

# TOO SOON to TELL

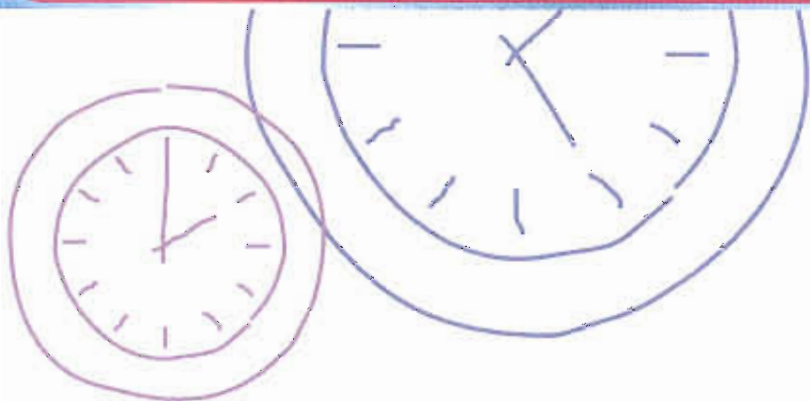
While policymakers grapple with just how to implement Wall Street reform, the financial services industry as a whole is eagerly awaiting the call on too-big-to-fail. Here's what's happened, what hasn't and what to expect now

By Apryl Motley

As its name implies, the Dodd-Frank Wall Street Reform and Consumer Protection Act is intended mainly to address two major problems that the financial crisis exposed. With the law's enactment last year, much emphasis was placed on the latter topic—consumer protection—as in the debate over the creation of the Consumer Financial Protection Bureau. However, the law's host of other, and arguably more important, systemic measures to rein in Wall Street and end too-big-to-fail are quietly being implemented.

The Wall Street Reform Act established the Financial Stability Oversight Council (FSOC) and gave the Federal Reserve and the FDIC unprecedented authority to keep a closer watch on the nation's largest and most complex financial entities. However, according to ICBA and other public policy analysts, how regulators use that





broader authority remains to be seen. Meanwhile, financial over-concentration has only increased since the financial crisis and the passage of Wall Street reform.

"We're far away from an even playing field," says Arthur E. Wilmarth Jr., a professor of law at George Washington University Law School who worked as a consultant to the Financial Crisis Inquiry Commission, the body

community banks need to keep making."

ICBA Senior Regulatory Counsel Chris Cole says "it's going to be a slow process over two years" to implement too-big-to-fail measures in the Wall Street Reform Act. "By the end of 2012, you'll see higher capital and liquidity requirements for big banks," he predicts. "The economy has been very slow to

about and engaged in the ongoing policy discussion—as well as monitor any further action to impose regulatory requirements. In March, in fact, ICBA recommended that Congress enact additional too-big-to-fail measures, such as establishing a pre-funded resolution fund, adopting antitrust provisions that consider the effect of systemic risk, and imposing a lower deposit concentration cap. Meanwhile, policymakers continue to work to implement Wall Street Reform Act provisions to fully address the problem.

"We pushed for the creation of the Financial Stability Oversight Council, the Fed's nonbank systemic-risk powers and the FDIC's expanded liquidation authority," ICBA President and CEO Camden Fine wrote in *ICBA Independent Banker*. "How regulators implement those measures, however, will determine whether they are successful and whether new legislation will be necessary."

**"More effort needs to be made to ensure that big banks internalize the risks and costs of their activities. That's an important equity argument that community banks need to keep making."**

—ARTHUR E. WILMARTH JR.,  
GEORGE WASHINGTON UNIVERSITY LAW SCHOOL

established by Congress to report on the causes of the financial crisis. "More effort needs to be made to ensure that big banks internalize the risks and costs of their activities. That's an important equity argument that

recover, and there has been reluctance from regulators to increase capital requirements on large banks too quickly."

With debate over too-big-to-fail far from over, community bankers will need to stay informed

#### **THE FSOC—FOCUSING ON SYSTEMICALLY IMPORTANT NONBANK FINANCIAL FIRMS**

Four meetings down; two studies completed and approved, one on implementation of the Volcker Rule and the other on the concentration limit on large financial companies; and two notices of proposed rulemaking issued,

both dealing with the designation and supervision of systemically important nonbank financial firms. That about sums up the recent activities of the FSOC since its inception with the passage of the Wall Street Reform Act nearly a year ago.

Chaired by the secretary of the Treasury, the council is made up of 10 voting members, nine from the federal financial regulatory agencies and one independent member with insurance expertise. The council, which has five nonvoting members, has a statutory mandate to identify risks and respond to emerging threats to overall financial stability.

In November, the FSOC approved rules for designating nonbank financial firms as requiring additional regulation and supervision as systemically important institutions. More pointedly, in addressing too-big-to-fail, Fine points out that the FSOC has the authority to force the breakup of any bank or nonbank that it considers systemically unstable. "ICBA is going to be all over [the FSOC] like a cheap suit to use [its breakup authority] if the conditions warrant it," he says.

The Wall Street Reform Act requires the council to consider six broad factors when determining whether nonbank financial firms

should be subject to increased prudential supervision as systemically risky institutions:

- the size of an institution's financial assets;
- the lack of alternatives available for the financial services and products the company provides;
- the company's interconnect- edness with other financial firms;
- the company's leverage of debt to capital;
- its degree of liquidity risk and maturity mismatch; and
- the amount of regulatory scrutiny it receives.



Consultants to the Financial Industry  
**Young & Associates, Inc.**

*Liquidity Planning*

*Strategic Planning*

*Regulatory Assistance*

*Stock Valuations*

*Capital Markets*

*Expansion & De Novo Bank Charters*

*Internal Audit*

*Information Technology*

*Recruitment & Human Resources*

*Lending & Loan Review Services*

*Compliance*

*Policy Development*

**BANKERS WORKING FOR BANKERS**

**800.525.9775**  
**younginc.com**

Additional factors may be considered at the FSOC's discretion. However, ICBA believes that an institution's size and interconnectedness with other financial firms are the most important considerations.

It is unknown whether FSOC will cast its net wide enough when making these designations and publicly identify nonbank companies as systemically important. ICBA says the list of systemically important nonbank financial companies should include,

but not necessarily be limited to, large investment banks, insurance companies, hedge funds, private equity funds, venture capital firms, mutual funds (particularly money market mutual funds), industrial loan companies, special-purpose vehicles and nonbank mortgage origination companies.

ICBA has recommended subjecting certain large nonbank financial companies to higher capital, leverage and liquidity standards, concentration limits

and contingent resolution plans. ICBA has also asked the FSOC to consider the degree to which a nonbank financial company is regulated and that a nonbank financial firm should not be automatically excluded from systemic-risk regulation if it is partially or substantially regulated by a state, federal or foreign government entity.

"We've asked them to look at a wide range of companies from GE to hedge funds and private equity funds," Cole says.

In March, ICBA repeated its strong support to the FSOC for establishing an effective 10 percent concentration limit under the Wall Street Reform Act. The law adds a new financial concentration cap to the existing Riegle-Neal limit preventing any institution from controlling more than 10 percent of the nation's financial assets. The new cap prevents any institution from controlling more than 10 percent of nation's financial liabilities. ICBA says the new concentration limit for liabilities should provide greater stability and a more comprehensive limitation on growth



**"There will be a more even playing field, but Dodd-Frank won't end too-big-to-fail."**

—CHRIS COLE,  
ICBA SENIOR REGULATORY COUNSEL

## ICBA POLICY RESOLUTIONS FOR SYSTEMIC RISK

- ICBA supported the creation of the Financial Stability Oversight Council (FSOC), whose duties include identifying and responding to emerging threats and risks to the stability of the U.S. financial system.
- Banking Institutions with \$50 billion in assets or more and certain nonbank financial companies should be subject to enhanced prudential standards including higher capital, leverage, liquidity standards and concentration limits, and to contingent resolution plans.
- FSOC's process for determining which nonbank financial institutions should be considered systemically risky should be a

sufficiently broad inquiry to include as many large or interconnected nonbank financial firms as possible. It is critical that the new Office of Financial Research focus on not only the large banking institutions but also the shadow industry and compile information on the nature, scope, size, scale, concentration, interconnectedness and mix of activities of nonbank financial companies.

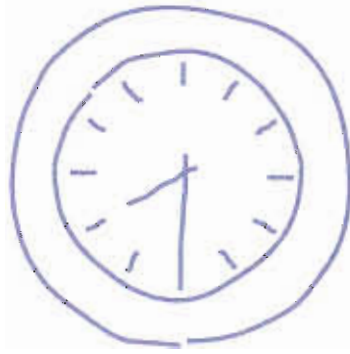
- ICBA generally supports the Volcker Rule and believes it is an important step toward building a wall between the fundamental business of banking and the excessive and hidden risks associated with proprietary trading and

because it covers both nondeposit liabilities and off-balance-sheet exposures.

The association is also advocating that the exception to the concentration limit include the acquisition of any type of insured depository institution in default or in danger of default, provided that the Fed uses the exception only under limited circumstances. An FSOC study also found that the 10 percent Riegle-Neal cap on nationwide deposits provides incentives for banking firms to shift liabilities from deposits to potentially more volatile on- and off-balance-sheet liabilities.

As with other still-unimplemented Wall Street reform measures, how effective the FSOC will be in helping to end too-big-to-fail is uncertain. One limitation is that the council is not the hands-on systemic-risk regulator; the Fed is. Congress gave the council overall authority to recommend action, but the Fed will oversee the regulation of both bank and nonbank systemically important financial institutions.

Lawrence G. Baxter, professor of the practice of law at



Duke University and a former Wachovia executive, also points to the FSOC's size and reliance on the newly created Office of Financial Research as potential hindrances to its work. "One basic problem is that the council has so many members that it will be hard to reach consensus," he says. "Further, the OFR is not fully established, and FSOC can only act on information provided by that office."

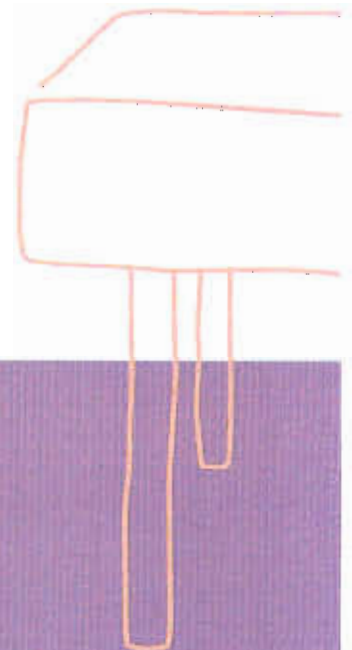
#### **THE FED—REGULATING SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS**

As the regulatory agencies move forward with implementing too-big-to-fail statutory requirements,

much of the direct supervision of the largest and most complex financial institutions will be the responsibility of the Federal Reserve. Under the Wall Street Reform Act, the Fed is charged with developing more stringent prudential standards for banking firms with assets greater than \$50 billion and all nonbank financial firms the FSOC designates as systemically important.

To that end, Wilmarth argues that the Fed's first task should be to remedy the problem that there seems to be "no penalty for getting bigger."

Testifying before the U.S. Senate Banking Committee, Federal Reserve Chairman Ben Bernanke acknowledged that "one of the Federal Reserve's most important Dodd-Frank implementation projects is to develop more stringent prudential standards for all large banking organizations and nonbank firms designated by the council." In addition to capital, liquidity and resolution plans, those extra prudential safety measures will include periodic stress tests conducted by the Federal Reserve and the regulated

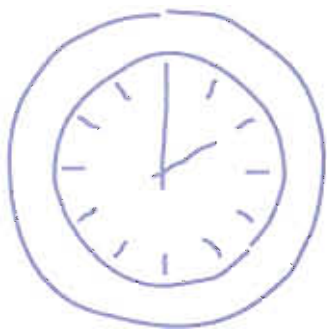


investing in or sponsoring hedge funds and private equity funds. Implementing regulations should separate the business of banking and these excessively risky activities to the fullest extent possible.

- ICBA supported the provisions of the Wall Street Reform Act that provide a process for the appointment of the FDIC as receiver of a failing financial company that poses significant risk to the financial stability of the United States. It is essential that the largest financial companies submit credible contingent resolution plans that will facilitate a rapid and orderly resolution of the company and

describe how the liquidation process can be accomplished without posing systemic risk to the public and the financial system. If the company cannot submit a credible plan, the FDIC and the Federal Reserve should exercise their authority to order a divestiture of those assets or operations that might hinder an orderly resolution.

- The provisions of the Wall Street Reform Act that allow for the downsizing of those institutions that pose the most systemic risk to our economy should be implemented to allow regulators broad discretion to exercise this authority.



companies and institutions, new counterparty credit limits and more intricate risk-management requirements.

In remarks at the ICBA National Convention in March, Bernanke also discussed the Federal Reserve's work with "other regulatory agencies and central banks around the world to design and implement a stronger set of prudential rules for large, internationally active banking firms." Late last year, these groups reached agreements on the major elements of the new Basel III prudential framework for large, globally active banks, which Bernanke believes "should make the financial system more stable and reduce the likelihood of future financial crises by requiring large banks to hold more and better-quality capital and more-robust liquidity buffers."

Many wonder whether these new measures will together significantly curtail too-big-to-fail institutions. "It will take a more rigorous regulatory approach than I've seen so far," Cole says. "If there isn't more willingness to break up large banks and increase requirements, we will still have too-big-to-fail."

In fact, some Washington observers have argued that the market-funding advantages for big banks have actually widened since the Wall Street Reform Act, which would mean the market is

behaving as if too-big-to-fail is still in effect.

So far the Fed's proposed rule-making on too-big-to-fail has been limited to bank holding company and nonbank financial company rules. Ultimately, those rules will define the circumstances under which a nonbank company is "predominantly engaged" in financial activities as well as the terms "significant nonbank financial company" and "significant bank holding company."

However, in the coming months, the board will have to address FSOC recommendations regarding modifications to the financial-asset concentration limit on large financial companies. Drafting rules to carry out provisions in the act designed to place checks and balances on growth of major financial firms by acquisition and to restrict the capital market activities of banking firms will likely fall under the Fed's jurisdiction as well. As the Fed ramps up its rulemaking, only time will tell how stringent supervision of the largest and most complex financial institutions will be.

In a high-profile speech in April, Federal Reserve Board Governor Daniel Tarullo urged policymakers to do more to prevent systemic risks posed by the shadow banking system. While the unregulated financial services

sector has been disrupted by the recent financial crisis, he said, "new conduits" will develop in response to Wall Street reform that will require regulatory oversight. He also advocated more studies on the efficiencies or inefficiencies of the largest financial firms to determine appropriate regulatory approaches, such as whether too-big-to-fail nonbank firms should be downsized.

#### **FDIC—FIGURING PROMINENTLY IN RESOLUTION OF LARGE FINANCIAL INSTITUTIONS**

In testimony this year before the U.S. Senate Banking Committee, FDIC Chairman Sheila Bair said the agency's expanded resolution powers under the Wall Street Reform Act should ensure that the largest financial companies, if necessary, can be wound down in an orderly fashion without taxpayer cost. "Under Title II of the Dodd-Frank Act, there are no more bailouts," she said. "It subjected all financial institutions, large and small, bank and nonbank, to our resolution process, which imposes losses where they belong—on shareholders and creditors—not on taxpayers."

At ICBA's convention, Bair emphasized the FDIC's bank resolution experience and its commitment to ensuring that there is "no avenue for a backdoor bailout" for the largest banks and



## A EUROPEAN VIEWPOINT

For a view on the European challenge over systemic risk and too-big-to-fail, read a column online by Chris De Noose, managing director at the World Savings Banks Institute in Brussels, Belgium. Find the column, titled "Domino Leery: Comparing Risk in Europe and the United States," at [www.independentbanker.org](http://www.independentbanker.org).

nonbank firms during the orderly liquidation process. One of the most critical steps in adopting the law's resolution measures occurred when the FDIC issued its interim rule earlier this year to clarify issues under its new orderly liquidation authority.

In March, the FDIC board of directors approved a joint notice of proposed rulemaking requiring systemically important financial institutions to submit resolution plans—also dubbed living wills—and report significant credit exposures. Under the rule, bank holding companies with at least \$50 billion in assets and nonbank financial firms deemed systemically risky by regulators would be required to provide quarterly reports on their business lines to legal entities; corporate structure; credit and other exposures; funding, capital and cash flows; domestic and foreign jurisdictions in which they operate; supporting information systems; and other elements of their operations.

"It may require the large guys to restructure themselves so that they can liquidate in a more orderly and reasonable fashion," Cole notes.

Given the size of today's largest financial institutions, others question the FDIC's ability to carry out its new liquidation authority in an orderly way to avoid public bailouts during a widespread, fast-moving crisis. "The complexity

is so enormous," Baxter says. "Now the agency will be dealing with banks that are substantially bigger." Adds Wilmarth, "Rarely will only one of these institutions have difficulties. During a systemic financial crisis, many large

pressure to do the same thing."

So too-big-to-fail hasn't gone away. No one knows how successful the Wall Street Reform Act will be in ending the threat—so community bankers would do well to heed Bair's advice to stay aware and

**"One basic problem is that the council has so many members that it will be hard to reach consensus."**


—LAWRENCE G. BAXTER,  
DUKE UNIVERSITY SCHOOL OF LAW

financial conglomerates are likely to face problems at the same time."

"There will be a more even playing field, but Dodd-Frank won't end too-big-to-fail," Cole says. "The administration wants the economy to get back on its feet. If the same situation were to occur again, at this point at least, the regulators and the Treasury secretary would do exactly what they did before, which is bail out large institutions.

"Under Dodd-Frank, it will be tougher, but there will be a lot of

involved. At the ICBA convention, she praised community bankers for maintaining constructive dialogue with policymakers during the debate over reform: "You kept a seat at the table, and you had an impact on the outcome."

She then encouraged community bankers to continue to take advantage of the "many venues to provide feedback to us as implementation moves forward." 

*April Motley, a writer in Columbia Md., is a regular IB contributor.*