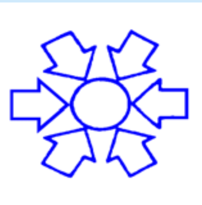

FedFin Client Report

Tuesday, June 1, 2010

FedFin Assesses the Big Disconnect in Reform Legislation

Client Report: **FHC18**

Executive Summary

In this report, FedFin looks at Title VI of H.R. 4173, the reform bill as passed by the Senate. This title includes some of the most significant strategic drivers in the measure, including new inter-affiliate transaction and credit-risk limits. These provisions are similar to those in the House bill and could, as noted in prior FedFin reports, lead to dramatic break-ups and reduced counterparty exposures for large, complex banking organizations. A little-noticed provision in all of the bills requires BHCs and S&LHCs to be "well-capitalized on enactment," heightening the current "adequate" standard. If the Collins amendment (see Client Report **SYSTEMIC27**) is included in even modified form, this could wreak more havoc than anticipated because of the even higher capital bar for U.S. banks.

Title VI also includes the "Volcker rule" and a prospective limit on bank size. Despite fierce debate over all of these provisions, they were not significantly changed from the version approved by the Senate Banking Committee (see Client Report **FHC16**). The Volcker rule and liability cap are not included in the House-passed measure, although Chairman Frank (MA) has signaled acceptance of them even as Senate advocates of still tougher measures push for them in conference.

Analysis

Key provisions in Title VI as passed include:

- **Non-Bank Banks**: The Senate bill would not shut these down, instead mandating a three-year moratorium on new charters outside of emergency situations or ordinary mergers among commercial firms involving non-bank bank ownerships. During the moratorium, GAO would conduct a study on whether non-bank banks should continue and, if so, under what regulatory framework.

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- **Holding-Company Regulation**: As in prior bills, the measure would reverse language in the Gramm-Leach-Bliley Act (GLBA) that limits FRB regulatory and examination authority over functionally regulated subsidiaries in financial holding companies (FHCs). The FRB would thus have broader scope to mandate capital or other rules at the subsidiary level. All of these powers would apply not only to FHCs, but also to S&L holding companies (S&LHCs), along with any of their functionally regulated subsidiaries. In addition, the OCC and FDIC would double-check the FRB and have authority to review activities in BHC/S&LHC subsidiaries not subject to functional regulation (e.g., mortgage banking) and advise the Board of any concerns. However, if the Fed does not act on them, then the lead agency could take enforcement or other actions in a process detailed in the bill. Since the FDIC – not the FRB – would review holding-company activities related to state member banks – the FDIC would gain considerable, if indirect, authority over Fed-regulated banks.

- **Acquisitions**: As in prior versions of this legislation, the Senate-passed bill adds new procedures for large acquisitions. Prior notice is required for FHCs seeking to acquire a non-bank firm with more than $25 billion in assets (no such notice is now required if the non-bank is engaged in otherwise-permissible activities for the FHC). Prior notice is also required for bank acquisitions involving more than $25 billion, with a new criterion related to financial stability now required to be considered in regulatory approvals of large transactions.

- **Capital**: As noted, BHCs and S&LHCs would need upon enactment to meet a "well-capitalized" standard to avoid sanction. Any bank seeking interstate acquisitions would also have to meet this standard prior to and after acquisition. Current standards generally mandate only adequate capitalization, although market norms have led most institutions to meet the well-capitalized criteria.

- **Inter-Affiliate Transactions**: These provisions would significantly broaden the scope of the inter-affiliate transactions restrictions in Sections 23A and 23B of the Federal Reserve Act (see Client Reports in the **REGW** series). First, the rules would apply to an expanded class of investment funds related to an insured depository, curtailing support for related hedge funds, investment companies and similar entities. Second, repos would become subject to collateral requirements in addition to other restrictions and numerous potential credit exposures now exempt from these rules (e.g., securities financing, derivatives) would come under them, with the scope of coverage depending on implementing FRB rules. Further, collateral

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restrictions would cover the life of an exposure and generally be more stringently defined. A new process addressing netting and other exemptions is created in which the FRB would need to work with the OCC and the FDIC (with the latter agency in the past taking a far tougher stand on these issues than the FRB).

- **Loan Limits**: In addition to defining "credit exposures" more broadly with regard to inter-affiliate transactions, the bill would bring them under loan-to-one borrower limits. This would significantly reduce these counterparty exposures at many banks, with the limits made applicable also to state banks and set to take effect one year after the "transfer date" (twelve or eighteen months after enactment, as discussed in Client Report **REFORM49**).

- **Source of Strength**: The FRB would have to issue rules in this area for all BHCs and S&LHCs to ensure they support insured-depository subsidiaries. This would take effect on the transfer date, possibly subjecting private-equity firms and others that have acquired insured depositories in recent years to unanticipated demands and capital commitments.

- **Securities Holding Company**: As in other bills, the Senate measure would create this new entity under the FRB (not SEC) to provide a conglomerate regulator for any securities firm in need of one to comply with EU or other global regulations in this area.

- **Volcker Rule**: As in the reported bill (see Client Report **FHC16**), the bill would ban proprietary trading (with some exceptions) and ownership of hedge funds and/or private-equity firms by insured depositories and their affiliates (including parent holding companies). The restrictions would not apply to activities by foreign firms "solely" outside the U.S. In addition, the Board would need to issue capital, concentration and similar standards in these areas for any systemic non-banking organization. Any such firm (e.g., a large private-equity fund) could thus continue its basic operations, but only under rules likely to be far more stringent than those now applicable. The FSOC (see Client Report **SYSTEMIC27**) would first study this rule and recommend standards that could modify any of the express statutory injunctions or provide thresholds for applying the prohibitions, doing so six months after enactment. If thresholds are set that provide exemptions for banks, then the tougher capital and related requirements for non-bank systemic firms would need to cover any such permissible trading or investments. Implementing rules issued jointly by the banking agencies for proprietary trading and by the FRB for investments are due nine months

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thereafter and would have to reflect the FSOC recommendations. The injunctions would be applicable two years thereafter, although three one-year extensions are possible. The FSOC recommendations must address insurance companies to ensure ongoing appropriate trading, an issue the Senate said in a procedural motion should be adopted in conference following an amendment in this area by Sen. Hutchinson (R-TX).

- **Concentration Limit**: Prospective mergers and acquisitions would be barred for financial firms if the resulting firm would control more than ten percent of the liabilities in the U.S., with liabilities defined as U.S. assets under regulatory capital rules (less deducted exposures) minus regulatory capital for U.S. operations. A process for setting this standard for non-banks is provided. Again, the FSOC would set recommendations on implementing this restriction that could significantly modify it with the deadline again set at six months. The FRB would have to issue final rules nine months thereafter.

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