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The Final U.S. Basel III Capital Framework: The Banking Agencies Write a "Tale of Three Industries"

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WHAT'S INSIDE

5 The Long and Winding Road: Implementation of G-SII Measures in the United States

9 Be Forewarned: New Consumer Disclosures Required for International Electronic Funds Transfers

11 Pension Derisking: The Critical Role of the Independent Fiduciary

For a more in-depth discussion of this issue by the same authors, please click here or follow the link below.[2]

The Board of Governors of the Federal Reserve System (the "Board"), the Office of the Comptroller of the Currency (the "OCC") and the Federal Deposit Insurance Corporation (the "FDIC," and together with the Board and the OCC, the "Banking Agencies") have published the final U.S. "Basel III" capital framework (the "Final Rules").[3] Like the proposed rules implementing the Basel III framework (the "Proposed Rules"[4]), the Final Rules address and, relative to the Basel I framework under which U.S. banking organizations have operated for several decades, generally make more burdensome all aspects of the banking book capital requirements. As discussed further below, among other things the Final Rules raise the required capital ratios (and add a new common equity ratio and capital buffers), and narrow what constitutes capital (the numerator of the capital ratios).

The Final Rules establish a comprehensive set of "standardized" risk weights for bank assets applicable to all insured or federally regulated U.S. banking organizations other than bank holding companies ("BHCs") with $500 million or less of total consolidated assets, and modify risk weights for large banking organizations subject to the Basel II advanced approaches ("Advanced Approaches Banks").[5] Because of Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the so-called "Collins Amendment," Advanced Approaches Banks will ultimately be required to calculate risk weights under both the standardized

1 The authors wish to thank summer law clerks Lukman Azeez, Douglas M. Hirn, and Raj Krishnan for their invaluable help in drafting this article.

2 http://www.debevoise.com/files/Publication/6de2459b-3ea5-4da3-b8a3-adb3c2cd9c9b/Presentation/PublicationAttachment/c802069b-50e4-4615-bd28-c0fc85defda8/The%20Final%20U.S.%20Basel%20III%20Capital%20Framework%20The%20Banking%20Agencies%20Write%20a%20Tale%20of%20Th.pdf

3 Board, OCC, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule* (July 2, 2013); *FDIC, Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule* (July 9, 2013) (Interim Final Rule).

4 Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, 77 Fed. Reg. 52,792 (Aug. 30, 2012); Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements, 77 Fed. Reg. 52,888 (Aug. 30, 2012); Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule, 77 Fed. Reg. 52,978 (Aug. 30, 2012).

5 Advanced Approaches Banks generally include banking organizations with $250 billion or more in total consolidated assets or $10 billion or more on-balance sheet foreign exposures.

Continued from previous page

and advanced approaches, and apply the more stringent of the two calculations when evaluating capital adequacy. The Final Rules do not apply directly to non-U.S. banks (other than U.S. bank subsidiaries of non-U.S. banks), but may become more relevant to U.S. broker-dealers and other subsidiaries of non-U.S. banks if the Board finalizes a proposed rule implementing sections 165 and 166 of the Dodd-Frank Act for foreign banking organizations ("FBOs"), which may require certain FBOs to form U.S. intermediate holding companies that would be subject to the U.S. regulatory capital framework.[6]

Broadly speaking, the Final Rules confirm statements by senior members of the Banking Agencies throughout the rulemaking process that U.S. requirements would remain generally anchored to the international Basel III framework adopted by the Basel Committee on Banking Supervision (the "Basel Committee") in December 2010.[7] In this regard, despite having received over 2,500 comments on the Proposed Rules, the Banking Agencies left largely intact many aspects of the rules that mirror the international Basel III framework. In certain key respects, however, the Final Rules also evidence the Banking Agencies' evolving views since the issuance of the Proposed Rules with respect to three segments of the banking sector, both as to the applicability of the Final Rules and the implications for institutions subject to them.

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6 *See* Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76,628 (Dec. 28, 2012).

7 Basel Committee, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (revised June 2011), *available at* http://www.bis.org/publ/bcbs189.pdf.

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Continued from previous page

"The Final Rules generally make more burdensome all aspects of the banking book capital requirements."

Insurance Companies with Thrift Affiliates. Under the Proposed Rules, insurance companies that are savings and loan holding companies ("SLHCs") (after MetLife's disposal of its bank, no large insurance company remains a BHC) would have been subject to the same capital rules as traditional banking organizations. In response to substantial comments from the insurance industry about the inappropriateness of applying bank capital rules to insurers, the Final Rules *do not apply* to SLHCs in which the top tier holding company (i) is an insurance underwriting company or (ii) holds 25% or more of its consolidated assets in insurance underwriting subsidiaries (other than assets associated with credit risk insurance) ("Excluded Insurance SLHCs"). The preamble to the Final Rules states, however, that the Board expects to implement a separate capital framework for Excluded Insurance SLHCs by 2015 (implying that the Board currently still considers these SLHCs to be subject to the Collins Amendment, but may engage in additional tailoring for these companies). The insurance industry will continue to seek a complete exemption from bank-centric capital rules.[8]

Non-Advanced Approaches Banks. As to banking organizations not subject to the advanced approaches framework ("Non-Advanced Approaches Banks"), in the words of Board Governor Duke: "After hearing their concerns, numerous changes have been made to the [Proposed Rules] to reduce its complexity and to minimize the potential burden that would be placed on smaller and community banking organizations."[9] Changes in the Final Rules most relevant to Non-Advanced Approaches Banks include:

- Retaining the historical approach to capital requirements for residential mortgages, rather than applying the complex Type I/ Type II loan-to-value ("LTV") ratio approach contemplated by the Proposed Rules;
- For banking organizations with less than $15 billion in total consolidated assets, permanently grandfathering trust preferred securities ("TruPS") issued prior to the enactment of the Dodd-Frank Act, rather than eliminating these instruments from regulatory capital;
- Permitting a one-time "opt out" from accumulated other cumulative income ("AOCI") rolling fully into regulatory capital; and
- Delaying implementation of the Final Rules until 2015.

Advanced Approaches Banks. As to Advanced Approaches Banks, the Final Rules are less favorable. Advanced Approaches Banks with substantial mortgage activities may derive some incidental benefit from the changes to the treatment of mortgage exposure described above by virtue of the Collins Amendment, which requires them to use the more stringent of the advanced approaches rule or the standardized approach when determining capital adequacy. However, the other benefits set forth above for Non-Advanced Approaches Banks are not available to them. Rather, with the significant exception of also having to apply the standardized approach by virtue of the Collins Amendment, Advanced Approaches Banks will largely become subject to the Basel III framework adopted and modified by the Basel Committee. In addition, unlike under the Proposed Rules, Advanced Approaches Banks will have to use the *worse* of the advanced and the standardized approaches when applying the capital conservation buffer. The Banking Agencies have also made other technical changes to the advanced approaches framework, as described below.

Even more significant, Governor Tarullo stated during the open meeting adopting the Final Rules that the Board is currently developing certain additional proposals as a "complement" to the Final Rules. These additional proposals would

8 Commercial entities that are grandfathered unitary SLHCs are not subject to the Final Rules so long as 50% or more of either the consolidated assets or consolidated revenues of the enterprise is attributed to or results from non-financial activities. As to these SLHCs, the Board indicates in the preamble to the Final Rules that it plans to issue a proposal in the near future that would implement the intermediate holding company ("IHC") provisions of Section 626 of the Dodd-Frank Act and apply the Board's capital requirements to such IHCs.

9 Transcript of the Open Board Meeting (July 2, 2013), *available at* http://www.federalreserve.gov/mediacenter/files/open-board-meeting-transcript-20130702.pdf.

Continued from previous page

apply to the eight U.S. banking organizations designated by the Financial Stability Board (the "FSB") as global systemically important banks ("G-SIBs"), and would include:[10]

- Supplementary leverage ratios above that set forth in the Final Rules;
    - o In this regard, on July 9, 2013 the Banking Agencies proposed enhanced supplementary leverage ratios for banks (6% supplemental leverage ratio to be deemed "well capitalized") and BHCs (2% "leverage buffer" to avoid distribution/bonus limitations), in each case for BHCs with more than $700 billion of assets or $10 trillion in custody.[11]
- A requirement to maintain certain levels of holding company equity and debt, so as to facilitate the so-called "single point of entry" approach to resolving systemically important BHCs under Title II of the Dodd-Frank Act;
- The G-SIB capital surcharges contemplated by the Basel Committee (the Basel Committee published a revised methodology for these surcharges on July 3, 2013);[12] and
- Additional measures for risks arising from short-term wholesale funding, including additional capital requirements for banks dependent on such funding.

> "The Board is willing to impose requirements beyond those required by Basel III, particularly for the largest U.S. banks."

While these measures are not unexpected, given prior comments from members of the Board, they underscore the Board's aggressiveness in setting capital requirements based on the Board's own perspective. Although the Final Rules may largely follow the international Basel III framework, the Board is willing to impose requirements beyond those required by Basel III particularly for the largest U.S. banks. By comparison, the CRD IV framework adopted by the European Union last month more closely follows Basel III. This approach poses competitive issues for U.S. banks as they will be subject to additional burdens not applicable to competitors outside of the United States. Moreover, on July 5, 2013, the Basel Committee published a comparison showing "considerable variation" in risk-weighted assets in the banking book across jurisdictions, which may also lead to additional regulatory initiatives.[13]

Timing. The Final Rules require Advanced Approaches Banks to apply the higher capital ratios and restricted components of capital beginning January 1, 2014. Advanced Approaches Banks will treat the current Basel I approach to risk weighting of assets as the "generally applicable" capital rules for purposes of the Collins Amendment until January 1, 2015, at which time they will apply the standardized approach as set forth in the Final Rules for that purpose. For all other U.S. banking organizations subject to the Final Rule, the implementation period begins January 1, 2015.

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10 The FSB has designated Bank of America, Bank of New York Mellon, Citigroup, JPMorgan Chase, Goldman Sachs, Morgan Stanley, State Street and Wells Fargo as G-SIBs. *See* FSB, Press Release, *Update of group of global systemically important banks* (Nov. 1, 2012), *available at* http://www.financialstabilityboard.org/publications/r_121031ac.pdf.

11 Banking Agencies, Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and their Subsidiary Insured Depository Institutions (July 9, 2013).

12 Basel Committee, *Basel III: Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement* (July 2013), *available at* http://www.bis.org/publ/bcbs255.pdf.

13 Basel Committee, *Regulatory Consistency Assessment Program (RCAP): Analysis of risk-weighted assets for credit risk in the banking book* (July 2013), *available at* http://www.bis.org/publ/bcbs256.pdf.

The Long and Winding Road: Implementation of G-SII Measures in the United States

Amanda Greenwold Wise

In his testimony before the Housing and Insurance Subcommittee of the House Financial Services Committee on June 13, 2013, Michael T. McRaith, Director of the Federal Insurance Office (FIO) told the subcommittee that any implementation in the United States of measures relating to increased supervision of insurers designated by the Financial Stability Board (FSB) would be conducted through the Financial Stability Oversight Council (FSOC). Created by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Act) (Pub. L. 111-203), the FSOC's mandate is to identify and mitigate risks to the financial stability of the United States. The FSOC's authority, however, does not extend easily to the problem of identifying and mitigating global systemic risk. While Dodd-Frank installed FIO as the representative of the U.S. at the International Association of Insurance Supervisors (IAIS), the Act failed to provide a coherent approach to enforcing international insurance standards in the United States, even when the United States is a party to the agreement.

I. IAIS/FSB Process and G-SII Designation

As directed by the FSB, the IAIS is participating in the FSB's global initiative to identify institutions whose distress or disorderly failure would cause significant disruption to the global financial system and economic activity. In May 2012 the IAIS published its proposed assessment methodology for identifying and designating such companies as global systemically important insurers (G-SIIs). The proposal identified five categories the IAIS will consider in making a G-SII determination: size; global activity; interconnectedness; non-traditional (NT) and non-insurance (NI) activities; and substitutability. The IAIS subsequently issued data calls to approximately 30 insurers world-wide in order to determine if those institutions should be designated as G-SIIs. On recommendation from the IAIS, the FSB expects to designate the first G-SIIs in July 2013. Simultaneously, the IAIS will publish its final assessment methodology.

In October 2012 the IAIS published the proposed policy measures to be applied to G-SIIs in order to reduce moral hazard and risk to the global financial system. The IAIS proposed three broad supervisory measures: enhanced supervision (including separation of an institution's NT and NI activities from its traditional insurance business); effective resolution; and higher loss absorption capacity. Although the measures have not been finalized, the IAIS expects planning for enhanced supervision and effective resolution measures to begin immediately after a G-SII's designation; higher loss absorption capacity will have a longer timeline for implementation.

As a standard-setting body, the IAIS (like the FSB) has no authority to implement or enforce these proposals. Instead, in order to be effective, these measures must be adopted by the functional insurance supervisory authorities of each jurisdiction. The IAIS must also obtain FSB approval before finalizing the assessment and policy measures or designating G-SIIs.

II. FSOC Process and SIFI Designation

The United States is engaged in a similar process to identify risks to U.S. financial stability that could arise from the financial distress or failure of a financial institution. Dodd-Frank established the FSOC to, among other things, "require supervision by the Board of Governors [of the Federal Reserve System] for nonbank financial companies that may pose risks to the financial stability of the United States…" (Act at §112 (a)(2)(H)).

The FSOC may designate a non-bank financial company, foreign or domestic, as a systemically important financial institution (SIFI) if it believes that the company's nature, scope, size, scale, concentration, interconnectedness, or mix of activities might pose a risk to the United States' economy. SIFIs then will be subject to heightened supervision by the Board of Governors of the Federal Reserve System (FRB). FSOC has a three-stage process for designating non-bank SIFIs. The FSOC also has discretion to designate a non-bank financial institution as

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a SIFI even if it does not meet the Stage 1 threshold if the FSOC believes for some reason that the institution poses a systemic threat to the U.S. economy. The FSOC recently designated AIG and GE Capital as SIFIs, and Prudential has been notified that FSOC has recommended its designation.

"The FSOC's mandate for designation of a non-bank financial company as a SIFI is confined to the risk that the company poses to the *United States'* economy. The FSB's criteria for designating a G-SII evaluate the risk a company poses to the *global* economy. Designation as a G-SII does not mean that a company necessarily poses a risk to the economy of the *United States.*"

In late 2011 the FRB issued a proposed rule describing how it intended to carry out its heightened supervision of non-bank SIFIs (published on January 5, 2012 at 77 Fed. Reg. 594). While some of the provisions have been finalized, most have not. In general, the FRB's proposals for heightened supervision of non-bank SIFIs are based on the standards applied to banks, including increased capital and liquidity requirements. While the FRB has promised some measure of tailoring based upon differences between insurers and banks, the FRB's proposals have largely adhered to bank-like rules without specifics on how the supervisory rules would be adapted to the business model of a distinct institution or industry, such as insurance. Most recently, in its rules implementing the Basel III capital framework in the United States, the FRB exempted savings and loan holding companies that are primarily insurance companies from the framework, but promised to promulgate separate capital framework for these institutions without providing any further detail. (FRB, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule* (July 2, 2013)).

III. How the FSOC Process Could Be Used to Implement the IAIS/FSB Standards

The FSOC's mandate for designation of a non-bank financial company as a SIFI is confined to the risk that the company poses to the *United States'* economy. The FSB's criteria for designating a G-SII evaluate the risk a company poses to the *global* economy. Designation as a G-SII does not mean that a company necessarily poses a risk to the economy of the *United States*. In order for a G-SII to be designated as a SIFI, the FSOC must independently determine that the company poses a threat to the U.S. economy under the Dodd-Frank criteria. Dodd-Frank limits FSOC's designation authority to a company's effect on the economy of the United States, and FSOC has no other authority to broaden this mandate. Given this constraint, then, the FSOC could only designate for heightened supervision a G-SII that posed a systemic risk to the United States economy, thereby undermining the global nature of the FSB/IAIS designation initiative.

Once designated, the FRB, on its own or upon the recommendation of the FSOC, would be responsible for adopting any heightened supervisory measures to apply to a G-SII/SIFI "[i]n order to prevent or mitigate risks to the financial stability of the United States." (Act at § 165 (a)(1)). No matter what policy measures the FSB/IAIS adopts in its effort to promote global financial stability, the FRB is limited by statute to imposing only those heightened supervisory measures *which mitigate risks to the financial stability of the United States*. Unless IAIS policy measures would prevent or mitigate U.S. financial risk, the FRB is without authority to impose them on G-SII/SIFIs, even if it so desires.

Furthermore, the FRB is under no obligation to adopt any IAIS policy measures by virtue of international commitment. The U.S. members of the IAIS are FIO and the National Association of Insurance Supervisors (NAIC) (although the NAIC itself has no right to vote, only certain of its "designated members," *i.e.*,

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certain state insurance regulators do) (*see*, IAIS Bylaws, Art. 6 (2)(b) – (c) and (4)). The by-laws instruct members to "strive" to apply IAIS principles, standards, and guidance, "taking into account the specific circumstances of their markets." (Art. 2 (1)(a)).

This lack of specific commitment differs from the obligations of the United States members of the Basel Committee on Banking Supervision (BCBS), among them the FRB and the Federal Deposit Insurance Corporation. BCBS members "are committed to … implement and apply BCBS standards in their domestic jurisdictions within the pre-defined timeframe established by the Committee." (BCBS Charter at paragraph 2). Furthermore, "BCBS standards constitute minimum requirements.… The Committee expects standards to be incorporated into local legal frameworks through each jurisdiction's rule-making process within the pre-defined timeframe established by the Committee." (BCBS Charter at paragraph 12).

IV. Other IAIS/GSII Implementation Possibilities – Covered Agreements & State Action

Despite these constraints, U.S. policymakers apparently favor the FSOC route over the more obvious path provided in Dodd-Frank, the so-called "covered agreement." Among the duties Dodd-Frank gave the FIO is "assisting the Secretary [of the Treasury] in negotiating covered agreements.…" (Act at Section 502 (a)). "Covered agreements" are defined elsewhere in the section as:

> a written bilateral or multilateral agreement regarding prudential measures with respect to the business of insurance or reinsurance that:
>
> (A) is entered into between the United States and one or more foreign governments, authorities, or regulatory entities; and
>
> (B) relates to the recognition of prudential measures with respect to the business of insurance or reinsurance that achieves a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under State insurance or reinsurance regulation.

The Act also authorizes the Secretary and the United States Trade Representative (USTR) jointly to negotiate and enter into covered agreements on behalf of the United States after consulting with the House Ways and Means and Financial Services Committees, and with the Senate Banking and Finance Committees.

The FIO could have conducted negotiations over G-SII designation and policy measures as covered agreement negotiations. USTR could have joined FIO as part of its delegation to IAIS, or at least negotiated along with FIO as the IAIS process unfolded. USTR and FIO together could have informed the relevant Congressional committees that they were negotiating covered agreements on behalf of the United States. After all, discussions at the IAIS are intended to reach an agreement between the U.S. and other IAIS members relating to increased prudential measures for certain insurers. And, while it is less obvious if this level of heightened supervision will achieve a level of supervision equivalent to that achieved under state insurance regulation, certainly the argument could have been made that increased supervision of large international insurers would have enhanced overall regulation, bringing federal and international regulation more in line with established state regulation. Even if the U.S. had signed a covered agreement, it would only have preempted a conflicting state insurance measure if the state measure resulted in less favorable treatment of a non-U.S. insurer domiciled in a foreign jurisdiction and was inconsistent with the covered agreement.

But the Obama Administration chose not to take the covered agreement route. FIO did not invite USTR to join the IAIS delegation, and FIO and USTR have not individually or jointly consulted with Congress about negotiating a covered agreement. In his June 13 testimony, FIO Director McRaith mentioned that FIO might in the future consider using its covered agreement authority. As of yet, however, the authority remains untested, even in a situation where it would seem the logical route for adoption of international prudential measures.

The last available mechanism would have been adoption of FSB/IAIS policy measures by the individual states. Prior to Dodd-Frank, this had been the only route available in the United States for adoption of international prudential measures, because there was no

Implementation of GS-SII Measures in the U.S.

Continued from previous page

mechanism for federal involvement in state insurance, except for limited lines of business like airline passenger insurance. Once the NAIC and its members had agreed to the G-SII designations and policy measures promulgated at the IAIS and endorsed by the FSB, the states could have taken action directly by imposing new or different measures, by the means provided by applicable state law. The NAIC could have facilitated the process by promoting a model law, drafted with the idea that all or a substantial portion of the states would adopt the language to achieve uniformity in application across the various U.S. jurisdictions. In this way states could have imposed higher regulatory scrutiny on insurers identified as G-SIIs. There would have been no guaranty under this process, however, that the results would have been uniform across the U.S., which could have led to concerns about regulatory arbitrage.

So, despite the passage of Dodd-Frank and the creation of the FSOC to monitor systemic problems in the U.S. economic system, despite the creation of the FIO with the explicit task of representing the U.S. at the IAIS, despite a history of using the existing state regulatory mechanisms to implement global measures, the U.S. is left with only a partial means to participate in the international regulatory process underway at the IAIS and the FSB. FSOC has jurisdiction only over those companies who are also SIFIs; FIO can only negotiate covered agreements under limited circumstances, in coordination with USTR and in consultation with Congress; the NAIC and the state regulators can affect change only on a state-by-state basis. So where does that leave the United States?

"FSOC has jurisdiction only over those companies who are also SIFIs; FIO can only negotiate covered agreements under limited circumstances, in coordination with USTR and in consultation with Congress; the NAIC and the state regulators can affect change only on a state-by-state basis. So where does that leave the United States?"

It leaves the United States in a position to do little more than enforce the relevant provisions of Dodd-Frank. Unless an insurer has a bank holding company or a savings-and-loan holding company structure which otherwise makes the FRB its functional supervisor, the FRB has supervisory authority only if the insurer is designated as a domestic SIFI. These SIFIs will then be subject to the FRB's heightened supervisory standards, as contemplated in Dodd-Frank. In the case of any designated SIFI, whether or not a designated G-SII, the FRB could choose to adopt supervisory standards incorporating in whole or in part the IAIS policy measures, as long as those standards also meet the requirements of Dodd-Frank's heightened supervision standards. In the alternative, the FRB could impose the IAIS policy measures, in whole or in part, in addition to the Dodd-Frank supervisory standards.

In either case, it is up to the FRB whether to impose the IAIS policy measures, even though the FRB was not a party to the drafting or negotiation of the G-SII designation methodology or the policy measures. Unless certain state insurers adopt the IAIS policy measures, the IAIS measures will only be enforced against a discrete universe of domestic SIFIs, and only if the FRB chooses to adopt the IAIS measures at all. If the universe of United States G-SIIs is greater than the number of SIFIs, those non-SIFI G-SIIs will not see any practical consequence in the U.S. of their designation, beyond any reputational repercussions. And, if the FRB does not choose to adopt any of the IAIS policy measures, even SIFI G-SIIs will remain unaffected in the United States by the IAIS project.

Ironically, Dodd-Frank created the FIO to represent the United States at the IAIS. Yet this marquee IAIS project, negotiated by the FIO and the NAIC, depends for its enforcement upon the FRB, an entity without a great history and depth of insurance experience, and which was not a party to any of the international negotiations. While enforcing IAIS/FSB measures through the FSOC may be the best solution under current law, it removes the repository of insurance expertise in the federal government from the process.

Be Forewarned: New Consumer Disclosures Required for International Electronic Funds Transfers

Satish Kini, David Luigs and Paul Patton

On April 30, 2013, the Consumer Financial Protection Bureau (the "CFPB") finalized its remittance transfer rules (the "Remittance Transfer Rules") that impose disclosure and liability requirements applicable to electronic funds transfer from consumers located in the United States to recipients located outside the United States. The final rule (the "Final Rule") amends Regulation E and was adopted pursuant to Section 1073 of the Dodd Frank Act, which added a new section 919 to the Electronic Funds Transfer Act.[1]

The providers of these remittances transfers ("remittance transfer providers") are required by the Remittance Transfer Rules to give consumers written pre-payment disclosures regarding the exchange rate, applicable fees and taxes, and the amount to be received by the designated recipient. Remittance transfer providers are also required to provide a written receipt when payment is made for the transfer, and the receipt must include the prepayment disclosures as well as the date when funds will be available to the recipient, the designated recipient's contact information, and information regarding error resolution and cancellation rights. The Remittance Transfer Rules also impose liability requirements on remittance transfer providers for the acts of their agents.

The CFPB was confronted with balancing the statutory objective of providing more comprehensive disclosures to protect consumers from being charged for hidden fees versus the policy objective of ensuring that the new rules were not so burdensome that the rules themselves caused financial institutions to reduce or eliminate offering international wire transfer services. To address these risks, the Final Rules provide substantially greater flexibility to remittance transfer providers than earlier proposed approaches addressing disclosures and liability for consumer errors, as well as a greater period of time to satisfy the requirements of the Remittance Transfer Rules. However, remittance transfer providers will nonetheless need to devote substantial efforts to ensuring that they bring their programs into full compliance with the detailed and nuanced requirements of the Remittance Transfer Rules by October 28, 2013.

The Final Rule addressed the following three discrete issues:

I. Disclosures Regarding Third Party Fees and Taxes

The Final Rule eliminates a proposed requirement for remittance transfer disclosures to include third party fees imposed on the transfer (or an estimate of the highest amount of such fees), unless the fee is charged by an agent of the remittance transfer provider. Although the CFPB's objective was to craft requirements mandating consumer fee disclosures that would be as comprehensive as possible, the agency in the Final Rule accommodated industry concerns that it would be challenging, if not impossible, to obtain an accurate estimate of third party fees, and that a substantial number of financial institutions would no longer offer remittance transfers if they were subject to such a requirement. The CFPB continued to require inclusion of fees assessed by agents since such information should not be difficult to obtain. The Final Rule also clarified that the fees subject to disclosure would only include those fees specifically related to the transfer, thereby excluding overdraft fees, account fees and certain other extraneous fees.

The Final Rule also eliminates a proposed requirement for remittance transfer providers to disclose foreign national taxes imposed on the remittance transfer or to provide an estimate of the highest possible amount of such taxes. The CFPB opted instead to limit the tax disclosure to taxes collected by the remittance transfer provider. The CFPB concluded that, like the fee disclosures, the imposition of the proposed foreign tax disclosure requirements would be unduly burdensome and could reduce the number of financial institutions offering international remittance transfer services.

The Final Rule requires remittance transfer providers to include a disclaimer on the prepayment disclosure and receipt, or combined disclosure, indicating that the amount the recipient ultimately receives may be less due to fee's charged by the

1 Section 1073, Dodd Frank Wall Street Reform and Consumer Protection Act, Pub. Law 111-203, 124 Stat. 1376 (2010).

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recipient's bank or due to foreign taxes. The Final Rule also eliminated the requirement to include estimated third party fees and taxes in the calculation of the amount that the recipient would receive.

II. Error Resolution Provisions

> " …remittance transfer providers will nonetheless need to devote substantial efforts to ensuing that they bring their programs into full compliance with the detailed and nuanced requirements of the Remittance Transfer Rules by October 28, 2013."

The Remittance Transfer Rules generally make remittance transfer providers liable for failing to transfer the amount of funds stated in the disclosure or for failing to make funds available on the date of availability stated in the disclosure, subject to certain exceptions. In such situations, the remittance transfer provider must either refund the amounts provided by the sender in connection with the remittance transfer (or the amount appropriate to correct the error) or resend the transfer for free. The industry expressed significant concerns with potential exposure caused by a sender who provides an incorrect account number or other identifying information either accidentally or deliberately, which would obligate the remittance transfer provider to refund the amount of misdirected funds or resend the transfer.

In the Final Rule, the CFPB expanded the exception for errors caused by senders to include situations in which a sender provides an incorrect recipient institution identifier ("RII"), such as a SWIFT Code or BIC Code, rather than limiting the exception to situations in which a sender provides an incorrect account number. The Final Rule retains a number of requirements for the exception to apply. Accordingly, in order to avoid liability for errors committed by consumers, the remittance transfer provider maintain records demonstrating that: the remittance transfer provider notified the sender that he or she could lose the amount of the transfer if an incorrect account number or RII is provided; the consumer provided an incorrect account number or RII; the remittance transfer provider used reasonable efforts to verify the RII; the consumer's error resulted in a mis-deposit of funds; and the remittance transfer provider used reasonable efforts to recover the amounts involved.

III. Effective Date

The effective date of the Remittance Transfer Rules is October 28, 2013. The Remittance Transfer Rules had originally been scheduled to take effect on February 13, 2013, which was subsequently deferred to an unspecified date that would be 90 days after the issuance of a final rule. The CFPB ultimately decided to make the Remittance Transfer Rules effective on October 23, 2013, which is approximately 180 days after the issuance of the Final Rule on April 30, 2012. Remittance transfer providers should be working in earnest to review disclosures and effect the requisite operational and system changes to ensure that customers are receiving appropriate disclosures by the October 23rd effective date applicable to Regulation E's new remittance transfer rules.

Pension Derisking: The Critical Role of the Independent Fiduciary

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Recent jumbo de-risking transactions involving the transfer of large pension liabilities from corporate pension plans to insurers highlight the critical role of the independent fiduciary in the search for an annuity provider. Since the enactment of the Employee Retirement Income Security Act of 1974 ("ERISA"), the use of an "independent fiduciary" has been an important condition required by the Department of Labor in addressing situations where a plan fiduciary has been conflicted. In a de-risking transaction, the decision to de-risk is a business decision, while the choice of the annuity provider and the terms of the annuity are subject to ERISA's fiduciary standards. Under ERISA fiduciaries must act prudently (the "prudent man standard") and solely in the interest of plan participants and their beneficiaries, with the exclusive purpose of providing benefits to them (the "duty of loyalty"). Often times, the in-house plan fiduciary responsible for selecting the annuity is conflicted given the impact of the cost of the annuity purchase on the plan sponsor, and in jumbo transactions, the costs are in the billions. As recent litigation bears out, when an independent fiduciary is utilized (rather than the in-house fiduciary), there is unlikely to be a challenge to the plan sponsor's selection of the annuity provider.

What is Pension De-Risking?

De-risking, as the name suggests, is intended to reduce the volatile impact of defined benefit pension obligations on a company's financial statements due to changes in interest rates and other key assumptions. One way to de-risk a pension plan is to cause it to purchase an annuity contract from an insurer, thereby transferring the risks of the plan's performance from the plan to the annuity provider. De-risking can also be achieved through a liability-driven investment strategy whereby plan assets are invested in a portfolio of fixed income securities and derivatives so that income received matches the pensions payable. However, this alternative must absorb the risks of fluctuating interest rates and liabilities. A settlement program involving an annuity purchase can bring greater stability to a company's financial statements and other favorable consequences to the plan sponsor, including a reduction in investment management fees, PBGC premiums and administrative costs. However, these benefits come at the cost of annuity premiums, which may be substantial, particularly if the plan is underfunded at the time the plan sponsor is considering the annuity purchase. It is this cost impact on the plan sponsor that gives rise to the conflict when selecting an annuity.

What is a settlor or business function versus a fiduciary function?

Based on the law of trusts, under ERISA business decisions typically involving matters such as plan design, plan amendments, establishing or terminating a plan are settlor functions. In contrast, implementing business decisions impacting the plan often involves fiduciary functions. Thus, the decision to de-risk a pension plan through the purchase of an annuity is a settlor function, while the selection of an annuity provider is a fiduciary function.

Is an Independent Fiduciary required by the Department of Labor for the selection of an annuity?

Following the high profile failures of annuity providers such as Executive Life, in 1995, the Department of Labor ("DOL") issued Interpretative Bulletin 95-1 ("IB 95-1") which identified the need for an independent fiduciary, especially in situations involving plan terminations, where there are potential conflicts of interest relating to cost. Even if the plan sponsor is not overtly the decision maker, the selection of an annuity may be made by a plan investment committee consisting of employees of the plan sponsor or an affiliate of the plan sponsor. These committee members may be viewed as conflicted when selecting an annuity provider

Continued from previous page

because they are employed by the entity that will bear the cost of purchasing the annuity and, at the same time, benefit from both a reduction in its obligation to fund the plan and the reduction in risk of financial statement volatility attributable to the plan. In light of potential litigation, especially if the insurer becomes insolvent, the plan sponsor's retention of an independent fiduciary is viewed as a prudent proactive measure.

What must an Independent Fiduciary consider when selecting an annuity?

IB 95-1 is well-known to those working in the field for its directive to obtain the "safest annuity available," the so-called "gold standard." Contrary to the plain English meaning of the phrase, "safest annuity available" does not mean that it is actually needs to be the safest annuity on the market at any price. In fact, IB 95-1 permits a broader exercise of discretion and acknowledges that there may be more than one safest available annuity. Moreover, if the annuity provider of the safest annuity available is unable to administer benefit payments, IB 95-1 says it may be in the interest of participants to select a competing annuity provider.

The objective of obtaining the "safest annuity available" has been criticized by courts and others as not consistent with ERISA's prudence standard. Under ERISA's prudence standard, a fiduciary must act with the care, skill, prudence and diligence under the prevailing circumstances that a prudent person acting in a like capacity and familiar with such matters would act. This standard, also known as the "prudent expert" standard, focuses on procedural diligence rather than the actual outcome. To satisfy the prudent expert standard, a fiduciary must be able to demonstrate that it went through an objective, thorough and analytic search in selecting an annuity provider. In contrast, IB 95-1 is result oriented by specifying the factors to be considered in obtaining the "safest annuity available."

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The factors specified under IB 95-I include, among other things, the following:

a. The quality and diversification of the insurer's investment portfolio;

b. The insurer's size relative to the proposed contract;

c. The level of the insurer's capital and surplus;

d. The insurer's lines of business and other indications of its exposure to liability;

e. The annuity contract's structure and guarantees supporting the annuities, such as the use of separate accounts;

f. The availability of additional protection through state guaranty associations ("SGAs") and the extent of their guarantees;

g. The insurer's administrative claims paying capabilities; and

h. The rating of the insurer.

In addition, the plan fiduciary responsible for the selection of an annuity provider should also seek the assistance of qualified experts. Because of ERISA's "prudent expert" standard, it is crucial, from a fiduciary perspective, that the fiduciary be able to fully engage in all aspects of the annuity transaction, including identifying the range of potential issuers and soliciting proposals and negotiating the best possible terms. In IB 95-1, the DOL stated that unless the fiduciary has the expertise to evaluate the relevant factors, the fiduciary needs to obtain the advice of a qualified independent expert. In complex annuity transactions, these may include actuarial, financial and legal advisors.

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Are there other benefits in obtaining an Independent Fiduciary?

Where the independent fiduciary also qualifies as a "qualified professional asset manager" (commonly known as a "QPAM"), the parties also may receive the additional benefit of Prohibited Transaction Class Exemption 84-14 (the "QPAM Exemption") to cover certain transactions that arise in an annuity purchase. Under ERISA prohibited transaction rules, a plan may not engage in a number of transactions with parties in interest to the plan. Parties in interest include service providers and fiduciaries to the plan and certain of their respective affiliates. Penalties for prohibited transactions include excise taxes on the party in interest, personal liability to the plan fiduciary for losses to the plan and a possible unwinding of the transaction. Prohibited transactions may arise as a result of the purchase of the annuity from an insurer which may otherwise be a service provider to the plan or when the consideration for the annuity given to the insurer includes securities of the plan. Under the QPAM Exemption, an entity, such as an investment adviser registered under the Investment Advisers Act of 1940 (the "Advisers Act"), a bank or an insurance company which satisfy certain requirements, may qualify as a QPAM with respect to assets of the plan involved in the annuity purchase, and if the conditions of the exemption are satisfied, provide an exemption from certain prohibited transactions. One area for which the QPAM Exemption does not provide relief, however, is ERISA's prohibitions on fiduciary acting under certain conflicts of interest. However, if the QPAM, as an independent fiduciary makes the annuity selection decision, there is no longer a conflict needing exemptive relief.

"From the perspective of transaction certainty, engaging an independent fiduciary should lower the risk of a successful challenge to the de-risking transaction on the grounds that fiduciary duty was breached in the selection of the annuity provider."

Does use of an Independent Fiduciary provide protection against litigation in de-risking transactions?

From the perspective of transaction certainty, engaging an independent fiduciary should lower the risk of a successful challenge to the de-risking transaction on the grounds that fiduciary duty was breached in the selection of the annuity provider. In *Lee v. Verizon Communications Inc.*, No. 3:12-CV-4834-D (N.D. Tex Dec. 7, 2012), the District Court denied a preliminary injunction and let a de-risking transaction proceed. In that transaction, Verizon completed a partial de-risking of one of its pension plans by settling a portion of the plan's pension obligations through the purchase of an annuity contract from The Prudential Insurance Company of America ("Prudential"). Unlike most settlement transactions, Verizon amended and did not terminate its plan which would have ultimately removed the plan from ERISA coverage altogether. The Court found that the amendment of the plan to require the purchase of an annuity was a settlor decision. Therefore, the ultimate purchase of the annuity from Prudential did not result in a failure to diversify under ERISA's fiduciary standards since the purchase of the annuity resulted in a distribution of benefits rather than the investment of plan assets. The Court stressed that in a de-risking transaction, while certain decisions are settlor decisions, employers remain obligated under ERISA fiduciary standards in their choice of an annuity provider. While a number of claims were brought, including breach of fiduciary duty, none challenged the choice of Prudential as an annuity provider. It is significant that in the Verizon transaction, there was an independent fiduciary. On June 24, 2013, in a subsequent proceeding, the Court dismissed the breach of fiduciary claim for failing to state a claim but permitted amendment of the pleadings. This litigation will continue to be followed closely for guidance on fiduciary decisions in de-risking transactions as an amended complaint was filed on July 12, 2013.