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Impact of Obama's Financial Regulatory Reform on Banks and Holding Companies

On Wednesday, June 17, 2009, President Obama set forth his administration's blueprint for overhauling the financial system outlined in an 88-page white paper that touched everything from traditional banking regulation, such as capital ratios and liquidity, to nontraditional financial service firms, whose size alone impacts the overall economy. Traditional banking organizations will likely feel the greatest impact from the call for stronger capital and prudential standards for all financial firms and from the creation of the new office of the National Bank Supervisor, which will assume the duties of the Office of the Comptroller of the Currency and the ongoing duties of the Office of Thrift Supervision ("OTS"). The federal savings bank charter overseen by the OTS will be phased out under the proposal. The plan also proposes a new Consumer Financial Protection Agency with broad federal powers over consumer financial products and services, regardless of whether such products and services are offered through a bank. This article highlights aspects of the Financial Regulatory Reform white paper (the "white paper") that are most applicable to traditional banks and their holding companies.

Expansion of Federal Reserve Powers and Large Financial Firms

The white paper expands the powers of the Federal Reserve to include supervision of large interconnected firms whose failure could threaten the financial system's stability due to the combination of their size, leverage and interconnectedness (referred to as Tier 1 Financial Holding Companies in the white paper or "Tier 1 FHCs"). The Federal Reserve's power will extend over the Tier 1 FHCs regardless of whether the firm owns an insured depository institution and regardless of geographic location of the subsidiaries of the Tier 1 FHC. Although financial institution subsidiaries will continue to be regulated by their primary federal regulators, restrictions imposed by the Gramm-Leach-Bliley Act ("GLB Act") on the Federal Reserve's supervision of these subsidiaries will be removed or loosened so that the Federal Reserve will have direct access to regulatory reports and financial information of such entities.

The newly created office of Financial Services Oversight Council ("Council"), chaired by the Secretary of the Treasury ("UST") and including the heads of the principal federal financial regulators (including the Federal Reserve and the FDIC), will coordinate policy and supervision among the federal regulators, as

well as identify emerging risks. The Council replaces the currently existing President's Working Group. The Council will have coordination authority among the federal financial agencies, but will also specifically identify Tier 1 FHCs that should be subject to consolidated supervision by the Federal Reserve (based on standards established by Congress), as well as setting forth financial standards for such firms. The factors recommended in the white paper as legislative guidance in the identification of a Tier 1 FHC include: (i) the impact the firm's failure would have on the financial system and the economy; (ii) the firm's combination of size, leverage (including off-balance sheet exposures) and degree of reliance on short-term funding; (iii) the firm's criticality as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the financial system; and (iv) other relevant factors at the discretion of the Federal Reserve. From such legislation, the Federal Reserve will promulgate rules to identify Tier 1 FHCs. Per the white paper, identification of Tier 1 FHCs should also be made in consultation with any other federal regulators with supervisory responsibility over the firm.

Standards relating to capital, liquidity and risk management are anticipated to be stricter for Tier 1 FHCs than those imposed on other bank holding companies ("BHCs") and will also involve regular stress tests. Such Tier 1 FHCs will be subject to the restrictions on nonfinancial activities under the Bank Holding Company Act ("BHC Act"), even if they do not own insured depository institutions. The white paper suggests a five-year phase-in of the BHC Act activity restrictions. The Federal Reserve will also institute

prompt corrective action standards for Tier 1 FHCs similar to those currently in effect for insured depository institutions. Enhanced public disclosures will be required of Tier 1 FHCs to support market evaluation of such firms.

Focus on the consolidated activities of Tier 1 FHCs will require that the Federal Reserve shift its supervisory focus from the activities of insured financial institution subsidiaries of BHCs to a much broader range of financial and nonfinancial activities conducted by Tier 1 FHCs. By October 1, 2009, the Federal Reserve will release a report on how it will align itself to accomplish the newly designated duties.

In order to provide alternatives to financially distressed Tier 1 FHCs other than traditional capital raising and declaring bankruptcy, the applicable federal regulator will have authority to initiate special resolution procedures similar to the manner in which the FDIC manages distressed depository institutions, subject to approval of a regulatory panel from other federal banking agencies. The Federal Reserve will take the lead on special resolution procedures as the regulator of the Tier 1 FHCs. Under the white paper, the Federal Reserve may also be required to obtain prior written approval from the UST for emergency lending in "unusual and exigent circumstances."

Supervision of Banks and Bank Holding Companies

Safety and Soundness. The Obama administration perceives the current capital rules as an inadequate tool to measure safety and soundness. Accordingly, a working group of federal agencies and experts, led by the UST, will release a report by October 1, 2009,

with a reassessment of the supervision of banks and bank holding companies, and another report containing requirements to increase capital will be presented by December 31, 2009. Expected changes include higher capital requirements for institutions with off-balance sheet items and structured credit products; increased scrutiny of contingent capital instruments that convert into lesser-grade securities; additional risk weighting for investments that decline in value in stressed market conditions, such as ABS and OTC derivatives; and use of more transparent measures of leverage.

All financial holding companies, not just Tier 1 FHCs, will be required to be well capitalized and well managed on a consolidated basis to engage in the financial activities permitted under the GLB Act. Currently, only the insured depository institution is required to be well capitalized and well managed for its parent to qualify as a financial holding company ("FHC"). This is part of an overall effort in the white paper to manage all activities of a financial firm, not just the activities of the depository institution.

All companies that control an insured depository institution will be subject to "robust, consolidated supervision and regulation." The white paper specifically targets the limited supervision afforded to holding companies of thrifts, industrial loan companies, credit card banks, trust companies and grandfathered depository institutions, which are not subject to the BHC Act. The avoidance of BHC status by entities such as Bear Stearns and Lehman Brothers highlights the administration's focus on the BHC Act's limitations and restrictions. Such firms will be given five years to conform their existing activities.

The white paper does not distinguish the application of the robust consolidated supervision for small BHCs, which do not currently consolidate under federal capital guidelines, or for groups such as private equity funds, that may have control for purposes of the BHC Act but not for financial accounting purposes.

New National Bank Supervisor. In an effort to eliminate forum shopping among the federal regulators, one prudential regulator, the National Bank Supervisor, will supervise and regulate federally chartered depository institutions. The National Bank Supervisor will assume the duties of the Office of the Comptroller of the Currency and the ongoing duties of the OTS. As previously mentioned, the federal savings bank charter will be phased out under the proposal. The white paper suggests that eliminating thrifts is one of the most important steps in achieving a “prudent, efficient financial regulatory system.” The interstate branching rules of thrifts, which are looser than those currently in effect federally and in most states, will be applied to state and national banks. De novo branching without minimum age requirements is also proposed. The white paper also proposes reducing the differences in substantive regulations and supervisory policies among national banks, state member banks and state nonmember banks. Lastly, the administration would restrict the ability of troubled banks to switch charters and regulators.

Executive Compensation. Executive compensation continues to be a topic of conversation in the president’s white paper. The SEC will have authority to require companies to allow shareholders to vote on executive compensation packages. Banking regulators are

encouraged to issue additional guidelines to align compensation with shareholder value and with respect to preventing compensation practices that affect the safety and soundness of the supervised institutions. The white paper also encourages legislation to make compensation committees more independent.

Affiliates Act. The white paper suggest that firewalls between banks and their affiliates should be strengthened so that federal guarantees and subsidies will remain with the banks and not inure to their nonbanking affiliates. Such measures would limit the use of FDIC deposit insurance and access to Federal Reserve liquidity to the insured depository institution. Certain gaps identified by the Obama administration that need to be filled include: (i) banks engaging in OTC derivatives and securities financing transactions with affiliates; (ii) covered transactions not being fully collateralized for the entire life of the transaction; and (iii) discretion of the Federal Reserve to grant exemptions.

Accounting. The white paper encourages accounting standards to be reviewed to employ more forward-looking loan loss provisioning practices. Fair value accounting rules should also be reviewed to identify changes leading to greater transparency to investors.

Consumer Protection

Because of the perceived abuses in mortgage practices, the Financial Regulatory Reform put forth by the president creates an independent regulatory agency, the Consumer Financial Protection Agency (“CFPA”), to review the fairness of and enforce consumer protection regulations. The CFPA’s protection and enforcement

authority will not be limited to mortgages but will also extend to credit cards and auto loans. The CFPA will have the authority to write rules for bank and nonbank firms, supervise and examine institutions for compliance, and enforce compliance through penalties. In addition to setting federal standards, the CFPA will communicate with states and promote consistent regulation of similar products. The apparent goal is clear disclosure so that consumers have a better understanding of their financial decisions. The white paper focuses on the offering of “plain vanilla” products that are simple and straightforward in addition to whatever other lawful products may be offered. In addition, alternative products will be subject to more scrutiny. Heightened standards of care will also be imposed on the financial product providers.

Specifically with respect to mortgages, the CFPA would ensure that the consumer would have a simple, integrated federal mortgage disclosure, additional disclosures setting forth the risks and benefits of the product, and additional consumer protections. The CFPA will also investigate payment structures between lenders and mortgage brokers and will require loan originators or securitization sponsors to retain 5 percent of the credit risk in order to “keep skin in the game.” Banks, nonbanks and mortgage brokers will all be held to the same rules.

The resources of the Federal Trade Commission will also be expanded to ensure consumer protection, as will the authority of the SEC to protect investors.

The Financial Regulatory Reform white paper presents a comprehensive supervision of financial markets and

certain other issues not addressed in this article, including the regulation of securitizations and derivatives and hedge funds and private pools of capital; creation of an automatic IRA for employees whose employers do not sponsor a qualified retirement plan; increased tax incentives for retirement savings for taxpayers below a certain income level; establishment of an Office of National Insurance within the Treasury Department; setting of international standards consistent with the previously established G-20 goals; and formation of a plan for the future of Fannie Mae, Freddie Mac and the Federal Home Loan Banks by the Treasury Department and the Department of Housing and

Urban Development to be included in the president's 2011 budget.

The earliest and strongest criticisms of the white paper relate to the new powers granted to the Federal Reserve and the creation of the CFPB. Critics argue that the Federal Reserve does not have the ability or capacity to perform the duties assigned to it under the white paper. Critics of the CFPB argue that its influence could impact the safety and soundness of financial institutions and dampen innovation. Another concern is that the cost of complying with additional regulation will disproportionately impact community banks and other banks that engage primarily in traditional

banking services. The only certainty is that the white paper will not work its way through Congress intact, but certain aspects of the white paper are likely to successfully find their place in proposed legislation. Representative Frank has indicated that he will focus on and have various aspects of the legislation prepared before the August recess of Congress and will continue to work on other aspects of the white paper in September.

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