



FRESHFIELDS BRUCKHAUS DERINGER

# The bank of the future

Introduction



## Introduction

This update to *The bank of the future* focuses on the US regulatory changes outlined in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). In publishing this update we intend to provide a general overview of some of the key provisions in the Act, focusing on those that will have the greatest impact on banks and that are likely to influence the debate on how to address the same issues in other jurisdictions. We have also made some comparisons with global and EU developments to set the US reforms in an international context.

The format of this update follows the format of our previous publications on the bank of the future and looks at how the Act addresses certain key areas of regulation. (We do not in this update discuss accounting, competition policy or tax havens, as these topics are not directly addressed by the Act.) As was the case with our prior publications, we have not covered developments relating to the relationship between banks or other financial companies and their retail customers. Accordingly, we do not discuss in this update the many provisions of the Act addressing consumer protection.

This update should be read in conjunction with our original report, published in November 2009, and our March 2010 update, to get a broader overview of how the Act fits in with wider regulatory trends. The original report, the March 2010 update and related client guides and briefings can be obtained from [www.freshfields.com/microsites/bankofthefuture/index.asp?id=bouverie](http://www.freshfields.com/microsites/bankofthefuture/index.asp?id=bouverie)

Certain acronyms and defined terms used throughout the text are explained on their first use and included in the glossary on page 53.

### The Act in context

The Act itself runs to more than 2,300 pages and sets the stage for the development and implementation of a host of more detailed regulations. It instructs banking, securities and commodities regulators and other designated institutions to conduct at least 67 studies and to develop more than 240 sets of specific regulations.

The Act addresses a wide range of issues that were the subject of extensive and fast-moving political debate and negotiation among members of the US Congress. The Act expresses the consensus reached by the legislators who passed it, but delegates sweeping authority to the relevant regulators to design the specifics of the regulations, to refine key definitions and to exempt categories of persons and transactions from the scope of such regulations.

The timeframe for adopting and implementing such regulations varies, but the Act contemplates that some of the more complex ones will take years to adopt and implement. We have not detailed the mandated implementation timing of the Act's various provisions. Often it is likely that the timing will need to be adjusted to take into account the realities of the rule-making process.

Even now, the US Congress is discussing further legislation to clarify certain provisions of the Act, and following mid-term elections in November, debate on some of the more hotly debated provisions of the Act may be re-opened.

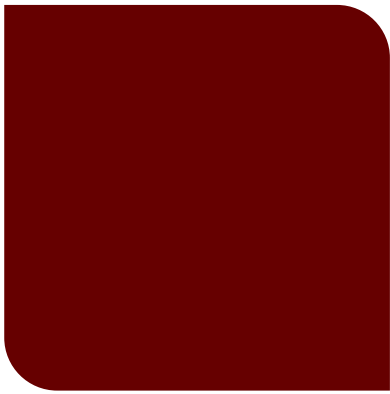


'The United States will go from laggard to the head of the parade if we get this legislation passed... This American legislation will be a kind of launching point for other countries.'

Paul Volcker, former chairman of the US Federal Reserve and current economic adviser to President Obama.

'[W]e will make sure we have a more level playing field – not just between banks and non-banks here in the United States – but also between our financial institutions and those in Europe, Japan, China, and emerging markets who are all competing to finance global growth and development. We will do this by setting high global standards and blocking a "race to the bottom" from taking place outside the United States.'

Timothy Geithner, US Treasury secretary, in a speech at New York University's Stern School of Business, 2 August 2010.



Certain important areas, such as the reform of key US government-sponsored enterprises, most notably the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), and the potential imposition of an additional tax on banks, may be addressed in separate legislation to be proposed later this year. In many ways, passage of the Act should be seen as only the beginning of a long and complex regulatory process.

### **Some key themes**

The Act is intended to have the biggest impact on the largest and most complex US financial companies. To address systemic risk, and the possibility that taxpayers will be forced to bail out large financial companies in the future, many of the Act's provisions are intended to create disincentives to becoming too large or complex.

Two complementary approaches to addressing systemic risk are reflected in the Act. On the one hand, much emphasis is placed on increasing the capital requirements applicable not only to systemically important banks, but also to other financial companies and market participants that are systemically important. On the other hand, the Act also attempts to focus on limiting the activities in which insured depository institutions can engage.

The Act increases the power of regulators to set policy and gives them great latitude on how it is enforced. In many circumstances, the Act authorises particular regulators to take action against particular financial companies on a case-by-case basis if they determine that US financial stability is at risk, even if those financial companies otherwise satisfy the provisions of the regulations or fall within a statutory exception. Although this gives US regulators more flexibility to address crises as they arise, it also builds a degree of uncertainty into the statutes themselves.

The Act also takes a tough stance on the rating agencies. It creates a new regulatory framework for them, mandates the removal of references to ratings as an indication of credit quality from statutes and regulations (including regulations establishing capital requirements) and removes exemptions from the securities laws that protected them from disclosure liability.

### **Changes to the regulatory framework**

Despite initial calls for a thorough overhaul of the US financial regulatory system, the Act does not fundamentally change the structure of US federal or state regulation of the financial sector. The existing federal and state framework for regulating banks, insurance companies and the securities and commodities markets remains in place, although the Federal Reserve is given substantially more statutory authority than it had been granted before the financial crisis. The only significant structural change embodied in the Act is the abolition of the Office of Thrift Supervision and the transfer of its powers and duties to the Federal Reserve, the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC). Rather than rationalising an overlapping and overly complex regulatory structure, the Act creates a new Financial Stability Oversight Council intended

to co-ordinate federal regulation of the financial sector, in consultation with representatives of state banking, securities and insurance regulators.

### **The Financial Stability Oversight Council**

The Council is chaired by the Treasury secretary. The voting members on the Council, in addition to the Treasury secretary, are the heads of the principal existing federal regulatory bodies (the Federal Reserve, the OCC, the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the FDIC, the Federal Housing Finance Agency (FHFA) and the National Credit Union Administration), the head of the new Bureau of Consumer Financial Protection (BCFP) created by the Act and an independent member with insurance industry expertise appointed by the President. In addition, the directors of the new Office of Financial Research and the new Federal Insurance Office (both created by the Act), a representative of the state insurance commissioners, a representative of the state banking supervisors and a representative of the state securities commissioners will serve in advisory capacities on the Council.

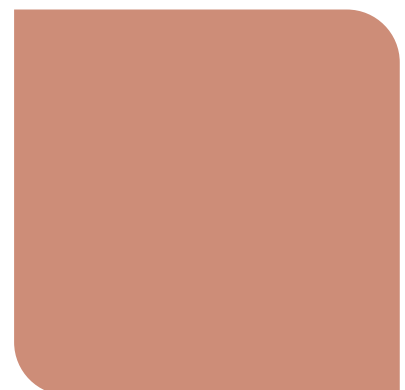
The Council's stated purpose is to identify risks to the US's financial stability arising from the failure of large, interconnected bank holding companies (LIBHCs) and non-bank financial companies (NBFCs) and, notably, to promote market discipline by eliminating the expectation that the government will rescue such institutions in the future.

The duties of the Council include:

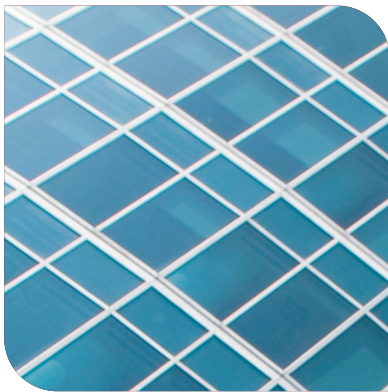
- collecting information from regulators and, if necessary, bank holding companies and NBFCs to assess risks to the US financial system, and supervising the new Office of Financial Research, which is established to support the work of the Council;
- monitoring domestic and international financial regulatory proposals and developments and advising the US Congress on such proposals and developments;
- identifying gaps in regulation that could pose risks to US financial stability;
- identifying NBFCs that may pose risks to US financial stability, and requiring such NBFCs to register with, and be supervised by, the Federal Reserve;
- making recommendations regarding heightened standards for risk-based capital, leverage, liquidity, contingent capital, resolution plans and credit exposure reports, concentration limits, enhanced public disclosure and overall risk management standards for NBFCs and LIBHCs that are supervised by the Federal Reserve; and
- recommending that primary regulators (the federal banking agencies, the SEC, the CFTC, the state insurance authorities and the FHFA) apply new or heightened standards and safeguards.

### **Non-bank financial companies**

By giving the Council the power to require supervision of systemically important NBFCs, and the Federal Reserve the power to supervise such NBFCs, the Act prevents large financial institutions in the US or abroad from



The Act defines a 'non-bank financial company' (NBFC) as a company that derives more than 85 per cent of its gross consolidated revenues from financial activities (as determined by the Federal Reserve under the BHCA) or a company whose gross consolidated assets that relate to financial activities represent 85 per cent or more of its total consolidated assets.



avoiding regulation by the Federal Reserve by structuring themselves so that they are not required to register with the Federal Reserve under the US Bank Holding Company Act (BHCA).

If the Council (by a two-thirds majority vote) determines that an NBFC (whether incorporated or organised in the US or another country) could pose a threat to US financial stability if it were in material financial distress or because of the nature, scope, size, scale, concentration, interconnectedness or mix of its activities, such NBFC will be subject to supervision by the Federal Reserve and subject to applicable prudential standards.

In determining whether a US-organised NBFC could pose a threat to US financial stability, the Council is required to consider, among other things:

- the extent of leverage of the company;
- the extent and nature of its off-balance-sheet exposures;
- the extent and nature of its relationships with other significant NBFCs and bank holding companies (BHCs);
- the importance of the company as a source of credit for households, businesses and local governments and as a source of liquidity for the US financial system;
- the extent to which the company manages third-party assets;
- the nature, scope, size, scale, concentration, interconnectedness and mix of activities of the company;
- the degree to which the company is already regulated by one of the principal US financial regulatory agencies;
- the amount and nature of the financial assets of the company;
- the amount and types of liabilities of the company and the degree of reliance on short-term funding; and
- any other risk-related factors that the Council deems important.

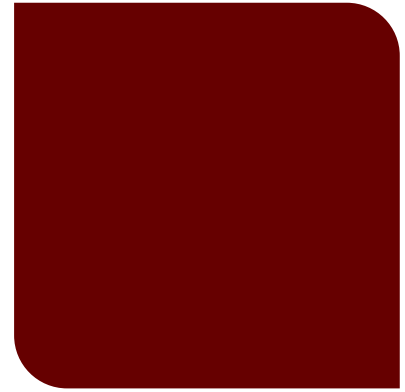
For an NBFC organised outside the US, the same set of factors is applied, but in most cases only for assets located in, or activities conducted in, the US and if such company is subject to prudential standards administered and enforced by supervisory authorities (comparable to the US regulatory authorities) in the home country of its parent.

The Act includes an anti-evasion provision that allows the Council to require an NBFC that poses a threat to US financial stability to be subject to Federal Reserve supervision if it is organised or operated in such a manner as to otherwise avoid application of the relevant provisions of the Act. In addition, under the Act, a BHC with total consolidated assets of \$50bn or more as of 1 January 2010 that received government assistance under the Emergency Economic Stabilization Act of 2008 would automatically be treated as an NBFC subject to supervision by the Federal Reserve if it ceases to be a BHC.

The Act does allow an NBFC to create an intermediate holding company subject to Federal Reserve supervision, in which the financial activities of such company and its subsidiaries are conducted, with non-financial activities conducted by the company and its other subsidiaries free from supervision by the Federal Reserve.

### Comparison with global and EU developments

Although both the US and the EU are committed to the regulatory reform programme outlined by the G20, there are significant differences of pace and emphasis between the two. This is most evident in the approach to the particular risks posed by systemically important institutions. Here, the EU is awaiting the proposals to be made by the global-level Financial Stability Board (FSB) to the G20 Summit to be held in November 2010. But it already seems clear that the FSB will not be recommending anything equivalent to the Act's mandatory restrictions of banks' permissible business. There is also little evidence of enthusiasm for the EU-level regulation to go further than the FSB, although in the UK this type of 'structural' approach is still a real possibility, depending on the recommendations of the Independent Commission on Banking.



This section is part of *The bank of the future: US regulation*, which you can read in full at [www.freshfields.com/bankofthefuture](http://www.freshfields.com/bankofthefuture).

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