

Financial Stability Act of 2010 (Title I of the Dodd-Frank Act)

Financial Stability Under the Dodd-Frank Wall Street Reform and Consumer Protection Act

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Financial Stability Act of 2010 (Title I of the Dodd-Frank Act)



Title I Financial Stability Act of 2010

- Subtitle A – Establishes the Financial Stability Oversight Council (the “Council”)
- Subtitle B – Establishes the Office of Financial Research (the “OFR”)
- Subtitle C – Expands the Supervisory Authority of the Federal Reserve (the “Board”)



The Council-Subtitle A

- Codification of the President's Working Group on Financial Markets (with addition of an insurance person)
- Chaired by the Secretary of the Treasury and consisting of 8 other Federal and State financial regulators plus one independent member having insurance expertise (Section 111)

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The Council (cont'd)

- **PURPOSE (Section 112(a)(1)):**
 - Identifying and, within the limits of its powers, responding to, emerging threats to the financial stability of the United States from conduct of:
 - Certain selected nonbank financial companies*
 - A company “predominantly engaged in financial activities” defined as 85% of revenues or assets
 - Large interconnected bank holding companies with assets of \$50 billion or greater*
 - “Or that could arise outside the financial services marketplace” (think GM)
 - Promote market discipline
 - eliminate the notion (“moral hazard”) that these SIFIs will be shielded from failure because they are “too big to fail”
- * Both are collectively hereafter referred to as Systemically Important Financial Institutions or “SIFIs”



The Council (cont'd)

- DUTIES (Section 112(a)(2)):
 - Collect financial data (primarily through Office of Financial Research) to assess risks to the U.S. financial system
 - Monitor financial market for potential threats
 - Monitor domestic and foreign financial regulatory proposals and developments and make recommendations that “will enhance efficiency, competitiveness and stability” (regulatory watchdog?)
 - Facilitate information sharing among federal and state financial regulatory developments
 - Advise Congress on ways to enhance stability of the U.S. financial markets (as part of Council’s annual reporting)



The Council (cont'd)

- DUTIES: (cont'd)
 - Identify gaps in regulation that could pose a risk to financial stability
 - **Require supervision** by the Board for nonbank SIFIs “that **may pose risks** to the financial stability of the U.S. in the event of their financial distress”
 - Make recommendations to the Board and other financial agencies regarding heightened or new standards relating to risk, liquidity, credit, etc.
 - Annual reporting to and testimony before Congress, with a signed statement by each Council member on whether Council is taking all reasonable steps to **ensure** financial stability and mitigate systemic risk
 - Sprinkled throughout the 2000+ page Act are various other powers and duties of the Council
 - Such as Section 716(l) which allows the Council to determine whether any swaps entity may no longer access Federal assistance with respect to swap activities, even though it availed itself of an exception to the swaps pushout rules in Section 716



The Council (cont'd)

- Examples of Duties
 - Under Section 112(a)(2)(D), (L) and (M), the Council must review accounting pronouncements of the Financial Accounting Standards Board (FASB) which has recently set forth in a draft ruling the expansion of the use of mark-to-market accounting to cover loans (*Proposed Accounting Standards Update, File Reference No. 1810-100, Issued: May 26, 2010*)
 - The proposed ruling would require banks to value unfunded loan commitments and loans they plan to hold to maturity in the same manner as they currently value loans they intend to sell. Many bankers feel this will exacerbate the credit crisis and lead to further financial instability – topic for the Council



The Council (cont'd)

- Examples of Duties (cont'd)
 - Council announced it plans to study the systemic risk associated with money market funds. 75 FR 61758 (October 6, 2010)
 - This follows on the August 9, 2010 Moody's Special Comment on "Sponsor Support Key to Money Market Funds" and could lead to capital recommendations for sponsors by the Council, particularly bank sponsors supervised by the Board
(http://v3.moody.com/researchdocumentcontentpage.aspx?docid=PBC_126231)
 - Whether FASB (and SEC which regulates it) or any other financial regulatory agency (SEC, which regulates money market funds) would follow such recommendations remains to be seen
 - Council has no authority to enforce most of its recommendations – aside from being a "bully pulpit" - other than to require supervision by the Board of SIFIs and a few other powers sprinkled throughout the Act



The Council (cont'd)

- Requiring Board's Supervision of nonbank SIFIs (Section 113)
 - Determination requires 2/3rds vote of Council
 - Covers domestic and foreign companies
 - Broad standard for making determination
 - Whether activities "could" pose a threat to (Section 112(a)(2)(H) says: "may pose risks" to) financial stability
 - May mean it does not matter if the nonbank financial company is healthy or in distress; if it is so big or interconnected then someday it "could" be a threat



The Council (cont'd)

- Factors Council Will Consider When Determining nonbank SIFIs Are Subject to Board Supervision (Section 113):
 - SIFIs' leverage, off-balance sheet exposures, and transactions with other SIFIs
 - There are various definitions of leverage in other provisions: Section 165(j) – debt to equity of no more than 15:1 and Section 171(a) – Tier 1 capital to total assets in Title I, but it is not clear if they apply to this factor, probably not until the Council does a rulemaking
 - SIFIs' importance as a source of credit and liquidity to U.S. financial system



The Council (cont'd)

- Factors Council Will Consider When Determining nonbank SIFIs Are Subject to Board Supervision (Section 113) (cont'd):
 - Extent SIFIs' assets are managed (a plus) or owned (a minus)
 - Size, scale and interconnectedness (no definition) of SIFI
 - Amount and types of liabilities, including the degree of reliance on short-term funding (the Bear Stearns problem)



The Council (cont'd)

- Require reporting by SIFIs to the Council—only through Treasury Office of Financial Research
 - May request Board to do examinations of SIFIs to obtain information to make its determinations
- Council must reevaluate its determinations annually. Hearings to challenge Council's determinations may be requested and judicial review of determination available at the U.S. District Court level (using arbitrary and capricious standard) (Section 113(d)-(h))
- “Antievasion” (Section 113(c))
 - Establishment of intermediate holding companies for financial activities to avoid Board regulation of whole nonbank company
- Resolution of Jurisdictional Disputes Among Member Agencies-nonbinding (Section 119)



The Council (cont'd)

- Enhanced Supervision and Prudential Standards for SIFIs (Section 115)
 - May make recommendations for the Board to establish prudential standards and reporting and disclosure requirements that are more stringent than those applicable to other companies



The Council (cont'd)

- Recommendations may differentiate among SIFIs subject to heightened standards on an individual basis or by category
 - Heightened standards may increase in stringency based on determination of Council



The Council (cont'd)

- Council is required to conduct feasibility study related to future imposition of contingent capital requirement on SIFIs (Section 115(c))
- Council may also recommend establishment of resolution plans and credit exposure reporting that details nature and extent to which company and other SIFIs have credit exposure to each other (Section 115(d)). Same for concentration limits, short-term debt limits and enhanced public disclosures (Sections 115 (e) – (g))



The Council (cont'd)

- Continued nonbank financial company supervision of companies that received assistance under TARP that cease to be bank holding companies (Section 117, the “Hotel California” provision)
 - Can request hearing and appeal
- Council can recommend new or heightened standards applicable to **activities** or **practices** conducted by bank holding companies or nonbank financial companies for financial stability purposes (Section 120)
 - Not limited to SIFIs
 - Applicable if the nature of the activity or practice “**could**” create or increase risk of significant liquidity, credit or other problems spreading among bank holding companies or nonbank financial companies or the financial markets
 - Regulatory agency must impose heightened standard or explain in writing why it did not follow Council recommendation
 - Council shall report this imbroglio to Congress



The Council (cont'd)

- Mitigation of Risks to Financial Stability of SIFIs (Section 121)
 - If Board determines SIFI poses a “grave threat” activities or practices could be restricted or terminated with a 2/3 affirmative vote by the Council
- Study of Financial Institutions and Capital Market Efficiency (the “Too Big to Fail” issue) (Section 123)
 - Study shall address explicit or implicit limits on size of financial institutions
 - Study shall also address limits on complexity, segregation of high-risk activities, commingling of commercial and financial activities (shades of Glass-Steagall), etc
 - Due 6 months after enacted and updated every five years.

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Title I Financial Stability Act of 2010- Subtitle B

- Establishes the Office of Financial Research
(Section 152)



The OFR

- Part of the Department of Treasury (Section 152) but:
 - Director appointed for 6 years by President with advice and consent of Senate
 - Director has sole discretion for carrying out duties
 - Budget supplied by the Board for first two years, but thereafter all activities funded by risk-based assessment on SIFIs (Section 155)
 - The new technique of Congress: establishing an independent agency within an agency (same for Bureau of Consumer Financial Protection within the Federal Reserve)



The OFR (cont'd)

- Purpose and Duties are to (Section 153):
 - Collect data on behalf of the Council
 - Standardize the types and formats of data
 - Perform applied research
 - Develop facts for risk measurement and monitoring
 - “Member agencies,” (i.e., regulators that are Council members, shall implement regulations promulgated by the OFR to standardize types and formats of data collected by OFR, and if they fail to do so, Council can do it for financial entities
 - While this will increase transparency in the marketplace, many companies will have to revise their reporting systems – very expensive. Could trickle down to SEC and other agency reporting



The OFR (cont'd)

- Establishment of the Data Center and Research and Analysis Center within the OFR (Section 154)
 - Empowered to collect data from financial companies
 - OFR has subpoena power

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Title I Financial Stability Act of 2010- Subtitle C

- Additional Federal Reserve Authority for SIFIs

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New and Enhanced Powers for the Board

- Examination and supervisory authority over nonbank SIFIs as determined by the Council (Section 161)
- Enforcement and authority over nonbank SIFIs and back-up enforcement over their subsidiaries (Section 162)
- Prior notification for large acquisitions (\$10 billion or more in consolidated assets) by SIFIs (Section 163)
- Prohibition against management interlocks between SIFIs (Section 164)

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New and Enhanced Powers for the Board

- Enhanced prudential standards for supervision (Section 165):
 - Risk-based capital requirements*
 - Leverage limits*
 - Debt to equity ratio (deposits excluded) of no more than 15:1 if SIFI poses a “grave threat”
 - Liquidity requirements*
 - Overall risk management requirements*
 - Resolution plan (“Living Will”) and credit exposure report requirements*
 - Note: Under Section 610 and 611, national and state banks are now required to include credit exposure arising derivative transactions, repos, securities lending and borrowing
 - Concentration limits*
 - Risk committee, if publicly traded*
 - Stress test (annually by Board, semi-annually by SIFI itself)*
 - Contingent capital requirement (after two-year study by the Council)‡
 - Enhanced public disclosures ‡
 - Short-term debt limits (does not include insured deposits ‡)
 - Additional prudential standards ‡
 - Note: Off-balance sheet activities must be accounted for in computation of capital*
- * These items are **required** to be imposed by the Board
- ‡ These items **may** be imposed by the Board



Applicability to Foreign Financial Companies

- Consider principle of national treatment and equality of competitive opportunity
- Consider extent foreign home country standards comparable to US standards

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Resolution Plan/Living Will (Section 165(d))

- Company needs to provide a resolution plan in the event of material financial distress or failure
- Credit exposure on bilateral basis with other SIFIs
- Board and FDIC (Section 172) review plan – can reject plan
- Board and FDIC (Section 172) can take further actions, including requiring divestiture of assets or operations
- FDIC has back-up exam authority over all SIFIs unless in generally sound condition (Section 172)

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Other Supervision Enhancements

- Early remediation of financial distress of SIFIs (Section 166)
 - Can go as far as limiting asset growth, distributions, or requiring management changes, asset sales, capital raising, etc.
- Intermediate holding company may be required by Board for nonbank financial company (Section 167)
- Safe harbor rules to be adopted exempting some SIFIs from Board supervision (Section 170)

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Consolidated Capital Requirements – Collins Amendment (Section 171)

- Federal banking agencies are to establish minimum leverage and risk-based capital requirements consistent with FDIA prompt corrective action requirements
 - Applies to SIFIs and insured depositories
 - Same capital standards for holding company and insured depository (Section 171(b)(7))
 - To address risks to other public and private stakeholders “from adverse performance of the institution
 - Must cover risks from derivatives, securitized products purchased and sold, repos, securities borrowing and lending, concentrations in market share for any activity
 - Excludes hybrids like trust preferreds from Tier 1 capital (Section 171(b)(2))
 - Grandfathers those issued before May 19, 2010 by holding companies under \$15 billion in assets
 - Generally cannot issue any more trust preferreds and count as Tier 1 capital
 - Thrifts now subject to consolidated capital requirements
 - Specific phase-in periods



Other Capital Requirements

- “Source of Strength” Doctrine Hard-wired into Statute (Section 616)
- Capital Requirements must be Countercyclical, i.e., increases in times of economic expansion and decreases in times of economic contraction (Section 616)
- Capital Studies mandated, such as treatment of Hybrids in Tier 1 Capital (Section 174)



What Does this Mean?

- Economies of Scale Strategy under Challenge
 - Management of Asset Size a Consideration
- Framework of Regulation under Development
 - At least 13 Rulemakings for this Subtitle
- Resolution Plan/Living Will Raises very Difficult Issues
- Capital Requirements Impacted by Basel III

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