Key Measures to Address Systemic Risk

The Dodd-Frank Act extends the focus of banking regulators beyond the financial condition of individual institutions to include systemic risk as a supervisory consideration, along with tools to minimize the likelihood of the collapse of a firm that previously would have been regarded as too big to fail. In the event that a large institution does become troubled, the Act also equips regulators with new powers to facilitate the process of managing such failure. It establishes the "Financial Stability Oversight Council" ("FSOC" or the "Council") to bring together the principal financial regulators for the purposes of monitoring and managing systemic risk.[1]

The key consequence of these changes, for financial firms that are not otherwise regulated by the Board of Governors, is that the Council and the Board of Governors will have the authority to require reports and examine any financial services firm in order to identify those firms that may pose any systemic risk. Any nonbank financial firm determined by the Council to pose systemic risk will become subject to Board of Governors supervision and a range of potential "enhanced prudential" supervision requirements for its business.

The key consequence for larger banking organizations with $50 billion or more in assets (subject to Board of Governors discretion to raise that threshold) is that they can be made subject to "enhanced prudential" requirements above and beyond the current bank regulatory requirements.

Both nonbank financial companies and bank holding companies subject to enhanced prudential supervision authority will be required to provide prior notice for any nonbank acquisition involving a financial firm with assets of $10 billion or more. In addition, supervised nonbank financial companies will be required to obtain approval to acquire 5% or more of the voting stock of a banking organization.

A cap on the absolute size of any nonbank financial company supervised by the Board of Governors or any banking or thrift organization will prohibit any merger, acquisition, or other business combination involving any such company if the resulting company would hold more than 10% of the total liabilities of all banking and thrift organizations and nonbank financial companies supervised by the Board of Governors.

A key consequence for financial firms, without regard to whether they are under Board of Governors supervision, is the ability of the Council to designate an "activity" (*i.e.*, a product or practice) as systemically risky and require that all federal regulatory agencies draft rules to address the activity.

Additional measures to address systemic risk include the special insolvency regime established by Title II of the Act for firms determined to pose systemic risk (see "Orderly Liquidation Authority"), authority in exigent circumstances for the Federal Reserve and the FDIC to create programs to extend credit or to guarantee the obligations of solvent firms (see "Federal Reserve Emergency Credit"), and authority for the Federal Reserve to supervise systemically important financial market utilities and payment, clearing and settlement activities conducted by financial institutions. See "Supervision of Payment, Clearing and Settlement."

Financial Stability Oversight Council

The FSOC is chaired by the Secretary of the Treasury. Its 10 voting members include the heads of the Board of Governors, Office of the Comptroller of the Currency ("OCC"), FDIC, SEC, CFTC, Federal

[1] Act § 111.

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Housing Finance Agency, National Credit Union Administration, the newly formed Bureau of Consumer Financial Protection and an independent member with insurance expertise appointed by the President and confirmed by the Senate. The Council also has five non-voting members, including the directors of the newly created Federal Insurance Office and Office of Financial Research (the "OFR"), a state insurance commissioner, a state banking supervisor, and a state securities commissioner. The work of the Council is to be supported by the OFR, which is housed within the Treasury.

The Act states that the Council is to identify risks to the financial stability of the United States, promote market discipline, and respond to emerging risks in the U.S. financial system. Its key powers will be the designation of a nonbank financial company for special supervision by the Board of Governors and the designation of business practices for special regulation by the federal financial and state insurance regulators.

The Council also is responsible for granting exceptions with respect to derivatives activities and for designating "systemically important financial market utilities and payment, clearing and settlement activities."[2]

Nonbank Financial Companies Subject to Enhanced Prudential Standards

The Council can designate a nonbank financial company, as defined below ("NFC"), for special supervision by the Board of Governors under certain "prudential standards." We refer to any such NFC as a "Supervised Nonbank Company."

To designate an NFC for special supervision, the Council must determine, with at least a two-thirds vote (including the Secretary of the Treasury, the Council's Chairperson), that the firm's financial distress or its nature, size, scale, concentration, interconnectedness, or mix of activities would pose a threat to the financial stability of the United States.

The Council may take into consideration a variety of factors in determining whether to subject an NFC to prudential supervision, including:

- the extent of the leverage of the company;
- the extent and nature of the off-balance-sheet exposures of the company;
- the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;
- the importance of the company as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the U.S. financial system;
- the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities;

[2] The Council would also facilitate information sharing and coordination among its members, recommend general supervision priorities and principles, monitor the financial services marketplace to identify potential threats to financial stability, identify gaps in regulation, and make recommendations to the agencies to apply new or heightened standards and safeguards for risky financial activities or practices.

- the extent to which assets are managed rather than owned by the company and the extent to which ownership of assets under management is diffuse;
- the nature, scope, size, scale, concentration, interconnectedness and mix of the activities of the company;
- the degree to which the company is already regulated by one or more primary financial regulatory agencies;
- the amount and nature of the financial assets of the company;
- the amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and
- any other risk-related factors that the Council deems appropriate.

Such a decision is subject to procedural protections and rights of appeal.

A "nonbank financial company" or "NFC" is a company that "predominantly" engages in financial activities.[3] As a result, an insurance company, an investment adviser, or a fund, as well as other types of companies engaged in financial services, could become subject to supervision by the Board of Governors.

Similar standards apply to a determination with respect to a foreign NFC, but several are modified to focus on the firm's U.S. operations.[4] Such a determination also must take into consideration competitive equality between U.S. firms and those based in the relevant country, as well as supervision by the company's home country regulator.

Any bank holding company with $50 billion or more in assets which received funding under the TARP program and subsequently sold its bank or thrift subsidiary would be deemed a Supervised Nonbank Company under the supervision of the Board of Governors.[5] The so-called Hotel California provision would prevent the recipients of the TARP largesse from seeking to avoid supervision through such a divestiture.

The Council also may cause the financial activities of a company that does not predominantly engage in financial services to become subject to supervision by the Board of Governors and enhanced prudential standards. This authority is available upon a determination that material financial distress related to the company's financial activities would pose a threat to the financial stability of the United States. Exercise

[3] Act § 102(a)(4)(C). An entity meets this test if either 85% of its consolidated annual gross revenues or 85% of its consolidated assets relate to activities that are "financial in nature" or to the ownership of one or more insured depository institutions. In defining what activities are "financial in nature," the Act references Section 4(k) of the BHCA. Section 4(k) is the laundry list of activities permissible for financial holding companies. Section 4(k) includes a wide range of activities generally regarded as financial, such as extending credit, dealing in securities, underwriting insurance, and providing investment advice. But there are also a number of less obvious activities that could be deemed "financial in nature" under section 4(k), such as data processing, management consulting and finder services.

[4] A foreign nonbank financial company includes any firm organized overseas that is "predominantly engaged" in U.S. financial services. The definition specifically notes that this "includes: firms that operate through a branch in the U.S.," and appears thereby to include any non-U.S. firm that operates either through a subsidiary or without any U.S. presence, provided that it would meet the predominantly engaged test. Act § 102(a)(4)(A).

[5] Act § 117.

of this authority requires somewhat higher procedural hurdles than the designation of an NFC as a Supervised Nonbank Company. Under this authority, in appropriate circumstances, the Council could bring under supervision, for example, the automobile financing arm of an automobile manufacturer. The Board of Governors is authorized to require reports from, conduct examinations of, and bring enforcement action against, a Supervised Nonbank Company and, as noted below, must establish certain enhanced prudential standards that would apply to such a firm.

Bank Holding Companies Subject to Enhanced Prudential Standards

The Act requires that enhanced prudential standards established by the Board of Governors for Supervised Nonbank Companies apply to any bank holding company with assets of $50 billion or more.[6] The Act does not define such institutions, but refers to them in various places as "large interconnected bank holding companies," and as "a company described in Section 165(a)."[7] This article refers to them as "Supervised Bank Holding Companies."

As described below, the Board of Governors has authority that permits the prudential standards to be tailored to particular institutions, subject to certain limits, and is given the authority to raise the $50 billion asset floor with respect to certain of the prudential standards. The authority permits the Board of Governors to exclude institutions by setting the floor sufficiently high from coverage of those particular standards and underscores the wide latitude that Congress has entrusted to the Board of Governors.

Board of Governors Supervision and Enhanced Prudential Standards

The Board of Governors is required to adopt and implement enhanced prudential standards for Supervised Nonbank Companies and "large interconnected bank holding companies." The enhanced prudential standards are for the purpose of preventing or mitigating risk to the financial stability of the United States. As a general matter, the Council has a role in making recommendations on such standards but the establishment of such standards is reserved to the Board of Governors.

The Act specifies subjects for enhanced prudential standards, but provides limited substantive requirements to guide the Board of Governors' exercise of its discretion in the development of these standards. The subjects of enhanced prudential standards include risk-based capital and leverage, liquidity, risk management, resolution plan, credit exposure and concentration limit requirements. The Board of Governors is also authorized, but not required, to impose requirements related to contingent capital, enhanced public disclosure, short-tem debt limits and such other subjects as it deems appropriate. The Act also provides for annual "stress tests" of covered firms and for risk committees for publicly traded Supervised Nonbank Companies and publicly traded bank holding companies with $10 billion or more in assets.

The enhanced prudential standards must be stricter than those applicable to organizations without systemic importance and more stringent for companies that meet or exceed certain enumerated considerations related to size and complexity of business. The enhanced prudential standards may be tailored to particular institutions subject to certain limits.[8]

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[6] Act § 165(a).

[7] Act §§ 115(a) & 166(b).

[8] Act § 165(b)(1)-(3).

Certain of the prudential standards are notable for the authority they grant to the Board of Governors. If the resolution plan submitted by a covered firm is rejected and the Board of Governors imposes more stringent requirements upon a firm, it also may require that the firm divest certain assets or businesses in order to facilitate an order resolution in the event of bankruptcy.

The concentration limit imposes a capital limitation on the total credit exposure of any firm to another at 25% of the firm's capital and surplus, or such lower amount as the Board of Governors may establish.[9]

A Supervised Nonbank Company is not subject to the full panoply of regulation by the Board of Governors under the BHCA that applies to a bank holding company, such as the limits on the type of non-banking activities a bank holding company may conduct. However, the Board of Governors could choose to require a Supervised Nonbank Company to transfer financial businesses to an intermediate holding company apart from its nonfinancial businesses.[10]

A Supervised Nonbank Company is also subject to the limits on director interlocks among banking firms, as if it were a banking organization.[11]

The Board of Governors is also authorized to implement regulations that provide for a series of early remediation consequences for a Supervised Nonbank Company or a Supervised Bank Holding Company in declining health (similar to the Prompt Corrective Action requirements applicable to banks). The Board of Governors could require such a company to terminate an activity, to modify an activity, or to sell assets.[12]

Supervisions of M&A Activity

The Act places several limits on the M&A activity of a Supervised Nonbank Company or Supervised Bank Holding Company. First, a Supervised Nonbank Company is treated as if it were subject to the BHCA for the purchase of shares of a bank, requiring that it secure prior approval of the Board of Governors to acquire more than 5% of the common stock of a banking organization.[13]

A Supervised Nonbank Company or a Supervised Bank Holding Company may acquire the voting stock of any firm engaged in financial services with assets of $10 billion or more only after providing prior notice to the Board of Governors, except as provided in Section 4(c) of the BHCA. Section 4(c)(6) of the BHCA exempts the acquisition of up to 5% of the voting stock of any firm from prior notice. Thus, any investment or acquisition that exceeds 5% of the voting stock of such a firm must come under one of the other exemptions or be subject to prior notice to the Board of Governors.[14] The standard applied to such a notice is that applied under the BHCA to a nonbank acquisition by a bank holding company that is not a financial holding company, with the added requirement that the Board of Governors consider the extent to which the transaction would result in more concentrated risks for "global" or U.S. financial stability or the U.S. economy.[15] For financial holding companies that have been permitted to acquire any financial firm other than a bank or thrift, without prior approval, this effects a significant loss of flexibility and speed in making investments in, and acquisitions of, other financial firms.

[9] Act § 165(e).

[10] Act § 167.

[11] Act § 164.

[12] Act § 166.

[13] Act § 163(a).

[14] Act § 163(b). See also 12 U.S.C. 1843(c).

[15] Act § 163(b)(4).

The Act imposes a new limit on the size of any single banking organization or Supervised Nonbank Company. Current law imposes a cap on the percentage of nationwide bank deposits that can be held by a single banking organization. The Act revises the deposit cap and creates a new cap based on total liabilities less regulatory capital of all banking and thrift organizations, and all Supervised Nonbank Companies. The Act prohibits a merger or acquisition by any banking organization or any Supervised Nonbank Company if the total consolidated liabilities of the resulting company would exceed 10% of the aggregate consolidated liabilities of all banking organizations and Supervised Nonbank Companies. The Board of Governors is charged with adopting implementing regulations and guidance.[16]

Supervision of Financial Activities and Practices

The Council has the power to recommend that federal financial agencies apply special standards for financial practices that the Council determines pose a risk of "significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies or the financial markets of the United States."[17] The agencies are required either to apply the recommended standards or to provide a written explanation for doing otherwise.

In making such a recommendation, the Council could act with a majority vote of its members, and the approval of the Secretary of the Treasury is not required, in contrast to the vote required to designate an NFC as a Supervised Nonbank Company. The practical effect of this authority could result in the adoption of broad-based rules governing products such as collateralized debt obligations, subprime loans, or particular accounting, marketing, or compensation practices.

Early Remediation and Orderly Liquidation

The Board of Governors is authorized to determine that a Supervised Nonbank Company or a Supervised Bank Holding Company poses a grave threat to the financial stability of the U.S., with the approval of two-thirds of the Council members. Upon any such determination, the Board of Governors may limit the ability of the company to enter into merger transactions, restrict the ability of the company to offer a financial product, require the company to terminate one or more activities, or impose conditions on the manner in which the company conducts activities. The Board of Governors also may limit the ability of the company or to sell or transfer assets or off-balance sheet items to unaffiliated parties.

The special insolvency regime created by the Act for large firms that pose a risk to the stability of the financial system was created to address the insolvency of firms such as Supervised Nonbank Companies or Supervised Bank Holding Companies, although that regime is made applicable to institutions only in special circumstances. See "Orderly Liquidation Authority."

Federal Reserve Credit and Payment and Clearing System Supervision

The Act also amends the authority of the Federal Reserve to extend credit to nonbank, private parties in unusual and exigent circumstances, and authorizes the FDIC, in the event that a liquidity event is determined to exist, to create a widely available program to guarantee the obligations of solvent-insured depository institutions or holding companies. See "Federal Reserve Emergency Credit."

The Act also provides the Federal Reserve with authority to supervise systemically important financial market utilities and payment, clearing and settlement activities conducted by financial institutions. See "Supervision of Payment, Clearing and Settlement."

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[16]Act § 622.

[17]Act § 120.