

## **Financial Regulatory Reform—The Obama Administration Proposal**

**June 19, 2009**

On June 17, 2009, the Obama administration released its recommendations to reform the financial regulatory system: *Financial Regulatory Reform—A New Foundation: Rebuilding Financial Supervision and Regulation*. Describing the regulatory gaps that led to the economic crisis the country is now facing, the administration's recommendations are designed to achieve five key objectives: (1) promote robust supervision and regulation of financial firms, (2) establish comprehensive supervision and regulation of financial markets, (3) protect consumers and investors from financial abuse, (4) improve tools for managing financial crises, and (5) raise international regulatory standards and improve international cooperation. In the proposed plan, which is a blend of legislative initiatives and elements that could be imposed by regulatory fiat, the administration will attempt to shift the focus of financial regulation from the safety and soundness of individual institutions to the interconnections between financial firms and the financial system as a whole.

The wide-ranging proposal also touches on the supervision and regulation of hedge fund advisors and money market mutual funds, the securitization markets, credit default swaps, and OTC derivatives.

The administration's proposal will be subject to extensive review, negotiation, and discussion by Congress as well as by financial regulators and industry experts, which could well produce legislation that differs greatly from the administration's proposal. These negotiations will play out while a congressionally mandated committee starts work assessing the causes of the 2007–2009 financial crisis, and federal and state banking agencies continue to fill perceived gaps and shortcomings in their regulatory and supervisory performance.

### **Creation of a Financial Services Oversight Council**

The recommendations, which were issued by the U.S. Department of the Treasury (Treasury Department), include the creation of a Financial Services Oversight Council. The Council will be chaired by the Treasury Department and its members will consist of heads of the principal federal financial regulators. Its responsibilities would include identifying emerging risks in the financial markets, advising the Federal Reserve as to financial firms whose failure could pose a threat to financial stability, and providing a forum for jurisdictional disputes between regulators.

### **Increased Authority of the Federal Reserve and Supervision of Tier 1 FHCs**

Citing the failure of AIG, the recommendations propose a significant increase in the authority of the Federal Reserve to regulate nonbanking firms. Specifically, "all large, interconnected firms whose failure

could threaten the stability of the system” (hereafter referred to as Tier 1 FHCs) will be regulated by the Federal Reserve regardless of whether they own an insured depository institution. The Federal Reserve has been directed to develop rules to define a Tier 1 FHC, and the proposal suggests that the Federal Reserve consider the firm’s “criticality as a source of credit” and its combination of size, leverage (including off-balance sheet exposure), and reliance on short-term credit, as well as the impact its failure would have on the financial system. Once a financial firm is designated as a Tier 1 FHC, the Federal Reserve would be vested with examination authority over the firm.

The capital, liquidity, and risk management standards imposed on a Tier 1 FHC will be more stringent than the standards imposed on other financial firms, including the standards imposed on bank holding companies. Such supervision will extend to the parent company and all of its subsidiaries (including unregulated and international subsidiaries). A Tier 1 FHC would be subject to capital requirements, a prompt corrective action regime that would require the firm or its supervisors to take prompt corrective action if capital levels decline, liquidity standards, and stress tests. The prompt corrective action regime would mirror the existing regime for insured depository institutions established under the Federal Deposit Insurance Corporation (FDIC) Improvement Act. Tier 1 FHCs would also be subject to restrictions on nonfinancial activities as set forth in the Bank Holding Company Act and would need to prepare and continually update a “credible plan” for the dissolution of the company in the event of “severe economic distress.”

### **Authority of Treasury Department to Institute Orderly Resolution of Failing Companies**

The administration also proposed the creation of a resolution regime to allow for the orderly resolution of failing bank holding companies (including Tier 1 FHCs) in situations where the stability of the financial system is at risk. Either the Treasury Department or the Federal Reserve would be able to initiate the resolution process. When the largest subsidiary of the failing firm is a broker-dealer or securities firm, the FDIC or the Securities and Exchange Commission (SEC) would also be permitted to initiate the process. The proposal emphasized that bankruptcy is the “dominant tool” for dealing with failed institutions; however, the resolution regime would be implemented for “extraordinary times.”

To invoke this authority, the Treasury Department would have to determine that “(1) the firm is in default or in danger of defaulting; (2) the failure of the firm and its resolution under otherwise applicable law would have serious adverse effects on the financial system or the economy; and (3) use by the government of the special resolution regime would avoid or mitigate these adverse effects.” After making that determination, the Treasury Department would still need to consult with the President and obtain the written recommendation of two-thirds of the members of the Federal Reserve Board **and** two-thirds of the members of the FDIC Board, to decide whether to resolve a failing firm under the special resolution regime. In the event that the largest subsidiary of the failing firm (measured by total assets) is a broker-dealer, then FDIC Board approval is not required and two-thirds of the commissioners of the SEC must approve the action. If the failing firm includes an insurance company, the Office of National Insurance would provide consultation to the Federal Reserve and the FDIC Board on insurance-specific matters.

Once receiving all of the required approvals, the Treasury Department would be vested with the authority to decide how to resolve a failing firm, including the ability to establish conservatorship or receivership for a failing firm and to stabilize a failing institution (including one that is in conservatorship or receivership) by providing loans, purchasing assets, guaranteeing liabilities, or making equity investments in the firm.

## **Federal Reserve's Oversight Adjusted**

The administration's plan also places some limitations on the Federal Reserve. The recommendations require the Federal Reserve to obtain the prior written approval of the Secretary of the Treasury before it lends funds to any individual, partnership, or corporation in "unusual and exigent circumstances" pursuant to the authority granted to it under Section 13(3) of the Federal Reserve Act, an authority used by the Federal Reserve during the present crisis.

The Federal Reserve is also directed to adjust its supervision of bank holding companies. The recommendations direct the Federal Reserve to expand bank holding company regulation beyond safety and soundness to include the activities of the financial institution as a whole and its impact on the financial system. So-called "loopholes" in the Bank Holding Company Act—which presently affect thrift holding companies, industrial loan companies, credit card banks, nondepository trust companies, and grandfathered "nonbank" banks—would be eliminated under the administration's plan. All companies that control an insured depository institution would be subject to the supervision of the Federal Reserve and the restrictions of the Bank Holding Company Act.

Further, the constraints that the Gramm-Leach-Bliley Act placed on the Federal Reserve's ability to examine "functionally regulated" entities contained within a financial holding company structure would be removed. The administration's plan provides that all financial holding companies, including Tier 1 FHCs, will be required to be "well capitalized" and "well managed" on a consolidated basis to engage in the financial activities permitted under the Gramm-Leach-Bliley Act.

The administration's plan also grants stronger authority to the Federal Reserve to oversee payment, clearing, and settlement systems. The Federal Reserve would also regulate and supervise investment bank holding companies that the SEC currently oversees under its consolidated supervision program.

## **Proposed Changes to Bank Regulation**

The administration's recommendations include the establishment of a National Bank Supervisor, a single agency with separate status in the Treasury Department with responsibility for federally chartered depository institutions. The National Bank Supervisor would oversee the chartering, supervision, and regulation of national banks and federal branches and agencies of foreign banks. The National Bank Supervisor would assume the responsibilities of the Office of the Comptroller of the Currency and the Office of Thrift Supervision. The thrift charter would also be eliminated as part of this regulatory shift—a move that is sure to spark controversy.

The administration's proposal also directs regulators to issue standards and guidelines for executive compensation to avoid compensation structures that could threaten the safety and soundness of a regulated institution. The SEC was granted the authority to require companies to allow shareholder votes on executive compensation packages.

The Treasury Department, along with federal financial regulatory agencies and outside experts, will reevaluate and report on the supervision of banks and bank holding companies. This report will be issued by October 1, 2009.

In addition, by December 31, 2009, the Treasury Department, along with federal financial regulatory agencies and outside experts, would reassess the existing regulatory capital requirements for banks, bank holding companies, and Tier 1 FHCs.

The administration's plan also recommends that banking regulators issue regulations that require the originator of a securitized loan or a securitization to retain 5% of the credit risk of securitized exposures.

### **Creation of a Consumer Financial Protection Agency**

The administration also recommended that a Consumer Financial Protection Agency (CFPA) be established. The CFPA would enforce consumer protection regulations, reduce gaps in federal supervision and enforcement, and improve coordination with the states. The CFPA would replace the Federal Reserve as the key federal bank regulator in the area of consumer protection, and have supervisory and enforcement authority and jurisdiction over bank and nonbank firms and many firms not previously subject to federal supervision. The CFPA would also have the authority to reform mortgage laws to ensure that consumers are presented with all risks and benefits of a mortgage product. The CFPA has also been tasked with the enforcement of the Community Reinvestment Act and fair lending laws.

The CFPA would regulate consumer financial services and products such as credit, savings, and payment products and related services, as well as the institutions that issue, provide, or service these products. States would be given the right to adopt and enforce stricter laws and would have concurrent authority to enforce the CFPA's regulations.

### **Enhanced Oversight of the Insurance Sector**

The administration's proposal stops short of endorsing a federal insurance charter, a position advocated by many insurers and several trade groups. The proposal would establish an Office of National Insurance housed within the Treasury Department to "gather information, develop expertise, negotiate international agreements and coordinate policy in the insurance sector." The proposal encourages efforts to modernize and improve insurance regulation either through a federal charter or more effective action by the states. Any new regulatory regime must address current gaps in insurance company regulation under the proposal.

### **International Regulatory Standards**

The administration's plan directs the Basel Committee on Banking Supervision to develop a simple, non-risk-based capital measure to limit the amount of leverage in the international financial system and to improve Basel II to require more capital.

The recommendations are available online at [http://www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf).

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