

Regulatory Reform and the White Paper

June 2009

Objectives and Overview

- The white paper notes that the regulatory reform proposals are intended to address five key objectives:
 - Promotion of robust supervision and regulation of financial firms
 - Establishment of comprehensive supervision and regulation of financial markets
 - Protection of consumers and investors from financial abuse
 - Improvement of tools for managing financial crises
 - Enhancement of international regulatory standards and improvement international cooperation

Summary of Proposals

White Paper Summary				
Supervision of Regulation of Financial Firms	Regulation of Financial Markets	Consumer and Investor Protection	Resolution Authority (a/k/a TBTF)	International Standards
<ul style="list-style-type: none"> • Financial Services Oversight Council • Identifying Tier 1 FHCs • Expanding BHC status • Stronger capital standards • National Bank Supervisor • Regulation of “non-banks” or “shadow banking system” • Office of National Insurance • Elimination of thrift charter • Assessment of the role of GSEs 	<ul style="list-style-type: none"> • Enhanced regulation of participants in the securitization market • Oversight and regulation of NRSROs • Regulation of OTC derivatives and OTC derivatives dealers • Harmonizing futures and securities regulation • Federal Reserve oversight of payment, clearing & settlement systems 	<ul style="list-style-type: none"> • Consumer Financial Protection Agency • Financial Consumer Coordinating Council • Transparency, fairness, accountability, access, and appropriateness of consumer and investor products • “Plain vanilla” products 	<ul style="list-style-type: none"> • Addressing Too Big To Fail problem • Resolution authority for Tier 1 FHCs • FDIC or SEC as conservator or receiver • Federal Reserve to obtain Treasury approval for SEC 13(3) lending 	<ul style="list-style-type: none"> • Support for G-20 initiatives • Foreign firms to be tested for FHC status

New Regulators

- Beyond the objectives, the white paper also introduces several new regulators or agencies that will have new oversight responsibilities
- Restructuring the regulatory framework and creating these new entities is intended to remedy the perceived “gaps” or opportunities for regulatory arbitrage that are identified as having contributed to the financial crisis

Summary of Changes

Changes in Regulators/Oversight		
New	Purpose	Composition/Structure
Financial Services Oversight Council	To identify emerging systemic risks and improve interagency cooperation	Chaired by Treasury; will include heads of principal federal financial regulators as members (8 members)
National Bank Supervisor	To supervise all federally chartered banks	Separate status in Treasury
Consumer Financial Protection Agency	<ul style="list-style-type: none"> • To protect consumers across the financial sector from deceptive practices • Focused on credit, savings, and payments markets • Authority to reform mortgage laws 	Independent entity
Office of National Insurance	To coordinate regulatory policy in the insurance sector	<ul style="list-style-type: none"> • Separate status in Treasury • “Merges” OTS and OCC

Enhanced Powers for the Federal Reserve

- Under the proposals, the Federal Reserve and the FDIC maintain their “respective roles in the supervision and regulation of state-chartered banks”
 - In many important respects, the authority of the Federal Reserve would be enhanced as a result of the proposals

Federal Reserve
Summary of new/additional authority
<ul style="list-style-type: none">• Supervise all firms that could pose a threat to financial stability, even those that do not own banks (Tier 1 FHCs)
<ul style="list-style-type: none">• Oversee payment, clearing, and settlement systems
<ul style="list-style-type: none">• Enhance authority over market infrastructure
<ul style="list-style-type: none">• Will have a right to assess risk and set higher standards of a Tier 1 FHC to protect against excessive risk taking

I. Supervision and Regulation of Financial Firms

Identified Problems

- The white paper identified several problems:
 - Financial institution regulation proved inadequate and inconsistent
 - Having oversight responsibilities divided among many agencies resulted in fragmentation and regulatory “loopholes”
 - Capital and liquidity requirements were too low and regulators did not require institutions to plan for stress scenarios where access to liquidity would be constrained
 - Regulators did not take into account the full systemic impact, given the interconnectedness of our markets, of the failure of one of the largest financial institutions

Financial Services Oversight Council

- Treasury will chair a Financial Services Oversight Council (FSOC)
- FSOC will:
 - Fill supervisory gaps
 - Facilitate coordination of policy and resolution of disputes
 - Identify emerging risks
 - Advise the Federal Reserve on the identification of firms whose failure could pose a threat to financial stability as a result of their size, leverage or interconnectedness
 - Such an entity will be referred to as a Tier 1 FHC

Consolidated Supervision and Regulation

- Tier 1 FHCs
 - Will be subject to stricter capital, liquidity and risk management standards
 - Regulation will extend to all subsidiaries of a Tier 1 FHC, regulated and unregulated, domestic or foreign
 - The Federal Reserve will have authority to collect information and reports from financial institutions of a certain size and to impose activity restrictions on subsidiaries of Tier 1 FHCs

Consolidated Supervision and Regulation (cont.)

- A National Bank Supervisor (NBS), that merges the OCC and the OTC, shall conduct prudential supervision and regulation of all federally chartered depository institutions, and all federal branches and agencies of foreign banks
- Entities that control an insured depository institution would become subject to consolidated supervision and regulation by the Federal Reserve and subject to the nonbanking activity restrictions of the Bank Holding Company Act (BHCA) in order to eliminate any regulatory loopholes

Proposals for Regulation of Hedge Funds

- Classify hedge funds and other private pools of capital as Tier 1 FHCs and impose greater regulation
- Treat hedge funds, private equity funds and venture capital funds identically
- Require investment advisers (IAs) of hedge funds and other private pools of capital to register with the SEC as investment advisers under the Advisers Act, if the IAs meet a modest specified amount of assets under management
- Require registered IAs to provide the SEC with sufficient data to permit an assessment of the private fund's status as a Tier 1 FHC
- Hedge funds and other private pools of capital advised by registered IAs will be subject to record-keeping obligations
- The SEC to conduct regular compliance examinations

Money Market Funds

- The regulatory framework applicable to money market funds should be strengthened in order to make money market funds less susceptible to downturns

Executive Compensation

- Federal regulators should issue standards and guidelines to better align executive compensation practices of financial firms with long-term shareholder value
- Compensation practices should not incentivize excessive risk-taking
- Non-binding shareholder proposals on executive compensation and additional independence requirements for compensation committees should be supported

Review of Accounting Standards

- Accounting standards setters should review accounting standards to determine how financial firms should be required to employ more forward-looking loan loss provisioning practices that incorporate a broader range of available credit information

Insurance

- Contemplates the establishment of an Office of National Insurance (ONI) within Treasury to:
 - Gather information
 - Monitor the insurance industry
 - Negotiate international agreements
 - Identify regulatory problem areas that could lead to future market crises
 - Recommend to the Federal Reserve any insurance companies it believes should be supervised as Tier 1 FHCs

Insurance (cont.)

- The white paper then identifies six principles for guiding modernization of the U.S. system of insurance regulation:
 - Effective systemic risk regulation
 - Strong capital standards for insurance companies and capital allocation matched with liabilities
 - Meaningful and consistent consumer protection
 - National uniformity in insurance regulation
 - Consolidated regulation of insurance companies and their non-insurance affiliates
 - International coordination

Future of the GSEs

- The white paper puts forward various options for GSE reform, including:
 1. Returning them to their prior status as GSEs with the paired interests of maximizing returns for private shareholders and pursuing public policy home ownership goals
 2. Gradual wind-down of their operations and liquidation of their assets
 3. Incorporating the GSEs' functions into a federal agency
 4. A public utility model where the government regulates the GSEs' profit margin, sets guarantee fees and provides explicit backing for GSE commitments
 5. Conversion to providing insurance for covered bonds
 6. The dissolution of Fannie Mae and Freddie Mac into smaller companies

II. Regulation of Financial Markets

Summary of Proposed Securitization Related Reforms

- Change incentive structure for securitization participants
- Risk retention of 5% of the credit risk of securitized exposures
- No hedging of retained risk
- Tie broker, originator and sponsor compensation to the long-term performance of the securitization
- Eliminate gain on sale accounting
- Require standardized, stronger representations and warranties
- Require enhanced disclosure requirements, including loan level disclosure and disclosure regarding the compensation for the broker, originator and sponsor

Summary of Proposed Securitization Related Reforms (cont.)

- Expand TRACE reporting to include ABS
- Require conflicts of interest policies and procedures for credit rating agencies
- Differentiate structured finance ratings
- Require credit rating agencies to explain the meaning of their ratings for ABS and the way in which such ratings differ from corporate debt ratings
- Require credit rating agencies to disclose information on methodologies and originator reviews

Objectives for OTC Derivatives Regulation

- To prevent derivatives activities from threatening the stability of the financial system
- To promote market efficiency and transparency
- To prevent market manipulation, fraud and other market abuses
- To ensure that OTC derivatives are not marketed inappropriately to “unsophisticated” investors

Summary of Proposed OTC Derivatives Regulations

- Require transparency for all OTC derivatives trades and positions through recordkeeping and reporting requirements
- Ensure that market regulators have clear, unimpeded authority to “police and protect” fraud, market manipulation and other market abuses
- Subject all OTC derivatives dealers and other participants in the OTC derivatives markets that create large exposures to counterparties to a “robust and appropriate” regime of prudential supervision
- Require standardized derivatives to be cleared through regulated central counterparties (CCPs) and executed on regulated exchanges and electronic trade execution systems

Summary of Proposed OTC Derivatives Regulations (cont.)

- Presume that an OTC derivative that is cleared through a CCP is a “standardized” derivative
- Require CCPs to impose robust margin requirements and other risk controls
- Impose higher capital charges for customized OTC derivatives
- Tighten eligibility limits for parties that participate in derivatives transactions or impose additional disclosure requirements or standards of care when marketing derivatives to less sophisticated counterparties such as small municipalities
- Harmonize futures and securities laws for similar types of financial instruments
- CFTC and SEC to report to Congress by September 30, 2009

Payment, Clearing and Settlement Systems

- Four measures to strengthen oversight:
 1. Assign the Federal Reserve stronger statutory authority to oversee covered systems and activities
 2. Enable the Federal Reserve to identify covered systems and activities
 3. Coordinate oversight of covered systems and activities among the Federal Reserve and other federal regulators
 4. Authorize the Federal Reserve to provide covered systems access to Reserve Bank accounts, financial services and the discount window

Harmonizing Broker-Dealer and IA Regulation

- Recognizing the evolution of business practices of securities brokers, the white paper advances a proposal to reconcile the fiduciary duties of broker/dealers and IAs under federal law, in order to hold brokers to the same types of fiduciary duties when providing investment advice to retail investors as those that apply to IAs under the Advisers Act

III. Protect Consumers and Investors from Abuse

Consumer Financial Protection Agency

- The white paper proposes the creation of a new Consumer Financial Protection Agency (CFPA) to protect consumers of financial products and services and regulate the providers of such products and services:
 - CFPA to be an independent agency to reduce gaps in federal supervision and enforcement
 - CFPA to encourage the development of “plain vanilla” products
 - CFPA will have sole authority to promulgate and interpret regulations under existing consumer financial services and fair lending statutes
 - Funding for CFPA would come in part from fees assessed on entities and transactions across the financial sector

IV. Tools for Managing Financial Crises

Resolution Authority

- The white paper proposes special resolution authority to address Too Big To Fail institutions:
 - Authority resides with Treasury
 - Gives Treasury authority to appoint a receiver or a conservator for the TBTF entity (which may be the FDIC or, in limited cases, the SEC)
 - The conservator or the receiver will have broad powers, including authority to operate the TBTF entity or to sell or transfer assets (in the case of the TBTF entity's derivatives, the conservator or the receiver will have the power to transfer those contracts to a bridge institution and thus avoid termination of those contracts by the TBTF entity's counterparties, notwithstanding any contractual right of those counterparties to terminate the contracts upon the appointment of a receiver or conservator)

Resolution Authority (cont.)

- Conveys the authority to provide loans, assume liabilities or inject capital
- Be invoked by Treasury only after consulting with the President and upon the written recommendation of two-thirds of the members of the Federal Reserve and the FDIC or SEC, as appropriate
- In order to invoke the authority, Treasury must determine that:
 - The firm is in default or in danger of defaulting
 - The failure of the firm would have serious adverse effects on the financial system
 - The use of the special resolution authority would avoid or mitigate these adverse effects

Exigent Circumstances

- The white paper proposes legislation that amends Section 13(3) of the Federal Reserve Act (relied upon during the financial crisis) to require Treasury's prior written approval for any extensions of credit by the Federal Reserve in "unusual or exigent circumstances"

V. International Standards

Issues for International Consensus

- The white paper suggests focusing on reaching international consensus on four core issues:
 - Regulatory capital standards
 - Oversight of global financial markets
 - Supervision of internationally active financial firms
 - Crisis prevention and management

International Recommendations

- Standardization and improved oversight of credit derivatives and other OTC derivatives markets through the use of CCPs
- Strengthening of arrangements for international cooperation on supervision of global financial firms
- BCBS modifications and improvements to Basel II through refining of risk weightings applicable to derivatives and securitized products, introduction of a supplemental leverage ratio and improvements to the definition of capital
- The imposition of registration and disclosure requirements for hedge funds or their managers
- The introduction of executive compensation schemes that better align compensation with long-term shareholder value

Conclusion

- There is still a need for additional studies and policy recommendations
- The Administration is focused on preventing “gaps” and “loopholes” in supervision in the future
- The white paper supports the G-20 recommendations, which will help further international standardization
- It may be difficult to achieve the objective of creating a simple or straightforward regulatory framework by adding new agencies and granting broader authority to existing agencies and the Federal Reserve