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Regulatory Watch: Treasury Recommends A Massive Reconstruction of Financial Regulation

[This is the second in the series of regular continuing reports on how the regulation of financial firms and markets may change as a result of the current financial stress and the intervention by the government.]

In its "Blueprint for a Modernized Financial Regulatory Structure" released today, the Department of the Treasury has presented a series of "short-term" and "intermediate-term" recommendations to improve regulatory coordination and oversight in the wake of recent events in the U.S. credit and mortgage markets and to eliminate some of the duplication in the U.S. financial regulatory system. The Treasury also has presented more far-reaching proposals to modernize the U.S. financial regulatory structure by adopting an objectives-based approach to supervision.

Generally, the proposed long-term reforms would substantially restructure the federal financial regulatory system and extend regulation to payments systems and mortgage lending businesses, as well as various investment funds, including hedge funds, private equity funds, and venture capital funds, not currently regulated. Presumably, state consumer lending entities would also be subject to some form of federal regulation.

The Federal Reserve could lose its bank holding company and state member bank oversight authority, but it would keep its monetary policy authority and powers and gain broad umbrella authority to obtain information from borrowers at the discount window, oversee payments systems and mortgage lenders, examine depository and non-depository institutions under limited circumstances, and require corrective action from financial firms. The Treasury would assume broad authority for the initial development of federal regulation for the insurance business, from underwriters to agents. All current federal banking charters would be replaced by a single federal charter, and all such institutions would be supervised by a single federal banking agency.

Treasury cited two prior reports as precedents for the current report: *Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services* (1984),[1] and *Modernizing the Financial System: Recommendations for Safer, More Competitive Banks* (1991). In proposing new regulatory models, Treasury indicated that it hopes to initiate a discussion about the current regulatory structure and its goals. Since the proposal, by extending different forms of federal

[1] There have been many proposals in the last 40 years to redraw the lines of financial regulation. Most have not been successful. A co-author of this Alert, Thomas P. Vartanian, served on the Task Group for the 1984 report during his tenure as General Counsel of the Federal Home Loan Bank Board from 1981-83.

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regulation to new players in the market, raises as many questions as it seeks to answer, it is sure to draw a wide range of financial firms and federal agencies into the debate.[2]

SHORT-TERM RECOMMENDATIONS

The Treasury suggested that three measures be adopted immediately:

1. The President's Working Group on Financial Markets ("PWG"), which is chaired by the Secretary of the Treasury and also includes the heads of the Federal Reserve, the Securities and Exchange Commission ("SEC"), and the Commodity Futures Trading Commission ("CFTC"), should be modernized:
    a. To include the entire financial sector, rather than solely financial markets.
    b. To include the heads of the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), and the Office of Thrift Supervision ("OTS").
    c. To foster better inter-agency coordination and communication in four distinct areas: mitigating systemic risk to the financial system, enhancing financial market integrity, promoting consumer and investor protection, and supporting capital markets efficiency and competitiveness.
    d. To engage in consultation efforts, as might be appropriate, with other domestic or international regulatory and supervisory bodies.
    e. To issue reports or other documents to the President and others, as appropriate, in its role as the coordinator for financial regulatory policy.[3]
2. Improved regulation of mortgage originations:[4]
    a. A new federal commission, the Mortgage Origination Commission ("MOC"), should be created under a Director appointed by the President. The MOC would have a six-member board, comprised of the principals (or their designees) of the Federal Reserve, the OCC, the OTS, the FDIC, the National Credit Union Administration, and the Conference of State Bank Supervisors.[5]
        i. Federal legislation should set forth (or provide authority to the MOC to adopt) uniform minimum licensing qualification standards for state mortgage market participants.[6]

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2 Treasury must appreciate that history would indicate that the likelihood of political success of the proposal is inversely related to the number of industries and business segments that are impacted by the changes that it is proposing.

3 Under the current circumstances, which include broad financial turmoil in the markets, questions may be raised about the actual impact that the enhancement and enlargement of the PWG can have on the workings of the marketplace. In addition, these suggestions do not seem to be consistent with the Treasury's stated goals of increasing regulatory efficiency and eliminating duplication.

4 It appears that Treasury prefers to have mortgage bankers and brokers directly regulated at the federal level, rather than attempting to do so indirectly through the regulation of depository institutions and the housing GSEs. Given the large number of non-federally regulated businesses throughout the country engaged in the mortgage industry, any proposal to regulate mortgage originators surely will bring a large numbers of participants into the political process.

5 Critics may question whether a multi-headed commission will be efficient, able to act rapidly in times of financial stress, and not be subject to myriad political and industry pressures.

6 The legislation or regulation would presumably need to determine the breadth of mortgage market participants that would be subject to such regulation and oversight. For example, would "mortgage market participants" include, in addition to mortgage brokers and bankers, servicers, aggregators, securitizers, and traders?

These standards would address personal conduct and disciplinary history, minimum educational requirements, testing criteria and procedures, and license revocation standards.

ii. The MOC also would evaluate, rate, and report on the adequacy of each state's licensing and regulation.[7]

b. The authority to draft federal mortgage lending regulations should continue to be the sole responsibility of the Federal Reserve because of its experience in implementing the Truth in Lending Act ("TILA").[8]

c. Enforcement authority for federal laws should be clarified and enhanced, and any issues concerning the authority of the Federal Reserve (as bank holding company regulator), the OTS (as thrift holding company regulator), and state supervisory agencies in conjunction with the Federal Reserve or OTS to examine mortgage originators that are affiliates of depository institutions and enforce federal mortgage laws with respect to those affiliates should be addressed.[9]

3. The Federal Reserve's procedures to provide liquidity during those rare circumstances when market stability is threatened should be enhanced to ensure that the process is transparent, appropriate conditions are attached to lending, the flow of information to the Federal Reserve, through on-site examination or other means, is adequate, and the PWG considers broader regulatory issues associated with providing discount window access to non-depository institutions.[10]

INTERMEDIATE RECOMMENDATIONS

Over the intermediate future, Treasury suggested five changes to federal supervision of financial institutions and markets:

1. Over a two-year period, phase out and transition the federal thrift charter to the national bank charter, and merge the operations of the OTS into the OCC.[11]

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7 In this, as in many other areas, the proposal appears to reduce substantially the role of the states.

8 This suggestion seems to require clarification. The TILA is largely a disclosure-based law, and the Federal Reserve certainly understands those aspects of consumer law. However, experience with the TILA does not necessarily translate into expertise in writing mortgage lending regulations. In that regard, the OTS, which the Treasury would eliminate, has argued that it has extensive expertise in understanding and regulating mortgages as a result of its supervison of the thrift industry over the last 75 years. The S&L crisis in the 1980s and the current market turmoil have demonstrated that mortgages are among the most complex financial instruments that a financial institution can hold in its portfolio because of the various interest rate, credit, prepayment, and other risks associated with them.

9 This reference seems to reflect the recent competition between state attorneys general and federal regulators with regard to enforcement of laws meant to protect consumers.

10 By proposing that the Federal Reserve be given greater information during a crisis, rather than making borrowers subject to greater Federal Reserve regulation, Treasury has adopted a deliberate approach to lending to non-depositories.

11 The stated premise for this recommendation is that the thrift charter is no longer essential to providing housing finance in the United States. A transition to a national bank charter would presumably eliminate qualified thrift lender requirements and provide federal thrifts with full commercial bank authority. This could result in more institutions adopting similar business plans and chasing the same assets. The Treasury proposal provides for continuing grandfathered activity authority for unitary savings and loan holding companies that meet certain requirements.
In addition, charter changes would have to be evaluated to the extent that they may impact the continuing business plans of transitioned thrift institutions. For example, would the loss of certain preemption or branching powers subject consumer and mortgage assets on the books of these institutions to additional laws and limitations, or would those assets receive some form of protection?

2. "Rationalize" the federal supervision of state-chartered banks by placing all such authority under the Federal Reserve or the FDIC.[12]

3. Place payments and settlement systems, which are generally not now subject to any uniform, specifically designed, and overarching regulatory system, under federal oversight.

   a. A mandatory federal charter for "systemically important payment and settlement systems" would be created and would provide federal preemption powers.

   b. The Federal Reserve would have primary oversight responsibilities for payment and settlement systems, with a full range of authority to establish regulatory standards.

4. Eliminate inefficiencies in the insurance industry.

   a. Establish an optional federal charter ("OFC") and system of supervision for insurers, reinsurers and insurance agents and brokers under a newly created Office of National Insurance ("ONI") within Treasury.

   b. The states would have no jurisdiction over those electing to be federally regulated.

   c. An insurer holding an OFC could not engage in underwriting both life insurance and property and casualty insurance.

   d. Establish an Office of Insurance Oversight ("OIO") within Treasury to address international regulatory issues and advise the Secretary on major domestic and international policy issues. The OIO would become the lead regulatory voice in the promotion of international insurance regulatory policy for the U.S. (in consultation with the National Association of Insurance Commissioners ("NAIC")), be granted the authority to recognize international regulatory bodies for specific insurance purposes, and ensure that the NAIC and state insurance regulators achieved the uniform implementation of the declared U.S. international insurance policy goals.

5. Merge the SEC and CFTC into a single agency.

   a. Pre-merger, the SEC should do the following:

      i. Adopt core principles to apply to securities clearing agencies and exchanges.

      ii. Update and streamline the self-regulatory organization ("SRO") rulemaking process to recognize the market and product innovations of the past two decades.

      iii. Consider streamlining the approval for any securities products that are commonly available in the marketplace.

      iv. Undertake a general exemptive rulemaking under the Investment Company Act of 1940 ("Investment Company Act"), consistent with

[12] Treasury recommends a study, which would include an examination of the evolving role of Federal Reserve Banks, in order to make a definitive proposal regarding the appropriate federal supervisor of state-chartered banks.

investor protection, to permit the trading of products already actively traded in the U.S. or foreign jurisdictions.

v. Propose legislation to Congress that would expand the Investment Company Act by permitting registration of a new "global" investment company.[13]

b. Post-merger, the new agency should undertake three initiatives:

i. Adopt overarching regulatory principles, drafted by the PWG, focusing on investor protection, market integrity, and overall financial system risk reduction.[14]

ii. Permit all clearing agency and market SROs to self-certify all non-retail investor related rulemakings (except those involving corporate listing and market conduct standards), which the SEC would retain the authority to abrogate at any time.

iii. Harmonize differences between futures regulation and federal securities regulation.[15]

c. Statutory changes should be made by Congress to harmonize the regulation and oversight of broker-dealers and investment advisers that offer similar services to retail investors, including establishing a self-regulatory framework for the investment advisory industry that is similar to that of broker-dealers.

LONG-TERM OPTIMAL REGULATORY STRUCTURE: RECONFIGURATION OF THE REGULATORY STRUCTURE

Treasury has dedicated significant time and effort to a top-to-bottom evaluation of the financial services industry. In proposing an objectives-based regulatory system, the obvious question is whether the new structure would be more nimble, flexible, safe and sound than the current system. Schematics of the regulatory structures proposed by Treasury are attached.

While identifying significant issues and substantive improvements that could be achieved, Treasury's proposal, in some cases, seems merely to change the names of current regulators and eliminate certain agencies. In any event, the proposal broadens the range of financial firms that would be subject to some form of federal regulation.

Objectives-based regulation. An objectives-based regulatory approach would have three key objectives:

1. Market stability regulation – to address overall conditions of financial market stability that could impact the real economy;

2. Prudential regulation – to address issues of limited market discipline caused by government guarantees;[16] and

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13 There is no discussion in the proposal of the scope or purpose of a global investment company.

14 Policy and legal issues are raised by the adoption by a federal agency of rules drafted by another federal entity.

15 This would include rules regarding margins, segregation, insider trading, insurance coverage for broker-dealer insolvency, customer suitability, short sales, SRO mergers, implied private rights of action, the SRO rulemaking approval process, and the agency's funding mechanism.

16 It is interesting that Treasury points to government intervention as the source of breakdowns in market discipline. The multiple failures of sophisticated financial firms to exercise due diligence over their counterparties and the risks embedded in the financial instruments they purchased from each other, leading to the current financial market crises, appeared in those areas with the least government intervention and in the absence of government guarantees. Treasury's aside may indicate the rearguard action of market deregulation.

3. Business conduct regulation (linked to consumer protection regulation) – to address standards for business practices.

New Federal Charters. Treasury would establish three new charters, a federal insured depository institution ("FIDI") charter, a federal insurance institution ("FII") charter, and a federal financial services provider ("FFSP") charter.

1. A FIDI charter for all depository institutions with federal deposit insurance would:
    a. Consolidate the national bank, federal savings association, and federal credit union charters, whether in stock, mutual, or cooperative ownership structures;
    b. Provide "field" preemption over state laws to reflect the national nature of financial services;
    c. Be mandatory in order to obtain federal deposit insurance;[17] and
    d. Provide the operating and investment authority, initially at least, of a national bank.[18]
2. A FII charter for insurers offering retail products, where some type of government guarantee is present.[19] A uniform and consistent federal guarantee structure, the Federal Insurance Guarantee Fund ("FIGF"), could accompany a system of federal oversight, but existing state-level guarantees also could remain in place.
3. A FFSP charter for all other types of financial services providers, including broker-dealers, hedge funds, private equity funds, venture capital funds, and mutual funds.[20]
    a. A FFSP charter would create appropriate national standards in terms of financial capacity, expertise, and other requirements.
    b. Financial standards would resemble the net capital requirements for broker-dealers.
    c. Holders of FFSP charters would also have to remain in compliance with appropriate standards and provide regular updates on financial

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17 This appears to suggest that there is no room in the proposal for state chartered banks if having a FIDI charter is a prerequisite to having federal deposit insurance. This would likely raise significant opposition to the proposed by the states, which Treasury would not want to invite. At the same time, the proposal states that, in the optimal structure, the states should continue to have this authority to charter financial institutions and continue to have a role in regulating business conduct.

18 The powers of federal thrifts, federal credit unions, and national banks are not co-extensive today. The ability to continue to maintain assets and lines of business in such an extensive consolidation would have to be carefully examined.

19 The Treasury does not elaborate on what a government guarantee is in this context or the kinds of insurance contracts in which some type of government guarantee is present.

20 Safety and soundness regulation of entities such as hedge funds, equity funds, and venture capital funds is likely to raise questions about the effect of such increases in federal regulation on the overall competitiveness and flexibility of the capital markets in an increasingly global economy. Leverage limitations and capital requirements on these businesses may have intended as well as unintended consequences for the economy.
The proposal is vague as to whether a federal charter for this extraordinarily wide range of entities would be a voluntary option or a *de facto* requirement. Even if an entity decides not to take up this charter option, it appears that Treasury envisions that the federal conduct of business regulator would have extensive regulatory authority over entities engaged in financial services activities through a state charter. The proposal also may encompass providers of other consumer financial services.

conditions to the Conduct of Business Regulatory Agency ("CBRA"), the Federal Reserve, and the public, as part of their standard public disclosures. (CBRA would also oversee and regulate the business conduct of FIDIs and FIIs.)

4. "Field preemption" would be provided to FIDIs, FIIs, and FFSPs, preempting state business conduct laws directly related to the provision of financial services.

    a. States would retain clear authority to enact certain other laws and take enforcement actions against state-chartered financial service providers.

    b. State authorities could be given a formalized role in CBRA's rulemaking process in order to utilize their extensive local experience, and would have limited authority to address business conduct issues involving federally chartered institutions.

New Federal Regulators. Regulatory authority would be dispersed to the following federal agencies to reflect the proposal's objectives-based regulatory approach.

1. Market Stability Regulator**.** As the market stability regulator, the Federal Reserve would have a degree of authority over all three types of federally chartered institutions (FIDIs, FIIs, and FFSPs). The Federal Reserve would no longer be the principal regulator of bank holding companies, but it would assume an umbrella-type role and have responsibility over several related areas:

    a. Monetary policy and the provision of liquidity to the financial system;

    b. Participate with the Prudential Financial Regulatory Agency ("PFRA") and the CBRA in the examination of the three types of federally chartered institutions and initiate such examinations (in coordination with the PFRA or CBRA) targeted on practices important to market stability when the required information is not available from the PFRA or CBRA;

    c. Payment and settlement systems;

    d. Collect detailed information about the business operations of PFRA- and CBRA-regulated financial institutions and their respective holding companies, including:

        i. Requirements to consolidate financial institutions on the balance sheet of the overall holding company and at the segmented level of combined federally chartered financial institutions;

        ii. Detailed reports on overall risk management practices;

    e. Publish broad aggregates or peer group information about financial exposures that are important to overall market stability;

    f. Mandate additional public disclosures for federally chartered financial institutions that are publicly traded or for publicly traded companies that control such institutions;

    g. Develop information-reporting requirements for FFSPs and for holding companies with federally chartered financial institution affiliates;

    h. Consult with the PFRA and the CBRA on the adoption or modification of regulations affecting market stability, such as capital requirements and liquidity risk management;

    i. Undertake corrective actions (presumably including enforcement actions) related to enhancing market stability;

j. Require corrective actions to address current risks or to constrain future risk-taking (*e.g.,* require financial institutions to limit or more carefully monitor risk exposures to certain asset classes or certain types of counterparties or to address liquidity and funding issues) when overall financial market stability is threatened;

k. Collaborate with the other regulators on corrective actions when necessary in the interest of overall financial market stability; and

l. Continue to act as "lender of last resort" through the discount window, while maintaining a distinction between "normal" lending to FIDIs and "market stability" lending to non-FIDIs.

2. Federal Prudential Regulatory Agency. The PFRA would be responsible for the financial regulation of FIDIs and FIIs, including the following:

a. Assume the roles of the OCC and the OTS as the prudential regulators of federally chartered depository institutions;[21]

b. Focus on the original intent of holding company supervision, protecting the assets of the insured depository institution, and for this purpose monitor and examine a FIDI's holding company and affiliates; and[22]

c. Apply prudential regulation to individual financial institutions as current regulation applies to insured depository institutions, including capital adequacy requirements, investment limits, activity limits, and direct on-site risk management supervision.

3. Conduct of Business Regulatory Agency. The CBRA would be responsible for business conduct regulation, including consumer protection issues, across all types of firms, including the three types of federally chartered institutions. This oversight would fall into three broad categories—disclosures, sales and marketing practices (including laws and regulations addressing unfair and deceptive practices), and anti-discrimination laws. Business conduct regulation in this context would include:

a. Mandatory disclosures, business practices, and chartering and licensing for firms to enter the financial services industry and sell their products and services to customers under an FFSP charter;

b. FII business conduct issues associated with such matters as policy forms, unfair trade practices, and claims handling procedures;

c. Operational ability, professional conduct, testing and training, fraud and manipulation, and duties to customers (*e.g.*, best execution and investor suitability);

d. Replacing the authority of the Federal Reserve and other insured depository institution regulators, state insurance regulators, most aspects of the SEC's and the CFTC's responsibilities, and some aspects of the FTC's role.

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[21] The PFRA could presumably also undertake the prudential regulatory and supervisory duties of the FDIC and the Federal Reserve with regard to state-chartered depository institutions.

[22] With this protection in place, Treasury believes that, from the perspective of protecting a FIDI, activity restrictions on FIDI affiliates are much less important. Accordingly, direct oversight by the PFRA of the holding company and affiliates could be limit to the protection of FIDIs from inappropriate affiliate relationships.

e. Setting national standards for a wide range of business conduct for all financial services firms, whether federally or state-chartered.[23]

4. Federal Deposit Insurance Regulator. This responsibility would be transferred to the Federal Insurance Guarantee Corporation ("FIGC"), which would:

   a. Administer not only deposit insurance but also the FIGF;[24]

   b. Not possess any additional direct regulatory authority;

   c. Function primarily as an insurer to set risk-based premiums, charge ex-post assessments, act as receiver for failed FIDIs or FIIs, and maintain some back-up examination authority over those institutions.

5. GSE regulator A single federal prudential regulator would have oversight of the government-sponsored enterprises ("GSEs"), and the market stability regulator (the Federal Reserve) would have the same ability to evaluate GSEs as it would have for other FIDIs.

6. Corporate Finance Regulator. Certain supervision formerly provided by the SEC, as well as certain responsibilities of the former federal banking agencies,[25] would be assigned to the Corporate Finance Regulator ("CFR").

   a. The CFR would be responsible for general issues related to corporate oversight in public securities markets, including the SEC's current responsibilites over corporate disclosures, corporate governance, accounting oversight, and similar matters;[26] and

   b. The CBRA, not CFR, would assume the SEC's current business conduct regulatory and enforcement authority over financial institutions.

OBSERVATIONS AND ANALYSIS

1. A wide range of new businesses in financial services would be included in what would amount to a broader range of Federal regulation. The legal and operational issues, and related costs caused by these fundamental changes will be significant. There will be those who question the benefits relative to these costs. In addition, in return for becoming subject to systemic supervision and regulation, entities are likely to want the direct and indirect benefits that go with federal regulation (*e.g.,* membership in the Federal Home Loan Bank System).

2. The Treasury proposal is not expected to have an immediate impact on the current market dislocations in the mortgage market and the credit markets in general. Thus, it is not likely to benefit from any Congressional momentum directed at measures aimed at addressing current real estate market and borrower concerns. In that regard, it will face all the hurdles associated with moving significant legislation in an election year.

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23 The Treasury proposal states that, in an optimal structure, the states should retain the authority to enact laws and take enforcement actions against state-chartered financial institutions as long as the state laws do not conflict with federal law.

24 The extent of federal protection provided by the FIGC and its fund is not explicitly described in the summary released by Treasury.

25 For example, under Section 12(i) of the Securities Exchange Act of 1934, the OCC and the OTS currently have statutory authority to regulate securities issuances and disclosures by national banks and federal thrift institutions, respectively, that do not have holding companies. The CBRA, not the PFRA, would possess this authority under the proposal.

26 This would represent a significant erosion of one of the SEC's central roles, and cast doubt on a regulatory structure and conventions that developed over six decades.

3. At the same time the Treasury proposal is likely to trigger strong opposition from various groups on a range of grounds including:

   a. It appears to call for a significant reduction in the role of the states and state-chartered financial firms. States and non-federally regulated entities are likely to be opposed to a comprehensive expansion of federal authority where the federal government has not previously demonstrated a benefit of or need for federal chartering or supervisory authority. The parameters of the Treasury proposal in this regard remain vague, but federal intervention into areas that do not have a clear federal nexus, such as deposit insurance, is likely to encounter spirited opposition.

   b. The Treasury proposal appears to assume that the Federal Reserve should be placed in charge of the entire financial system because of the superior abilities of that organization. Critics are likely to argue that the Federal Reserve, as a result of its broad involvement in the mortgage market through TILA, the Equal Credit Opportunity Act and the Home Owners Equity Protection Act, and its systemic monitoring and analysis of financial activity, was in an excellent position to identify the subprime problem both at depository and at non-depository institutions and either failed to do so or to act appropriately. Some in Congress and elsewhere have argued that the Federal Reserve's banking supervisory role should be reduced, not increased, as a result of its record.

   c. The proposal appears to embrace the concept that far broader federal intervention and supervision is necessary to maintain the proper functioning of the extremely diverse "financial services" industry. On the other hand, the proposal appears to suggest that regulatory intransigence, particularly in the securities markets, is threatening the country's position in global capital markets. Observers may argue that burdens such as those imposed by Sarbanes-Oxley and by corporate taxation policy may play a far greater role in the nation's competitiveness in the global markets.

4. The proposal signals Treasury's willingness to explore significant changes in the separation of banking and commerce.

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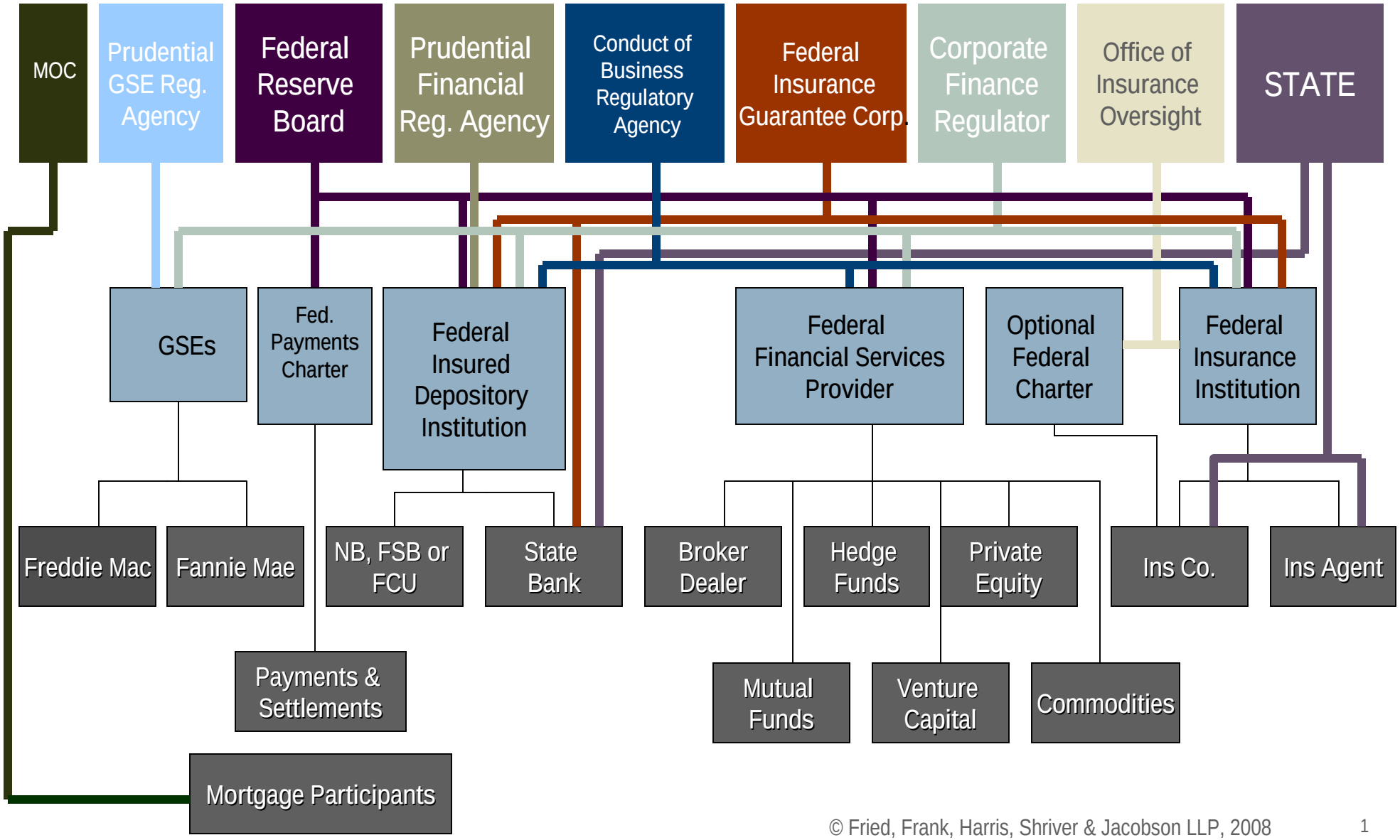
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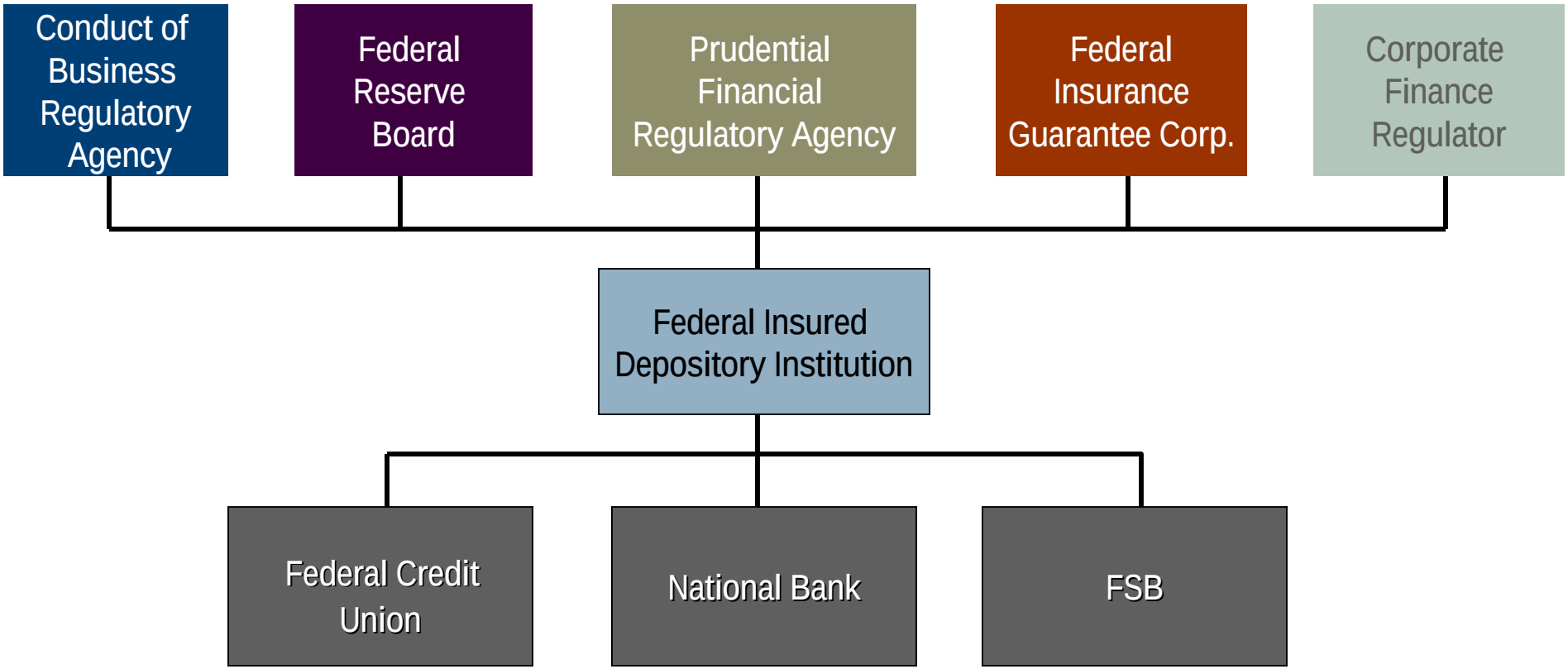
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Treasury's Proposed Financial Regulatory Structure – All Entities



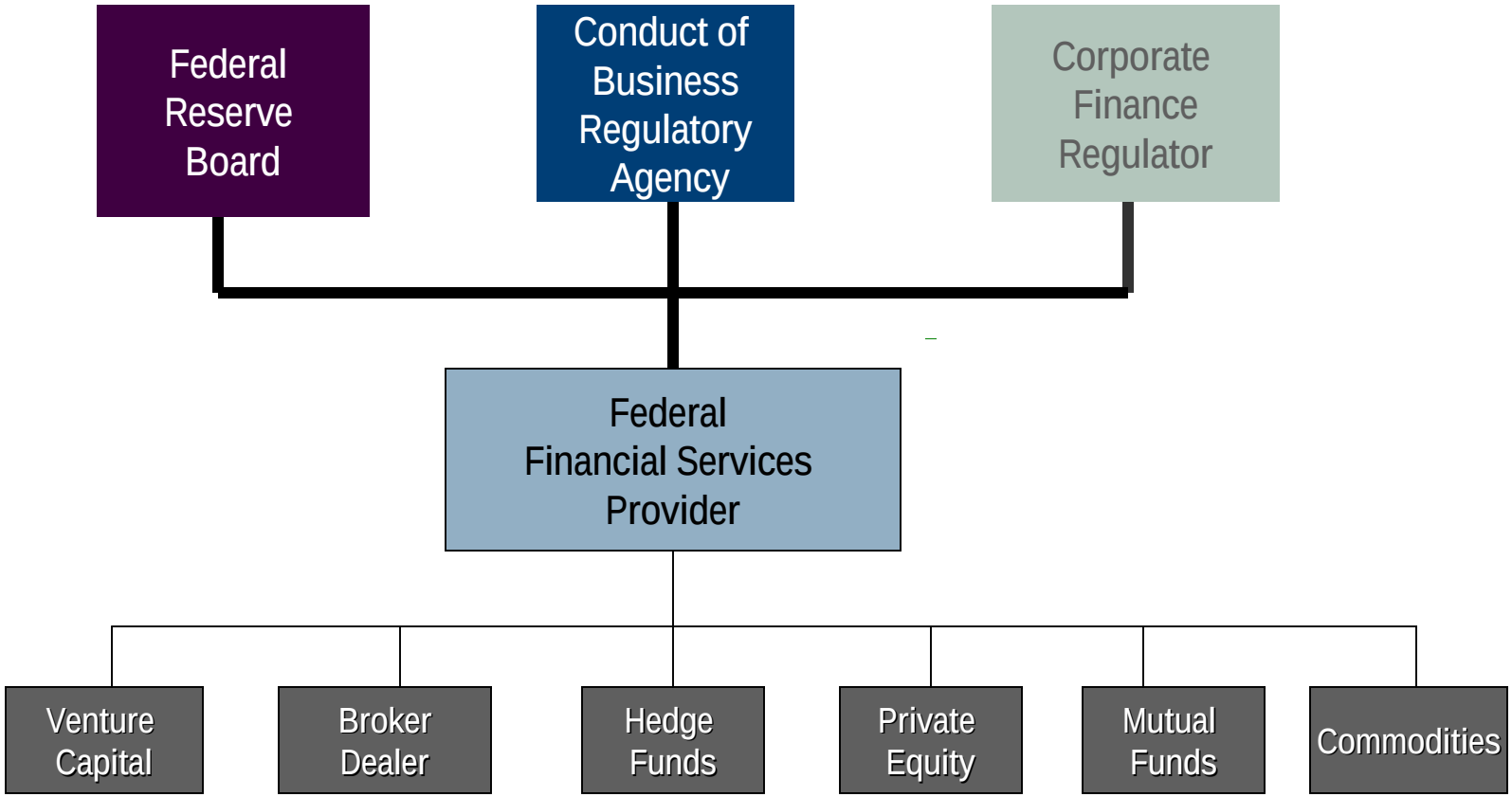
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Treasury's Proposed Financial Regulatory Structure – Prudential (Bank) Regulation



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Treasury's Proposed Financial Regulatory Structure – Investment, Securities & Commodities



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