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Systemic Risk Regulation: The Missing Link?

Gaps in oversight prompt the creation of a new interagency council that will be charged with identifying, monitoring, and responding to systemic risks in the financial sector.

June 14, 2010

While the root causes of the current financial crisis are still being debated and investigated, many academicians, incumbent financial regulators, and now both houses of Congress appear to agree on at least one shortfall in regulatory oversight that contributed to the crisis: the failure of any one regulator to identify the systemic risk caused by the origination of poorly underwritten home mortgages and the distribution thereof, directly and via securitization, through the financial system warrants the appointment of a superregulator charged with identifying, monitoring, and responding to systemic risks in the financial sector in the future.

Implicitly and explicitly acknowledging the failure of the "functional regulation" model developed in the Gramm-Leach-Blilely Act of 1999 (GLBA), both the Wall Street Reform and Consumer Protection Act of 1999 (H.R. 4173 or the House Bill) and the Restoring American Financial Stability Act of 2010 (S. 3217 or the Senate Bill) provide for the creation of a financial services oversight body charged with identifying systemic risks and strengthening the regulation of financial holding companies and certain nonbank companies deemed to be "systemically important" and worthy of heightened prudential standards. Differences in these bills will be resolved in formal House-Senate conference proceedings over the next few weeks.

The Regulatory Gap

Federal banking supervisors during the 1980s and 1990s issued supervisory guidance on subprime lending, the use of derivatives and other complex financial instruments, and the dangers of concentration of risk, but lacked an integrated focus once poorly underwritten mortgage loans were distributed via securitization, thus disappearing from the balance sheets of their supervised banks.

The securitization of mortgages, which began in the 1930s and flourished after the "originate to hold" model of mortgage financing became discredited during the thrift crisis of the 1980s, changed mortgage financing dramatically, expanding the supply of and the sources for home mortgages. Over the decades, lenders devised new products to make mortgages available to more borrowers—adjustable-rate mortgages and mortgages with flexible terms proliferated, and what was "creative financing" in the 1970s and 1980s became "no doc," "no credit check," and other "subprime" products.

During this same period, financial firms devised new products to match investors' needs with mortgage borrowers' needs. Nonbank mortgage originators were a major source of subprime lending, operating free of federal supervisory oversight and with light state supervision. Concurrently, pieces of securitizations were resecuritized, with multiple lower-rated tranches that were purportedly diverse supporting new high-rated tranches.

The Federal Reserve Board (the Board) was designated as the "umbrella" supervisor of financial holding companies by GLBA, but GLBA (i) limited the Board's focus and examination authority to the holding company and any subsidiary that could have a materially adverse effect on the safety and soundness of any depository institution subsidiary, and (ii) required the Board to defer to the "functional regulator" of securities and insurance subsidiaries of financial holding companies. In a time of explosive growth in the volume and complexity of derivatives products and linkages between banks and securities firms, the Board was not equipped or positioned to be a true systemic overseer with the ability to identify emerging risks to the financial system. State regulators lacked the legislative tools and manpower to regulate the nonbank mortgage originators, which operated relatively free of regulatory oversight.

The SEC, in its role as a "functional regulator," presided over a disclosure-oriented regulatory scheme rather than one focused on the safety and soundness of its charges or geared to identify systemic risk.

The Solution

The Senate version of reform legislation would create a Financial Stability Oversight Council (the Council), chaired by the Secretary of the Treasury and consisting of eight other members: the Chairmen of the Federal Reserve, the U.S. Securities and Exchange Commission, the Federal Deposit Insurance Corporation (FDIC), and the Commodities Futures Trading Commission; the Comptroller of the Currency; the Directors of the Bureau of Consumer Financial Production and the Federal Housing Finance Agency; and an independent member with insurance expertise named by the President and confirmed by the Senate.

The Senate Bill charges the Council with a threefold mission:

- Identifying risks to the financial stability of the United States that could arise from the material financial distress or failure of large, interconnected bank holding companies or nonbank financial companies
- Promoting market discipline by eliminating expectations on the part of shareholders, creditors, and counterparties that the government will bail them out in the event of future failures
- Responding to emerging threats to the stability of the U.S. financial markets

The Senate Bill entrusts the Council with the following duties:

- Collecting information from member agencies and other federal and state sources and directing the new Office of Financial Research (OFR) to collect information from bank holding companies and nonbank financial companies
- Requesting data and analyses from OFR
- Monitoring the financial services marketplace in order to identify potential threats to financial stability
- Facilitating information sharing and coordination among member and other agencies regarding domestic financial services policy development, rulemaking, examinations, reporting

requirements, and enforcement actions

- Recommending to the member agencies general supervisory priorities and principles
- Identifying regulatory gaps that may pose risks to financial stability
- Requiring supervision by the Federal Reserve of nonbank financial companies that may pose risks to the financial stability of the United States in the event of their material financial distress or failure
- Recommending to the Federal Reserve heightened prudential standards for risk-based capital, leverage, liquidity, contingent capital, resolution plans and credit exposure reports, concentration limits, enhanced public disclosures, and overall risk management for nonbank financial companies and large (at least $50 billion in assets), interconnected bank holding companies supervised by the Federal Reserve
- Identifying systemically important financial market utilities and payment, clearing, and settlement activities, and requiring such utilities and activities to be subject to standards to be established by the Federal Reserve
- Making recommendations to the primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase the risk of contagion
- Resolving jurisdictional disputes among Council members
- Reporting annually to Congress on a variety of issues

The Council is also charged with determining which U.S. nonbank financial companies are to be supervised by the Federal Reserve and obliged to observe enhanced supervision and regulatory standards that are to be developed by the Federal Reserve. To qualify as a nonbank financial company the company must be "predominantly" engaged in financial activities, which means 85% or more of the firm's consolidated annual gross revenues or consolidated total assets are attributable to activities that are "financial in nature," as defined in GLBA, and, if applicable, attributable to the ownership or control of one or more insured depository institutions.

The determination would be based upon a finding that the material financial distress of the nonbank financial company would pose a threat to the financial stability of the United States. The Council would consider the company's leverage amount and nature of financial assets; amount and types of liabilities (including the degree of reliance on short-term funding); extent and type of off-balance-sheet exposure; interconnectedness with other significant nonbank financial companies and significant bank holding companies; the importance of the company as a source of credit and liquidity; the operation of, or ownership interest in, any clearing, settlement, or payment business of the company; the extent to which the assets of the company are managed, rather than owned by the company; and the extent to which the ownership of assets under management is diffused.

Under existing law, bank holding companies are generally not permitted to engage in nonbanking activities unless they are "so closely related to banking as to be a proper incident thereto." Financial holding companies may engage in "financial activities" and in activities "incidental" or "complementary" to financial activities. These limitations on owning interests in nonbanking organizations, or engaging in nonbanking activities, are not applied to systemically important nonbank financial companies as a result of the new legislation.

What's Next?

The details of the operations of the systemic risk regulator will be finalized in conference committee during the next few weeks. Once the legislation is signed into law and staff assembled, the Council will begin its daunting task. Federal bank regulators have worked together in the past on the Federal Financial Institutions Examination Council, a formal interagency body composed of representatives from the Federal Reserve, FDIC, National Credit Union Administration, the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) that is empowered to prescribe uniform principles, standards, and reporting forms for the federal examination of financial institutions, and to make recommendations to promote uniformity in the supervision of financial institutions.

Another group formed by Executive Order in 1988 by President Ronald Reagan, the President's Working Group on Financial Markets, consists of the Secretary of the Treasury and the Chairmen of the Federal Reserve, the SEC and the Commodities Futures Trading Commission. And banking regulators have acted on an interagency basis from time to time over the years on specific topics like developing privacy and insurance regulations. The Federal Reserve and SEC were directed by Congress to jointly promulgate Regulation R affecting the broker-dealer activities of banks. But interagency cooperation on a permanent basis and on so large a scale will be a first.

Meanwhile, Congress in the final legislation will require the promulgation of hundreds of new regulations and will commission numerous studies to be conducted by these member agencies. The OTS will be phased into the OCC, and consumer protection experts from the various banking agencies will be detailed to the new consumer financial protection agency. During this same timeframe, hundreds of additional banks are expected to encounter serious regulatory difficulties as a result of the continuing effects of the financial crisis, and many are expected to fail. There is also a Financial Crisis Inquiry Commission formed in 2009 by congressional fiat and charged with reporting back to the President on December 10, 2010 as to the causes of the financial crisis. To the extent the commission unveils new causes and culprits, the Council could see important additions to its already burgeoning "To Do" list.

We will continue to monitor the ongoing developments of Financial Regulatory Reform. If you have any questions or would like more information on the issues discussed in this Law Flash, please contact the authors, **Kathleen W. Collins** (202.739.5642; kcollins@morganlewis.com) and **Robert C. Mendelson** (212.309.6303; rmendelson@morganlewis.com), or any of the following Morgan Lewis attorneys:

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