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FINANCIAL REGULATORY REFORM POLICY UPDATE

From: Patton Boggs Financial Services Policy Group
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Subject: **House Financial Services Committee Reports Financial Stability Improvement Act (H.R. 3996)**

On December 2, 2009, the House Financial Services Committee (HFSC) voted 31-27 to approve the "Financial Stability Improvement Act" (H.R 3996 or "FSIA"), a measure that would provide for a historic overhaul of the financial services regulatory system. The following is a summary of the key provisions of the legislation.

Executive Summary

The FSIA reflects key elements of the Obama Administration's previously announced initiatives for the historic overhaul of the U.S. financial regulatory framework. Key components of the FSIA include establishing a Financial Services Oversight Council (FSOC) as a systemic risk regulator, providing for a resolution authority to wind down large financially-troubled non-bank financial institutions, and imposing a credit risk retention requirement in the securitization context, among other initiatives discussed below. In December, the Senate Committee on Banking, Housing and Urban Affairs is anticipated to mark up its financial regulatory reform package (Restoring American Financial Stability Act of 2009) and ultimately the two chambers' proposals will need to be reconciled. The reconciliation process is anticipated to extend into early 2010.

Discussion of Key Provisions

The following is a summary of key provisions in the proposal, as amended in the markup last week, including: (1) creating a Financial Services Oversight Council; (2) granting the FSOC preemptive divestiture power to break up an organization before it becomes "too big to fail"; (3) providing the FDIC resolution authority funded by risk-based assessments on financial companies with more than $50 billion in assets and hedge funds with more than $10 billion in assets; (4) expanding the list of "too big to fail" institutions; (5) expanding powers of the Federal Reserve; (6) creating a credit risk retention requirement; (7) providing for greater accountability for the Financial Accounting Standards Board (FASB); (8) and integrating the Office of Thrift Supervision into the Office of the Comptroller of Currency.

Highlights include:

(1) Creation of a Financial Services Oversight Council to Monitor Systemic Risk

The FSIA would establish the FSOC to identify financial companies and financial activities that pose a threat to financial stability. The FSOC would have voting members, including the Secretary of the Treasury (who shall serve as the Chairman of the Council), the Chairman of the Board of Governors of the Federal Reserve, and the Comptroller of the Currency, among others. It would also have non-voting members including a state insurance commissioner and a state banking supervisor.

The legislation would empower the FSOC to act as a systemic risk regulator, monitoring and implementing tougher controls on these systemically significant bank and nonbank financial institutions that could cause systemic risk in the event of a failure. Essentially, it would subject those systemically significant companies and activities to more stringent prudential oversight, standards and regulation.

Additionally, the FSOC would advise Congress on financial regulation, making recommendations on how to enhance the integrity, efficiency, orderliness, competitiveness, and stability of the United States financial markets. It would issue formal recommendations for agencies with members on the FSOC to adopt heightened prudential standards for firms they regulate to mitigate risk. And, the legislation would facilitate information sharing and mitigate jurisdictional/regulatory disputes between agencies with members on the council.

(2) Divestiture Power: Kanjorski Amendment

This amendment to the legislation gives the government the ability to preemptively limit the size, complexity and risk of any financial institution. It grants authority to the FSOC to break up firms posing too great of a risk to the economy and orders the divestiture of assets, regardless of the firm's health. This amendment was created to ensure that there would be no need for future bailouts, as no firm could become "too big to fail."

Generally, this power will be limited to situations where the firm is so large and so interconnected that the United States economy would still be threatened even if the resolution authority followed the firm's failure plan and wound the firm down in the event of a collapse. The amendment requires that regulators consider an institution's size, exposure, leverage and interconnectedness when deciding whether this extreme action should be taken.

(3) Creation of Dissolution Authority & Potential FDIC Assessments on Financial Companies with More than $50 Billion in Assets

The legislation would establish a dissolution authority under the FDIC to wind down large, financially-troubled non-bank financial institutions. The wind down process would be facilitated by a $150-billion dollar systemic dissolution fund. The fund would allow the FDIC, with the approval of the Treasury Department and Federal Reserve, to make a loan to or offer guarantees for a solvent company if necessary to "prevent financial instability during times of severe economic distress."

The legislation is designed to ensure that the shareholders and creditors, rather than taxpayers, bear the losses of a failing firm. As amended by Rep. Sherman (D-CA), the dissolution fund will be funded by fees charged to financial firms with more than $50 billion in assets and hedge funds with more than $10 billion in assets based upon individual risk assessments conducted by the FDIC and the SEC. The fund would be capped at $150 billion, with a provision allowing the regulators to raise another $50 billion with the approval of Congress, the US Treasury and the president. The FDIC dissolution authority ends on December 31, 2013 unless extended by Congress and the president.

(4) Institutions Susceptible to Too Big to Fail

The legislation extends the list of potential bailout recipients to anyone engaging in finance, including bank holding companies, hedge funds, auto makers, and retail chains. As amended by Chairman Frank during the markup, the legislation uses a one-step process to subject these firms to regulation. Rather than creating a list of the "too big to fail" institutions and subsequently subjecting those firms to restrictions, the process will now merge imposing restrictions on institutions at the time they are identified as posing a systemic risk. This, coupled with the foregoing Kanjorski amendment, allows for the regulation and potential dismantling of almost any entity engaging in financial activity.

(5) Expanded Powers of the Federal Reserve

The legislation grants the Federal Reserve the power to direct any large financial holding company to reduce its size by selling or transferring assets or curtailing certain activities if the Federal Reserve determines there could be a "threat to the safety and soundness of such company or to the financial stability of the United States." It also empowers the Federal Reserve to set concentration limits for large financial holding companies, prohibiting the companies from having credit exposures to purchase an unaffiliated entity that exceeds 25 percent of the holding company's capital stock and surplus. Additionally, the legislation requires that the Board of Governors of the Federal Reserve (and the FDIC and Secretary of the Treasury) approve the FDIC's extension of credit or guarantee of obligations of solvent insured depository institutions or other solvent companies. The legislation also gives the Federal Reserve the power to force a financial holding company into bankruptcy if the Federal Reserve determines the entity is critically undercapitalized.

The legislation also amends Section 13(3) of the Federal Reserve Act to read "in unusual and exigent circumstances," the Board of Governors of the Federal Reserve System may authorize discounted notes, drafts and bills of exchange for any individual, partnership or corporation provided that certain provisions are met. First, this action is only authorized as part of a broadly available credit or other facility and not made available for only a single, specific individual, partnership or corporation. Further, before discounting for an individual, partnership or corporation, the Federal Reserve Bank must show that the entity is unable to secure adequate credit from other banking institutions.

However, several additional legislation provisions specifically limit the Federal Reserve's power, including the creation of a Consumer Financial Protection Agency, which would strip the Federal Reserve of its consumer oversight powers. The power to make emergency loans to nonbanks would also fall under a new check and balance provision. An amendment by Reps. Paul (R-TX) and Grayson (D-FL) requires an audit of the Federal Reserve's lending programs and monetary policies to be completed within 12 months of the enactment of the legislation.

(6) Credit Risk Retention Requirement

The legislation, as amended by Rep. Minnick (D-ID), provides for stricter underwriting requirements and more detailed securitization rules. It requires creditors to retain 5 percent or more of the credit risk from loans transferred or sold on the secondary market, including for the purpose of securitization. The SEC and the Federal Reserve, however, may adjust the amount as high as 10 percent, or as low as 0 percent where appropriate. The legislation also has customized the retention provisions to be specific for the commercial mortgage-backed securities market, granting flexibility by allowing third party investors to satisfy the risk retention requirements.

(7) Accounting Standards – FASB Accountability

The legislation as amended by Reps. Perlmutter (D-CO) and Lucas (R-OK) would allow the FSOC to review and comment on current and proposed accounting rules, but allows the FASB and the SEC the freedom to accept or reject the suggestions. This provision preserves SEC authority over FASB, while granting a supervisory role to the FSOC.

Further, an amendment by Rep. Garrett (R-NJ) would bring certain FASB rules under scrutiny. It requires a study of the effects of rules FAS 166 and FAS 167 scheduled to be implemented in January affecting the way financial institutions account for securitizations. As part of the study, FASB would be required to make recommendations for eliminating any negative impacts on the asset-backed securitization market caused by the new regulations and legislation.

(8) Regulatory Consolidation: Integration of the Office of Thrift Supervision

The legislation, as amended by Reps. Green (D-TX) and Bachus (R-AL), integrates the Office of Thrift Supervision (OTS) into the Office of Comptroller of Currency (OCC). Under the provision, the OCC will have a new division of thrift supervision which will have all of the powers that had previously been vested in the OTS. Further, it requires that the OTS, the OCC and the FDIC work together to provide improved regulation of banking institutions and to provide a one year report after integration of the OTS into the OCC discussing the steps taken to improve regulation.