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Administration Releases Its Plan for Strengthening Financial System Stability and Regulation

President Obama, on June 17, 2009, following in the footsteps of Treasury Departments going back a half century, announced his Administration's plan to improve the effectiveness of the federal regulatory structure. Treasury released the plan in the form of a Treasury paper entitled "A New Foundation: Rebuilding Financial Supervision and Regulation."

Among the factors that it identifies as contributing to the current economic turmoil are:

- Ill-defined regulatory responsibility regarding systemic threats.
- Inadequate supervision of large financial organizations.
- Inadequate attention to the protection of consumer interests.

Among the most significant elements of the plan are the following.

1. Focus on Financial Services Firms that Pose a Systemic Risk to the Financial System

The plan, which is designed to leapfrog long-standing regulatory jurisdictional lines to ensure that financial services organizations that may pose a risk to overall financial stability will be subject to the strictest level of federal regulation, includes:

- A Financial Services Oversight Council ("Council") comprised of eight federal regulatory heads will advise the Federal Reserve Board ("FRB") on which institutions should be treated as "Tier 1 Financial Holding Companies (Tier 1 FHCs)"; that is, those that may potentially pose systemic threats. The Council, which will maintain a permanent staff at Treasury, will also serve as a vehicle for surfacing and evaluating emerging systemic risks.
- Supervision of Tier 1 FHCs will be assigned to the FRB, which will be given expanded authority over their affiliates.
- Tier 1 FHCs will be subject to stricter safety and soundness standards, including those regarding capital, liquidity and risk management.
- Tier 1 FHCs that do not control a bank would become subject to a prohibition on the mixing of banking and commerce and would be required after a five-year transition period to limit their activities to financial activities permitted for FHCs.

- As previously proposed by the Treasury in March 2009, the plan would give the Treasury authority under certain circumstances to resolve a troubled Tier 1 FHC that threatens the stability of the financial system by appointing the Federal Deposit Insurance Corporation ("FDIC") or another entity as a conservator or receiver and bypassing federal bankruptcy laws.

- Interestingly, the plan would give the Treasury a new check on the FRB by requiring prior written approval of the Secretary of the Treasury for the FRB to exercise its emergency lending authority.

See 21st Century Alert, No. 09-03-30, *Treasury Proposes Wide-Ranging Resolution Authority Over Financial Institution Holding Companies; Proposes Other Significant Regulatory Changes,* for a discussion of issues that will arise with regard to the identification and regulation of systemically significant companies.

2. A New Structure for Prudential Bank Regulation

The plan, which contemplates restructuring the current bank regulatory system, provides for the following:

- The federal thrift charter would be eliminated. Federally chartered banks would be granted the same unrestricted interstate branching authority that is currently available to federal thrifts.

- The Comptroller of the Currency and the Office of Thrift Supervision would be combined into a single agency – the National Bank Supervisor ("NBS") – which would charter and provide prudential supervision of federally chartered institutions.

- Companies that control various types of depository institutions (such as savings institutions, industrial loan companies, credit card banks and trust companies) that do not cause the parent company to be a bank holding company ("BHC") will be required to become a BHC. These companies would be given five years to conform their activities to BHC limitations.

- Capital requirements for BHCs and banks will be strengthened to address risks that are currently inadequately addressed.

- New standards for executive compensation intended to align compensation with long-term shareholder value and to avoid threats to the safety and soundness of a financial firm would be issued by the financial regulatory agencies.

- Tightening of affiliate transaction restrictions.

- Permitting the Treasury under certain circumstances to resolve a troubled BHC that threatens the stability of the financial system by appointing the FDIC or another entity as a conservator or receiver, bypassing bankruptcy law.

- The plan suggests that the federal banking agencies propose regulations that would require loan originators or sponsors to retain five percent of the credit risk of securitized exposure.

See 21st Century Alert No. 08-03-31, *Regulatory Watch: Treasury Recommends A Massive Reconstruction of Financial Regulation,* for a further analysis of the types of issues raised by widespread changes to the current regulatory structure.

3. A New Consumer Financial Protection Regulator

The plan, which finds fault with the federal bank regulators' consumer protection efforts in recent years and sees problems with areas that are subject to relatively weak state regulation, includes the following provisions:

- Under the plan a new agency, the Consumer Financial Protection Agency ("CFPA") would be established and be given broad regulatory and enforcement authority over a wide range of consumer protection laws, which would include the Community Reinvestment Act and the fair lending laws.

- The CFPA would have authority to protect consumers in the financial products and services markets (other than products and services already regulated by the Securities and Exchange Commission ("SEC")). In this regard, the plan calls for the CFPA to define standards for "plain vanilla" products. For example, a plain vanilla mortgage, which could have fixed or adjustable rates, would not include prepayment penalties; would be fully underwritten to document income; would collect escrow for taxes and insurance; and would be differentiated by a single characteristic, the interest rate. The plan states that the CFPA should require financial firms to offer plain vanilla products alongside whatever lawful products a firm chooses to offer.

- The CFPA would have jurisdiction over state and federal banking institutions. It would also have authority over nonbanking institutions on a backup basis to state regulators. The CFPA would largely supplant the Federal Trade Commission's current authority in regard to financial products and services.

- CFPA rules would constitute a floor rather than a ceiling. States could adopt and enforce stricter rules.

In what is likely to be a controversial move, the plan provides that nondiscriminatory state consumer protection laws may be enforced with regard to federally chartered institutions, subject to arrangements with prudential supervisors.

4. Additional Provisions

The plan contains a range of additional proposals. Notable among these are the following:

- A requirement that advisers to hedge funds and other private pools of capital whose assets under management exceed a specified threshold be required to register with the SEC. Such registered advisers would be required to report information on the funds they manage in order to determine whether any funds require regulation for financial stability purposes.

- An Office of National Insurance ("ONI") would be established within the Treasury. The ONI would recommend to the FRB any insurance companies that it believes should be regulated as Tier 1 FHCs. It will be charged with leading federal efforts in the areas of systemic risk, capital and consumer protection and it may offer a federal insurance charter option.

- Treasury and the Department of Housing and Urban Development are to undertake a study of the future of Fannie Mae, Freddie Mac and the Federal Home Loan Banks and report to Congress and the public.

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The Administration's release of its plan sets the stage for a broad range of conflicts among and between many business interests, as well as federal and state regulators. In that regard, it signals the beginning of a long debate between well-entrenched constituencies.

It remains to be seen how Congress will deal with the two most critical questions in this debate:

1. Can a shuffling and even enlargement of regulatory responsibilities and agencies reduce the likelihood of future financial crises enough to offset the potentially adverse impact of new regulation on the financial innovation of US companies?

2. If the US had no regulatory system in place today, what type would be created to best address the complex financial companies that exist, understanding that it is unlikely that current market forces and trends that foster large organizations and financial complexity will change in the future?

There are precedents in the modern history of financial regulation in this country when economic disasters have been followed by the enactment of wide-ranging consumer protection legislation. Fairness would suggest that there is a divergence of opinion on the effectiveness and economic impact of such regulation. For example, the blizzard of consumer protection legislation in the 1970's, which included the Equal Credit Opportunity Act, the Community Reinvestment Act, the Truth in Lending Act, the Home Mortgage Disclosure Act, and the Real Estate Settlement Procedures Act apparently failed this time to protect consumers from themselves and those who would take advantage of them, notwithstanding the unending 10-point type disclosures and prophylactic procedures that they created.

The Administration and Congress face enormous challenges in dealing with the aftermath of this crisis as they evaluate the causes and the next forms of financial regulation that should be put in place. It will be difficult for them to avoid the temptation to enact changes that address the last crisis but may not avert the next.

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