

ClientAlert

Financial Markets Developments

July 2010

Dodd-Frank Wall Street Reform and Consumer Protection Act

Prudential Supervision of Bank Holding Companies and Nonbank Financial Companies

One of the most important goals of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”)¹ is to try to ensure that the financial system never again need to call on the federal government and the Federal Reserve for special and massive financial support. Time will tell if this goal will be achieved. After every crisis Congress has added provisions to ensure that that same crisis will not occur again. Unfortunately, they do. Perhaps with the supervisory actions discussed below the potential for massive financial difficulties in the financial system will be lessened materially. The question is what will be the source of the next crisis.

1. What organizations are covered by these new prudential supervisory requirements?

The purpose of enhanced supervision is to prevent or mitigate risk to the financial stability of the United States that could arise from material financial distress, failure, or ongoing activities of large interconnected financial institutions.² Enhanced prudential standards, disclosure, and reporting requirements will be imposed on nonbank financial companies supervised by the Federal Reserve and large interconnected bank holding companies. Bank holding companies (“BHCs”) include foreign banks with branches, agencies or commercial lending subsidiaries in the United States.³ These foreign banks are treated as if they were bank holding companies. Issues related to nonbank financial companies supervised by the Federal Reserve are found in the client alert discussing such companies.⁴

Those BHCs with total consolidated assets of US\$50 billion or more will be subject to these enhanced requirements.⁵ Pursuant to a recommendation of the Financial Stability Oversight Council (the “Council”),⁶ the Federal Reserve can set the threshold above US\$50 billion.⁷

2. What agency will issue these enhanced prudential standards?

These prudential standards will be issued by the Federal Reserve.

3. What is the safe harbor from Federal Reserve prudential supervision?

In consultation with the Council, the Federal Reserve must establish regulatory criteria for exempting certain classes of nonbank financial companies from Federal Reserve supervision.⁸ Every five years the Federal Reserve must review these regulations. Revisions will take effect two years after the final revised regulation is issued.



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4. What standards guide the Federal Reserve?

The Council may make prudential standards, disclosure, and reporting recommendations to the Federal Reserve.⁹ The Council is given broad discretion as to the nature and scope of its recommendations. These recommendations may address prudential standards, contingent capital, resolutions plans (living wills), credit-exposure reports, concentration limits, short-term debt limits, and public disclosure (Pillar 3 of Basel II). The Council's recommendation must be published for comment.¹⁰

The Federal Reserve, whose Chairman is a member of the Council, or any other agency receiving a Council recommendation must impose the standard or explain to the Council the reason for not doing so. In the case where a recommendation is rejected, the Council must report on the failure to implement its recommendation to Congress. One might be hard put to find a situation where the Council makes a recommendation opposed by the Federal Reserve representative on the Council and then the Federal Reserve refuses to act on the recommendation. In sum, it is likely that all recommendations of the Council will be adopted.

In prescribing these enhance prudential standards, the Federal Reserve may differentiate among companies on an individual basis or by category and take a series of factors into consideration.¹¹

The Federal Reserve's prudential standards must encompass:

- Risk-based capital
- Liquidity requirements
- Overall risk-management requirements;
- Resolution plans¹²
- Credit exposure report requirements
- Concentration limits.¹³

The Federal Reserve may also establish additional standards, including:

- Contingent capital requirements¹⁴
- Enhanced public disclosure
- Short-term debt limits¹⁵
- Any other appropriate standard¹⁶

In consultation with the Council, the Federal Reserve is not required to impose risk-based capital requirements on a company that is subject to more stringent prudential standards as a result of the company's activities or structure.¹⁷

5. Will off-balance-sheet exposures be included in risk capital calculations?

Yes. Off-balance-sheet activities are defined to include any liability not currently on a company's balance sheet that may become a balance sheet liability upon the happening of a future event.¹⁸ Such activities may include: (i) direct credit substitutes in which a bank substitutes its credit for that of a third party; (ii) irrevocable letters of credit guaranteeing repayment of commercial paper or tax-exempt securities; (iii) risk participations in bankers' acceptances; (iv) repurchase agreements; (v) asset sales with recourse against the seller; (vi) interest rate and credit swaps; (vii) commodities contracts; (viii) forward contracts; (ix) securities contracts; and (x) other activities that the federal banking agencies define.

The federal banking agencies may make exemptions for a company or transaction from this requirement.

6. Are there additional depository institution-related leverage and capital adequacy requirements?

Yes, the limitations of the Collins Amendment. The federal bank regulatory agencies must establish minimum risk-based and leverage requirements for insured depository institutions, BHCs and savings and loan holding companies, and nonbank financial companies supervised by the Federal Reserve, that are the same as those imposed on insured depository institutions.¹⁹ One significant effect of this provision is to exclude the inclusion of trust preferred securities as Tier 1 capital for these purposes.

The language of the Collins Amendment refers to "capital deductions required by" the Collins Amendment. This apparently is intended to refer to trust preferred securities.

Because of the impact of this provision, it is phased in over time, with large organizations subject to its provisions sooner than smaller ones and some organizations are exempted. As a general rule, the provisions of the Collins Amendment become effective May 19, 2010.²⁰ However, various exceptions and limitations apply.

- The Collins Amendment will not apply to small bank holding companies with consolidated assets of less than US\$15 billion on December 31, 2009 that are subject to the Federal Reserve small BHC policy statement.²¹
- The Collins Amendment will not apply to depository institution holding companies that are not bank or thrift holding companies and that are not deemed nonbank financial companies subject to Federal Reserve supervision.

- For other small bank holding companies with consolidated assets of less than US\$15 billion on December 31, 2009 or for mutual holding companies, the deduction for trust preferred securities will not apply to instruments issued before May 19, 2010.
- For depository institution holding companies supervised by the Federal Reserve on the date of enactment and nonbank financial companies, the deduction for trust preferred securities will be phased in over a three-year period beginning January 1, 2013.
- For depository institution holding companies not supervised by the Federal Reserve on the date of enactment (i.e., thrift holding companies), the Collins Amendment will become effective five years from the date of enactment.
- For bank holding company subsidiaries of foreign banking organizations that relied on the Federal Reserve SR-01-1,²² the Collins Amendment will become effective five years from date of enactment.
- The Collins Amendment will not apply to TARP preferred shares purchased by the Treasury or any other instrument issued prior to October 4, 2010 to the United States Government, any federal agency or any instrumentality of the government under the Economic Emergency Stabilization Act of 2008.
- The Collins Amendment will not apply to Federal Home Loan Banks.

Implementing regulations must be issued within 18 months of the effective date of Title I of the Dodd-Frank Act, which is one day after enactment.²³

The Collins Amendment also makes clear that depository holding companies and nonbank financial companies are not required to deduct from their capital for capital adequacy purposes amounts invested in its insured depository institution's "financial subsidiary."²⁴ Section 121 of the Gramm-Leach-Bliley Act permitted national banks to engage in expanded financial activities through financial subsidiaries.

7. Are statutory credit exposure limits prescribed?

The statute imposes a limit on a nonbank financial company's or BHC's credit exposure to an unaffiliated company.²⁵ This limitation becomes effective three years from the date of enactment and may be delayed for an additional two-year period.²⁶ It is designed to limit the company's interconnectedness with an unaffiliated company. The statute sets an exposure limit of 25 percent of the company's capital stock and surplus. The Federal Reserve may set a lower limit.

"Credit exposure" is defined to include: (i) extensions of credit to the unaffiliated company; (ii) repurchase agreements and securities borrowing and lending agreements that create credit exposure to the nonaffiliated company; (iii) guarantees, acceptances, and letters of credit issued on behalf of the unaffiliated company; (iv) securities issued by the unaffiliated company; (v) counterparty credit exposure in connection with a derivatives transaction; and (vi) any similar transactions that the Federal Reserve determines to be a credit exposure.²⁷

Similar to the provisions of Section 23A of the Federal Reserve Act that limit transactions with affiliates, an attribution rule applies to the credit exposure limit. Any transactions by the nonbank financial company or BHC with any person where the proceeds are to be used for the benefit of the unaffiliated company are deemed to be transactions with the unaffiliated company.²⁸

8. Is there a specified leverage limit imposed on a nonbank financial company supervised by the Federal Reserve or a BHC?

Yes. A debt-to-equity leverage limit of 15 to 1 will be imposed upon a determination of the Council that the company poses a grave threat to the financial stability of the United States and that imposition of this requirement is necessary to mitigate that risk.²⁹

This leverage limit is worded as if it is to be imposed on a company-by-company basis. Whether the Council will make a wholesale determination regarding all nonbank financial companies supervised by the Federal Reserve or BHCs remains to be seen.

9. Must a nonbank financial company supervised by the Federal Reserve or a BHC have a risk committee?

Each nonbank financial company that is a publicly traded company must have a risk committee within one year of the date of the final determination that it is such a company.³⁰ Any publicly traded BHC with assets of US\$10 billion or more must establish a risk committee.³¹ The Federal Reserve may require a bank holding company with assets of less than US\$10 billion to establish a risk committee.³²

10. Will a nonbank financial company supervised by the Federal Reserve or a BHC conduct an annual stress test?

Yes. The Federal Reserve, in coordination with the appropriate federal regulatory agency and the newly created Federal Insurance Office, will conduct at least an annual stress test for the purposes of evaluating whether each company has the capital necessary to absorb losses as a result of adverse economic conditions.³³ The test will use three different sets of conditions—baseline, adverse, and severely adverse. The Federal Reserve must publish a summary of the results of the stress tests.

The company must update its resolution plans based on the results of the tests. In addition, a company must conduct semiannual stress tests and provide the results to the Federal Reserve and its primary financial regulatory agency.³⁴

All financial companies that have consolidated assets of more than US\$10 billion and that are regulated by a primary federal regulatory agency must conduct an annual stress test.³⁵ The regulations issued by these agencies in coordination with the Federal Reserve and the Federal Insurance Office for these tests must be consistent and comparable.

11. Will the same prudential standards apply to US and foreign companies?

To the extent appropriate, the Council must consult with the appropriate foreign regulatory authorities when exercising its duties in respect of foreign nonbank financial companies and foreign-based bank holding companies.³⁶

Both the Council³⁷ and the Federal Reserve³⁸ must give consideration to additional factors regarding foreign nonbank financial companies and foreign-based bank holding companies. They must give due regard to the principle of national treatment and equality of competitive opportunity, and take into account the extent to which the foreign nonbank financial company or foreign-based bank holding company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States. This suggests that these foreign companies will be treated similar to the way that the Federal Reserve treats foreign banks.

12. Will the standards for nonbank financial companies and BHCs be identical?

Not necessarily. The Federal Reserve may take into consideration the fact that a company owns an insured depository institution and the nonfinancial activities of a company and its subsidiaries.³⁹ This seems to suggest that the standards applied to a company that does not own an insured depository institution and that engages in nonfinancial activities might be subject to more liberal standards.

13. Must the Federal Reserve consult with a primary federal regulator before imposing certain standards or taking certain actions?

If the Federal Reserve plans to take certain actions regarding a functionally regulated subsidiary or depository institution, the Federal Reserve must consult with the appropriate member of the Council.⁴⁰ Functionally regulated subsidiaries include: (i) SEC registered broker/dealers; (ii) SEC or state registered investment advisers; (iii) SEC registered investment companies, (iv) state regulated insurers; and (v) companies subject to the jurisdiction of the Commodity Futures Trading Commission.⁴¹

14. What are the consequences of falling afoul of a supervisory standard?

If the past is any guide to the future, the response that the Federal Reserve will take regarding the deficiency will depend on the particular standard and the degree to which the company has failed to comply with the standard.

In some instances, the statute provides direction to the Federal Reserve. For example, if the Federal Reserve and Federal Deposit Insurance Corporation (“FDIC”) jointly determine that a company’s resolution plan is deficient, the company will be notified to submit a revised credible plan.⁴² The plan must provide for the rapid and orderly resolution of the company in the event of material financial distress or failure. If the company fails to timely submit the revised plan, the Federal Reserve and FDIC may jointly impose more stringent capital, leverage, or liquidity requirements and restrictions on growth, activities or operations of the company.⁴³

If more stringent requirements are imposed, the Federal Reserve and FDIC may, in consultation with the Council, order the company to divest certain assets or operations.⁴⁴

15. What is an early remediation requirement?

In consultation with the Council and the FDIC, the Federal Reserve may prescribe remedial requirements that must be taken by a nonbank financial company supervised by the Federal Reserve or a BHC that is experiencing increasing financial distress.⁴⁵ These remedial actions will be intended to minimize the possibility that the company will become insolvent and the potential harm that such insolvency would have on the financial stability of the United States.

The measures established by the Federal Reserve by regulation will increase in stringency as the financial condition of a company declines. These requirements may initially place limits on capital distributions and asset growth. If the company's financial condition declines, these remedial measures may include preparation of a capital restoration plan, capital raising requirements, limits on transactions with affiliates, management changes and asset sales. These measures are not dissimilar to the prompt corrective action provisions applicable to insured banks.⁴⁶

16. Have the standards for the establishment of a state or federal branch, agency or a commercial lending company subsidiary in the United States changed?

Yes. In acting on such an application, the Federal Reserve must take into account whether the applicant foreign bank presents a risk to the stability of the United States financial system and whether the home country has adopted or is making demonstrable progress toward adopting an appropriate system of financial regulation for the financial system of that home country to mitigate that risk.⁴⁷ This is not a standard for approval like the comprehensive consolidated supervision standard, as modified by the working toward comprehensive consolidated supervision standard.⁴⁸ It is, however a factor that must be taken into account. The statute provides no guidance as to how the Federal Reserve should take this new standard into account.

While the Federal Reserve can terminate the operation of a state branch or agency or a commercial lending subsidiary, it cannot terminate the operations of a federal branch or agency. Instead, if the Federal Reserve finds that the home country does not adequately address this risk, the Federal Reserve can make a recommendation to the Comptroller of the Currency that the Comptroller terminate the license of a federal branch or agency of a foreign bank operating in the United States.⁴⁹ The Comptroller is authorized to terminate a license upon receipt of such a recommendation.⁵⁰

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1. H.R. 4173, 111th Cong. (2010).
2. Financial Stability Act of 2010 § 115(a)(1).
3. Unless otherwise indicated, "BHC" will refer to a bank holding company with assets of US\$50 billion or more.
4. <http://events.whitecase.com/fmd/alerts-Systemic-Nonbank-Financial-Companies.pdf>
5. Financial Stability Act of 2010 § 165(a)(1).
6. Financial Stability Act of 2010 § 115(a)(2)(B).
7. Financial Stability Act of 2010 § 165(a)(2)(B).
8. Financial Stability Act of 2010 § 170.
9. Financial Stability Act of 2010 § 115(a).
10. Financial Stability Act of 2010 § 120(b).
11. Financial Stability Act of 2010 § 165(a)(2).
12. Section 165(c) of the Financial Stability Act of 2010 sets forth a series of factors for the Federal Reserve to consider in deciding whether to impose a contingent capital requirement.
13. Financial Stability Act of 2010 § 165(b)(1)(A).
14. *Supra* n. 12.
15. Financial Stability Act of 2010 § 165(g)(3). The short-term debt limit does not include insured deposits. In addition, the Federal Reserve may exempt or make adjustments to the limits imposed on a nonbank financial company that does not control an insured depository institution. This may be a reference to finance companies that tend to rely on short-term debt. Financial Stability Act of 2010 §§ 165(g)(3), (5).
16. Financial Stability Act of 2010 § 165(b)(1)(B).
17. Financial Stability Act of 2010 § 165(b)(1)(A)(i) (the subsection references investment company activities or assets under management as examples of activities that could subject a company to stringent prudential supervision).
18. Financial Stability Act of 2010 § 165(k).
19. Financial Stability Act of 2010 § 171(b)(1).
20. Financial Stability Act of 2010 § 171(b)(4).
21. Small Bank Holding Company – Policy Statement on Assessment of Financial and Managerial Factors 12 C.F.R. app. C. Such a small BHC must have assets of less than US\$500 million, not conduct significant off-balance-sheet activities, and not have a significant amount of SEC registered securities outstanding (other than trust preferred securities).
22. Application of the Board's Capital Adequacy Guidelines to Bank Holding Companies owned by Foreign Banking Organizations SR 01-1 (SUP (Jan. 5, 2001)), <http://www.federalreserve.gov/boarddocs/srletters/2001/sr0101.htm>.
23. Dodd-Frank Act § 4.
24. Financial Stability Act of 2010 § 171(b)(3).
25. Financial Stability Act of 2010 § 165(e)(2). Federal Home Loan Banks are exempt from the credit exposure limits required under this subsection and the Federal Reserve may exempt transactions from the definition of "credit exposure." Financial Stability Act of 2010 § 165(e)(6).
26. Financial Stability Act of 2010 § 165(e)(7).
27. Financial Stability Act of 2010 § 165(e)(3).
28. Financial Stability Act of 2010 § 165(e)(4).
29. Financial Stability Act of 2010 § 165(j)(1). This requirement does not apply to a Federal Home Loan Bank.
30. Financial Stability Act of 2010 § 165(h)(1). This provision is silent on the point whether it is limited to companies publicly traded in the United States. Perhaps the presumption that statutes are presumed to not apply extraterritorially will be applied here.
31. Financial Stability Act of 2010 § 165(h)(2)(A).
32. *Id.*
33. Financial Stability Act of 2010 § 165(i).
34. Financial Stability Act of 2010 § 165(i)(2).
35. Financial Stability Act of 2010 § 165(i)(2).
36. Financial Stability Act of 2010 § 113(i). The term "foreign-based [BHC]" is not defined.
37. Financial Stability Act of 2010 § 115(b)(2).
38. Financial Stability Act of 2010 § 165(b)(2).
39. Financial Stability Act of 2010 § 165(b)(3).
40. Financial Stability Act of 2010 § 165(b)(4).
41. BHC Act § 5(c)(5).
42. Financial Stability Act of 2010 § 165(d)(4).
43. Financial Stability Act of 2010 § 165(d)(5)(A).
44. Financial Stability Act of 2010 § 165(d)(5)(B).
45. Financial Stability Act of 2010 § 166(a).
46. 12 U.S.C. § 1831o.
47. Financial Stability Act of 2010 § 173(a).
48. 12 U.S.C. §§ 3105(d)(3), (d)(5).
49. 12 U.S.C. § 3105(e)(6).
50. 12 C.F.R. § 28.24(a)(5).

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