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The End of "Too Big To Fail"? Potential New Size and Activity Restrictions on Financial Firms

by Satish M. Kini and Thomas S. Wyler

On January 21, 2010, President Barack Obama, with former Federal Reserve Chairman Paul Volcker at his side, promised that "[n]ever again will the American taxpayer be held hostage by a bank that is 'too big to fail.'" With that pronouncement, the President unveiled the Administration's controversial proposals to limit the size of financial institutions and to narrow the scope of permissible activities of all banking organizations.

The Administration's plan, about which few details are yet known, is only one in a series of reforms that have been proposed to address the perceived systemic risks posed by financial institutions that are so large and interconnected with other firms that they cannot be allowed to fail in the same manner as other businesses. Until recently, the principal approach pursued on Capitol Hill and in international coordinating bodies, such as the Basel Committee on Banking Supervision (the "Basel Committee"), called for measures such as enhanced powers for regulatory bodies, increased capital and liquidity requirements and greater transparency regarding exposures to derivatives and other transactions. On political and policy grounds, some objected that the approach was too tepid and derisively deemed this set of responses to the financial crisis to be overly bureaucratic.

As a consequence, other more vigorous and dramatic proposals are being advanced, not only by the Obama Administration but also by other policymakers and notable commentators. These alternatives include an express reinstatement of the Glass-Steagall Act, the largely repealed Depression-era U.S. law that had separated commercial banking from investment banking, and the use of enhanced antitrust laws to break up large financial firms.

Each of these alternatives likely will receive serious consideration as reform efforts gather steam in Congress in advance of mid-term elections this fall. Several of the proposals also have drawn favorable comment from regulators and policymakers across the European Union. Whichever approach or, more likely, combination of approaches is ultimately chosen in the United States and abroad, financial services firms are apt to face a significantly altered, and more challenging, regulatory landscape in the future. In this article, we review each of the reform proposals, starting with the Administration's latest approach.

Latest Obama Administration Proposals

As noted above, the Obama Administration has called for limits both on the scope of activities of banking firms (dubbed the "Volcker Rule," after its principal advocate) and on the size of all financial institutions (the "Size Restriction").

The Volcker Rule

The Volcker Rule, as set forth by the Obama Administration, would not allow any financial institution "that contains a bank" either to "own, invest in or sponsor a hedge fund or private equity fund" or to engage in proprietary trading "unrelated to serving customers." The Volcker Rule therefore would appear to prohibit many activities that currently are permissible for U.S. banking firms. U.S. bank holding companies, for example, are allowed to engage in various types of trading and investment activities unrelated to serving their customers. Over 500 banking organizations also have qualified for treatment as financial holding companies, and may therefore engage in all activities

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What's Inside

A Review of Recent NAIC Capital & Surplus Relief Efforts Applicable to Life Insurers

by Elizabeth K. Brill and Michael K. McDonnell

In November 2008, at the height of the recent financial crisis, the American Council of Life Insurers (the "ACLI") submitted a detailed capital and surplus relief proposal to the National Association of Insurance Commissioners (the "NAIC"). At the time, economic turmoil and disruptions in the capital markets were causing severe stress for financial institutions generally, including U.S. life insurers. The ACLI's proposal was designed as an emergency response to the crisis and was intended to provide immediate relief, on year-end 2008 statutory financial statements, from certain conservative reserve and risk-based capital requirements applicable to life insurers, life insurance policies and annuity contracts. See the next page for a table showing the components of the ACLI proposal.

The proposal, at least in its initial form, quickly encountered resistance. In the face of pointed criticisms from consumer advocates, state legislators and other interested parties, the NAIC's Executive Committee rejected the proposal in its entirety in January 2009, largely on procedural grounds. Among other things, critics questioned the appropriateness of relaxing regulatory capital requirements when they were needed most, at a time of financial stress. Critics also noted that the ACLI's proposal was fundamentally inconsistent with a growing consensus in favor of more stringent capital requirements for banks and other financial institutions.

Despite the Executive Committee's initial rejection in January 2009, several portions of the proposal proved resilient. During the course of 2009, many U.S. life insurers successfully obtained permission from state insurance regulators to implement various components of the proposal. This

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The ACLI Proposal

Life Insurance

- With the consent of the domestic Commissioner, allow the 2001 CSO preferred mortality tables to be used with contracts based on the 2001 CSO and issued prior to 1/1/07.
- With the consent of the domestic Commissioner, allow Actuarial Guideline XXXVIII section 8C to be effective for policies and certificates issued 7/1/05 to 12/31/06 which are currently covered under section 8B.
- Clarify by means of an actuarial guideline that when using the preferred structure tables of the 2001 CSO for basic reserves, the original smoker or non-smoker tables may be used for determining segments when complying with the Valuation of Life Insurance Policies Model Regulation.
- Remove artificial X factor restrictions from the deficiency reserve calculation required by the NAIC Valuation of Life Insurance Policies Model Regulation.
- Facilitate Commissioners' use of existing discretionary authority under the Model Law and Regulation on Credit for Reinsurance to provide immediate relief to ceding insurers.

Variable Annuities

- Eliminate standalone asset adequacy analysis requirements in Actuarial Guideline XXXIX – Reserves for Variable Annuities with Guaranteed Living Benefits.
- Modify C-3 Phase II for year-ends 2008 and 2009 to waive the standard scenario.

Investments

- Temporarily modify the calculation of the life risk-based capital mortgage experience adjustment factor.

Accounting

- Replace current limits on the admissibility of deferred tax assets under SSAP 10 with a valuation allowance approach similar to U.S. GAAP.

permission typically took the form of a "permitted accounting practice" granted by an insurer's domestic state regulator. As a result, regulatory capital and surplus relief varied by type and scope from company to company. At the same time, the NAIC continued to review and discuss the proposal subsequent to the Executive Committee's action in January. As a result of this review, the NAIC ultimately adopted several elements of the proposal.

On the next page is a brief description of the components of the proposal that were ultimately adopted and a discussion of the broader implications of the proposal for future insurance regulatory reform.

Reserve Relief

Several important aspects of the ACLI proposal are intended to mitigate reserving requirements that are generally accepted among regulators and industry participants to be overly conservative. In large part, these aspects of the proposal were derived from portions of the NAIC's continuing effort to develop and implement a new principles-based system of life insurance reserves. The regulation of life insurance reserves in the United States is based on an inflexible and formulaic regulatory model that has changed little since its inception in the mid-nineteenth century, despite the introduction of new products and improved underwriting methods. Regulators have been working for years to introduce a more modern regulatory system for establishing life insurance reserves (see our article on principles-based reserves in the October 2009 issue of the Financial Institutions Report, available at www.debevoise.com, for additional detail). The effects of the financial crisis presented an urgent impetus to move more rapidly toward a system of principles-based reserves.

In its written evaluation of the ACLI proposal, the NAIC's Life and Health Actuarial Task Force ("LHATF") remarked on the inadequacies of the existing regulatory system, which prescribes specific

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assumptions for mortality and interest rates without regard to actual company experience. In LHATF's words, "[t]he current 'one-size-fits-all' approach may result in reserves that are overly conservative for some products and underwriting classifications and inadequate for others." While the challenges of the old system may have been tolerable in good economic times, many reinsurance and financing solutions for conservative reserve requirements became prohibitively expensive or simply unavailable at the height of the crisis. In order to mitigate this problem, LHATF recommended, and the NAIC adopted, four changes to life insurance reserving regulations, all of which are summarized in the table below. Each of these changes is consistent with the NAIC's broader, ongoing effort to adopt a system of principles-based life insurance reserves.

Mortgage Experience Adjustment Factor

The ACLI proposal suggested a modification to the mortgage experience adjustment factor ("MEAF") used in the calculation of risk-based capital for life insurers. The MEAF is a component of the determination of the amount of capital that a life insurer must hold based on the composition of the insurer's commercial mortgage portfolio. The MEAF is calculated by dividing a measure of the insurer's historical commercial mortgage default experience by an industry average of commercial mortgage defaults calculated over the previous eight quarters. Since commercial mortgage default rates have been low until relatively recently, the denominator in this equation has generally been close to zero. As a result, just one or two defaults in a life insurer's commercial mortgage loan portfolio could cause a significant increase in the insurer's MEAF and, as a consequence, in its required level of risk-based capital.

In response, the NAIC determined to increase the minimum MEAF from 50 percent to 75 percent and decrease the maximum MEAF from 350 percent to 125 percent for 2009 risk-based capital calculations. The NAIC is working on a longer-term solution that will apply to risk-based capital calculations for subsequent periods.

Changes Adopted to Life Insurance Reserving Requirements

- A new Actuarial Guideline 1C was adopted. The new guideline provides that a recalculation of segments under Section 4B of the Valuation of Life Insurance Policies Model Regulation (Model 830) is not required for policies issued on a policy form filed for approval prior to January 1, 2010 that are subject to a company election to substitute the 2001 Preferred Class Structure Table for the 2001 CSO Mortality Table.
- The Valuation of Life Insurance Policies Model Regulation (Model 830, known as "Regulation XXX") was revised to remove several artificial X factor restrictions from the deficiency reserve calculation.
- Revisions relating to disclosure in the regulatory asset adequacy issues summary were incorporated into the Actuarial Opinion and Memorandum Regulation (Model 822).
- The Model Regulation Permitting the Recognition of Preferred Mortality Tables for use in Determining Minimum Reserve Liabilities (Model 815) was revised to permit the use of the 2001 CSO Preferred Class Structure Table for the valuation of certain policies issued prior to January 1, 2007 (with regulatory consent and subject to the satisfaction of specified conditions).

Deferred Tax Assets

The ACLI proposal advocated a liberalization of the statutory accounting treatment of deferred tax assets on the balance sheets of U.S. life insurers. Significant declines in the value of investments during the course of 2008 created large losses for many life insurers. These losses, in turn, yielded tax deductions of significant size that may be available to reduce taxable income in future reporting periods. In the industry's view, statutory accounting principles limit the admissibility of deferred tax assets in a manner that does not properly reflect the likelihood that tax loss carryforwards will actually be used in future periods. In this regard, the statutory accounting approach is much more conservative than U.S. generally accepted accounting principles ("U.S. GAAP") or International Financial Reporting Standards. The ACLI proposed aligning the statutory accounting treatment with U.S. GAAP standards.

The deferred tax asset reform proved to be one of the more controversial components of the overall capital and surplus relief effort. After an extended debate, the NAIC narrowly adopted a modified version of the proposal in December 2009. The revisions adopted by the NAIC adjust limitations applicable to the calculation of admissible deferred tax assets by increasing (i) the "realization period" (i.e., the time period within which an insurer must expect to realize

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a deferred tax asset) from one to three years and (ii) the limit on admissible deferred tax assets from 10 percent of statutory capital and surplus to 15 percent. A life insurer is only eligible to admit additional deferred tax assets as a result of these changes if its risk-based capital exceeds minimum thresholds. In addition, whether or not the revisions will increase the amount of deferred tax assets that a life insurer may admit, the life insurer must apply a statutory valuation allowance to the extent of any deferred tax assets that have a less than 50 percent chance of being realized.

> **These modernization efforts reflect a recognition, on the part of both the industry and regulators, that capital and reserving requirements in the life insurance industry ... do not adequately account for the complexity, risks and benefits of modern life insurance products and operations.**

Implications for Future Insurance Regulatory Reform

Although conceived in large part as an emergency response to the financial crisis, several elements of the ACLI proposal were derived from longstanding, ongoing NAIC projects intended to modernize regulatory capital and reserving requirements, including the effort to establish a principles-based system of reserves for life insurers. These modernization efforts reflect a recognition, on the part of both the industry and regulators, that capital and reserving requirements in the life insurance industry are inflexible and outdated and do not adequately account for the complexity, risks and benefits of modern life insurance products and operations.

The NAIC's partial adoption of the ACLI proposal is a reflection of the continuing need to address these shortcomings. The long debate, however, indicates the complexity of the challenge faced by regulators in addressing these shortcomings in the wake of the financial crisis. The stress of the financial crisis added a new and urgent focus to the debate over modernization. At the same time, the upheaval in the financial markets and obvious failures in existing regulatory structures have made regulators and legislators more cautious in their review of proposals for change, in particular where a proposal will increase industry flexibility or relax protections designed to ensure solvency.

Still, regulatory reforms that emanate from the financial crisis will not inevitably be inconsistent with the regulatory modernization initiatives that predated its onset. The recent NAIC decision to replace rating agency evaluations with an independently developed model for purposes of determining capital charges

> **[T]he upheaval in the financial markets and obvious failures in existing regulatory structures have made regulators and legislators more cautious in their review of proposals for change....**

attributable non-agency residential mortgage investments provides a good example. This decision dramatically reduced the much-criticized role of rating agencies in the establishment of regulatory capital requirements while simultaneously serving as a source of significant additional capital relief. In decisions such as these, insurance regulators have demonstrated continued receptiveness to the imperatives of modernization. Nevertheless, it is clear that the task has become more difficult as legislators and regulators seek to address the causes and effects of the financial crisis without abandoning the effort to improve inflexible and outmoded regulatory schemes. ■

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FDIC Proposes to Increase Assessment Rates for Risky Compensation Structures

By Beth Pagel Serebransky, Gregory J. Lyons and Charity Brunson Wyatt

The Federal Deposit Insurance Corporation (the "FDIC") has joined the worldwide bank compensation reform effort by proposing rules under which it would incorporate employee compensation criteria into its determination of a bank's deposit insurance assessment rate (the "FDIC Proposal").[1]

The FDIC Proposal was undertaken based on the belief that certain compensation structures create skewed employee incentives and induce imprudent risk taking within financial organizations, which in turn contribute to financial institution failures. According to the proposal, employee compensation programs were cited as a contributing factor in 35 percent of the reports prepared in 2009 investigating the causes of insured depository institution failures and the associated losses to the Deposit Insurance Fund ("DIF").

The FDIC Proposal suggests using employee compensation criteria as a basis for adjusting the risk-based assessment rate charged to insured institutions in order to correctly price and assess the risks presented by certain compensation programs. A pass/fail metric would apply these criteria to adjust the assessment rates. The FDIC intends to develop criteria that will be straightforward, will require little additional data to be collected and will allow the FDIC to determine easily whether an institution's compensation system either "passes" or "fails." While institutions that "fail" will pay higher rates than those that "pass," compliance will not be compulsory—the proposal is designed to provide depository institutions with an incentive to exceed minimum supervisory standards rather than to replace existing minimums.

While the FDIC Proposal's criteria have yet to take final form, the FDIC's stated intention to create an easy-to-assess, pass/fail metric would appear to necessitate a more formulaic and quantifiable approach than the proposed principles-based guidance issued by the Federal Reserve Board.

The FDIC Proposal focuses on compensation structure and will not involve caps on pay. Its goals are (i) to adjust rates in order to compensate the DIF adequately for compensation-related risks, (ii) to provide incentives for insured institutions to adopt compensation programs that align employees' interests with those of other stakeholders, including the FDIC and (iii) to promote the use of compensation programs that reward employees for focusing on risk management.

The FDIC Proposal suggests that compensation programs meeting these goals may include (i) a substantial portion of compensation for employees with a significant impact on risk paid in restricted, non-discounted company stock, (ii) multi-year vesting periods for and clawback provisions on awards and (iii) a compensation program administered by a committee of the board composed of independent directors, with input from independent compensation professionals.

While the FDIC Proposal's criteria have yet to take final form, the FDIC's stated intention to create an easy-to-assess, pass/fail metric would appear to necessitate a more formulaic and quantifiable approach than the proposed principles-based guidance issued by the Federal Reserve Board. This could result in an approach to U.S. financial reform that is closer to the more rigid rules-based approach favored in recent European reforms.

The FDIC Proposal's criteria are subject to revision based on responses received during the public comment period. The comment period ends on February 18, 2010. In addition to inviting comment on the suggested criteria, the FDIC has requested comment on other issues, including (i) whether the criteria should apply only to larger institutions, institutions that engage in certain types of activities, or all insured depository institutions, (ii) how large the adjustment

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should be, (iii) which employees should be subject to the restrictions, (iv) how to define compensation, (v) what periods are reasonable for vesting and for deferral, (vi) whether the criteria should be used to reward conformity or to penalize noncompliance, (vii) how to assess compensation oversight by a board of directors, (viii) whether quantifiable measures should be used, (ix) whether the criteria should apply only to insured depository institutions or also to their holding companies and affiliates, (x) what mix of current and deferred compensation would provide the best incentives, (xi) whether certain bonus compensation practices (such as guaranteed bonuses, bonuses greatly disproportionate to base salary, or non-deferred bonuses) should be a basis for adjustment of assessment rates and (xii) whether another type of employee compensation arrangement altogether would better achieve the FDIC's goals.

The final rule, which could be issued within a year, may also be influenced by the Compensation Principles and Standards Assessment Methodology issued by The Basel Committee on Banking Supervision on January 22, 2010.[2] The Basel Methodology provides new guidance for supervisors to follow in reviewing compensation practices and assessing their compliance with the Financial Stability Board Principles for Sound Compensation Practices. ■

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1. *See FDIC proposal, available at http://www.fdic.gov/regulations/laws/federal/index.html.*

2. *Available at http://www.bis.org/publ/bcbs166.htm.*

Beyond the Contract: U.S. Banking Agencies' New VIE Rules Continue More Expansive Approach to Capital Requirements

By Gregory J. Lyons

On January 21, 2010, the four U.S. federal banking agencies (the "Banking Agencies") published their final capital guidelines (the "VIE Capital Guidelines") implementing the 2009 changes by the Financial Accounting Standards Board ("FASB") to the accounting treatment of transfers to special purpose entities (referred to as variable interest entities or "VIEs"), as set forth in FAS 166 and FAS 167.[1] In general, FAS 166 and FAS 167 result in the consolidation of a wider range of VIEs onto the balance sheets of sponsoring and other institutions under U.S. generally accepted accounting principles ("U.S. GAAP"). For banking institutions, FAS 166 and FAS 167 are most likely to require U.S. GAAP consolidation of VIEs associated with (i) asset-backed commercial paper ("ABCP") programs, (ii) master trust revolving securitizations, including credit card and home equity line of credit securitizations and (iii) non-government-backed mortgage loan securitizations.

FAS 166 and FAS 167 are effective for the first annual reporting period beginning after November 15, 2009. The VIE Capital Guidelines will become effective on March 29, 2010 (the "Implementation Date"), and banking organizations may apply them concurrently with the effective date of FAS 166 and FAS 167. Notably, in December 2009, FASB proposed that the application of these new principles to VIEs used in connection with asset management, money market and private equity investments would be deferred for an indefinite period. These types of VIEs are therefore not addressed by the VIE Capital Guidelines.

Because of the potential significant capital impact of FAS 166 and FAS 167, the Banking Agencies published a notice of proposed rulemaking in September 2009 asking for comment as to how, if at all, the implementation of FAS 166 and FAS 167 under U.S. GAAP should be altered for regulatory capital purposes.[2] Ultimately, the Banking Agencies did not grant significant substantive capital relief from U.S. GAAP treatment of FAS 166 and FAS 167 in the VIE Capital Guidelines. In addition, some of the underlying themes contained in the preamble to the VIE the Capital Guidelines

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may prove problematic for affected banks, both as to the VIE Capital Guidelines themselves and as to other pending national and international rules.

The VIE Capital Guidelines

The principal relief granted by the VIE Capital Guidelines relates not to substance but rather to timing of the application of FAS 166 and FAS 167 for risk capital purposes. The VIE Capital Guidelines provide for a transition period for risk capital purposes (in contrast, banks must comply with the leverage requirement as soon as the VIE Capital Rules become effective). However, despite many banking industry commenters' requests for at least a three-year transition period, the Banking Agencies concluded that a transition period of no more than one year is appropriate. The VIE Capital Guidelines therefore provide that, under the circumstances described below, a bank may elect (i) an optional two-quarter delay (after implementation of FAS 166 and FAS 167) for recognition of the effects of FAS 166 and FAS 167 on risk-weighted assets and on allowance for loan and lease losses ("ALLL") includable in tier 2 capital that results from the bank's implementation of FAS 166 and FAS 167 and (ii) an optional phase-in, if the bank has opted into the initial two-quarter delay, of these effects over the next two quarters.

To qualify for any transition period, (i) the VIE must have existed prior to the Implementation Date, (ii) except with respect to ABCP programs, the bank must not have already consolidated the VIE prior to the Implementation Date and (iii) the bank may not have provided support to the assets beyond its contractual obligations (so-called "implicit recourse"). As to ABCP programs, a bank may qualify for the transition period if the bank is the sponsor of the program and the bank consolidated the program's assets under U.S. GAAP but excluded them for regulatory risk capital purposes prior to the Implementation Date. (In addition, the VIE Capital Guidelines also prevent banks from continuing to exclude from risk-weighted assets ABCP program assets that are consolidated under U.S. GAAP and for which the bank acts as a sponsor.)

A bank electing to rely upon the transition period would have to apply it to all relevant VIEs. During the first two quarters of the transition period, the bank would only include in risk-weighted assets an amount equal to what it would have been required to calculate for its contractual exposures to VIEs on the Implementation Date. For the third and fourth quarters of the transition period, a bank that has adopted the transition approach for the first two quarters may continue to exclude from risk-weighted assets fifty percent of the amount of the risk-weighted assets that the bank excluded on the Implementation Date.

> **[D]espite many banking industry commenters' requests for at least a three-year transition period, the Banking Agencies concluded that a transition period of no more than one year is appropriate.**

As to ALLL, during the first two quarters of the transition period a bank that excludes VIE assets as described above could include in tier 2 capital the full amount of the ALLL as of the Implementation Date that is attributable to excluded assets (i.e., without consideration of the 1.25% of risk-weighted assets limit on ALLL in tier 2 capital in the general risk-based capital guidelines or the corresponding limit on ALLL in the Basel II guidelines). Similar to the risk-weighted asset approach, during the third and fourth quarters of a transition period a bank may include in tier 2 capital, without limit, up to fifty percent of the ALLL amount attributable to excluded assets as described above.

As noted above, while the VIE Capital Guidelines provide at least limited interim relief as to risk-weighted assets, they afford no such relief with regard to the leverage ratio. The Banking Agencies declared in the VIE Capital Guidelines that "the maintenance of a leverage rule as a balance-sheet assessment separate from the assessment of relative risk is a particularly important feature of prudential regulation." In addition, the VIE Capital Guidelines also include a new express reservation of authority, which provides each Banking Agency the ability to consolidate, for risk-based capital purposes, any entity not consolidated on a bank's balance sheet (above and beyond any consolidation required by FAS 166 and FAS 167) if the Banking Agency determines that "the capital treatment for a bank's exposure or other relationship … is not commensurate with the actual risk relationship of the bank to the entity."

Additional Underlying Themes

The themes underpinning the Banking Agencies' decisions as to the final provisions of the VIE Capital Guidelines suggest possible challenges for banks beyond the

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rules themselves. In the preamble to the VIE Capital Guidelines, the Banking Agencies repeatedly justified applying a risk capital charge for the full amount of the assets of the VIE, rather than simply for the amount of the contractual liability of the bank to the VIE, concluding that banks were likely to provide support to off-balance sheet vehicles beyond their express contractual requirements. The preamble further states that banks, while asserting in comment letters that the expansive view of risk proposed by the regulators was inappropriate, had not provided sufficient specific examples in support of a lesser charge. This preamble discussion suggests that the Banking Agencies may be shifting their view of how to evaluate bank exposure from one under which the appropriate risk charge is based primarily on express contractual risk to one under which the charge is based on the more expansive (and amorphous) concept of implicit support.

In addition to creating additional risk capital charges under the VIE Capital Guidelines, this approach could pose more fundamental challenges for banks if it becomes a precursor to a more general move by U.S. and international regulatory agencies towards looking beyond contractual obligations. For example, as discussed in more detail in the January 2010 issue of the Financial Institutions Report (available at

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www.debevoise.com), the December 2009 Basel Committee capital and liquidity proposals also seek comment on whether additional capital or liquidity charges might be appropriate in connection with off-balance sheet vehicles that may create reputational risk, even if they do not create strictly contractual risk.

Bank capital and liquidity requirements based on the potentially broad concept of reputational risk may be substantially higher than requirements based on actual exposures. Such requirements, combined with additional pressure on "high quality capital" evidenced in other recent proposals, could create pressures that may make a bank's recovery from the recent financial crisis more difficult. Given this and the potentially broad implications of the themes expressed in the preamble to the VIE Capital Guidelines, banks favoring requirements based on actual contractual exposures rather than on potential reputational risks may find it in their best interest to respond to regulatory requests for comment on capital and liquidity proposals with concrete, specific examples in support of their position whenever possible. ■

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1. 75 Red. Reg. 4,636 (Jan. 28, 2010) (to be codified at 12 C.F.R. pts. 3, 208, 225, 325, 567).

2. Regulatory Capital – FAS 166/167 and ABCP Conduits Notice of Proposed Rulemaking, OCC Bulletin 2009-30, available at http://www.occ.treas.gov/ftp/bulletin/2009-30.html.

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that are "financial in nature" or incidental or complementary thereto, including proprietary trading and merchant banking, within certain regulatory limits.

In proposing the Volcker Rule, the President cited both risk and conflict-of-interest concerns. President Obama argued that the trading and investing activity that would be barred by the Volcker Rule causes bankers to take undue risks – the kind of risks that should not be encouraged in deposit taking institutions. The President also suggested that firms' proprietary trading and investing activities conflict with their customers' interests.

Few particulars about the Volcker Rule have been released by the Administration; the White House issued only a short press statement at the time the President announced the proposal. In addition, although this reform was first suggested in a January 2009 report issued by the Group of Thirty, a private assembly of leading

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financiers and academics chaired by Mr. Volcker, the Group of Thirty report contains few details. Accordingly, as we go to press, several key questions remain open:

- Will the Volcker Rule's ban on proprietary trading bar hedging activities? There is no indication in the White House press release, but some have speculated that hedging customer risks and other customer-driven transactions would be allowed.
- Will existing hedge and private equity fund stakes held by banking firms be "grandfathered" from the Volcker Rule? Rep. Barney Frank, Chairman of the House Financial Services Committee, has suggested not but has said that, at a minimum, affected firms will need to be given several years to divest newly impermissible holdings.
- Will financial services firms be permitted to "de-bank" by divesting their banks in order to avoid the Volcker Rule? This important question is thus far unanswered. Many have speculated that any legislation effecting the proposal will make de-banking difficult, although Treasury officials have been quoted as saying that de-banking will be a permissible option. As a political matter, there may be a strong backlash if firms that became bank holding companies at the height of the financial crisis to take advantage of Federal Reserve liquidity programs are able to avoid the Volcker Rule by de-banking promptly after the crisis wanes. Moreover, during the Glass-Steagall era, the Federal Reserve was reluctant to allow firms to de-bank so as to become able to engage in then-restricted investment banking activities.
- Will the Volcker Rule apply to foreign banking firms operating in the United States? The answer is unclear, but Administration officials have been quoted in the press as saying that the Volcker Rule would apply to foreign banks that have branches or representative offices in the United States. In the past, restrictions applicable to U.S. banking firms have also been applied to their foreign counterparts operating in the United States for reasons of competitive equity.

These and other questions likely will not be fully answered until Congress and the Obama Administration craft legislative language to effect these reforms.

Size Restriction

President Obama also called for a cap (at a yet-unspecified level) on the total non-deposit liabilities at the "largest financial firms," a term that is undefined but appears to include not only large banking organizations but also other financial services providers. According to the White House press release, the Size Restriction would operate in a manner similar to, and would supplement, existing restrictions that prevent any one banking firm from holding more than 10 percent of the bank deposits in the United States.

As with the Volcker Rule, few further details about the Size Restriction are currently available. The Size Restriction seems to be aimed at limiting the growth and consolidation of large financial institutions, which the current deposit cap already does for large banking firms. In addition, the restriction seeks to prevent large financial institutions from relying extensively on non-depository and non-equity sources of funding.

Consequences and U.S. and International Reactions

If enacted as proposed, the Administration's proposals could have dramatic effects. For example, many banking firms likely would need to divest businesses, such as their private equity or merchant banking arms. In addition, the Volcker Rule would limit the trading activities of banking firms and the Size Restriction would curb the participation of large financial firms in transactions, such as repurchases, that increase their leverage. The net result may be to limit, and to raise the cost of, liquidity in many markets.

[T]he Volcker Rule would limit the trading activities of banking firms and the Size Restriction would curb the participation of large financial firms in transactions, such as repurchases, that increase their leverage. The net result may be to limit, and to raise the cost of, liquidity in many markets.

In Congress and elsewhere, reaction to the Administration's proposals has been mixed. Politicians in both U.S. political parties have expressed guarded support, in part for political reasons – they do not want to be seen as siding with the highly unpopular banks in opposing the Administration's populist stance. Others have indicated a

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willingness to consider the Volcker Rule seriously, in deference to Mr. Volcker's intellectual clout and his deep reservoir of political capital.

Opponents also have emerged. They have questioned whether the Volcker Rule addresses real or only imagined weaknesses in the financial system and have argued that the financial crisis did not result from the kinds of activities that would be barred if it is adopted. Opponents also have questioned why the Volcker Rule singles out banking organizations, since several non-banks like Bear Stearns were at the forefront of the financial crisis. Others have expressed concern that the proposals, if adopted, would lead to an exodus of talent from affected firms and have noted that it is difficult to define the barred activities precisely.

The Administration's proposals represent a departure from the internationally coordinated approach to reform that was being advanced by the U.S. Treasury Department and others through the Basel Committee, the G-20, and other international forums. To this end, many have argued that the Volcker Rule will be ineffective as a stand-alone United States measure, since prohibited activities will merely be moved offshore in order to avoid the restrictions. Alternatively, if applied more broadly to prohibit activities anywhere within a U.S. banking organization, the Volcker Rule could put U.S. firms at a significant competitive disadvantage to foreign counterparts.

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On this score, it remains to be seen whether other countries will follow the Administration's approach. The U.K. Labour government initially said that it would consider the Volcker Rule seriously but, more recently, Prime Minister Gordon Brown suggested that the rule's approach would not be necessary in England. Meanwhile, the U.K. Conservative Party has expressed strong support for the Volcker Rule. The French finance minister has called the Administration plan a "very good step forward." The German government's reaction, on the other hand, has been less favorable, likely because Germany historically has permitted its banks to engage in a broad range of activities under the "universal bank" model. European Central Bank President Jean-Claude Trichet provided guarded support but argued that any reforms should only be effected on a globally coordinated basis. The Administration's proposals are therefore likely to be a prime topic at the June 2010 G-20 meetings in Canada.

A Return to Glass-Steagall Restrictions

As many have observed, the Volcker Rule harkens back to the spirit of the Glass-Steagall Act, which was formally repealed in 1999 by the Gramm-Leach-Bliley Act. (It is important to note, however, that the Volcker Rule departs from the Glass-Steagall Act in that the Volcker Rule does not limit securities underwriting and related activities in the same manner as the Glass-Steagall Act did.) A distinguished group of commentators and policymakers, including former Treasury Secretary Nicolas Brady and former Citibank CEO John Reed, has called for a reinstatement of the Glass-Steagall Act's separation of commercial and investment banking and have argued that the lack of Glass-Steagall "guard rails" contributed to the financial crisis.

Senators John McCain, Russ Feingold, and Maria Cantwell have co-sponsored bipartisan legislation, entitled the Banking Integrity Act of 2009, designed principally to reinstate Glass-Steagall.[1] Much like the Glass-Steagall Act, the McCain bill would prevent any bank from affiliating with a firm "engaged principally" in securities underwriting, distribution, and other related activities and would prohibit director, officer, and employee interlocks between banks and firms "engaged primarily" in securities underwriting, dealing, and related activities. The bill also contains a prohibition on a bank engaging in the business of insurance or any insurance-related activity, which would be in addition to any applicable provisions of state law.

If enacted, this bill likely would lead to further regulatory and legal battles over such key terms as "engaged principally" and "engaged primarily." It was, in part, those battles, conducted over the course of several decades, that eviscerated Glass-Steagall and ultimately led to its formal demise.

The Antitrust Option

A third approach suggested by some academics and commentators is to use antitrust principles to limit the size and examine the behavior of large financial institutions. Essentially, their theory is that if an industry is so highly concentrated that the failure of one institution creates a great risk of industry-wide failure, U.S. antitrust laws should be deployed to force these institutions to downsize.

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Advocates of this view argue that the U.S. government should look beyond market share of deposits (a traditional approach to reviewing market power in the banking industry) to examine other parts of, and services provided by, the financial services industry, where allegedly high concentration, collusive behavior and above-market profits exist. Supporters of this approach note that it would favor smaller banks at the expense of large financial services firms and, thereby, be appropriately aligned with the current populist sentiment.

Any antitrust investigations likely would take years and consume significant resources. Thus, this approach alone is unlikely to satisfy reform proponents. Whether or not this approach gains currency, other antitrust restrictions currently applicable exclusively to banking firms may be expanded. For example, banks currently are subject to special anti-tying restrictions, which limit them from linking the offering of certain products and services. The financial reform legislation that was passed by the House of Representatives in December 2009, entitled the Wall Street Reform and Consumer Protection Act of 2009 (the "House Bill"),[2] would make these restrictions applicable to certain intermediate holding companies that control a bank. The House Bill also would require additional regulatory approvals for acquisitions by financial holding companies of firms with assets exceeding $25 billion.

Regulatory, Capital, and Other Reform Efforts

Even if none of these more dramatic reform approaches is adopted, large financial services firms are certain to face an array of new restrictions as a result of other ongoing legislative and regulatory efforts both in the United States and internationally.

For example, the far-reaching House Bill would, among other things, create a Financial Services Oversight Council ("FSOC"), the chief purpose of which would be to identify and impose heightened capital, liquidity, leverage, concentration and other standards on systemically significant financial firms. Also under the House Bill, the FSOC would be empowered to make a finding that a systemically significant firm poses a "grave threat" to the financial stability of the United States, in which case the FSOC would require the firm to take "mitigatory action" that could include terminating activities or selling off businesses. In addition, the House Bill would empower the Federal Reserve to limit the proprietary trading activities of a systemically important financial firm if such trading poses a systemic threat or risk to the safety and soundness of the firm.

Thus, if the House Bill is enacted, the FSOC and the Federal Reserve may possess discretionary authority to impose many of the restrictions that would be mandated by the Volcker Rule. The difference between the two approaches is that the House Bill relies on regulator discretion and allows case-by-case and tailored determinations, while the Volcker Rule does not. (If some version of the House Bill is enacted along side the Volcker Rule, then firms that de-bank in order to avoid the Volcker Rule could potentially become subject to similar restrictions adopted by the FSOC or Federal Reserve with the new powers granted to them under the House Bill.)

Significant regulatory changes also are afoot that will affect financial services firms of all sizes. For instance, the Basel Committee's capital framework and its U.S. analogue have been, and continue to be, revised in the wake of the financial crisis. These changes, apparently favored by the European Union, will require firms to hold additional and higher-quality capital, will increase capital requirements for certain types of exposures, and will impose express leverage and liquidity requirements. We have detailed many of these new measures in the October and December 2009 and the January 2010 issues of this publication (available at www.debevoise.com) and discuss another of them in this issue.

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Conclusion

Policymakers continue to wrestle with how best to address the perceived problem of financial institutions that are "too big to fail." The Administration's proposals, including the Volcker Rule, are only the latest – but perhaps the most dramatic – in a long line of proposals that attempt to curb the size and reach of these firms. Over the next several months, there will likely be a significant political fight over these proposals. U.S. and international financial institutions will need to pay close attention as this process unfolds.

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1. *S. 2886, 111th Cong. (2009).*

2. *H.R. 4173, 111th Cong. (2009).*