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The Push from the G-20 Leaders: Enhanced International Financial Institution Regulation and Coordination

by Gregory J. Lyons and Satish M. Kini

The Leaders of the G-20 concluded their Pittsburgh Summit on Friday, September 25, by pledging to push for increased regulation and coordinated oversight over banking and other financial institutions. The numerous detailed steps included in the G-20 Leaders' communiqué and in the simultaneously issued reports of the Financial Stability Board ("FSB") could lead to higher capital and liquidity requirements for banking organizations, limits on executive pay, and other forms of tighter regulation.

The G-20's actions are not self-executing, and the principles outlined by the G-20 need to be implemented by the United States and other member countries to have force of law. Traditionally, international frameworks such as the one announced in Pittsburgh have fallen prey to divergent interests at the national level. As many commentators have noted, there are indications that the outcome will be different this time; as a result of the severe economic downturn and recent disruptions in the financial system, the United States and other G-20 countries appear committed to acting on the initiatives announced here. Indeed, many of the specifics included in the G-20 Leaders' communiqué, particularly with respect to bank capital, already reflect the strongly held views of the Obama Administration and were presaged by principles published by the U.S. Treasury Department earlier this month. (These principles were the subject of a Client Update entitled, "The U.S. Treasury Department Presents Its Core Principles for Regulatory Capital," issued on Sept. 8, 2009 available at www.debevoise.com.)

Context: Expanding Internationalism

Before detailing the G-20's substantive initiatives, the context from which these initiatives arose is worth noting. In Pittsburgh, the former "Group of Seven" big industrial nations – the United States, Britain, France, Canada, Italy, Germany and Japan – formally re-constituted itself as the Group of 20, a group which includes China, India, Brazil, South Korea and South Africa. This change reflects the increased importance to the global economy of the world's fast developing economies. The change also parallels actions taken in April this year to create the FSB as the successor to the former Financial Stability Forum (which was created by the G-7), with the FSB comprising, among others, representatives of the national financial authorities of all of the G-20 nations.

These changes mean that, increasingly, international initiatives on financial services regulation will reflect not only the views of the United States and the European Union, as has traditionally been the case, but also those of emerging financial services marketplaces. Some of these countries may have far different postures and priorities than the United States and European Union on issues such as market access, the need for transparency, and the importance of tax evasion, money laundering and other controls.

Substantive Initiatives: An Array of Increased Regulatory Standards

Compensation. The G-20 Leaders appear to have concluded (rightly or wrongly) that compensation practices promoted the excessive risk taking that facilitated the financial crisis. For this reason, compensation structures received substantial attention, with the G-20 Leaders calling compensation reform "an essential part of our effort to increase financial stability."

In April, the FSB had issued "Principles for Sound Compensation Practices;" the Leaders' communiqué strongly endorsed the fundamental tenets of those Principles, including avoiding multi-year guaranteed bonuses, requiring a significant part of variable compensation to be deferred and tied to performance, ensuring variable compensation does not adversely affect an

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WHAT'S INSIDE

Letter from the Editor

As this issue of the Debevoise & Plimpton Financial Institutions Report nears publication, much is changing in the regulation of financial institutions around the world through legislation, regulatory action and international cooperation, continuing the developments discussed in our last issue of the Financial Institutions Report available at www.debevoise.com. These changes will have profound effects on transactions in the financial services industry.

The world's financial institutions have become more interconnected, and that interconnectedness had bad consequences as some of them faltered or failed last year. In response, leaders of the largest economies gathered in Pittsburgh last weekend to address coordinated approaches. Our first article describes the general approaches on which the leaders have agreed, and what remains to be agreed.

The U.S. insurance industry continues to be regulated principally by the states. The National Association of Insurance Commissioners (the "NAIC"), feeling the threat of a greater federal role in regulating that industry, has been considering whether to support a proposal for a National Insurance Supervisory Commission run by insurance commissioners that would achieve nationwide uniformity by asking Congress to exercise its Commerce Clause powers. The proposal has already provoked strong criticism from state legislators. These and other developments at last week's quarterly meeting of the NAIC are reported in our Client Update of September 28, 2009.

At the meeting, the NAIC took important steps in its long-running efforts to introduce principles-based reserves for life insurance policies. Our second article in this issue discusses the status of these efforts and their implications for transactions.

Meanwhile, Congress continues to work on regulatory reform designed to protect consumers and reduce the risk of another financial crisis of similar severity. At the end of March, Treasury Secretary Timothy Geithner presented a bill for resolution of failed financial institutions of significant size. In June, the Obama Administration presented its White Paper on regulatory reform, as discussed in our June 18 Client Update, available at www.debevoise.com, and submitted comprehensive legislation. Now legislative work has begun in earnest, as discussed in the final article appearing in this issue of the Financial Institutions Report.

We will continue to participate in these developments and report on them in the Debevoise & Plimpton Financial Institutions Report and in Client Updates.

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Modernization of U.S. Insurance Regulation: Principles-Based Reserving for Life Insurers

by Elizabeth K. Brill, Michael K. McDonnell and Marilyn A. Lion

The National Association of Insurance Commissioners (the "NAIC") has been engaged for some time in a broad effort to modernize the insurance regulatory regime in the United States. While the nation's state-based system of insurance regulation has a well established track record, pressures for greater uniformity and regulatory efficiency among the states have grown as the business of insurance has become increasingly global in scope. The recent financial crisis has had a complex effect on the NAIC's regulatory modernization efforts, introducing a measure of added caution on the part of regulators and legislators in the review of modernization proposals, while also bringing urgency to the search to improve the regulation of insurance company liquidity and solvency, consumer protections, and systemic risks that transcend individual companies as well as state and national borders.

The NAIC's reform efforts span a wide range of topics, including, among others, U.S. and international reinsurance regulation, holding company and group solvency regulation, the role of rating agencies in the regulation of insurance companies, and the privacy of consumer financial and health information. This article focuses on a specific modernization effort that has been under development by the NAIC for a number of years and has shown increasing momentum in recent months: the shift to a principles-based system of reserving for life insurance companies, which would modernize the methodology for calculating liabilities with respect to policy reserves recorded on life insurers' statutory financial statements. The introduction of principles-based reserving for life insurance would mark a fundamental shift in the regulation of life insurance in the United States, touching many different aspects of the business. Among other things, insurance company directors and management should be aware of the corporate governance implications of principles-based reserving. An understanding of principles-based reserving will also be important to the pricing and structuring of corporate transactions in the life insurance industry, whether in the context of M&A, financings or other capital markets transactions.

Existing Framework for the Valuation of Life Insurance Reserves

For over 150 years, states have regulated life insurance reserves using a relatively rigid, formulaic approach. Currently, the NAIC's Model Standard Valuation Law (the "SVL") mandates the use of static formulas for the calculation of reserves for most life insurance and annuity products, with prescribed mortality and interest rates. The SVL is based on a legislative model that has not changed significantly since its inception in the mid-1800s. In the meantime, life insurance products and underwriting methods have advanced significantly.

Although the life insurance industry has continued to adapt despite the SVL's formulaic approach, concern has steadily increased among industry participants and regulators that the SVL is inflexible and outdated. In some cases, the formulaic approach to reserving may not adequately capture all of the risks of new, complex products. In other cases, the formulaic approach can be far too conservative, giving inadequate credit to modern underwriting techniques that can substantially reduce the risk inherent in a particular block of life insurance business.

Existing statutory reserving requirements for level term life insurance (commonly known as "Regulation XXX") and for universal life insurance with secondary guarantees (commonly known as "Regulation AXXX") illustrate the shortcomings of the current version of the SVL. Both Regulations XXX and AXXX were designed to modify the existing formulaic reserve requirements to accommodate modern product features. However, both are widely understood to require reserves that exceed, by a substantial margin, the level of economic reserves needed to fund future policy obligations. In recent years, life insurers active in these lines of business have entered into sometimes expensive and complicated reinsurance or financing transactions, increased rates or limited new business in order to address these formulaic reserve requirements. In order to address this type of problem, regulators and industry participants have sought to establish a more flexible set of reserving principles, one that is tailored closely to the actual experience of life insurers and that demonstrates greater adaptability as products and associated risks evolve.

The New Principles-Based Approach to Reserves

On September 23, 2009, at its 2009 Fall National Meeting, the NAIC adopted a revised version of the SVL that would implement a new principles-based approach to life insurance and annuity reserves. The new SVL would permit minimum required reserves based on modern principles of risk analysis and stochastic modeling. Unlike formulaic reserves, which are calculated based on standard mortality tables and other prescribed assumptions without consideration of an individual company's experience, the new SVL would base reserve calculations in part on assumptions formed after an analysis of relevant company data, and would require life insurers to submit company-specific

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mortality, morbidity, policyholder behavior, expense experience and other similar data to regulators as required by a valuation manual. Before it takes effect in a particular state, the new SVL will need to be enacted by the state legislature. New York and Wisconsin are the only states that voted against adopting the new SVL at the NAIC Fall National Meeting.

Valuation Manual

While the SVL includes general guidelines for the selection of reserve assumptions, risk analysis methods, margins for uncertainty and other factors for use in the establishment of principles-based reserves, much of the detail of the new requirements, including the specific company reporting requirements, will be set forth in a valuation manual that is still under development by the NAIC. Targeted for completion by the end of 2009, the valuation manual is envisioned as the reserving analogue to the NAIC's *Accounting Practices and Procedures Manual,* and is intended to improve the ability of regulators to adapt reserving requirements to the evolving business practices of life insurers. The new SVL would permit states, where possible, to follow the requirements of the valuation manual as amended each year by the NAIC without having to adopt new legislation or regulations. State legislators and regulators would retain the power to alter any requirements in the valuation manual that the legislators or regulators believe are not in compliance with the new SVL. In addition, the new SVL explicitly permits a state regulator to require an insurer to change any assumption or method that the regulator believes is necessary to comply with the new SVL or the valuation manual.

Effectiveness; Prospective Application Only

Under the terms of the new SVL, principles-based reserving will take effect on January 1 of the first calendar year following the first July 1 as of which all of the following have occurred: (1) the valuation manual is adopted by the NAIC by a vote of the greater of 75% and 42 of the NAIC's member insurance commissioners, (2) the new SVL, or substantially similar legislation, is enacted by states representing more than 75% of the direct life and health premium written in 2008, and (3) the new SVL, or substantially similar legislation, is enacted in at least 42 U.S. jurisdictions. Principles-based reserving, once effective, will apply prospectively to business written by life insurers after the effective date, but will not apply retroactively to reserves on existing blocks of business. Currently existing reserve requirements will continue to apply to policies that are already in force on the effective date and, for certain types of products, the valuation manual may initially incorporate existing reserving requirements. The process of legislative enactment is expected to take several years.

Corporate Governance Requirements

Because a principles-based valuation approach allows life insurers substantial flexibility in determining the assumptions, methods and models that support reserves, corporate oversight and internal control requirements are an important part of the new SVL and the proposed valuation manual. In particular, the new SVL requires that a company using a principles-based valuation (1) establish procedures for corporate governance and oversight of the actuarial valuation function consistent with requirements in the valuation manual, (2) provide to its board of directors and insurance regulators an annual certification of the effectiveness of its internal controls with respect to the principles-based valuation, and (3) develop, and file with insurance regulators on request, a principles-based valuation report that complies with standards prescribed in the valuation manual.

The current draft of the valuation manual provides additional detail on these points. According to the manual, just as directors are responsible in general for overseeing a corporation's affairs, they are also responsible for "general oversight" of the principles-based reserves actuarial function at a level that is "[c]ommensurate with the materiality of principles-based reserves in relationship to the overall risks borne by the insurance company." The responsibilities of the board of directors will include oversight of:

- the process taken by senior management to correct material weaknesses in internal controls;
- the adequacy of the infrastructure to implement and oversee principles-based reserves; and
- the documentation of "review and action undertaken by the board" relating to principles-based reserving in the minutes of the meetings of the board of directors.

Similarly, the current draft of the valuation manual defines oversight responsibilities for senior management and company actuaries. Specifically, senior management is charged with oversight of the actuarial function (including by ensuring that adequate infrastructure has been established, reviewing principles-based reserving elements and results, and addressing significant or unusual issues), adoption of internal controls, determining that resources are adequate, overseeing processes and review procedures, and communicating with the board of directors. In turn, one or more qualified actuaries must oversee calculation of principles-based reserves, review assumptions, methods and models, provide a summary report to senior management and the board of directors, provide an opinion on the adequacy of reserves, and cooperate with internal and external auditors, regulators and senior management.

While the new SVL and valuation manual include significant detail regarding corporate governance, they are not intended to alter basic duties under applicable corporate law. In fact, the September 2009 draft of VM-G, the section of the valuation manual including corporate governance provisions, specifically notes that it does not expand "the existing

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legal duties of a company's board of directors, senior management and appointed actuary and/or other qualified actuaries." Instead, the valuation manual indicates that it is intended "to emphasize and clarify how their duties apply to the principle-based reserves actuarial valuation function of an insurance company or group of insurance companies." The valuation manual implies, for example, that directors may continue to rely on experts as appropriate in the oversight of principles-based reserving. Nonetheless, the adoption of principles-based reserves will require that directors and management devote significant attention to the establishment of procedures for compliance with the governance guidelines set forth in the new SVL and the valuation manual.

Implications for Transactions in the Life Insurance Industry

The implementation of principles-based reserving is likely to have a significant impact both on life insurance companies and on future transactions involving participants in the life insurance industry. The most significant effects may be felt in the market for life insurance reserve financings. Over the last decade, many life insurers addressed reserve requirements imposed by Regulations XXX and AXXX by entering into securitization and structured letter of credit transactions. Depending on the specifics of the final valuation manual and the state legislative process, it is possible that the implementation of principles-based reserving will alter the dynamics in the market for these types of financing solutions. Because principles-based reserving will not apply retroactively, however, life insurers will likely continue to seek financing solutions for in-force blocks of business that are subject to Regulations XXX and AXXX.

Even outside the realm of reserve financings, principles-based reserving will have important implications for transactions involving U.S. life insurers. For example, in an acquisition of a life insurer or a block of life insurance business, the application of principles-based reserving will mark a fundamental shift in valuation methodologies. This shift will inevitably affect the negotiation of terms, introducing new pressure on the representations, warranties and covenants expected by buyers of life insurance businesses and on the specific mechanics for the determination of the purchase price and any related purchase price adjustments. Similarly, in the capital markets, issuers, underwriters and investors will likely bring a renewed focus to the due diligence of a life insurer's reserving practices and corporate governance procedures. ■

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institution's capital base, fully disclosing compensation policies and structures, and making certain that compensation committees are independent of management.

The FSB noted that many countries already are implementing these Principles, with the United Kingdom, Switzerland and Australia all finalizing rules that will come into force in early 2010. France issued binding rules on payout parameters in August, and the European Commission and U.S. federal banking agencies also have been widely reported to be at work on compensation reform.

On September 25, the FSB issued "Implementation Standards" to highlight those components of the aforementioned Principles "in which especially rapid progress is needed." The highlighted components included: (1) governance, (2) compensation and capital, (3) pay structure and risk alignment, (4) disclosure, and (5) supervisory oversight. A word or two on each component:

1. As to governance, the FSB Standards emphasize the need for "significant financial institutions" to have remuneration committees. Such committees are called on to have independent judgment, to work with the firm's risk committee to ensure incentives are properly aligned, to make certain that compensation policies comply with FSB and other applicable regulatory guidance, and to develop an annual compensation review that is submitted to national regulators or disclosed publicly.
2. The FSB Standards draw a link between compensation and capital. Specifically, the FSB Standards state that variable compensation, which often is based on net revenues, should not be allowed to adversely affect a firm's capital base.
3. With respect to pay structure and risk alignment, the FSB Standards provide that, for "significant financial institutions," variable compensation arrangements should take into account the full range of current and future risks. Accordingly, variable compensation should be reduced dramatically if a financial institution's revenues are low or negative, and a large portion (e.g., 60%) of the variable compensation of senior management should be paid on a deferred basis and subject to clawback if the firm's or business line's performance declines. The FSB Standards also regard guaranteed bonuses

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to be inconsistent with safe and sound practices.

4. The FSB Standards call on firms to disclose annually their compensation policies and the actual compensation received by senior officers.
5. Finally, the FSB Standards state that supervisors should both require remedial action on the part of institutions that do not follow this guidance and ensure that the guidance is applied consistently on an international basis.

The G-20's numerous actions with respect to compensation are noteworthy both because of their detail and breadth and because of what measures they avoid taking. Specifically, some G-20 Leaders were widely reported to have wanted specific caps on executive compensation, a step that the G-20 pointedly avoided.

Increasing Capital. Enhancing bank capital requirements was another principal focus of the G-20 Leaders' communiqué. The G-20 framework calls for minimum bank capital requirements to "increase substantially" (but does not establish any specific numbers, a point of continued contention) and establishes a series of ambitious deadlines for member countries to implement harmonized capital requirements that will be consistent across borders (to permit easier comparisons and reduce arbitrage opportunities). The communiqué also notes the need for capital requirements to be counter-cyclical, a theme repeated from prior G-20 meetings and in other reports and studies, such as Lord Turner's Review of the Global Banking Crisis on behalf of the U.K. Financial Services Authority.

Among other specifics, the G-20 capital regime calls for:

- twice as much capital to support trading books – which encompass Value-at-Risk modeling and include many securities, finance and other exposures that constituted a principal source of stress during the recent downturn – by 2010.
- a leverage standard to be imposed globally by the end of 2009. The use of a leverage ratio represents a significant departure from the traditional capital approach taken by the European Union but, in a compromise reached with the European Union, the leverage ratio would first "supplement" and not replace the Basel II risk-based framework and ultimately migrate into Pillar 1 of the Basel II framework.
- heightening the quality of capital, with Tier 1 capital (the most required form of capital) consisting of voting common stock and retained earnings.

In a further compromise with the European Union, all G-20 financial centers have committed to adopt the Basel II framework, adjusted as set forth above, by 2011. It remains to be seen whether this goal will cause changes in how the United States implements the Basel II regime.

If G-20 members treat these capital objectives seriously, they likely will need to commence actions soon to achieve the tight deadlines established by the G-20. Indeed, the FSB states that, to meet these new requirements, supervisors should soon begin requiring banks to retain profits by restricting dividends and, as noted above, to limit variable executive compensation that might otherwise impinge on banks' ability to meet these requirements.

Enhancing Liquidity. The G-20 Leaders and FSB emphasized that a healthy banking system requires strong liquidity positions as well as strong capital. The FSB noted that the recent crisis demonstrated that adequate liquidity, including cross-border foreign exchange and liquidity flows, is a prerequisite for financial stability.

To promote liquidity, the FSB calls on the Basel Committee to adopt a new minimum global liquidity standard by the end of 2009 and to create a so-called "structural ratio," which focuses on avoiding liquidity mismatches. The FSB also describes efforts to promote cross-border liquidity and notes that supervisors will closely monitor banks' liquidity management practices per the Basel Committee's 2008 "Principles for Sound Liquidity Risk Management and Supervision."

Addressing Too Big To Fail. The G-20 Leaders' communiqué calls on the FSB, by the end of October 2010, to propose possible measures to address the systemic risk posed by the largest and most complex financial institutions. Possible measures include additional capital and liquidity requirements for these enterprises, along with other incentives for them to reduce complexity and, possibly, size. On this score, it will be interesting to observe the interplay of these future measures and the Obama Administration's "Tier 1 FHC" approach to addressing the same set of issues.

The FSB also states that "too-big-to-fail" institutions that operate across borders will be required to develop contingency plans for rapid resolution (dubbed "living wills" by Mervyn King, governor of the Bank of England) should the need arise. This living-wills approach has, in past, drawn mixed reviews from industry participants, with some opposed (noting that fashioning such a plan will be an extremely difficult task) and others in favor (noting that the living-wills tack may forestall more intrusive regulatory mandates that otherwise will be imposed on "too-big-to-fail" cross-border institutions). For better or for worse, this concept seems to be gathering support and momentum. Indeed, Secretary Geithner announced the Obama Administration's support for living wills in his prepared testimony on September 23 before the House Financial Services Committee.

Harmonizing Accounting Standards. The G-20 Leaders also call on international accounting standard setters to "redouble

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their efforts to achieve a single set of high quality, global accounting standards … and complete their convergence project by June 2011." The FSB further encouraged the accounting bodies to ensure that these converged standards: (1) enable banks to recognize loan losses at an earlier stage to mitigate pro-cyclality, (2) simplify accounting principles for financial instruments and their valuation, and (3) better address what should constitute off-balance sheet activities.

Conclusion

The G-20 has put forth an ambitious and detailed blueprint for regulatory reform aimed at strengthening the global financial system. Yet, various issues remain to be resolved and details to be worked out, and only time will tell whether the United States and other G-20 member countries enact home country reforms that comport fully with the G-20's proposals and goals. ■

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U.S. Financial Services Reform: The Legislative Debate Begins in Earnest

By Satish M. Kini, Gregory J. Lyons and Christopher J. Ray

Earlier this year, the Obama Administration (the "Administration") issued draft legislation to revise substantially regulation of the U.S. financial services industry. The Administration's ambitious legislative proposal would, among other things, (1) create a Consumer Financial Protection Agency ("CFPA") vested with broad authority to develop standards for financial products delivered to consumers; (2) create a new class of financial institutions, dubbed "Tier 1 FHCs," which would include the most systemically significant institutions (whether or not they own a bank), and subject those institutions (of which Federal Reserve Chairman Bernanke has said that there would be about two dozen) to heightened oversight, capital and liquidity requirements; (3) provide the Federal Reserve supervisory authority over Tier 1 FHCs, as well as a greater role in seeking to prevent future financial crises; and (4) consolidate two of the four federal banking agencies (the Office of the Comptroller of the Currency and the Office of Thrift Supervision) into a new National Bank Supervisor.

The Administration's proposal has been subject to significant scrutiny and debate on Capitol Hill and elsewhere, and, when political attention turned to health care, the momentum behind financial reform appeared to stall. On the one-year anniversary of the collapse of Lehman Brothers, the President signaled his renewed commitment to resolving these open issues and to working with Congress to enact meaningful financial services reform this year. The first steps toward that process began last week, with a series of hearings in front of the House Financial Services Committee (the "Committee"), chaired by Rep. Barney Frank (D. Mass.).

The Committee's hearing schedule evidences a plan to discuss all of the elements of the Administration's reform proposal, but this article focuses on the two principal topics that the Committee has tackled in advance of our September 27 publication deadline: the CFPA and Tier 1 FHCs. The comments and developments pertaining to these topics during the Committee's hearings may provide insights to the prospects for the Administration's proposals regarding the CFPA and Tier 1 FHC structure.

Consumer Financial Protection Agency

The Administration proposed to grant the CFPA supervisory authority over consumer financial services and products (a role currently principally served by the federal banking agencies). The Administration also proposed to require banks and other covered financial services institutions to offer "plain vanilla" products (such as 30-year fixed rate mortgages and low-interest, low-fee credit cards). In addition, and of greatest significance to federally chartered banks, the Administration proposed to eliminate federal preemption of state and local consumer protection laws. The CFPA garnered much attention during the Committee's hearing, with testimony both in favor and opposed to its creation, with Chairman Frank offering a new proposal to resolve some of these differences.

To begin with, and perhaps unsurprisingly, Treasury Secretary Geithner defended the Administration's proposal at the Committee hearing. The Treasury Secretary argued that the current consumer regulatory framework fails to provide a "home . . . for the mission of protecting consumers." Secretary Geithner acknowledged the very public opposition to the CFPA from federal bank regulators but asserted that the current system, which gives consumer protection responsibilities to multiple federal agencies, is not working. The

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Secretary also responded to community bankers' concerns by arguing that the CFPA would not pose undue burdens on these institutions, since the new agency's oversight resources would be allocated on the basis of risk posed to consumers, with firms that pose less risk facing "proportionally less burdensome oversight."

Comptroller of the Currency John Dugan voiced objections to the CFPA – objections generally representative of those raised from other quarters (including from regulators and industry groups). Mr. Dugan indicated support for the CFPA in concept but expressed concern about the potential consolidation of all consumer protection, rulemaking and enforcement in one agency that would be "divorce[d] from prudential regulation." As to rulemaking, the Comptroller asserted a continuing need for banking supervisor input. Mr. Dugan also objected to the repeal of federal preemption of state consumer protection standards, which he said would up-end the long-regarded virtue of uniformity. Finally, Mr. Dugan argued that the banking agencies, not the CFPA, should have enforcement authority with regard to banks in matters of consumer protection. He suggested that moving rulemaking and enforcement functions to the CFPA would distract the new agency from regulating the "shadow banking system," such as mortgage originators.

During the hearings, Chairman Frank announced a revised proposal for the CFPA. The Frank proposal would move away from allowing the CFPA to trump banking agencies on rulemaking and other matters; rather, pursuant to revised legislation released on September 25, the CFPA and the federal bank regulators would conduct concurrent bank examinations that would address both consumer compliance and safety and soundness. If a bank received conflicting direction from the CFPA and its federal bank regulator, the bank could appeal to an independent governance panel. The revised bill also would eliminate the requirement for "plain vanilla products," a change that Treasury Secretary Geithner indicated a willingness to accept. Untouched by Rep. Frank's proposal is the Administration's plan to eliminate federal preemption of consumer laws; Chairman Frank acknowledged that preemption would be "one of the great questions that will be dealt with going forward."

Treatment of Large Systemically Significant Firms

As indicated above, another key piece of the Administration's reform proposal calls for designating systematically significant financial firms as "Tier 1 FHCs" and subjecting them to Federal Reserve supervision and heightened capital and liquidity requirements.

At the Committee hearing, Secretary Geithner defended as appropriate the heightened oversight and capital requirements for large, interconnected financial firms, given the benefit to major financial firms of implicit or explicit government subsidies. Secretary Geithner also defended the proposal's requirement that major financial firms prepare and update plans for rapid resolution (so-called "Living Wills") and for resolution authority in the case of a failure of a major financial firm. Finally, Mr. Geithner argued that the absence of a fixed list of Tier 1 FHCs under the Treasury Department's proposals, as well as the absence of any explicit subsidies to firms designated as Tier 1 FHCs, was a crucial aspect of the proposal, since the designation and associated regulation are intended to serve as "a disincentive for firms to become too big, complex, leveraged, and interconnected" rather than as a blueprint for "too-big-to-fail" status.

Some Democrats on the Committee suggested completely eliminating any safety net for large institutions, a suggestion that Secretary Geithner indicated was most likely unrealistic, preferring to characterize the goal of the Administration's proposals as one of "balance" between providing not enough and too much support. FDIC Chairman Bair and Comptroller Dugan generally supported the Administration's proposal during their testimony.

Former Federal Reserve Chairman Paul Volcker and a panel of industry experts including former SEC Chairman Arthur Levitt expressed divergent views at the hearing. Mr. Volcker would limit Tier 1 FHC designation only to systemically significant commercial banks. Mr. Levitt contended that the resolution authority was more important than naming any systemic regulator; he added that, in his view, any proposal should "make failure possible." Several economists offered varying views as to whether resolution authority or receivership was a better approach to failing systemic firms and whether public funds should be available to rescue all, part or none of their operations.

Conclusion

The debate over the Administration's proposals to reform the financial services industry appears finally to be moving forward. Chairman Frank has said that he remains committed to re-writing the rules this year. That is an ambitious objective, given that major open issues remain. In fact, Chris Dodd, the Chairman of the Senate Banking Committee, is reportedly drafting his own version of a financial reform bill. Also, the federally chartered and bi-partisan Financial Crisis Inquiry Commission finally selected an executive director and held its first public hearings in mid-September. It remains to be seen how Sen. Dodd or the Commission's work will proceed and affect the substance and timing of the on-going debate. ■

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