DechertOnPoint

July 2011 / Issue 9

A legal update from Dechert's Financial Institutions Group

Designation of Systemically Important Financial Institutions, Living Wills and Enhanced Prudential Regulation One Year Later: A Question of Balance

Congress passed the Dodd-Frank Act one year ago to reduce or eliminate the risks that led to the financial crisis. Today, there is growing concern that the laser-like focus on risk reduction was not properly balanced by an appreciation of the costs of such regulation, including its potential impact on economic growth in the U.S. These costs are of heightened concern to the extent that foreign jurisdictions do not impose similar regulation on their own financial institutions, such as with regard to the Volcker Rule and derivatives regulation.

Controversy over Qualified Residential Mortgage Standards: Risk Reduction vs. Economic Growth

One example of the potential economic impact of Dodd-Frank is the proposed set of requirements for "qualified residential mortgages ("QRMs")," which would be exempt from a 5% risk retention requirement when included in asset securitizations. Historically, only about 20% of residential mortgages would qualify as QRMs under the proposed standards. Uncertainty about the availability and pricing of non-QRM residential mortgage loans has led to strong opposition to the proposed rule, including by a bipartisan group of nearly half the members of the U.S. Senate and an unusual coalition of financial services trade associations and consumer and public interest groups. More attention to underwriting standards and loan quality are desirable; unnecessarily restricting access to housing finance at a time of dramatic weakness in the housing sector of the economy is not.

The Treatment of Large Financial Institutions and Economic Growth

A key aspect of Dodd-Frank is the provision in Title I that the Federal Reserve Board ("FRB") impose enhanced prudential supervision on bank holding companies with consolidated assets of $50 billion or more ("Large BHCs") and on systemically important nonbank financial institutions that are designated by the Financial Stability Oversight Council ("FSOC") for supervision by the FRB ("SIFIs"). The exercise of this authority over Large BHCs, which control over two-thirds of activities of the U.S. banking industry assets, may have a significant impact on the activities of the U.S. banking sector. Moreover, the SIFI designation process could impose new forms of federal regulation on nonbanking sectors of the U.S. financial system.

On January 18, 2011, the FSOC published a proposed rule setting forth its criteria for designating SIFIs. The proposed rule and the

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rulemaking notice as a whole have been widely criticized for basically restating the statutory criteria without providing significant additional guidance regarding the FSOC's intended standards and procedures or for providing a meaningful opportunity for public comment. *See DechertOnPoint*, Financial Stability Oversight Council Proposal Includes Few Clues About Who Will Be Designated as Systemically Significant. In House and Senate hearings, members of Congress have joined in the criticism and strongly recommended that the FSOC essentially start over in order properly to inform the public and to give the public an appropriate opportunity to participate in the rulemaking process.

As we pointed out in our comment letter on the proposed rule to the FSOC, while Dodd-Frank directs the FSOC to make SIFI designations, it does not give the FSOC the authority to issue substantive rules regarding SIFI designation. *See DechertOnPoint*, Dechert Issues Comment Letter Regarding Financial Stability Oversight Council's Proposed Rule Regarding the Designation of Systemically Important Financial Companies. Sheila Bair, who recently completed her term as chair of the FDIC, appeared to acknowledge these issues in her testimony before the Senate Banking Committee on May 12, 2011, when she noted that "there may be a legal issue with the FSOC's ability to write rules with this kind of criteria versus guidance." Neal Wolin, Deputy Secretary of the Treasury, who also testified at the hearing, stated that the manner in which the FSOC would proceed was yet to be determined.

At present, major nonbank financial institutions remain without guidance as to the likelihood that they may be designated as SIFIs. More significantly, they do not know how to restructure themselves to avoid systemic designation. The range of uncertainties shadowing large nonbank financial institutions and the capital markets is unlikely to be helpful to overall economic recovery.

There is an ongoing evolution in regulatory thought, at least at the FDIC, in regard to the key criteria for the designation of SIFIs. Former Chairman Bair has suggested that credible resolution planning *i.e.*, the preparation of a "living will," should be a key factor in determining whether to designate a nonbank financial company as a SIFI, although this is not a statutory factor and is not included in the proposed rule. As she stated before the Senate Banking Committee:

> We believe that the ability of an institution to be resolved in a bankruptcy process without systemic impact should be a key consideration in designating a firm as a SIFI. . . . If an institution can be reliably deemed resolvable in bankruptcy by the regulators, and operates within the confines of the leverage requirements established by bank regulators, then it should not be designated as a SIFI.

On June 14, 2011, Michael Krimminger, General Counsel of the FDIC, testifying before a subcommittee of the House Financial Services Committee, made a similar statement: "[T]he ability of a financial institution to be resolved in a bankruptcy process without systemic impact should be a key consideration in deciding whether to designate a firm as a SIFI." Requiring non-SIFIs to develop living wills to avoid designation as SIFIs may have theoretical merit, but it may impose substantial costs on a large number of non-systemic institutions.

Living Will Criteria

The FDIC and the FRB have jointly issued a proposed rule describing the requirements for a Large BHC or SIFI to prepare a resolution plan. A company may be required to address in its living will a wide array of internal and external financial distress scenarios and must demonstrate, among other things, that a company can be resolved in those circumstances under the Bankruptcy Code in a rapid and orderly fashion and with minimal effect on U.S. financial stability.

Commenters have identified a range of significant problems with the proposed rule:

- There is no stated basis upon which to identify and agree upon a reasonable number of scenarios or a range of financial or economic indicators that a living will must address;

- Many Large BHCs may not present a significant systemic risk outside their banking subsidiaries, which are subject to separate resolution procedures under the Federal Deposit Insurance Act;

- It is not clear how a company could convincingly demonstrate that its living will satisfied the proposed rule's planning criteria. Companies would be expected to demonstrate that resolution under the Bankruptcy Code would occur in a timely manner and would protect U.S. financial stability, although neither of those standards is expressly contained in the Dodd-Frank Act's living will provisions or included in the mandates of the Bankruptcy Code. In fact, concern that the Bankruptcy Code did not adequately provide for the resolution of failing nondepository financial institutions is what spurred Congress to establish a federal receivership regime for such companies in Title II of the Dodd Frank Act;

- The absence of statutory confidentiality provisions exposes companies that file a living will to the risk that either the agencies or the courts may release sensitive information to the public; and

- The requirement that the board of directors of a company approve its living will, coupled with the proposed regulatory requirement that the living will serve the interests of U.S. economic stability, may confront those boards with significant conflicts of interests with their fiduciary duties to shareholders and, in some instances, to creditors.

If a company does not submit a resolution plan that is acceptable to the FDIC and the FRB, they may jointly impose more stringent capital, leverage or liquidity requirements or restrict the company's growth or activities. After two years, and following consultation with the FSOC, they may order the company to divest certain assets or operations. Former Chairman Bair stated on several occasions that "down-sizing" Large BHCs and SIFIs is an essential power to exercise to ensure that no financial institution becomes "too big to fail." On June 9, 2011, before an audience at the Council of Foreign Relations, she stated, "The burden is put on these large institutions to show that they can be resolved in an orderly way, and . . . if they cannot make that showing, then the FDIC and the Fed have the authority to order restructuring or divestiture." She further stated, "[U]nless those large banks think that we are serious about using that authority, I think instead of getting credible resolution plans, we're going to get nice paper exercises to sit on the coffee table somewhere." Divestitures may be more than a last resort.

Enhanced Prudential Requirements for Large BHCs and SIFIs

FRB Chairman Ben Bernanke has indicated to the Senate Banking Committee that the FRB will publish proposed rules this summer for the enhanced prudential supervision of Large BHCs and SIFIs. A critical element of those standards will be higher capital requirements.

Based on international efforts to develop new capital requirements and the mandate of the Collins Amendment to the Dodd-Frank Act, the direction of regulatory capital requirements is unquestionably upward, but the specific requirements remain unclear. On June 25, 2011, members of the Basel Committee on Banking Supervision agreed in concept that globally significant banks should maintain a "macroprudential" reserve of common equity, over and above all other capital requirements, equal to 1% to 2.5% of risk-weighted assets, and that the very largest or riskiest of those institutions should be subject to an additional 1% surcharge.

Balancing the Interests

In light of the financial disasters of the last few years, there is no doubt that the system could benefit from increased regulatory tools, better risk management and solid preventative maintenance. Dodd-Frank provides that and more. However, too much of any of these good things could have an adverse impact on our economy for years to come. As always, the challenge is a question of balance.

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