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INTERNATIONAL BANKING

Expert Analysis

U.S. and EU Proposed Regulatory Reforms: Chance for Real Change?

In addition to trying to ease the current worldwide financial crisis, international regulators have been working on long-range plans to avoid or minimize the adverse effects of a severe financial downturn happening in the future. On Nov. 15, 2008, the leaders of the Group of 20 (G-20) an informal group of Finance Ministers and Central Bank Governors, met in Washington, D.C., to discuss the then still-unfolding crisis and issued a declaration that, inter alia, pledged to "implement reforms to strengthen financial markets and regulatory regimes so as to avoid future crises."[1]

Further discussions by the G-20 at its London summit in April 2009 led to issuance of a declaration that proposed additional goals for regulatory reform on both the macro-prudential and micro-prudential levels.[2] Since then, the United States and the European Union (EU) have issued papers outlining specific proposals, to be followed up by proposed legislative language. Whether a particular firm is headquartered in the U.S. or EU, any bank operating in those jurisdictions will need to be aware of the new rules that would be governing their ability to operate in these jurisdictions. This month's column will discuss the general approaches the U.S. and the EU have taken in implementing the G-20 mandate from a macro-prudential, i.e., system-wide, viewpoint.

The U.S. Approach

In its paper "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation" issued June 17, 2009,[3] the U.S. Department of the Treasury set forth five key objectives of its reform plan:

- Promote robust supervision and regulation of financial firms;
- Establish comprehensive supervision of financial markets;
- Protect consumers and investors from financial abuse;
- Provide the government with the tools it needs to manage financial crises;
- Raise international regulatory standards and improve international cooperation.

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By **Kathleen A. Scott**

Aiming For Systemic Stability

As the keystone of its plan to address macro-prudential issues, the Treasury Department has proposed the establishment of a Financial Services Oversight Council (FSOC), and the granting of new authority to the Board of Governors of the Federal Reserve System (FRB) to supervise all firms that could potentially threaten U.S. financial stability regardless of whether the firm owns an insured bank (the current trigger for FRB oversight), and to the Federal Deposit Insurance Corporation to liquidate such institutions outside of the usual U.S. bankruptcy process. The FRB also would have new authority to oversee payment, clearing and settlement systems.

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However, under the reform proposals, the FRB would no longer have the ability on its own to invoke its emergency lending authority under the Federal Reserve Act, of which it has made frequent use during the crisis, to lend money to nonbank financial institutions. Under the proposal, prior to invoking this emergency authority, the FRB would need the approval of the Secretary of the Treasury, a political appointee, which could inject a note of possibly partisan politics into a process that is supposed to be independent of politics.

Role of the FSOC

The FSOC would be responsible for identifying emerging systemic risks, encouraging more inter-agency cooperation and facilitating resolution of jurisdictional disputes among the various financial system regulators. The FSOC would be headed by the Secretary of the Treasury, and its members would include the FRB, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, and the banking regulators. The FSOC would be housed at the Treasury Department with a permanent staff.

An important function would be advising the FRB on those companies so systemically important that they should be subject to consolidated umbrella supervision by the FRB regardless of whether the firm owns an insured bank. These so-called "Tier 1 financial holding companies" ("Tier 1 FHCs") would be subject to higher capital, liquidity and risk management standards than those applicable to institutions less likely to cause a severe adverse effect on the U.S. financial system in case of failure. Whether this is an honor some firms not currently subject to FRB oversight will be seeking remains to be seen.

Supervision would include not only the parent company but also the subsidiaries, U.S. or outside the U.S., regulated or unregulated. Moreover, the FRB, in consultation with other regulators as necessary, would have the authority to impose enhanced prudential requirements on any subsidiary, whether or not it otherwise is regulated, to address systemic risk concerns.

The FSOC itself would have no authority over specific institutions; instead its role is advisory. Nonetheless, the FSOC would have the ability to require reports from any financial firm (whether or not a Tier 1 FHC or otherwise already regulated) for purposes of assessing the extent to which a particular financial activity, or a financial market in which the firm participates, poses any threat to the U.S. financial system as a whole.

Tier 1 FHCs

In making its determination as to whether a particular financial firm is to be considered a Tier 1 FHC subject to heightened supervisory scrutiny, the FRB would be required to take into consideration such factors as the impact the failure of the specific firm would have on the U.S. financial system, the firm's degree of reliance on short-term funding and whether the firm is critical to the financial system both as a source of credit and as a source of liquidity.

The FRB would have the authority to collect periodic reports from, and conduct examinations of, any financial firm meeting minimum size thresholds in order to determine whether a particular firm should be treated as a Tier 1 FHC. Moreover, under the Treasury reform proposal, Tier 1 FHCs would become subject to the same activities restrictions under which a financial holding company operates (such as a prohibition on actively engaging in manufacturing activity) with a five-year time frame for those Tier 1 FHCs that are not currently under FRB umbrella supervision to conform to these restrictions.

Once under the FRB's umbrella supervision, the Tier 1 FHC would be subject to strict capital and liquidity requirements based on essentially a worst-case scenario. Tier I FHCs would be required to maintain sufficient capital and liquidity at all times that would be enough to see the Tier 1 FHC through economically stressful times. In addition, the company's overall risk management policies would have to include regular stress tests using a variety of scenarios both institution-specific and market-wide, and including both on-balance and off-balance sheet exposures. Tier 1 FHCs would be expected to be able to identify all exposures quickly on a firm-wide basis.

Moreover, while businesses, including financial services companies, currently are expected to have disaster recovery plans and test them on a regular basis, Tier 1 FHCs would be expected to go beyond the usual business continuity planning to maintain and continuously update a "credible" plan for the rapid resolution of the firm if there is "severe financial distress"; this requirement is supposed to encourage the Tier 1 FHC to better monitor and simplify its organizational structure in order to be able to make it more efficient to resolve (i.e., close and liquidate) if circumstances warrant.

In exercising this umbrella supervision, the FRB would need to assess the potential impact on critical markets and the financial system of the activities and risk profiles of both an individual Tier 1 FHC and of all Tier 1 FHCs in the aggregate. In order to effectively carry out this new role, the FRB also would need to review and change its own organizational structure.

The EU Approach

On June 19, 2009, EU leaders approved a European Commission report proposing regulatory reforms that would provide a new EU supervisory framework aimed at change both system-wide and at the individual institution supervisory level.[4] The general objectives for reform of the EU supervisory system are to:

- Improve the effectiveness of the EU financial supervision system;
- Enhance EU financial stability by more efficiently curtailing possible risks to the economy and to the public finances;
- Safeguard the interests of those utilizing financial services, from consumers to investors to employees;
- Increase competitiveness of EU financial markets.

Establishing a Council

One of the major proposals is to establish the European Systemic Risk Council (ESRC), which would be responsible for monitoring risks and assessing potential threats to financial stability within the entire EU financial system. In performing these functions, it would be responsible for collecting and analyzing relevant data, identifying and prioritizing risks to financial system stability, and, where the risks appear significant, issuing warnings or recommendations to address those risks and monitoring the results of issuing such warnings or recommendations. As part of its oversight role, it also would be responsible for liaising with international organizations and third country counterparts on matters of mutual interest.

Similar to the FSOC, the ESRC would be an independent body and would not have any legally binding powers. However, it would be expected to exert major influence on the addressees of those warnings or recommendations and those addressees would be expected to act on them unless inaction could be adequately justified. Public disclosure of these warnings or recommendations also would be expected to encourage compliance. The ESRC would have regular reporting responsibilities to the European Parliament and others but would not be expected to have any direct crisis management responsibilities.

The ESRC would have a large membership: the president of the European Central Bank (ECB) (who would chair the ESRC), the ECB vice-president, each of the governors of the 27 EU Member State central banks, chairs of each of the three new European Supervisory Authorities being established to address reform at the micro-prudential level, and a member of the European Commission. A small steering committee would be established, consisting of the ESRC chair, vice-chair (elected by the ESRC members outside the euro monetary system) five additional central bank members of the ESRC, the chairs of the European Supervisory Authorities and one commission member. Meetings would be held quarterly and more often in times of economic stress.

The ESRC would work with the European Supervisory Authorities by reviewing relevant data on specific institutions, particularly cross-border groups, and would be able to launch ad hoc surveys on specific issues requiring direct input from national supervisors and/or market operators.

Cross-Border Financial Groups

The EU also has attempted to address the possible systemic risk of large cross-border groups through its Financial Conglomerates Directive. Colleges of supervisors have started to be created for the larger cross-border financial institutions in the EU to provide a forum for cooperation and information exchange between home (where the parent company is organized) and host countries (which have subsidiaries of the parent company).

Memoranda of understanding also have been negotiated between respective supervisory authorities on an ad-hoc basis. At the EU level, supervision of cross-border financial conglomerates is carried out by the Joint Committee on Financial Conglomerates, which is part of the European Commission but has no regulatory or executive powers.[5]

Conclusion

It is understandable that the U.S. and the EU would want to attempt to institute a process for monitoring systemic risk. However, both the FSOC and the ESRC are just that, advisory monitors. These proposals could be viewed as just more bureaucracy with no authority to force changes that still would need to be implemented at the level of each regulator. True reform can be accomplished only if "turf" considerations are put aside and all parties—the systemic risk overseers and the individual regulatory agencies—work together to implement a more stable and workable international financial system.

1. The Nov. 15, 2008, G-20 "Declaration: Summit on Financial Markets and the World Economy" may be accessed at http://www.g20.org/Documents/g20_summit_declaration.pdf.
2. The April 2, 2009, G-20 "Declaration on Strengthening the Financial System communiqué may be accessed at http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf.
3. The paper is available through the Treasury Department's Web site, www.treas.gov.
4. The May 27, 2009, European Commission Communication "European Financial Supervision" approved on June 19, 2009, may be accessed through http://ec.europa.eu/internal_market/finances/docs/committees/supervision/communication_may2009/C-2009_715_en.pdf.
5. More information on the Financial Conglomerates Directive may be accessed through http://ec.europa.eu/internal_market/financial-conglomerates/supervision_en.htm.