Our Perspectives: Commentary on the economy & regulatory policies affecting financial companies

Barnett Sivon & Natter P.C.
ATTORNEYS at LAW
WASHINGTON, DC

The Power to Direct and the Power to Recommend*

Jim Sivon

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A lively debate is underway in the UK over the type of power regulators should have to address systemic risks. This debate, which has been playing out in the pages of the *Financial Times*, was triggered by a proposal that the Financial Policy Committee (FPC), once it is established, have the power to direct other regulators to impose "sectoral" capital requirements on financial firms. In other words, it has been proposed that the FPC have the authority to require financial firms to hold additional capital against exposures to certain sectors of the economy, such as residential mortgages, commercial property, or loans to leveraged financial firms. According to one leading UK banker (Peter Sands, CEO of Standard Chartered), this proposed power to direct sectoral capital requirements "reeks of 1970s style quasi-nationalization of the industry."

A similar, and equally lively, debate is likely to emerge in the U.S. based upon the power of the Financial Stability Oversight Council (FSOC) to recommend heightened prudential standards for financial activities or practices. This power was granted in section 120 of the Dodd-Frank Act. Under that authority, U.S. financial regulators could require financial firms to hold higher capital against certain products or even prohibit firms from offering certain products. Since the exercise of this authority could impact whole segments of the financial services industry, one can easily envision a reaction in the U.S. similar to Mr. Sands' reaction to the UK proposal if, and when, FSOC decides to exercise this power to recommend.

The Power to Direct

The financial crisis has caused the UK, like the U.S., to establish a new

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system for addressing systemic risks. One of the proposed features of the UK system would be the new FPC, which would be the British counterpart to our FSOC. Like the FSOC, it would have the authority to identify potential systemic risks and make recommendations for controlling those risks. Unlike FSOC, however, it also would have the power to "give directions" to other financial regulators. In other words, the FPC could require a regulator to take certain actions.

In March, an interim version of the FPC recommended that the FPC's power to direct include the authority to require sectoral capital requirements for financial firms. That is, hold extra capital against certain sectors of the economy. In support of this recommendation, the interim group noted that previous financial crises have emerged in certain sectors, such as commercial and residential property or lending to other leveraged parts of the financial sector itself, and that sector capital requirements would enable UK regulators to target risks building in such areas.

This recommendation triggered a lively exchange in the UK's /textit-Financial Times. Peter Sands, CEO of Standard Chartered, started the exchange by calling the FPC's approach "extremely interventionist" and the equivalent of "quasi-nationalization." Mr. Sands also noted that "in effect the FPC wants to control how much lending there is in every aspect of the economy, from manufacturing to mortgages, and how much it costs."

Paul Tucker, the Deputy Governor of the Bank of England and a member of the interim FPC, responded to Mr. Sands by noting that "…it is neither with the proposed remit of the FPC, nor the intention of the committee, to micromanage the banking system or the allocation of credit."

Martin Wolf, a regular contributor to the *Financial Times*, then posted a blog in defense of the proposal. He noted that "[the interim FPC] agreed that sectoral capital requirements should not be used to try to steer the supply of credit to achieve objectives other than financial resilience." Mr. Wolf also suggested that such sectoral capital requirements are similar to risk weighting, which is in wide use today.

The outcome of this debate will not be settled in the pages of the *Fi-*

nancial Times. It will be determined by the UK Treasury and Parliament as those bodies fashion the final statutory mandate for the FPC.

The Power to Recommend

FSOC cannot direct financial regulatory agencies to take actions; it may only make recommendations to those agencies. Yet, its power to recommend heightened standards for certain financial activities and practices could trigger concerns in the U.S. not dissimilar to those raised by Mr. Sands.

To be the subject of an FSOC recommendation, FSOC must determine that the "conduct, scope, nature, size, scale, concentration, or interconnectedness" of an activity or practice "creates or increases" the risk that a "significant liquidity, credit, or other problem" may "spread among bank holding companies and nonbank financial companies, financial markets of the United States, or low-income, minority, or underserved communities." This is an extremely broad authority. It would apply to *any* conduct that creates *any* type of significant risk that *may* spread among financial institutions, markets or certain communities. Thus, this authority could reach specific retail products (e.g., a certain type of mortgage), certain wholesale practices (e.g., payments activities), or certain products designed for specific sectors of the economy (e.g., commercial real estate loans).

The range of heightened standards that FSOC may recommend is equally broad. The heightened standards applicable to an activity or practice could range from an increased capital requirement, to a concentration limit, or even an outright prohibition.

Congress did place some procedural limits on the exercise of this authority. Before making a recommendation, FSOC must consult other regulators and seek public comment on the recommendation. Also, in recommending a standard, FSOC must take into account the costs of the standard to long-term economic growth.

On the other hand, the power to recommend requires only a majority vote of the Council. This contrasts with FSOC's power to designate a nonbank financial company for supervision by the Federal Reserve Board, which requires an affirmative vote of two-thirds of the Council (including its

Chair). Moreover, if a financial agency does not implement a recommended standard, the agency must explain its decision in writing. Thus, in practice, it may be rare for a recommendation not to be implemented.

In summary, FSOC's power to recommend heighten standards for financial products and activities may be just as powerful as the FPC's proposed power to direct sector capital requirements. As such, one can easily envision a lively debate in the U.S. over the scope and impact of this power, if and when, FSOC decides to exercise it.

Jim Sivon is a partner with the law firm of Barnett Sivon & Natter, P.C.