Treasury Department Outlines Reforms to U.S. Financial Supervision and Regulation

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On June 17, the U.S. Treasury Department released a proposed outline for comprehensive reform of the nation's financial system. With the goal of preventing future financial crises, the proposal focuses on three major initiatives:

- Comprehensive federal supervision of systemically significant financial organizations, regardless of whether they are affiliated with a bank, and increased powers to regulate and resolve those organizations.

- Expanded supervision of financial markets, including regulation of over-the-counter derivatives and structural changes to the securitization markets that would require issuers and originators to retain a material risk of loss in securitized loans.

- Consumer protection from unfair or inappropriate financial products, through a newly created Consumer Financial Protection Agency (CFPA), an independent agency that would have authority to set the terms of financial products offered to consumers and require financial service providers to also offer consumers "plain vanilla" products.

The proposal contemplates that, in order to more effectively understand and control systemic risk, a broad range of financial markets participants, including hedge funds and private capital pools, would become subject to federal regulation for the first time, and that all companies that own a depository institution would be subject to regulation by the Federal Reserve as bank holding companies (thereby eliminating the existing exemptions for industrial loan companies, credit card banks, trust companies and similar entities). The proposal does not, however, attempt to bring insurance companies under federal supervision unless they are part of a systemically significant organization.

In addition, the proposal does not contemplate a fundamental reordering or consolidation of the existing regulatory structure for the financial system and markets. There is some shifting of jurisdictions: the Federal Reserve would gain new responsibilities for consolidated supervision of the largest financial holding companies, but responsibility for identifying future systemic risks would be given to a newly formed Financial Services Oversight Council comprised of eight different agency heads supported by a new permanent staff at Treasury. Responsibility for consumer protection would be taken from the federal banking agencies and given to the new CFPA; in addition, the states would be given the right to adopt and enforce stricter consumer protection laws against all financial institutions, including federally chartered ones, and also to enforce federal laws against those institutions. However, except for the Office of

Thrift Supervision (which, with the Comptroller of the Currency, would be merged into a new agency responsible for all federally chartered depository institutions), all of the other federal banking and financial markets agencies would remain intact with their current mandates and powers essentially unchanged.

The specific proposals in the Treasury outline attempt to address what Treasury identifies as key causes of the current financial crisis: a fragmented regulatory system (both domestically and internationally) that allowed credit and liquidity risks to build up in major institutions and in the financial system generally without detection and that failed to recognize the degree to which global markets and financial organizations have become interconnected; inadequate capital and liquidity standards for major financial organizations; opacity in the derivatives markets and a breakdown of underwriting standards in the securitization markets, which became a source of contagion rather than financial stability; and abusive sales practices for consumer credit products, particularly subprime mortgage loans, which generated large volumes of ultimately "toxic" assets that damaged many financial institutions.

The proposal also notes a number of other causes of the financial crisis, including inadequate analyses by the ratings agencies; weaknesses in money market mutual funds that resulted in a catastrophic run on those funds in October 2008; and lack of international coordination in identifying and addressing systemic risks. For these issues, as well as for many of the details needed to implement the initiatives described above, the proposal only contains general comments or suggestions of alternative approaches that will need to be developed over the coming months. Some of these developing initiatives, such as a plan to fundamentally reassess (by the end of the year) and increase capital requirements and make loss reserving more counter-cyclical, could have very significant effects on the operations of all U.S. financial organizations.

The future path of Treasury's proposals is highly uncertain at this point. Congressional hearings have already begun, but given Congress's competing priorities and the lack of a broad consensus on some of the most important provisions in the proposal, there is likely to be a long road ahead before any reform legislation is adopted.

A. CHANGES TO SUPERVISION AND REGULATION OF FINANCIAL ORGANIZATIONS

The Treasury proposal focuses on weaknesses in the financial system regulatory framework as a primary factor in causing the financial crisis. These weaknesses included both a lack of supervision of all market participants, which allowed partially regulated and unregulated organizations to accumulate dangerous amounts of credit and liquidity risks, and piecemeal supervision of regulated organizations, which resulted in no regulatory authority having the perspective to see, or responsibility to deal with, worsening systemic risks.

Treasury proposes to address these weaknesses by creating a framework for comprehensive supervision and resolution of all systemically significant financial organizations and by expanding the supervisory framework for currently regulated financial organizations.

Establishment of Financial Services Oversight Council

Treasury's proposal would create a "Financial Services Oversight Council" comprised of the Treasury Secretary, as chairman, and the heads of seven other federal banking and financial markets agencies. The Financial Services Oversight Council would have authority to gather information on systemic risks and coordinate financial regulation among the different agencies but would not have any supervisory or enforcement powers.

Designation of Tier 1 Financial Holding Companies

One of the most significant changes contemplated by Treasury is a proposal to impose comprehensive regulation by the Federal Reserve on any firm "whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed." These firms, which are referred to as "Tier 1 Financial Holding Companies" or "Tier 1 FHCs," would be identified by the Federal Reserve, in consultation with Treasury, based on various quantitative and qualitative factors to be specified in the adopting legislation. The Treasury proposal emphasizes, however, that there should be no bright-line tests for determining a firm's status as a Tier 1 FHC, noting that:

- a firm can be designated as a Tier 1 FHC regardless of the specific financial business it is in and whether or not it is affiliated with a depository institution; and

- the criteria for designation are to be applied flexibly "to minimiz[e] the risk that an 'AIG-like' firm could grow outside the regulated system."

The Treasury proposal specifically states that consolidated supervision of a Tier 1 FHC should extend to the parent company and all of its subsidiaries, both U.S. and foreign, but does not address the jurisdictional issues of regulating foreign operations. These issues will of course be very important for non-U.S. financial organizations with major U.S. operations.

Significantly, even if a Tier 1 FHC does not control an insured depository institution, it would be restricted from engaging in nonfinancial activities. Treasury proposes that these non-bank holding company firms be given five years to conform their activities to those permissible under the Bank Holding Company Act of 1956 (the BHC Act).

Registration of Hedge Funds and Other Private Pools of Capital

Hedge funds and other private pools of capital, such as private equity funds and venture capital funds, have traditionally operated largely outside the financial regulatory framework. Treasury's proposal would change this by requiring all advisers to hedge funds and other private funds having assets under management exceeding a minimum "modest" threshold to register with the SEC under the Investment Advisers Act. Registered advisers would be required to report to the SEC, on a confidential basis, information regarding assets under management, debt, off-balance sheet exposures and other information that would assist regulators in assessing whether a fund or fund family poses a threat to financial stability. The proposal contemplates that the SEC would share such disclosures with the Federal Reserve in connection with the Federal Reserve's assessment of whether any particular fund or fund family should be subject to additional supervision and regulation as a Tier 1 FHC.

Broadening the Scope of Bank Regulation

The proposal seeks to eliminate regulatory "blind spots" related to companies that have been permitted to control certain types of insured depository institutions without the corresponding supervisory and regulatory burdens imposed on bank holding companies under the BHC Act. Under the proposal, holding companies of thrifts, industrial loan companies, credit card banks, trust companies and the few remaining grandfathered CEBA "non-bank banks" would be deemed bank holding companies for purposes of the BHC Act and would have a five-year window to conform their non-banking activities to the restrictions of the BHC Act.

In addition, Treasury proposes that the thrift charter be eliminated, subject to "reasonable transition arrangements." Responsibility for chartering and supervising all federally chartered depository institutions would be transferred from the Office of Thrift Supervision and the Comptroller of the Currency to a newly-formed "National Bank Supervisor."

Treasury's proposal would, however, preserve one of the principal current advantages of a federal thrift charter—the right to open branches in any state without restriction—and make it available to all banks, both federal and state chartered. State minimum age requirements for acquisitions would also be eliminated, but state deposit concentration caps would be allowed to remain.

Stronger Capital and Prudential Standards for All Banks and Bank Holding Companies

Characterizing existing capital and liquidity requirements as "simply too low," the proposal generally calls for higher capital and liquidity requirements for all banks. The proposal identifies several areas where regulatory capital and other standards need to be substantially strengthened. Recognizing that many of the banks that had failed during the financial crisis were considered "well-capitalized" shortly before their failure, the proposal calls for the Treasury Department to lead a working group to issue recommendations by the end of the year on how existing regulatory capital requirements should be amplified. In particular, the review will focus on the extent to which regulatory capital requirements should be increased to reflect certain investments and exposures posing high levels of risk under stressed market conditions, including exposures to sponsored off-balance sheet vehicles and credit exposures to low-credit quality firms and persons. The proposal also proposes to subject Tier 1 FHCs to even higher capital, liquidity and risk management standards to reflect more accurately the risks that those institutions pose to the financial system upon failure. Among other things, Tier 1 FHCs would be required to undergo assessments of capital and liquidity adequacy under severe stress scenarios and enhance their public disclosures regarding their overall risk management practices.

In addition, compensation practices are cited as a significant cause of the financial crisis, with the proposal calling for, among other things, Congressional passage of "say on pay" legislation and new powers for the Securities and Exchange Commission (SEC) to require more meaningful disclosure of compensation practices and incentive structures. Treasury also suggests that the federal banking regulators should issue standards and guidelines to better align compensation practices with long-term shareholder value and avoid incentives for undue risk-taking.

The proposal also recommends that accounting standard setters consider ways to require financial firms to be more forward-looking in their assessment of loan loss provisioning.

Finally, the proposal would require stronger firewalls between banks and their affiliates under Sections 23A and 23B of the Federal Reserve Act. The proposal would also make it harder for banks to engage in OTC derivatives and securities financing transactions with affiliates.

Resolution of Failing BHCs

Treasury's outline notes that the federal government's ability to respond to the impending failures of certain systemically important firms, such as Lehman Brothers and AIG, was complicated by the lack of a statutory framework for avoiding the disorderly failure of non-bank financial firms. Accordingly, Treasury proposes the creation of a new 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.

According to Treasury's proposal, the new regime would not replace bankruptcy procedures in the ordinary course for failed bank holding companies. Instead, the regime would be available only in extraordinary circumstances affecting financial stability and only after a formal determination that the special resolution regime should be used. Authority for deciding whether to use the special resolution regime would be vested in Treasury, after consultation with the President, and only upon recommendation of two-thirds of the members of the Federal Reserve Board and two-thirds of the FDIC Board (or two-thirds of SEC commissioners where the largest subsidiary firm is a broker-dealer).

To invoke the regime, Treasury would need to determine, among other things, that resolution of the firm under otherwise applicable law would have serious adverse effects on the financial system and that use of the special resolution regime would avoid or mitigate those adverse effects.

The authority to decide how to implement the resolution would also be vested in Treasury, which could appoint a conservator or receiver or stabilize the firm through other means, such as providing loans, purchasing assets, making investments or granting guarantees. The conservator or receiver appointed by Treasury would normally be the FDIC, although Treasury would have the authority to appoint the SEC in the case of a holding company whose largest subsidiary is a broker-dealer. The conservator or receiver would have broad resolution powers, including the power to sell assets and renegotiate or repudiate contracts. The conservator or receiver could also transfer the failed organization's derivatives contracts to a bridge institution, which would override any contractual termination rights that the counterparties have. Funding for these resolutions would come from borrowings from Treasury, which would be repaid through assessments on bank holding companies based on their total liabilities other than insured deposits.

The Insurance Sector

The Treasury proposal contemplates that a new federal "Office of National Insurance" be created within Treasury. The Office would be responsible for "monitoring all aspects of the insurance industry" but would not have any supervisory or regulatory powers. Although Treasury notes that the U.S. is virtually the only country without a federal insurance regulatory authority, the proposal does not contain any specific recommendations to federalize the regulation of insurance companies.

B. CHANGES TO REGULATION OF FINANCIAL MARKETS

The proposal describes Treasury's view of certain market forces gone awry as it argues for changes in regulation of financial markets. It focuses on areas, such as securitizations and derivative markets, that due to increased complexity, lack of transparency and limited regulation, contributed to the financial crisis. It proposes changes in these areas as well as in the management of market infrastructure and the regulation of futures markets.

New Regulations for the Securitization Market

Citing the role of securitization, or the packaging and selling of loans as securities, in the erosion of lending standards for mortgage and other lending businesses, the proposal calls for new discipline for the securitization market. One of the most significant proposed changes would require that originators of loans underlying asset-backed securities retain at least 5 percent of the loss risk. According to Treasury, requiring originators to keep "some skin in the game" will incentivize banks and securitizers to consider the performance of loans underlying asset-backed securities well after such securities have been issued. Other aspects of the proposal to reform the securitization market call for:

- changes in accounting rules to reflect the longer-term performance of securitized assets;

- greater transparency about the assets backing such securities (e.g., more disclosures to assess the credit quality of the assets underlying the securities at inception and over the life of the transaction);
- clearer guidance from rating agencies about the differences between asset-backed securities and regular corporate debt;
- stronger monitoring and disclosure by rating agencies of conflicts of interest; and
- better alignment of the compensation structure for parties involved in securitization to the long-term performance of the financial assets underlying asset-backed securities.

New Regulations for OTC Derivatives

The proposal notes Treasury's concerns that a "lax regulatory regime" for over-the-counter (OTC) derivatives (particularly credit default swaps), combined with the exponential increase in the use and complexity of those products, resulted in significant systemic risk by leaving a void in regulatory authority to identify and address significant counterparty exposures revealed during the financial crisis. It also notes that insufficient transparency in the market led to undisclosed concentrations of risk. The proposal seeks to address these issues in four ways:

- Containing the systemic risk posed by the OTC derivatives market by amending the Commodities Exchange Act (CEA) and securities laws to require clearing of all standardized OTC derivatives through regulated central counterparties and subjecting OTC derivatives dealers and other relevant firms to additional regulation, including "conservative" capital requirements, standards of business conduct and rules relating to initial margins on counterparty credit exposures. The proposal does not specify which contracts would be considered "standardized," other than stating that customized OTC derivatives should not be used solely in order to avoid the need to use a central counterparty and that if an OTC derivative is accepted for clearing by a central counterparty, it should be presumed to be a standardized contract. Treasury anticipates that counterparty risks with respect to customized bilateral OTC derivative transactions would be dealt with by the expanded regulatory regime proposed for derivatives dealers.
- Improving the transparency of the OTC derivatives market by requiring recordkeeping and reporting with respect to all OTC derivatives, requiring standardized derivatives to be traded over regulated exchanges and electronic trade execution systems for OTC derivatives and requiring customized derivatives to be reported to a regulated trade repository.
- Preventing market manipulation, fraud and other market abuses by amending the CEA and the securities laws to ensure that the Commodity Futures Trading Commission

(CFTC) and the SEC have "unimpeded authority" to address these issues with respect to all OTC derivatives.

- Limiting the marketing of OTC derivatives to "less sophisticated" counterparties, which Treasury suggests could be effected by limiting eligible counterparties, requiring additional disclosures or imposing a specific standard of care.

Notably, Treasury's proposal does not suggest the reshuffling of regulatory authority with respect to OTC derivatives. Rather, authority would continue to be split between the SEC and the CFTC. In testimony before a Senate committee on June 22, SEC Chairman Mary Schapiro proposed that the SEC would be responsible for regulating securities-related OTC derivatives, including equity derivatives and credit and other fixed income security-related derivatives, while the CFTC would have authority over other types of derivatives, including those relating to interest rates and foreign currencies, as well as all non-financial derivatives (such as energy-related derivatives). Chairman Schapiro also indicated that the SEC would not seek to serve as an additional regulator for OTC derivatives dealers that are banks, which would be supervised by their federal banking regulator. The SEC would supervise all non-bank OTC derivatives dealers transacting in securities-related OTC derivatives.

Harmonization of Futures and Securities Regulation

The proposal highlights the gap that has developed in the treatment of futures products and securities (including options products that are similar in effect to a comparable futures product), arguing that many distinctions in treatment are arbitrary or no longer appropriate. The proposal supports "harmonization" of the regulatory regimes using a rules-based approach while preserving flexibility for innovative financial products. The proposal recommends that the CFTC and the SEC prepare a report to Congress by September 30, 2009 identifying all conflicts in existing statutes and regulations with respect to similar financial products and making recommendations for changes to eliminate differences.

Oversight of Systemically Important Payment, Clearing, and Settlement Systems

Treasury proposes to provide the Federal Reserve with oversight authority over systemically important payment, clearing and settlement systems and activities of financial firms and to provide firms conducting those activities with access to Reserve Bank accounts, financial services and the discount window. This new Federal Reserve authority, which would supplement any existing primary regulation of those systems by the CFTC or SEC, is intended to address perceived current weaknesses in settlement arrangements, particularly repurchase agreements and OTC derivative arrangements, among banks and other financial institutions. Treasury noted that strengthening those arrangements can help guard against instability and that weaknesses in those arrangements can be a potential source of contagion in times of financial stress and were a particular source of concern during the financial distress of 2008.

Under the proposal, legislation would define the characteristics of systemically important payment, clearing and settlement systems based on the risk that their failure or disruption would increase the risk of spreading liquidity or credit problems in the financial system. The Federal Reserve would have supervisory authority over the safety and soundness and risk management policies applicable to those systemically important systems (in conjunction with the primary regulator of those systems, if applicable). Those systems would also be provided with emergency Federal Reserve discount window access.

C. CONSUMER PROTECTION INITIATIVES

While acknowledging the recent legislative activity to increase consumer protections relating to credit cards and mortgages, the proposal calls for comprehensive reform in the regulation of consumer financial products. Treasury notes that multiple agencies have had responsibility for consumer protection regulation in the financial area, but that gaps still exist, and accordingly proposes the formation of the CFPA to hold centralized authority for such regulation.

Establishment of CFPA

Treasury proposes the formation of the CFPA to protect consumers across the financial sector from unfair, deceptive and abusive practices. According to Treasury, creation of the CFPA is necessary to remedy the gaps and weaknesses of the current consumer protection regulatory scheme, where numerous federal and state regulations have existed but failed to stem abusive practices in various areas, particularly credit cards and mortgages.

The CFPA would be given rulemaking, supervisory and enforcement authority over consumer financial products and services, such as credit, savings and payment products, as well as the institutions that provide those products, but the CFPA's authority would not extend to investment products and services already regulated by the SEC or CFTC. The CFPA would be charged with reducing gaps and improving enforcement of federal regulations; coordinating with state regulators; and promoting higher regulatory standards and consistent regulation of similar products. As proposed by Treasury, the CFPA would:

- be an independent agency with its own funding;
- be granted sole rule-making authority over federal consumer financial protection statutes, such as the Truth in Lending Act, Real Estate Settlement Procedures Act, Home Mortgage Disclosure Act and Community Reinvestment Act;
- have supervisory and enforcement authority over all persons and entities covered by the statutes it implements, both banking and non-banking institutions;
- set minimum rules but not ceilings and would not preempt the ability of states to adopt and enforce stricter consumer protection laws;

- coordinate with the states to unify and strengthen standards, including through registration and licensing requirements for consumer financial service providers; and
- have a wide variety of tools and capabilities to perform its functions, including research and information gathering, consumer complaint collection and review, and financial education and community affairs capabilities and functions.

Other Consumer and Investor Protection Initiatives

Treasury also proposes that the Financial Services Oversight Council would establish a Financial Consumer Coordinating Council to focus specifically on consumer and investor protection issues. The Financial Consumer Coordinating Council would have a broad membership of federal and state consumer protection agencies and a permanent role for the SEC's Investor Advisory Committee.

The proposal includes a series of recommendations for new legislative and regulatory initiatives to be administered by the CFPA and the SEC, organized around the themes of transparency, simplicity, fairness, accountability and access. The recommendations include:

- reforming consumer disclosure requirements, in particular those relating to mortgage disclosures, with a focus on simplicity and "reasonableness";
- requiring prominent disclosure of "plain vanilla" products in marketing materials, and granting the CFPA authority to increase regulation of alternative mortgage products;
- authorizing the SEC to require that certain disclosures, such as a summary prospectus, be provided to investors at or before the point of sale (rather than in connection with a confirmation of sale), if the SEC determines that this would improve investor understanding;
- aligning the duties of broker-dealers and investment advisers in connection with providing investment advice by imposing a fiduciary duty on such broker-dealers, and evaluating (with the goal of possibly eliminating) the use of mandatory arbitration clauses in broker-dealer and investment adviser contracts with retail customers; and
- creating a fund to pay whistleblowers for information leading to successful enforcement actions.

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