mitigate an immediate threat to the financial system. This “emergency exception” would enable the Federal Reserve to make an expedited designation of systemic importance. The Federal Reserve can invoke this exception without consulting the Council or other regulator.

Risk Management Standards

The legislation provides that the Federal Reserve, in consultation with the Council, the SEC and the CFTC, must prescribe risk management standards governing the:

- operations of systemically important financial market utilities; and
- conduct of systemically important payment, clearing and settlement activities by any financial institution.

Objectives of risk management standards:

- promote robust risk management
- promote safety and soundness
- reduce systemic risks
- support the stability of the broader financial system

Risk management issues that could be addressed:

- risk management policies and procedures
- margin, collateral, capital and default policies and procedures
- the ability to complete timely clearing and settlement of financial transactions
- other areas determined by the Federal Reserve to be necessary to achieve the objectives and principles of the risk management standards

The “Supervisory Agency” of a designated financial market utility may be the:

- SEC, for an SEC-registered clearing agency;
- CFTC, for a CFTC-registered derivatives clearing organization;
- FDIC, for an insured state nonmember bank or an insured branch of a foreign bank;
- OCC, for a national bank or a federal branch (other than an insured branch) or a federal agency of a foreign bank (to be replaced by the National Bank Supervisor);
- OTS, for a savings association or a savings and loan holding company (to be replaced by the National Bank Supervisor); or
- If the designated financial market utility is not primarily regulated by a Supervisory Agency, the Federal Reserve.

The objectives of these risk management standards, and the issues they could address, are set forth in the adjacent sidebar.

This authority would permit the Federal Reserve to address the most important systemic risks associated with payment, clearing or settlement systems, including credit, liquidity, business continuity, shortfall, finality and other risks. Shortfall risk is the risk that a settlement system has an insufficient pool of securities under its control at any point in time to satisfy the claims of all its entitlement holders at that time. Finality risk is the risk that participants in a payment, clearing or settlement system are unable to determine with legal certainty when a delivery or payment is unconditional, irrevocable and irreversible.

Operations of Designated Financial Market Utilities

As expected, the proposed legislation authorizes the Federal Reserve to open and maintain an account for a designated financial market utility and offer the designated financial market utility the same financial services, discount window and borrowing privileges as the Federal Reserve may provide to a depository institution under the Federal Reserve Act. The proposed legislation also gives the Federal Reserve the authority to exempt a designated financial market utility from the reserve requirements of Section 19 of the Federal Reserve Act.

This means that designated financial market utilities would have access to central bank money, meaning that it would be feasible for them to settle delivery-versus-payment transactions in US dollars on their own books, without going through intermediary banks. They would also be able to tap the Federal Reserve as a lender of last resort, should they have liquidity issues.

The proposed legislation requires a designated financial market utility to provide 60 days prior notice to its Supervisory Agency (as described in the adjacent sidebar) of any change to its rules, procedures or operations if the change could materially affect the nature or level of risks presented by the designated financial market utility. If there is a Supervisory Agency other than the Federal Reserve, it must consult the Federal Reserve before making any decision on a proposed change and provide the Federal Reserve a copy of all information it receives from the designated financial market utilities it oversees. If the Supervisory Agency objects to a change, the designated financial market utility may not implement it. However, a designated financial market utility may implement a change without giving advance notice if it determines there is an emergency and such immediate change is necessary for it to carry out its activities in a safe and sound manner. In this case, the Supervisory Agency may require modification or rescission of such change later on.

It is not clear how these rules will interact with the prior approval requirements for rule changes by registered clearing agencies under Section 19 of the Securities Exchange Act of 1934. One answer might be

The “appropriate financial regulator” of a financial institution engaged in a designated activity may be the:

- SEC;
- CFTC;
- FDIC;
- OCC;
- OTS;
- Federal Reserve;
- National Credit Union Administration Board;
- Applicable state insurance authority; or
- If the financial institution is not otherwise regulated by an appropriate financial regulator, the Federal Reserve.

that the prior approval requirements in Section 19 will be superseded by the new rules.

Examination, Enforcement and Reporting

The proposed legislation vests certain federal regulators with the authority to examine, take enforcement action against and require reporting by systemically important financial market utilities and financial institutions engaged in systemically important payment, clearing and settlement activities. The standards applicable depend on the type of institution or activity. The chart on the next page summarizes these powers.

	Systemically Important Financial Market Utilities	Financial Institutions Engaged in Systemically Important Payment, Clearing or Settlement Activities
Regulating Entity	Supervisory Agency	Appropriate Financial Regulator
Examinations	Required Annually	Permitted
Scope of Examination	<ul style="list-style-type: none"> The nature of the operations of, and the risks borne by, the designated financial market utility; 	<ul style="list-style-type: none"> The nature and scope of the designated activities engaged in by the financial institution;
	<ul style="list-style-type: none"> The financial and operational risks presented by the designated financial market utility to financial institutions, critical markets or the broader financial system; 	<ul style="list-style-type: none"> The financial and operational risks the designated activities engaged in by the financial institution may pose to other financial institutions, critical markets, or the broader financial system;
	<ul style="list-style-type: none"> The resources and capabilities of the designated financial market utility to monitor and control such risks; 	<ul style="list-style-type: none"> The resources available to and the capabilities of the financial institution to monitor and control risk;
	<ul style="list-style-type: none"> The safety and soundness of the designated financial market utility; 	<ul style="list-style-type: none"> The financial and operational risks the designated activities engaged in by the financial institution may pose to the safety and soundness of the financial institution;
	<ul style="list-style-type: none"> The designated financial market utility's compliance with the legislation and rules and regulations; and 	<ul style="list-style-type: none"> The designated financial market utility's compliance with the legislation and rules and regulations; and
	<ul style="list-style-type: none"> Extends to affiliates and third parties providing services integral to the operation of the designated financial market utility. This would subject joint ventures and outsourced technical and operational service providers to examination. 	<ul style="list-style-type: none"> Does not explicitly extend to affiliates and third parties providing services integral to the operation of designated activities engaged in by the financial institution.
Enforcement	Subject to the provisions of sections 8(b)-(n) of the Federal Deposit Insurance Act (see sidebar on page 8) to the same extent as if the designated financial market utility were an insured depository institution for which the Supervisory Agency is the appropriate federal banking agency.	The appropriate financial regulator shall take actions it deems necessary to ensure compliance with the legislation and rules and regulations. If the Federal Reserve takes enforcement action, subject to the provisions of Sections 8(b)-(n) of the Federal Deposit Insurance Act (see sidebar on page 8).
Federal Reserve Involvement	<ul style="list-style-type: none"> Supervisory Agency required to consult regarding examinations; May elect to participate in any examination led by a Supervisory Agency; May recommend enforcement by the Supervisory Agency; May refer disputes over instituting enforcement action to the Council for mediation; May exercise enforcement authority if Council does not resolve dispute; and May take immediate action if the action or condition of a designated financial market utility poses an imminent risk of substantial harm to financial institutions, critical markets or the financial system overall. 	<ul style="list-style-type: none"> Technical assistance as may be required by the appropriate financial regulator; Appropriate financial regulator may request Federal Reserve participation in examination; Appropriate financial regulator may request that Federal Reserve initiate enforcement action; Has discretion whether to initiate enforcement action upon request; and Subject to certain limitations, may unilaterally conduct examination and/or initiate enforcement action.
Reporting	<ul style="list-style-type: none"> Frequency and form to be prescribed by the Federal Reserve. To assess safety, soundness and systemic risk. 	<ul style="list-style-type: none"> Frequency and form to be prescribed by the Federal Reserve. Solely with respect to the conduct of the designated activity. Solely to assess whether the risks to the financial system presented by the activity are appropriately regulated and whether the activities of the financial institution comply with applicable regulations.

Asset-Backed Securitization Reform

Like the White Paper, the proposed legislation takes a two-pronged approach to the reform of the securitization markets. First, the proposed legislation aims to strengthen underwriting standards by requiring originators and securitizers to retain some of the risk of the loans they extend or package as part of an asset-backed securities securitization chain. These “skin-in-the-game” provisions would reduce the incentives for originators and securitizers to fund loans regardless of the borrower’s ability to pay, as is alleged to have occurred frequently in the subprime mortgage market. Second, the proposed legislation aims to make the asset-backed securities investment process itself more transparent through a combination of disclosure by asset-backed securities issuers and improved information dissemination by credit rating agencies.

Retention of Risk by Loan Originators and Securitizers

In a typical securitization, loan originators extend credit to borrowers and sell the income stream from that loan to a securitizer, who packages it along with many similar loans in a special purpose vehicle. Slices of the special purpose vehicle’s income stream are sold to investors as asset-backed securities. Securitization technology is meant to spread risk; instead of trapping capital at the lender level by requiring a lender to hold all of the credit risk of a loan until its maturity, securitization allows a lender to sell the loan immediately and use the funds received to originate new loans. Securitization has led to an enormous increase in the availability of credit financing for businesses and individuals over the past two decades and, as such, has been a major engine of economic growth.

However, a loan originator’s ability to relieve itself of the credit risk of individual borrowers through securitization can also reduce that originator’s incentive to only make loans that the borrower is likely to be able to repay. In the extreme, if a lender retains no risk and is compensated for making loans regardless of repayment by the borrower, there may be no incentive for the lender to determine the creditworthiness of the borrower. Allegations of such behavior in the subprime mortgage market (so-called “no-doc” loans, for example) led the Obama Administration to propose requiring originators and securitizers of loans to retain some of the risk in the loans they sell as part of the securitization chain.

The proposed legislation instructs the SEC and the federal banking agencies (the Federal Reserve, the National Bank Supervisor and the FDIC) to enact regulations requiring securitizers to keep 5% of the risk of loans packaged in securitization transactions. The regulators will specify permissible forms of risk retention. For example, the regulations may require a first loss position or a *pro rata* slice, either horizontal (e.g., 5% on a given tranche) or vertical (across all tranches). It separately provides for the enactment of regulations to allocate risk between originators and securitizers. Securitizers would not be allowed to hedge or otherwise reduce the risk they are required to hold by these regulations. The federal

banking agencies would be empowered to exempt originators and securitizers from these regulations or change the risk threshold when that would “ensure high quality underwriting standards for securitizers and originators of assets” and “facilitate appropriate risk management practices by such securitizers and originators, improve access of consumers to credit on reasonable terms or otherwise serve the public interest.” The regulations would apply to insured depository institutions but would allow for exemptions for asset-backed securities issued or guaranteed by the United States, a US agency, or US Government Sponsored Enterprise (“**GSE**”).

There are three notable differences between the proposed legislation and the securitization agenda laid out by the Administration in the White Paper. First, the proposed legislation imposes a 5% risk retention requirement only on the securitizer, while the White Paper proposed a 5% risk retention requirement on “sponsors [*i.e.*, securitizers] or originators.” Second, the proposed legislation does not directly address the White Paper’s recommendation that compensation for originators and securitizers be aligned with long-term performance. While the proposed legislation does implicitly tie compensation to performance through the risk retention mechanism, additional recommendations, such as amending Generally Accepted Accounting Principles to eliminate immediate recognition of gain on loan sales, consolidating asset-backed securities on the balance sheet and reflecting securitized assets on the issuer’s consolidated financial statements, are outside the scope of the legislation. However, the combination of the regulators’ choice of permissible risk retention and accounting rules may nonetheless require on-balance sheet treatment. Third, the allowance for exemptions for asset-backed securities issued or guaranteed by the United States, a US agency, or GSE, not present in the White Paper, presumably indicates trust in the ability of the US government and GSEs to avoid the conflict of interest problems in the private credit market, as well as reflects the Administration’s desire to retain the positive aspects of securitization (such as the ability to stimulate home buying through the GSEs) where possible.

Improving Transparency of Asset-Backed Securities

The proposed legislation implements the White Paper’s calls for increased disclosure to improve the transparency of the asset-backed securities market. The proposed legislation would amend Section 15 of the Exchange Act to require additional disclosure by asset-backed securities issuers, specifically requiring these issuers to provide tranche- or security class-level disclosure on the underlying assets of that tranche or security class, and asset- or loan-level disclosure including the broker or originator of the loan, the form in which that broker or originator is compensated and the amount of risk the broker or originator retains. This would allow asset-backed securities investors to perform their own diligence on asset-backed securities rather than relying on credit rating agencies’ determinations. The proposed legislation would also remove asset-backed securities from the exemption from Exchange Act filings for securities held by less than 300

Functions of the Office of National Insurance

- Monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the US financial system;
- Recommend to the Federal Reserve that it designate an insurer, including its affiliates, as an entity subject to regulation as a Tier 1 financial holding company;
- Assist Treasury in administering the Terrorism Risk Insurance Program;
- Coordinate federal efforts and establish federal policy on prudential aspects of international insurance matters, including representing the United States as appropriate in the IAIS and assisting Treasury in negotiating international insurance agreements on prudential measures;
- Determine whether state insurance measures are preempted by international insurance agreements on prudential measures;
- Consult with the states regarding insurance matters of national importance and prudential insurance matters of international importance;
- Perform such other related duties and authorities as may be assigned to it by Treasury; and
- Advise the Treasury Secretary on major domestic and prudential international insurance policy issues.

persons, although the SEC would be given the power to suspend this requirement when in the interest of investors and the public. Furthermore, the proposed legislation would remove the Securities Act registration exemption for certain mortgage-backed securities. Finally, under the proposed legislation, asset-backed securities issuers would be required to provide data on fulfilled repurchase requests across all trusts of the issuer and credit rating agencies would be required to include in their reports a description of the representations, warranties and enforcement mechanisms of the asset-backed security and any difference between those and similar issuances. This information would allow investors to compare the riskiness of asset-backed securities between and within issuers. It should be noted, however, that the proposed legislation does not directly address the concern in the White Paper of the overreliance of regulators on credit ratings of asset-backed securities.

Office of National Insurance

The Administration's draft legislation would create an Office of National Insurance within Treasury. The Office of National Insurance would be headed by a director, to be appointed by the Treasury Secretary, and would be responsible for the functions specified in the sidebar. Although not the optional federal regulator for which some in the insurance industry continue to lobby, the Office of National Insurance would have real, albeit limited, powers and could portend increased federal involvement in the insurance industry. See Davis Polk's memorandum, [The Debate Over Federal Insurance Regulation](#), April 14, 2009. The text of the bill partly parallels that of the [Insurance Information Act](#), introduced on May 21, 2009 by Rep. Paul Kanjorski.

The scope of the Office of National Insurance's powers would extend to all lines of insurance except health insurance. In order to serve the functions described herein, it is given authority, with subpoena powers, to collect information from insurers (of a threshold size) and their affiliates. The Office of National Insurance would be required to coordinate with the applicable state regulator (or regulatory agency) to determine if any requested information can instead be obtained from or by such regulator.

The legislation provides the Treasury Secretary with the explicit authority to negotiate and enter into international insurance agreements on prudential measures. Currently, representatives from 56 US jurisdictions as well as the National Association of Insurance Commissioners participate in International Association of Insurance Supervisors activities, which can complicate the development of a uniform US perspective on insurance matters.

Preemption of State Insurance Laws

The Office of National Insurance would be given authority to preempt any state insurance law if, and to the extent that, such law:

- treats a non-US insurer domiciled in a foreign jurisdiction that is subject to an international agreement on prudential measures less favorably than it treats a US insurer authorized in the state and
- is inconsistent with an international agreement on prudential measures.

Although the scope of what constitutes a “prudential measure” is not specifically defined, it seems likely to encompass regulation regarding risk assessment and management, investments and capital adequacy.

Before preempting a state law, the Office of National Insurance must publish notice of the inconsistency and the preemption in the Federal Register and provide for a comment period. Even with these procedural impediments, the preemption power could have significant implications if used assertively. Under the proposed legislation, however, the Office of National Insurance will have no authority to preempt state laws governing rates, premiums, underwriting or sales practices, coverage requirements or the application of antitrust laws.

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- [Administration's Regulatory Reform Agenda Moves Forward: National Bank Supervisor and Resolution Authority Legislation Sent to Capitol Hill](#) (July 23, 2009)
 - [Title I—Financial Services Oversight Council](#)
 - [Title II—Consolidated Supervision and Regulation of Large, Interconnected Financial Firms](#)
 - [Title III—Improvements to Supervision and Regulation of Federal Depository Institutions](#)
 - [Title V—Office of National Insurance](#)
 - [Title VI—Further Improvements to the Regulation of Bank Holding Companies and Depository Institutions](#)
 - [Title VIII—Payment, Clearing and Settlement Supervision](#)
 - [Title IX—Additional Improvements to Financial Markets Regulation](#)
 - [Title XII—Enhanced Resolution Authority](#)
 - [Title XIII—Additional Improvements for Financial Crisis Management](#)
- [Republicans Introduce Comprehensive Financial Regulatory Reform Legislation](#) (July 23, 2009)
- [A New Foundation for Financial Regulation?](#) (June 22, 2009)
- [White Paper on Financial Regulatory Reform](#) (June 17, 2009)



This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and should not be relied upon as legal advice.

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