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U.S. Financial Regulatory Reform – Implications for Banking Institutions

On June 17, 2009, the Department of Treasury ("Treasury") released a broad financial reform plan ("Plan") that recommends changes that would have a significant impact on the financial industry.[1] This client alert summarizes the key components of the Plan that will affect the way banks and financial institutions conduct business.

Proposed Regulatory Reforms

Federal Reserve as Systemic Risk Supervisor

The Plan assigns to the Board of Governors of the Federal Reserve System ("Federal Reserve") the task of being the U.S. systemic risk supervisor. Specifically, the Plan creates the category of a "Tier 1 Financial Holding Company" ("Tier 1 FHC"), which designation would be imposed on any financial firm, that based on a combination of size, leverage, and interconnectedness would make its failure a system risk. The Federal Reserve's ability to designate any financial firm as a FHC is a stark departure from decades of precedent under the Bank Holding Company Act of 1956, as amended ("BHCA"). As it currently stands, the BHCA subjects to Federal Reserve consolidated supervision only entities that control banks.

A Tier 1 FHC would be subject to the consolidated supervision of the Federal Reserve. The Federal Reserve would impose on any Tier 1 FHC more robust capital, risk management, liquidity, and prompt corrective action standards than those imposed on Bank Holding Companies. In addition, Tier 1 FHCs would be subject to the nonbanking activities restrictions of the BHCA. We expect that the Federal Reserve will impose the designation on highly leveraged entities, such as systemically important insurers or financing companies. The Plan provides for authority to resolve a failing Tier 1 FHC, and the Federal Reserve would require each Tier 1 FHC to prepare and continuously update a credible plan for the rapid resolution of the firm in the event of severe financial distress. Further, the Plan notes that forthcoming legislation will propose the criteria that the Federal Reserve must consider in identifying Tier 1 FHCs.

The designation of the Federal Reserve as the systematic risk supervisor has drawn the most fire from Congress. Concerns are that the Federal Reserve has not shown itself capable of the job in light of its recent performance, the effect of centralizing power, and the effect of this power on the Federal Reserve's independence.

Financial Services Oversight Council

The Plan recommends the creation of a new interagency body, called the Financial Services Oversight Council ("Council"), which would replace the President's Working Group on Financial Markets. The Council would have eight members including the heads of the securities, commodities, and federal banking regulators with the

[1] Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation, available at: http://www.financialstability.gov/roadtostability/regulatoryreform.html.

Treasury acting as Chair of the Council. Each member regulatory agency would retain "exclusive jurisdiction to issue and enforce rules to achieve its mission." The Council would be located within, and staffed by, Treasury. The Council would have the authority to gather information from any financial firm, refer emerging risks to the attention of regulators, and make recommendations regarding firms that should be regulated as Tier 1 FHCs.

Although the Council appears to have significant powers, its powers are limited to an advisory role. The Federal Reserve gains much more authority to regulate and supervise financial companies under the Plan.

Other Changes to Bank Holding Company Regulation

As noted above, even non-BHCs may be subjected to Federal Reserve Consolidated Supervision by being designated as Tier 1 FHCs. Moreover, the Plan recommends closing loopholes in the BHCA that allowed companies controlling thrifts, industrial loan companies, credit card banks, trust companies, and grandfathered "nonbank banks" to avoid regulation as a BHC. Companies sought to avoid BHC designation to avoid Federal Reserve consolidated supervision and to remain free from the BHCA's nonbanking prohibitions. The Plan recommends that any company that controls an insured depository institution be required to register as a BHC. Before the current financial crisis radically altered the landscape, several investment banks had avoided BHC registration while owning insured depository institutions by owning Utah industrial loan companies.

Five-Year Grace Period for Tier 1 FHCs and Nonbank Holding Companies

Tier 1 FHCs and nonbank holding companies would be given five years to conform all of their activities to the BHCA. This will likely cause FHCs and nonbank holding companies to spin-off and divest interest in companies that do not qualify under the BHCA.

Stronger Capital Requirements for All Financial Firms

The Plan calls for all financial companies to be "well capitalized" and "well managed" on a consolidated basis in order to engage in the "financial in nature" activities permitted under Section 4(k) of the BHCA. Currently, only subsidiary banks must meet these standards.

The Plan recommends the Treasury create a working group to conduct a "fundamental reassessment" of existing capital requirements, with a report to be issued by December 31, 2009. The Working Group would address implicit exposure to off-balance-sheet vehicles, trading assets, structured credit products, over-the-counter ("OTC") derivatives (if not centrally cleared), equity investments, and Tier 1 capital instruments. The review will also address changes to the existing capital framework to reduce "procyclicality" and focus on the importance of developing a "simpler, more transparent measure of leverage for banks and BHCs to supplement risk-based capital measures."

Reorganization of Federal Bank Supervision

New National Bank Supervisor

The Plan calls for a "National Bank Supervisor", which in essence merges the Office of the Comptroller of the Currency and the Office of Thrift Supervision. The National Bank Supervisor would regulate all federally-chartered banks. The National Bank Supervisor would have separate status within Treasury and would have a single executive.

Elimination of the Office of Thrift Supervision and Federal Thrift Charter

The Plan recommends the elimination of the federal thrift charter created in the Home Owners' Loan Act of 1933. The Plan does not eliminate state-chartered thrifts.

Interstate Branching

The Plan calls for the elimination of the remaining restrictions on interstate branching by national and state banks. States would not be allowed to prevent *de novo* branching into their states, or to impose a minimum requirement on the age of in-state banks that can be acquired by an out-of-state banking firm.

Further, the Plan recommends a reduction in the differences in the substantive regulations and supervisory policies applicable to national banks, state member banks, and state nonmember banks. The Plan proposes to restrict the ability of troubled banks to switch charters and supervisors. This restriction means that differences in the regulatory treatment between a national bank and state bank would be further reduced.

Strengthen Sections 23A and 23B of the Federal Reserve Act

Sections 23A and 23B place limitations on transactions between a bank and its affiliates and are designed to protect a depository institution from suffering losses in its transactions with affiliates. The Federal Reserve implements these statutory provisions for all depository institutions and has the power to provide exemptions from these provisions.

The Plan calls for more effective constraints on the ability of banks to engage in OTC derivatives and securities financing transactions with affiliates. Covered transactions between banks and their affiliates would be required to be fully collateralized throughout the transaction's life. Existing federal restrictions on transactions between banks and affiliates would be applied to transactions between a bank and all private investment vehicles sponsored or advised by the bank. The Federal Reserve's discretion to provide exemptions from the bank/affiliate firewalls would be limited.

Proposed Non-U.S. Bank Regulation

There are few specific references to non-U.S. banks. The Plan exhorts other nations' supervisors to strengthen their own supervisory systems in terms of capital adequacy, prudential supervision and the like. The references the Plan makes regarding non-U.S. banks relate to the determination of FHC status for non-U.S. banks. Further, although the Plan changes the FHC eligibility requirements, it does not propose to dictate the manner in which those requirements are applied to foreign financial firms with U.S. operations. The Plan proposes to permit the Federal Reserve, in consultation with Treasury, to determine how to apply these new requirements to foreign banks that seek FHC status. The Federal Reserve will make its determination giving due regard to the principle of national treatment and equality of competitive opportunity. The Federal Reserve could, for example, apply the "well capitalized" and "well managed" standards to a non-U.S. bank that owns or controls a U.S. bank but does not operate any branches or agencies in the United States.

Going Forward

The Department of the Treasury's Plan with respect to the regulation of the banks and financial institutions provides the outline of a more comprehensive approach. Some proposals make a significant change from current practices, while others are more incremental. Many significant details will need to be worked out in the legislative process. We will provide further alerts as legislation develops.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

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