

Treasury Proposes Special Regulation for Systemically Important Institutions

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The U.S. Treasury has outlined how it proposes to reorganize financial regulation. Among the proposals sketched in the outline is enhanced supervision for companies determined to be systemically important. Enhanced supervision would be designed to satisfy a number of characteristics:

- Regulation would not be voluntary;
- The regulated institutions could not choose their regulators; and
- The institutions to be regulated would be selected based on their interconnectedness with the rest of the financial system, their size and leverage, the degree to which they depend on short-term funding, and the importance of their roles as providers of credit and liquidity.

Upon becoming systemically important, institutions would be subject to higher capital requirements that would be designed to be anti-cyclical, higher standards for managing liquidity, counterparty risk and credit risk, and special resolution regimes that would permit the systemic risk regulator to take control of their activities prior to insolvency.

Among the institutions mentioned as being potentially subject to this special regulatory regime are bank and thrift holding companies, and holding companies that control broker-dealers, insurers and futures commission merchants. These institutions would be in addition to those that are already and always subject to the taking of prompt (regulatory) corrective action, such as insured depository institutions, but would differ from those already under this regime by apparently being subject to prompt corrective action only if and when they were found to be systemically significant.

Establishing a regulatory system that varies in its application based on an ongoing determination of systemic importance raises a number of issues. The U.S. Treasury has not yet released enough details of its proposals to allow the public to see how these issues will be dealt with. Nevertheless, it may be useful to mention some of them in furtherance of the upcoming public debate:

- How would newly identified systemically important institutions ("SII's") transform their capital and risk-management structures to meet the new requirements that would be imposed on them?
- Would becoming an SII be easier than exiting that category (like the Hotel California in the song by the Eagles)?
- How would lenders to non-SII's structure the terms of their credit if they knew that different resolution regimes could apply, depending on a future decision by the macroprudential regulator? Which notion (if any) of insolvency preference should apply?
- What could or should be done for non-US holding companies that turn out to be SII's? In the absence of appropriate international agreements, should US regulators require there to be a US holding company for all controlling investments by non-US financial companies or will non-US firms be dealt with like foreign banks with US branches?
- Since institutions presumably do not always intend to become SII's, should those that do bear the entire burden of being found to fall into that category? Should every financial firm be required to contribute in some way to the resolution of problems created by the existence of SII's? Is it the case that all participants in the financial system benefit from the existence of SII's? If so, what does that imply with regard to the presumably more conservative, and therefore less profitable, structures that could be imposed on SII's?
- Because it is possible that different kinds of institutions could become SII's, would the macroprudential regulator need to have expertise in every area of finance? If so, what would that imply about the remaining institutional components of the financial regulatory system?
- Given that deposit insurance is one of the principal components of the current prompt corrective response arrangements for insured depository institutions, does that mean that some kind of assessment-based insurance underpinning is necessary or advisable for the effective regulation of SII's?
- Should the degree to which a putative SII serves as a repository for investments by the public (such as pension investments) be an additional criterion for determining SII status?
- Are there systemic effects that can result from something other than mere bulk, for example, effects that result from the fact that a

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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particular institution is one of only a few providers of a particular service or has cornered the market in a crucial, but small part of the financial world?

- Are there ways of protecting markets by keeping institutions from becoming SII's in the first place?

The complexity of these issues takes the proposed treatment of SII's well beyond the usual discussions of regulatory reform. All participants in the financial system and everyone affected by it will need to pay especially careful attention to the debate and participate if possible.

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