STATEMENT OF

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THE FINANCIAL SERVICES ROUNDTABLE

ON

SYSTEMIC RISK, PRUDENTIAL MEASURES, RESOLUTION AUTHORITY, AND SECURITIZATION

BEFORE THE

FINANCIAL SERVICES COMMITTEE

UNITED STATES HOUSE OF REPRESENTATIVES

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Chairman Frank, Ranking Member Bachus, and Members of the Committee, I am Scott Talbott, Senior Vice President of Government Affairs for the Financial Services Roundtable (Roundtable). Thank you for the opportunity to appear today and address the Committee's Discussion Draft (Discusson Draft) of October 27th on systemic risk, prudential standards, failure resolution and securitization.

We support greater systemic risk oversight, a failure resolution mechanism, more effective prudential supervision, and risk retention. As such, we commend the Committee in addressing these necessary reforms through the coordination of a Financial Services Oversight Council (Council), the Federal Reserve Board (Board), and the prudential regulators.

The Discussion Draft is a significant improvement from earlier proposals. The following are some of our initial reactions.

1. No Public List: The Discussion Draft does not call for the public identification of systemically significant financial holding companies. This is a positive change. We were concerned that public identification of such companies would increase moral hazard and raise competitive issues.
2. Coordination with Prudential Regulators: While the Board has significantly enhanced authority over identified financial holding companies, we are encouraged that the Discussion Draft includes coordination between the Board and the prudential regulators. Such coordination should be refined to minimize the potential for regulatory overlap and duplication between the Board and prudential regulators, including state insurance regulators. However, the Discussion Draft does not address the need to have a federal insurance regulator on the Council. Additionally, we believe the Director of the Federal Insurance Office should be a member of the Council.
3. Preservation of ILC and Thrift Charters: The Discussion Draft preserves Thrift Charters and grandfathers Industrial Loan Charters (ILCs) and their lawful affiliations with commercial companies. However, limits on cross marketing between parents and ILCs would restrict activities and the ability to meet consumer needs.
4. Limitation for Foreign Owned Companies: The Discussion Draft limits the extraterritorial reach of U.S. financial regulations to foreign-owned financial companies. However, these provisions should be refined to ensure that U.S. regulations do not conflict with or overlay home country regulation.
5. Actions Based on Size of Identified Financial Holding Company: The Discussion Draft grants excessive authority to the Board to take actions based on the size of an identified

financial holding company.  Size alone should not be an indicator of safety and soundness.  Large financial institutions remain vital sources of funding in our economy.

6. Excessive Focus on Capital:  The Discussion Draft continues to place an excessive focus on capital as the answer to safety and soundness concerns.  Higher and higher capital requirements could have a negative impact on economic growth.  The better answer to safety and soundness is a combination of capital, activity restrictions where appropriate, prudential supervision, liquidity requirements, and other prudential standards deserve equal focus.
7. Living Wills Requirement:  The Roundtable remains concerned that the requirement for identified financial holding companies to create "living wills" could force such companies to adopt an organizational structure based on liquidation rather than the structure that is most efficient for serving consumers and business.  That said, there is a legitimate need for firms to discuss their contingency plans with their regulators.
8. Securitization:  The Discussion Draft proposes a 10% risk retention requirement for mortgage lenders and securitizers.  The Roundtable supports risk retention and endorsed the risk retention provisions in H.R. 1728, which called for a 5% requirement and gave regulators some flexibility in the implementation of that requirement.  For example, in H.R. 1728, the regulators could impose the requirement on a first-loss or pro-rata vertical slice.  Any risk retention requirement should not apply to prudently underwritten mortgages, including mortgages that meet FHFA, Ginnie Mae, and GSE standards. Moreover, the 10% requirement is unstudied and could have a significant negative impact on mortgage finance.  It could have the unintended consequences of significantly limiting the securitization and subsequently the ability of mortgage finance for consumers seeking

to purchase a home. We support requiring some credit risk retention, but there needs to be ability to ensure credit is available for homeowners and other consumers.

9. Derivative Transactions Between Affiliates: The Discussion Draft would subject derivative transactions between the bank and its affiliates to the quantitative limit in Section 23A of the Federal Reserve Act (10% of a bank's capital). Derivative transactions between affiliates did not contribute to the crisis; they are a risk management tool and are already subject to the arms-length standards in 23B of the Federal Reserve Act.

10. Treatment of Unsecured Creditors: The Discussion Draft would mandate haircuts for unsecured creditors affected by systemic failure resolutions. This is a provision that would have a negative impact on the ability of firms to raise operating funds.

11. Supervisory Costs for large financial companies: The Discussion Draft authorizes new assessments for large bank holding companies and systemically significant companies, in addition to the existing assessments that they currently pay to their prudential regulators and the potential assessments that would have to be paid to the proposed Consumer Financial Protection Agency. The combination of these assessments can be quite significant, at times accounting for hundreds of millions of dollars for large institutions and could detract from an institution's ability to increase capital or make new loans.

12. Balance: The Discussion Draft places an overemphasis on financial stability – which is understandable in this current environment. However, we should not lose sight that financial stability should be balanced with the ability of markets to serve consumers and promote sustained economic growth nor should we neglect the need for companies to bring value to their shareholders.

In addition to these concerns, I'd like to highlight some additional issues for the Committee:

1. **Common Objectives and Principles**
2. **Too Big and Too-Big-To-Fail**
3. **Create Financial Services Oversight Council**
4. **Clarify Market Stability Authority**
5. **Ensure Balanced and Better Prudential Standards for All**
6. **Establish Orderly Resolution Regime for Large Nonbank Financial Institutions during Financial Emergencies**
7. **Enact National Insurance Regulation**
8. **Ensure Global Harmonization Standards**
9. **Restart Securitization**
10. **Payment Systems**

## 1. <u>CODIFY COMMON OBJECTIVES AND PRINCIPLES</u>

The financial crisis revealed that our fragmented financial regulatory system lacks basic common objectives and principles. Regulatory agencies at both the federal and state levels are assigned different, and sometimes conflicting, missions. Common objectives and principles are needed to guide regulatory behavior and achieve desired policy outcomes. Therefore, the Discussion Draft could be strengthened with the enactment by Congress of a set of clear policy objectives and a set of commonly accepted principles to guide financial regulators and the firms they regulate.

**Common Policy Objectives**

Setting common policy objectives will force us to decide what we collectively — Congress, the Administration, policymakers, and the financial services industry — want our financial system to achieve for the benefit of all consumers and sectors of our economy. We propose three, simple objectives as a starting point for the Committee's deliberations:

1. Enhance the competitiveness of financial services firms to meet the financial and related needs of all consumers and investors;
2. Promote financial market stability and security; and
3. Support sustained economic growth and new job creation in a globally integrated economy.

These are outcomes that would benefit all consumers and sectors of our economy. We recommend that they be added to the statutory mission statement of every financial regulatory agency.

**Guiding Principles**

Once we agree upon *"what"* we want our financial system to achieve for the benefit of society, we then need to agree on a common set of principles to guide *"how"* all financial regulators and firms behave. Guiding principles can act as a compass for all to follow. They would not replace more detailed regulations. To the contrary, regulations will remain necessary, especially at the retail level for the protection of consumers. However, a set of guiding principles would become a touchstone against which financial regulations could be evaluated in a policy and legal context. Regulations that are not consistent with the principles should be revised or eliminated. Likewise, some laws may need to be changed to be consistent with the principles.

Mr. Chairman, the Roundtable supports six basic principles to guide all financial regulators and all regulated firms going forward; these are attached as Appendix A in my testimony. Whatever objectives and principles Congress adopts, they should guide the application and review of *all* regulatory policies in the future. They should be designed not only to be responsive to the needs of consumers; but also should ensure that the regulation of financial services and markets is balanced, consistent, and predictable. Principles such as these would help regulators and financial services firms focus on both desired policy outcomes and material risks to markets.

## 2. TOO BIG AND TOO BIG TO FAIL

There are two parts to this debate. First, some say that some financial institutions are simply too big. Large financial firms remain vital to our economy and our ability as a nation to compete internationally. Today, the top 50 financial holding companies regulated by the Federal Reserve or the Office of Thrift Supervision (OTS) hold 84 percent of all consumer loans made by insured depository institutions, 49 percent of all small business loans[1], and 74 percent of all 1-4 family mortgage loans. If we go down the extreme path of breaking up these institutions or over-regulating them in the name of safety and soundness, who will step in to make these loans and support economic recovery and growth? Small banks simply do not have the capital or the capacity to do so in the current environment.

Who is going to finance the S&P 500 companies? If large U.S. institutions with the capital and capacity can not, then this financing either will not be available or it will move to less regulated parts of our financial markets or, more likely, it will move overseas to our competitors. These same top 50 holding companies finance 56 percent of the total business and farm loans made today by all insured depository institutions.[2] Who finances these loans and makes up “lost” GDP growth in the meantime if the U.S. Government were to force drastic divestitures because “big” is somehow equated with “bad.” As Federal Reserve Chairman Ben Bernanke said recently, “We need a more subtle approach without losing the economic benefit of multi-function, international firms.”

[1] Commercial and industrial (C&I) loans less than $1 million; source: FDIC Call Reports, June 30, 2009
[2] These figures exclude loans made by nonbank financial institutions or other unregulated lenders.

The more subtle approach is to ensure that no financial institution is "too big to fail." We live in a capitalist society, and letting firms fail is part of an active market system. The way to achieve this is to put in place an orderly resolution mechanism, as envisioned by the Discussion Draft, which allows orderly resolution to occur in ways that do not cause systemic risk or contagion to other parties. While there may be ways to strengthen Subtitle G of the Discussion Draft as the legislative process moves forward, eliminating the notion of firms "too big to fail" is a priority for the Roundtable.

## 3. FINANCIAL SERVICES OVERSIGHT COUNCIL

The Roundtable has been a consistent advocate of better regulatory coordination and cooperation among financial regulators through an enhanced and expanded President's Working Group on Financial Markets (PWG). Therefore, we support the creation of a new Council, as envisioned in the Discussion Draft.

**Membership and Powers of the Oversight Council**

We recommend several changes to the structure and the powers of the Council. Specifically, we recommend the following:

1. A new National (or Federal) Insurance Supervisor should have a seat on the new Council. A new national insurance regulator is needed to give the Federal Government a better understanding and role in the systemic supervision of a key part of our nation's financial services sector. In the absence of such a regulator, we recommend that a representative from the proposed Federal Insurance Office should have a seat at the table until such a regulator is created.

2. All agencies represented on the Council should be required to develop “regulatory action plans” for periodically reviewing existing financial regulations to ensure that they are consistent with the statutory objectives and guiding principles, which we have urged Congress to adopt.

3. The Financial Accounting Standards Board (FASB) should be subject to oversight by the Council. Accounting standards are an integral part of ensuring investor confidence in public companies and our financial markets, and, as such, should be overseen by the new body. Moreover, actions by FASB also should be subject to the Administrative Procedures Act (APA). Making FASB subject to the APA will provide a new and fair standard of due process for public comment on current FASB accounting standard setting procedures.

4. A new Subcommittee should be created within the Federal Financial Institution’s Examination Council to monitor developments related to information technology, security and privacy and the impact of such developments on financial institutions. This subcommittee should prepare joint regulations or supervisory guidance to address such developments.

Attachment B contains proposed amendments to the Administration’s proposed Council, which address the structure and responsibilities of the Council. Attachment C includes proposed amendments to the Federal Financial Institution’s Examination Council.

**Regulatory consolidation**

The financial crisis made clear that we have too many financial regulators. The Roundtable supports further regulatory consolidation. Specifically, we generally support the Discussion Draft approach to folding the OTS into the OCC. For all intent and purposes, these two national regulators are engaged in the same basic activities when it comes to regulation and supervision of the depository institutions under their purview. Even if there are no net job losses among regulatory staff, a legitimate concern in this economy, there undoubtedly will be other costs savings to be captured by eliminating regulatory gaps and streamlining their operations under a single roof.

## 4. CLARIFY MARKET STABILITY AUTHORITY

To better manage systemic risk, the Board, in close cooperation with the new Council, should be authorized to act as a market stability oversight authority, as contemplated by the Discussion Draft. In this capacity, the Board should be responsible for looking across the entire financial services sector to identify those activities, practices, and inter-connections that could pose a material systemic risk to the U.S. financial system or economy. It should conduct a rigorous, ongoing assessment of the financial system at large, and it should engage in both scenario and contingency planning with other regulators on the Council. When necessary and appropriate, the Council or the Board should issue public warnings about any given activity or practice that could have a material adverse and harmful impact on consumers.

### The Board should not be a super-regulator

The Board, however, should not become a super-regulator with unchecked powers. If the Board finds that a particular activity or practice of a regulated firm poses a systemic risk, then it should be required to work jointly with the Council and other regulators to mitigate and eliminate that risk. Alternatively, if it finds that an unregulated firm is engaged in an activity or practice that presents a systemic risk, then the Board should be required to work with the primary regulators to ensure corrective actions. If the primary regulators do not agree, then the Board should raise its concerns with the Council. Finally, the Board should retain the power to take extraordinary actions in national or international financial emergencies, with appropriate disclosure to the Congress and the public.

The Council should work closely with the Board to ensure an appropriate balance between greater market stability, systemic risk mitigation, and competitive and innovative financial markets that are able to meet the needs of all consumers of financial services. The Council and the Board should jointly develop new, balanced prudential standards for financial firms, anticipate early crisis warning signs, conduct the necessary contingency planning, and make recommendations to Congress for future reforms.

Designating the Board as the primary financial stability authority is a natural complement to the Board's existing role as the nation's central bank and lender of last resort. However, we recognize that this new role would require the Board to expand its staff to include experts in all types of financial activities, practices, and markets. Also, if the Board is given this new authority, it would need to establish a clear and transparent governance structure internally to minimize any potential conflicts with its other existing responsibilities. Rigorous Congressional oversight of this new role for the Board and the Council will be critical. An expanded version of our views on systemic risk appears in Attachment D.

The purpose of any market stability oversight authority should be to promote the long-term stability and integrity of the nation's financial markets and financial services firms by identifying and addressing significant risks to the financial system as a whole. This new authority should be authorized to oversee all types of all financial markets and all financial services firms, whether regulated or unregulated. The market stability authority, however, should *not* concentrate its efforts on an arbitrary and public list of financial services firms based primarily size. The Discussion Draft strikes the right balance by keeping the list of identified financial holding companies confidential, just as supervisory ratings are today.

As a nation, we cannot afford another 25 or 30 new Government-Sponsored Enterprises (GSEs). That is exactly the result we would produce if we publicly draw a “bright line” around a class of firms. If the Board focuses exclusively on size in particular and not activities and practices that lead to broad systemic risk in general, then it runs the risk of missing the next problem that could be brewing in smaller, unregulated parts of the system, such as the small, state-licensed mortgage brokers who helped to fuel the fires of this crisis.

Any public designation would only increase the moral hazard, have a destabilizing effect on competition and the pricing of products, services, and funding, and ultimately work to the disadvantage of the long-term competitiveness of U.S. financial services firms and markets. Moreover, with the market stability oversight authority, the Board should work consistently and in coordination with its international counterparts.

The better solution is to ensure that any new, post-crisis capital, liquidity, and risk management requirements are balanced, effective, risk-based, and in tune with evolving international standards for all financial firms. We understand that there may be less leverage in our financial system and higher capital and liquidity requirements in the future for firms that pose greater risks than others, but we do not need a new publicly designated class of firms that could be perceived by consumers, investors, and the markets as the next generation of GSEs or quasi-public utilities.

**Companies Should Not Be Required to Divest Lawful Affiliations and Activities**

The Roundtable **opposes** any requirement for financial holding companies to divest lawful affiliations and commercial activities. Requiring each financial holding company to comply with the nonfinancial activity restrictions of the Bank Holding Company Act does not address the causes of the current credit crisis or threats to the safety and soundness of the financial system.

Commercial ownership of financial companies and banks has been a source of strength and capital to their financial affiliates and helped maintain the flow of credit to support the recovery of the nation's economy. These affiliations were in no way connected with the financial crisis.

The Discussion Draft could prevent financial affiliates in a commercial enterprise from doing business with any company that does business with any of their commercial affiliates. If these financial companies are not able to continue to serve and lend to these industrial and commercial customers because of the restrictions in the draft legislation, then small and mid-size businesses and companies in critical sectors of the U.S. economy, as well as their employees, and the economy as a whole, will suffer. For example, if the restrictions on affiliate transactions are enacted as written, companies in the health and clean energy industries could be frozen out of the credit markets because companies that are their current sources of credit could be effectively barred form doing business with them. The effect on small and mid-sized businesses could be particularly severe, shutting off credit to these companies exactly when they need it most.

**The Board should not have extraterritorial powers over foreign firms**

The Discussion Draft gives the Board the authority to impose prudential standards on foreign companies with U.S. financial operations. This provision should be clarified to ensure that such standards do not conflict with or overlap with home country requirements.

**The Board should not be authorized to enforce “living wills”**

The Discussion Draft contains a broad grant of authority for the Board to require financial holding companies to develop “rapid resolution” plans in the event of their failure – so-called “living wills” – which also are being discussed in the United Kingdom. Presumably, these would be formal contingency plans contemplating the failure of a firm, which even could be subject to formal disclosure in filings with the Securities and Exchange Commission (SEC). Contingency planning by financial firms is both necessary and prudent. Contingency plans should be robust and reviewed periodically with supervisors so most “surprises” should not surprise either management or their regulators.

However, there are potentially disruptive market confidence impacts, technical concerns, and unintended consequences that need to be considered carefully by Congress before moving forward, especially if these “living wills” were required to be disclosed under the securities laws. Managers at every financial firm adopt organization and operational structures designed to achieve strategic goals and objectives. Tax, accounting, legal and other requirements also impact organizational structures. Care needs to be taken that regulators not be able to use the “living will” requirement to force corporate reorganizations that impair the effective and efficient operation of firms. We should not move forward on this issue until we are assured that market distortions are fully vetted and other nations are moving in the same direction. We want to avoid creating any international competitive disadvantages for U.S. firms.

A better near-term and more practical first step would be to have the regulators and the industry jointly develop a set of principles and best practices for the rapid resolution of failing firms, beyond what the regulators can impose already under their existing “prompt, corrective action” authority. This approach is consistent with the Roundtable’s fifth principle, which supports management’s flexibility in a market economy to design a competitive strategy and organizational structure that bests fits a firm’s objectives for serving customers and attracting needed capital by providing a competitive return to investors. Moreover, this would give the regulators and the industry the opportunity to identify and resolve critical technical issues (e.g., monitoring and reporting counter-party risk) that impede a rapid resolution, but could result in more consistent and better reporting across all types of firms in the future.

**Derivative transactions with affiliates should not be subject to 23A limits**

The Discussion Draft would subject derivative transactions between a bank and its affiliates to the quantitative and collateral requirements of 23A of the Federal Reserve Act. These requirements would prohibit a bank from engaging in derivative transactions with an affiliate if the transactions exceeded ten percent (10%) of the bank's capital. This is a requirement that is not necessary and is potentially counterproductive. Derivative transactions between affiliates did not contribute to the financial crisis. They are a risk management tool for financial firms and already are subject to the requirements of 23B of the Federal Reserve Act, which mandates that they be on an arms-length basis. For safety and soundness purposes, institutions also collateralize these transactions. Imposing the qualitative limitations of 23A would increase costs for financial firms and force them to rely on third parties to engage in these transactions. That will only increase interconnectedness at a time when we are trying to mitigate risks caused by interconnectedness.

## 5. ENSURE BALANCED AND BETTER PRUDENTIAL STANDARDS FOR ALL

Much of the current debate over prudential standards has focused on the need for more capital. While the financial crisis did highlight serious capital deficiencies in some firms, higher and higher capital should not be the sole focus of regulators. Capital requirements should be just one of the "pillars" upon which sound supervision should be based. Other pillars are prudential supervision and market discipline. Going forward, we need a better balance among all three pillars.

**New capital and liquidity requirements.**

The conventional wisdom coming out of the crisis is that more capital and higher liquidity requirements could have averted the crisis. There is no doubt that we need new and better capital and liquidity standards as the first pillar of better prudential regulation. However, these standards need to be applied uniformly across firms based upon comparable activities. In other words, firms engaged in the same risks should be subject to the same capital requirements, regardless of charter, location, or state of domicile. Moreover, because financial markets are dynamic and change over time, these standards should be set by the prudential regulators, the parties that can identity both the strengths and weaknesses of the firms due to their constant interaction with them. Congress should not specify such standards in legislation.

Any new capital requirements must be carefully balanced and calibrated to achieve the twin objectives of financial stability *and* sustained economic growth. Unfortunately, much of the commentary to date has called for higher and higher levels of capital, without much consideration of the economic impact of such requirements. Treasury Secretary Geithner, for example, has called for "significantly" higher levels of capital for everyone. The Discussion Draft calls for "heightened standards" for capital, liquidity, risk management, and prompt correction action.

Taken to their extreme, new and tougher capital requirements could produce the safest financial system in modern times. But there also will be unintended consequences – in this scenario of higher capital standards, we could end up with a smaller, higher cost, less innovative financial system precisely at the wrong point in our nascent economic recovery.

The demand for strict, new capital requirements – more capital for the sake of having more capital – could undermine future economic growth more than any single other factor. Federal Reserve Governor Daniel Tarullo, while calling for higher capital levels, also cautioned policymakers to strike the appropriate balance: "In the first place, there is some danger that simply piling on a series of administrative reforms and restrictions intended to constrain the behavior of firms would have unnecessarily adverse consequences for the availability of credit on risk-sensible terms for consumers and businesses alike."[3]

Additionally, regulators are giving consideration to the creation of some type of "contingent capital," which starts out as debt but can be converted quickly to equity when a bank gets into trouble. We should resist any artificial requirement for contingent capital. From a market perspective, the cost of such capital – knowing that a hybrid debt instrument can be transformed into equity and used to cover losses immediately upon the demise of a firm – could be prohibitive and destabilizing in its own right. We have serious reservations with this proposal. Not only is it untested in the real world, but it also could be destabilizing as investors panic and withdraw funds in anticipation of the conversion. In other words, it could trigger the very systemic problems and exacerbate the very crisis it is supposedly intended to prevent. Further study analysis and testing is required before the Council or the Board moves forward on this issue.

As the Group of 20 (G20) and the new Financial Stability Board (FSB) have indicated, any new capital requirements should be fully transparent by the end of this year, fully vetted and tested in 2010, and then finally promulgated in 2011 to ensure that there is no negative impact and no unintended consequences. This approach is still likely to result in higher absolute levels of capital and less leverage in our financial system, which may be appropriate, so long as it carefully weighs the balance of financial market stability and is imperative for continued economic recovery and growth in the future.

[3] Governor Daniel K. Tarullo, "Confronting Too Big to Fail," Exchequer Club, Washington, D.C., October 21, 2009.

Congress should give its guidance, but it should not write hard and fast capital requirements into law. Instead, we should give the financial regulators, in consultation with other international regulators and the financial services industry, the needed leeway to adopt new risk-based, counter-cyclical rules that apply consistently and uniformly across the size of an institution, across sectors within the industry, across financial services charters, and across national borders.

**Balanced and better prudential supervision.**

The second pillar of safety and soundness should be effective supervision by financial regulators. The financial crisis revealed an inability of our fragmented financial regulatory structure to effectively supervise all types of firms on a consistent basis. There were significant gaps in regulation and clear failures to approach supervision on a comprehensive basis.

The application of balanced and better prudential supervision for all financial firms by all financial regulators is necessary in this market. From our perspective, prudential supervision is a form of supervision in which regulators and regulated entities maintain a constant and constructive engagement to ensure an effective level of compliance with applicable laws and regulations. Prudential supervision promotes the identification and correction of problems at their earliest stage, well before they reach a point of potentially harming consumers. Prudential supervision relies upon regular and open communications between firms and their regulators to discuss and resolve issues of mutual concern as soon as possible. Prudential supervision encourages regulated entities to bring matters of concern to the attention of regulators early and voluntarily. Prudential supervision promotes and acknowledges self-identification and self-correction of control weaknesses, thereby reinforcing continued focus and attention on sound internal controls.

This form of supervision governs much of the banking world today, but is not the case for most of the securities and insurance industry today. Our proposed amendments to Title I (see attachment B) would direct all federal financial regulators to apply this form of supervision.

**Market Discipline**

The third pillar of safety and soundness should be market discipline. While capital has received much of the attention as the preferred regulatory solution, we should not lose sight of the role that greater market discipline and transparency can play in controlling risks. It gives investors insights into the operations and activities of firms, and it serves as a check on management.

This can be accomplished in three basic ways:

1. Many observers acknowledge the need for better disclosure of critical information across the financial sector. Better market surveillance and better public reporting of risk concentrations and the rapid growth of both asset classes and deposits, especially brokered deposits, can play a vital role in ensuring that markets have the information they need to make informed investments and financial decisions. The frequent "stress tests" by the regulators aid in these market surveillance procedures.
2. The ultimate market discipline is the failure of bankrupt firms, with shareholders and creditors taking their losses as appropriate. As I noted earlier and will discuss in more detail below we need to eliminate "too-big-to-fail" from our vocabulary once and for all. Any firm, regardless of size, complexity, or interconnectedness should be allowed to fail if it can not compete in the marketplace. What we need to ensure, however, is that these failures do not lead to unnecessary instability or unintended consequences for unrelated firms, investors, or consumers. We need an orderly resolution regime for *all* financial firms, regardless of size or complexity.

3. We also must have standards that provide transparent information, but not ones that artificially drive economic activity in one direction or another. Making FASB subject to the APA will provide a new and fair standard of due process for public comment on current FASB accounting standard setting procedures. In the insurance industry, the same should be true for statutory accounting standards, which are essentially created by the NAIC and imposed upon the states and industry.

## 6. ESTABLISH AN ORDERLY RESOLUTION REGIME FOR LARGE NONBANK FINANCIAL INSTITUTIONS DURING FINANCIAL EMERGENCIES

The United States already has well-tested systems to protect insured bank and thrift depositors, customers of brokers and dealers, and insurance policyholders. Those systems have served us well as a nation, and need to be maintained "as is." However, the recent crisis has demonstrated a need for a resolution mechanism for holding companies. We support the creation of such a system, subject to the following constraints.

**This system should be reserved for financial emergencies**

Such a system should be reserved for emergency situations. The Discussion Draft proposes a resolution mechanism that requires a finding of systemic risk, following a multi-step process that involves prudential regulators, the Secretary of the Treasury and even the President. In general, we support such a procedural regime. It helps to ensure that this mechanism will be used only in rare, emergency cases that pose a significant material negative impact on our financial system on our economy.

**The system should rely upon bankruptcy rules**

Such a system also should rely upon the federal bankruptcy rules, to the maximum extent possible. While this resolution authority may be needed to avoid contagion in a systemic crisis, the rights of creditors (both secured and unsecured) should be protected, while creditors also suffer the first losses. The Discussion Draft is based upon the resolution procedures applicable to insured depository institutions. While these procedures may be needed to protect the interests of insured depositors, they are not appropriate in failures of holding companies. Holding company creditors should be given the same rights and protections available under federal bankruptcy law. That includes the ability to challenge valuations of assets and seek judicial review of determinations. Therefore, we recommend that the resolution title be aligned with the rights and procedures applicable under bankruptcy law, to the maximum extent possible.

**The Secretary of the Treasury should designate the resolution agency**

As the Discussion Draft suggests, we recommend that the Secretary of the Treasury be given the authority to select from various federal regulatory agencies, including the FDIC for depository institutions and the SEC for securities firms. Subsidiaries of financial holding companies should be resolved by existing regimes. We should explore the extent to which this new regime could rely upon existing bankruptcy courts.

**Existing funds should be protected**

Under this regime it should be explicit that the existing Deposit Insurance Fund (DIF) for banks and thrifts cannot be tapped to cover costs incurred in connection with nonbank resolutions. Any costs incurred by the Federal Government that exceed the residual assets of the failed nonbank firm (after shareholders are wiped out and creditors take their losses) should be repaid through post-event assessments on a fair and equitable basis. State insurance guaranty funds also should be protected.

## 7. ENACT NATIONAL INSURANCE REGULATION

Serious reform of our financial sector must include federal supervision for the insurance industry. Insurance is a national and international business, and an important factor in the health of our domestic economy. Federal regulation of insurance is one of the key gaps in our current financial regulatory system. As a newly designated market stability authority interacts with other regulators, there is an evident need to create a national insurance regulator for the insurance industry.

Insurance is a national and global business that has over $5 trillion under management, including municipal and corporate securities. Yet, it lacks a national insurance prudential regulator. Only through coordination with a national insurance regulator will a market stability regulator have the ability to both detect and act on risky market activity and business practices in a timely, uniform, and comprehensive fashion. Asking the market stability regulator to seek coordinated actions by multiple state insurance regulators is not an option that will effectively address systemic risk due to the different state and territorial insurance regulators, with varying legal and budget authority, and varying levels of expertise.

A national insurance regulator should have the authority to charter insurance companies –to establish and enforce prudential standards for those firms that chose a national charter, and to represent the U.S. internationally on behalf of federally chartered institutions. The national insurance regulator's authority should be an independent bureau within a federal agency headed by a Presidential appointee.

Some may say that creating a national insurance regulator creates regulatory redundancy. The Roundtable does not believe this is accurate. As long as the system is optional, it should function just as the dual banking system has functioned for the past 160 years. It would provide companies the ability to decide which system works best to serve their customers, a state or a national system. Furthermore, it will give consumers the choice. Consumers will choose whether to purchase insurance from nationally chartered or state chartered insurance companies. Regardless, there should be common principles in the national and state insurance systems. We commend Congresswoman Melissa Bean and Congressman Ed Royce for their tireless work on this specific issue, and we look forward to working with this Committee toward the creation of the national insurance regulator to enhance stability in our national insurance markets and reduce systemic risk in the future.

For starters, to address the lack of insurance expertise at the federal level, a Federal Insurance Office should be established within the Treasury Department as proposed in the current version of H.R. 2609 which we support. This is an important first step toward federal insurance regulation and Chairman Kanjorski and members of the Subcommittee should be applauded for this current version. However, this new Office should be authorized to charter and regulate national insurers, reinsurers, and insurance agents. State insurance regulation should remain intact and available for those firms, agents, and consumers that prefer state regulation. Insurance firms and agents that operate in multiple states should be able to select uniform, national regulation by the Federal Government.

Because insurance is a national and international business, it is in our own economic self interest to recognize it as such, especially for those insurance companies that choose to serve their customers' needs with a nationwide or global strategy. Omitting such an important part of our financial system from needed reforms would be like committing to strengthen a football team, but leaving the defense on the sidelines.

## 8. <u>ENSURE GLOBAL HARMONIZATION OF STANDARDS</u>

The United States cannot afford to act in a vacuum when it comes to regulatory reform, especially when it comes to new capital and liquidity standards or the creation of a new regime for systemically important firms. The ascendancy of the G20 is the single most significant international financial event since the creation of the Bretton Woods Agreements after World War II. We have moved from the old G7 world, to a more diverse and representative group – the G20 – accounting for roughly 80 percent of the world's GDP.

The recent G20 Leaders Summit in Pittsburgh stressed again the need for new and harmonized international regulatory standards and supervisory procedures among all nations. The G20 leaders also reaffirmed their support for open and competitive global markets that are well regulated and supervised as a precondition for sustained, stable economic growth. They also endorsed better coordination and cooperation at the international level, and opposed regulatory fragmentation among individual countries. Significant differences in regulatory regimes can undermine the safety and soundness of the financial system and produce competitive disparities across countries that will impede international trade, finance, and investment.

It is critical that the Administration play a visible and assertive leadership role within the G20 and the new FSB, which the G20 created specifically to oversee the transition to new international standards and rules for global financial markets. Specifically, the U.S. government needs to ensure that the proper structures and frameworks are implemented to achieve internationally consistent standards as well as the consistent enforcement of those standards by every nation.

Moreover, the Treasury Department needs to ensure – and Congress needs to oversee – that U.S. firms are not disadvantaged when competing globally under any new international regulatory structures or standards. New international regulatory standards for supervision, capital, liquidity, and risk management should not only be balanced, effective, and risk-based, but also recognize the benefits of globally competitive financial markets. Congress needs to ensure that any change in U.S. financial laws and regulations must be consistent with these evolving new international norms, and regulatory fragmentation among nations should be opposed as a matter of U.S. government policy. Failure to do so will put U.S. firms and our national economy at a distinct competitive disadvantage.

Accounting standards also are an integral part of ensuring investor confidence in public companies and our financial markets. We need to move ahead with the convergence of U.S. and international accounting standards as soon as possible. This includes moving forward with the proposed SEC roadmap that will permit all global and U.S. based publicly-traded firms to file their accounting statements according to the International Financial Reporting Standards, without having to reconcile such statements to the U.S.GAAP. Since financial institutions are different than other types of publicly traded companies, we also need to consider the recommendations of financial regulators on accounting related issues that have a potential impact on financial stability. Financial reporting needs to be accurate and maintain its integrity, but we grant financial regulators the ability, for example, to impose new rules governing loan loss reserving for financial institutions that may depart from current U.S.GAAP, so long as their methodology is fully disclosed and financial institutions are supervised on a continuous basis to ensure the integrity of their accounting methodology for loan losses.

## 9. RESTART SECURITIZATION

Securitization has helped millions of Americans obtain mortgage loans. It has facilitated a broad and liquid market for many traditional mortgage products, including the 30-year fixed rate mortgage loan. At the same time, securitization contributed to the recent financial crisis. It served as a means for lenders to pass along risky loans to investors who placed excessive reliance on credit rating agencies and failed to conduct their own due diligence.

Restarting prudent securitization should be part of financial reform. We believe that this can be achieved in two ways: (1) through risk retention policies that encourage each participant in the chain between a borrower and the investor to make independent credit risk management decisions, and (2) reform of the housings GSEs, Fannie Mae and Freddie Mac, in the next session of Congress.

**Risk Retention**

In hindsight, it is clear that in the years and months before the financial crisis many lenders deviated from prudential underwriting standards. One proposed policy response to this lapse is a requirement that all lenders retain some of the credit risk associated with riskier loans. Such a risk retention requirement was incorporated in section 213 of H.R. 1728, which your Committee wrote and which passed the House of Representatives earlier this year. We supported that provision. It set a 5% risk retention level and gave regulators the ability to implement that requirement, taking into consideration a variety of factors designed to minimize any negative impact on housing finance. In contrast, the Discussion Draft imposes a 10% requirement that would be imposed jointly by the SEC and banking regulators. Including the SEC in this process does seem appropriate especially for securitizers. However, the 10% requirement is untested and we are concerned that it could have a significant negative impact on the availability of mortgage finance for consumers.

**Reforming the GSEs**

Fannie Mae and Freddie Mac have been integral to securitization. They provide a market for mortgage loans, and have standardized many of the systems and procedures involved in securitization.

It is now clear, however, that the structure and mission of the GSEs were inherently at odds. The interests of private shareholders came into conflict with the public mission of the GSEs. One manifestation of this conflict was the expansion of the GSE portfolios, beyond the levels necessary to provide market liquidity. The portfolios became engines for earnings, not securitization. Another manifestation of this conflict was the purchase of lower quality mortgages by the two GSEs as they attempted to compete with other securitization markets. We urge the Congress to take up GSE reform after it completes its work on Financial Regulatory Reform.

GSE reform should be designed to eliminate the inherent conflict in the current structure and mission of Fannie Mae and Freddie Mac. The Housing Policy Council (HPC) of the Roundtable formed a task force of lenders, services and mortgage insurers to address this challenge. While that task force has not settled on a specific organizational structure for the GSEs, it has identified certain key principles upon which GSE reform should be based. (See Attachment E). The principles are intended as a framework for evaluating the appropriate role and structure of the GSEs going forward. They are high-level. Yet, they do identify some features of the GSEs that should be retained, and some that should be reformed.

The principles recognize a continuing need for the GSEs, or some successor entities, to facilitate the securitization of mortgages. Securitization has been critical to the development of the 30-year fixed mortgage and other traditional mortgage products, and the GSEs, or some successor entities, are needed to continue to perform this function.

However, the principles envision certain changes in the operations of the GSEs or their successors that would substantially reduce the risk profile of the GSEs or their successors:

- A return to the core mission – While the GSEs were created to support the conventional mortgage market, purchases of higher-risk mortgages contributed to their financial problems.

The GSEs or their successors should return to the core mission of providing liquidity for prudently underwritten, conventional mortgages. This would be fixed-rate mortgages and adjustable rate mortgages underwritten to their fully indexed rate at the time of origination

- An explicit federal guarantee – Confusion over federal support for the securities issued by the GSEs reduced the demand for these securities and increased mortgage costs for consumers. This confusion would be eliminated by an explicit federal guarantee on the securities issued by the GSEs or their successors. The federal guarantee should be the minimum amount necessary to provide investors with confidence in the securities, and should not be a guarantee of the entities themselves.
- Limited portfolios – The portfolios amassed by Fannie Mae and Freddie Mac were a major contributing factor in their financial collapse. Going forward, any portfolios maintained by the GSEs or their successors should be limited in size and held for liquidity purposes only.

The principles envision a continuing role for the GSEs, or their successors, in affordable housing, but not through specific housing goals. The statutorily-mandated affordable housing goals had the unintended effect of motivating practices by the GSEs that harmed many borrowers as well as the financial condition of the GSEs. Going forward, HPC member companies believe that the GSEs or their successors should support safe and sustainable mortgage products for all categories of borrowers regardless of income level, including first-time homebuyers with lower down-payments, and for multifamily properties. However, the GSEs or their successors should not be required to meet specific housing goals. Liquidity support for special categories of borrowers should be provided by FHA and other federal and state programs specifically designed for that purpose.

Our GSE task force continues to deliberate on how these basic principles could be incorporated into specific organizational structures for the GSEs or some successor entities. Our task force is looking at both public and private ownership structures. At this juncture, most of the members of the task force favor some continued role for private shareholders, but that view is not unanimous.

The other issue that our task force is discussing is the transition from the current conservatorship arrangement to some new structure for the GSEs. It is increasingly clear that the transition will take some time – possibly a period of years. Maintaining the integrity and continuity of the secondary market during this transition process will be important. We will share the results of our GSE task force deliberations with you as soon as they are final.

## 10. PAYMENT SYSTEMS

Payment systems are an integral part of our nation’s financial system. They are the conduit for funds to flow between and among domestic and international businesses, consumers, and government agencies at all levels. The Roundtable supports regulatory improvements that ensure the integrity, security and availability of these payments systems. The Roundtable believes that the Congress and regulators should not inhibit the ability of the private sector to sponsor and operate various payments systems. The Roundtable encourages the U.S. financial regulatory agencies to engage other federal agencies with oversight of telecommunications providers and consumer protection responsibilities to address safety and soundness and consumer protection concerns with emerging mobile financial services products.

## CONCLUSION

The Discussion Draft is an improvement over prior proposals. The Roundtable believes that the reforms to our financial regulatory system that we propose would substantially improve the protection of consumers by reducing existing gaps in regulation, enhancing coordination and cooperation among regulators, ensuring greater regulatory accountability for commonly desired regulatory outcomes, and identifying systemic risks. Broader regulatory reform – including all proposals to mitigate systemic risk in the future – is important not only to ensure that financial institutions continue to meet the needs of all consumers but to restart economic growth and much needed job creation.

Financial reform and ending the recession soon are inextricably linked – we need both. We need a financial system that provides market stability and integrity, yet encourages innovation and competition to serve consumers and meet the needs of a vibrant and growing economy. We need better, more effective regulation and a modern financial regulatory system that is unrivaled anywhere in the world. We deserve no less. The Roundtable stands ready to work closely with this Committee, the Congress, and the Administration to achieve our common goals to better serve all consumers of financial services and provide a stronger financial market foundation for our economy.

## Attachment A

## Six Guiding Principles for Regulators and Regulated Firms

***1. Fair treatment for consumers (customers, investors, and issuers).*** *Consumers should be treated fairly and, at a minimum, should have access to competitive pricing; fair, full, and easily understood disclosure of key terms and conditions; privacy; secure and efficient delivery of products and services; timely resolution of disputes; and appropriate guidance.*

Treating consumers fairly is a stated objective for most financial services firms today, and typically it is a critical component of a firm's strategy for doing business in all consumer segments. Fair treatment should occur throughout a financial transaction. At the beginning of a transaction, it involves the meaningful disclosure of terms. Meaningful disclosure, especially to the retail consumer, goes hand in hand with effective competition. After a consumer relationship is established, fair treatment includes maintaining the privacy of consumers' confidential personal information and providing a safe and secure environment in which to conduct financial business. Fair treatment includes facilitating all consumer transactions – payments, transfers, credit applications, setting up new accounts, sales, and purchases – to ensure that they are conducted in the most efficient and timely manner possible given available technology. Fair treatment includes the establishment of transparent, effective, and timely mechanisms in place for consumers and firms to resolve potential disputes. Fair treatment also requires a financial firm to consider the needs of a consumer in any interaction and to make sure that a consumer understands how the interaction will affect him or her. While effective disclosure often will constitute appropriate guidance, in some instances, it may be important to help a consumer to understand the purpose and function of a particular product or service by providing financial literacy training.

***2. Competitive and innovative financial markets.*** *Financial regulation should promote open, competitive, and innovative financial markets domestically and internationally. Financial regulation also must support the integrity, stability, and security of financial markets.*

Open, competitive, and innovative markets benefit consumers and are preferable to financial markets that are closed or restricted and new products and services that are subject to unnecessary regulatory hurdles and delays. To ensure a competitive U.S. environment, domestic and international firms doing business here should compete equally and not be subject to any form of discrimination based upon national origin. Unreasonable barriers to entry should be eliminated, but minimum capital levels, fit-and-proper tests for management, reasonable strategic plans, and appropriate internal controls should be required. Innovations in financial products and services should be encouraged, consistent with safety and soundness and consumer protection. A vigilant and forward-looking regulatory system that supports the integrity and security of our financial markets will help the U.S. maintain its competitive advantage as a productive and secure place to engage in the full spectrum of financial services. In this context, both policymakers and regulators will need to ensure that the competitiveness of U.S. financial markets relative to other international markets is considered fully in their deliberations and rulemaking.

***3. Proportionate, risk-based regulation.*** *The costs and burdens of financial regulation, which ultimately are borne by consumers, should be proportionate to the benefits to consumers. Financial regulation also should be risk-based, aimed primarily at the material risks for firms and their consumers.*

Financial regulation should be proportionate and risk-based. Regulatory efforts and resources should be targeted to the actual material risks of specific activities and material risks to the financial system as a whole.  Market discipline should play a key role in helping to ensure that risk management is effective and proportionate.  Government oversight should be risk-focused as well, with appropriate and proportionate responses to correct real deficiencies that inevitably occur from time to time as markets evolve, new products are introduced, and new players enter the markets.

***4.  Prudential supervision and enforcement.***  *Prudential guidance, examination, supervision, and enforcement should be based upon a constructive and cooperative dialogue between regulators and the management of financial services firms that promotes the establishment of best practices that benefit all consumers. In short, prudential supervision should be prudent rather than arbitrary and preventative rather than "after the fact" enforcement.*

The foundation of prudential supervision is an open and professional dialogue between regulators and regulated firms.  When corrective measures are required of regulated firms, prudential supervision is predicated on a spectrum of corrective measures that begins with voluntary remedial actions by management and then escalates progressively, culminating ultimately in formal enforcement action.  Prudential supervision is not grounded in a black-and-white world of either compliance or noncompliance where noncompliance results in immediate penalties and public enforcement actions. Moreover, prudential supervision is not based on a predicate of a presumption of guilt prior to a discussion of facts and circumstances or an examination. Prudential supervision does not eliminate need for enforcement when appropriate. It includes swift regulatory action, public enforcement, and tough penalties for willful misconduct, fraud, and similar crimes that can lead to a firm's failure or seriously harm consumers.

***5. Options for serving consumers.*** *Providers of financial services should have a choice of charters and organizational options for serving consumers, including the option to select a single national charter and a single national regulator. Uniform national standards should apply to each charter.*

Managers of financial services firms use a variety of competitive strategies to meet all of the financial product and service needs of their consumers locally, regionally, and globally. Most corporate strategies are designed after a thoughtful and ongoing assessment of market forces, competitive threats and opportunities, demographic trends, consumer needs, institutional capabilities, and core competencies. While there is a wide range of national and state charters and organizing structures available to management today, many strategies require multiple charters and licenses and an equal if not greater number of regulators, at both the national and state levels. Requiring financial services firms to use multiple charters and multiple regulators increases operating costs for those firms and some of those costs ultimately are borne by both consumers and investors. National standards should be applied when a product or activity is truly national in scope. Our consumer credit system, which includes products such as mortgages, credit cards, and auto loans, is a national one. Therefore, institutions that offer those products should be subject to uniform supervisory and consumer protection regulations. In addition, those entities, products and activities that are regulated by the federal government should be preempted from duplicative state regulation. Granting state authorities the power to conduct inquiries and enforcement actions for state and federal consumer protection laws will have a chilling affect on the products offered to consumers and increase the costs of providing those products.

***6. Management responsibilities.*** *Management should have policies and effective practices in place to enable a financial services firm to operate successfully and maintain the trust of consumers.*

*These responsibilities include adequate financial resources, skilled personnel, ethical conduct, effective risk management, adequate infrastructure, complete and cooperative supervisory compliance as well as respect for basic tenets of safety, soundness, and financial stability, and appropriate conflict of interest management.* Management also should ensure the establishment of compensation plans that are based upon long-term performance, not short-term risk.

Capable and well qualified management is critical for financial services firms that aspire to serve their consumers effectively and efficiently. Discipline imposed by the marketplace and government supervision is also critical in assuring that consumers are well served. Senior management is responsible for key elements of corporate success, including assuring adequate financial and human resources, appropriate and effective risk management and internal controls, accurate reporting, and consumer protection. An experienced management team with skilled personnel at all levels of the organization is important as is continuous training for all employees. Management should have in place a transparent code of conduct based on best practices observed through the industry to ensure ethical behavior of employees at all levels of the organization; education in ethics and good business conduct should be mandatory.

These are important issues that go to the heart of the financial crisis. Addressing these issues in a coherent and consistent manner will rebuild public trust in the financial services industry, and prevent a repeat of the crisis we have just experienced. Indeed, our economy will remain at great risk if we do not pursue coherent and consistent reforms in these areas. In his recent speech at Federal Hall in New York City, President Obama called for clearer rules of the road for financial regulation, but he also warned against legislation that stifles innovation and enterprise. Mr. Chairman and members of the Committee, it is in that spirit that the Roundtable pledges to work with you to reform our financial system to serve all consumers in ways that balance financial stability and sustained economic growth.

## ATTACHMENT B

### Amendments to Title I

1. Renumber existing section 102 as “103” and renumber the remaining sections accordingly;

2. Insert the following new section 102:

“SEC. 102. OBJECTIVES. – The objectives of this Act are to –

(a) Support sustained economic growth and new job creation in a globally integrated economy;

(b) Promote financial market stability and security; and

(c) Enhance the competitiveness of financial services firms to meet the financial and related needs of consumers and investors.

3. Strike the word “and” at the end of section 103(c)(1)(D) [as renumbered by amendment 1, above], strike the period at the end of section 103(c)(1)(E), and insert the following:

“; and

(F) issue interpretations of the principles established in Section 110 of this Act;

(G) oversee the implementation of regulatory action plans required by Section 111 of this Act; and

(H) develop a model policy statement on prudential supervision consistent with the requirements of Section 113 of this Act.”

4. Add the following new sections at the end of the Act:

“SEC. 110. PRINCIPLES**.**

(a) Five-Year Phase-in Period. – Each of the federal financial regulatory agencies represented on the Financial Services Oversight Council shall make its regulations, interpretations, guidelines, advisories and other supervisory actions consistent with the principles set forth in subsection (b) as soon as practicable, but not later than five (5) years after the date of enactment of this Act.

(b) Principles. –

(1) Fair Treatment for Consumers. – Consumers and investors shall receive fair treatment through uniform standards that ensure–

(A) protection from unfair or deceptive acts and practices;

(B)  clearly written disclosure of key terms and conditions;

(C) protection of non-public personal information;

(D) secure and efficient delivery of financial products and services;

(E) timely and fair resolution of disputes; and

(F) relevant guidance regarding financial products and services.

(2) Stability and Security. – Financial regulation and supervision shall support the integrity, stability, and security of financial markets and financial services firms.

(3) Competitive and Innovative Financial Markets. – Financial regulation and supervision shall support open, competitive and innovative financial markets.

(4) Proportionate, Risk-Based Regulation. – Financial regulation and supervision shall be proportionate to the benefits and risks of the product or service offered, and shall take into consideration the cost of such regulation and supervision to consumers, investors, financial services firms, and the economy.

(5) Prudential Supervision and Enforcement. – The examination, supervision, and enforcement policies and procedures of a financial regulator shall be informed by an open and on-going engagement with the managers of financial services firms and shall seek to encourage all segments of the financial services industry to utilize the best practices to ensure the safety and soundness of financial services firms, consumer and investor protection.

(6) Management Responsibilities. – The managers of a financial services firm shall take appropriate actions to promote –

(A) the maintenance of adequate financial and managerial resources and skilled personnel;

(B) ethical conduct at all levels of the firm;

(C) effective risk management and controls;

(D) complete and cooperative compliance with all applicable laws, regulations, and supervisory mandates;

(E) respect for, and compliance with, the basic tenets of safety, soundness and financial stability; and

(F) appropriate conflict of interest standards.

(c) Interpretations and Compliance Guidance. – Any firm supervised or regulated by a federal financial regulatory agency that is represented on the Financial Services Oversight Council may seek interpretations of these principles from the Council under the terms of section 103(c)(1)(F) of this Act.

SEC. 111. REGULATORY ACTION PLANS.

(a) Process for Reviewing Regulations and Supervisory Activities. – Each of the federal financial regulatory agencies represented on the Financial Services Oversight Council shall establish a continuing process for assessing the consistency of its regulatory and supervisory activities with the principles established in section 110 of this Act. Such process shall provide for –

(1) a continuous review of the consistency of the agency's regulations, interpretations, guidelines, advisories, and other supervisory actions with the principles;

(2) an opportunity for public comment on the consistency of such regulations, interpretations, guidelines, advisories, and other supervisory actions during the review described in paragraph (1); and

(3) the preparation of an annual regulatory action plan, as described in subsection (b).

(b) Annual Regulatory Action Plans. – Beginning one year after the date of enactment of this Act, and continuing annually thereafter, each of the federal financial regulatory agencies represented on the Financial Services Oversight Council shall issue a regulatory action plan that –

(1)

(A) identifies the regulations, interpretations, guidelines, advisories and other supervisory actions reviewed by the regulator during the preceding year pursuant to the process required by subsection (a),

(B) summarizes any public comments received as part of that review, and

(C) explains whether or not such public comment should be adopted;

(2)

(A) describes how its regulations, interpretations, guidelines, advisories and supervisory actions are consistent or inconsistent with the principles established in section 112, and

(B) explains how the agency plans to resolve any inconsistencies;

(3) makes, to the extent necessary, recommendations for changes in Federal law necessary to allow the agency regulator to eliminate any inconsistencies between its regulations, interpretations, guidelines, advisories and other supervisory actions and the principles; and

(4) outlines a schedule for reviewing other regulations, interpretations, guidelines, advisories and other supervisory actions in order to comply with the five-year cycle required by subsection (a).

(c) Submission of Plans. – Each of the federal financial regulatory agencies represented on the Financial Services Oversight Council shall submit the regulatory action plan described in subsection (b) to –

(1) the Chairman of the Financial Services Oversight Council who shall –

(A) provide a copy to all other members of the Financial Services Oversight Council; and

(B) cause such plan to be published in the Federal Register; and

(2) the Committee on Financial Services of the U.S. House of Representatives and the Committee on Banking, Housing and Urban Affairs of the U.S. Senate.

SEC. 112. PRUDENTIAL SUPERVISION.

(a) Required. – No later than three years following the date of enactment of this Act, each of the federal financial regulatory agencies represented on the Financial Services Oversight Council shall apply prudential supervision in the exercise of its responsibilities with respect to financial services firms.

(b) Compliance. – A federal financial regulatory agency shall be deemed to have complied with the requirement in subsection (a), if such agency has –

(1) adopted and implemented the policy statement specified in section 113 of this Act,

(2) taken the administrative actions specified in section 114 of this Act, and

(3) appointed the ombudsman required by section 115 of this Act.

SEC. 113. POLICY STATEMENT ON PRUDENTIAL SUPERVISION.

(a) Policy Statement on Prudential Supervision Required. – Each federal financial regulatory agency that is represented on the Financial Services Oversight Council shall develop and publish a policy statement on prudential supervision.

(b) Contents of Policy Statement. – The policy statement required by subsection (a) shall address the following matters. –

(1) Internal Controls. – The policy statement shall encourage financial services firms regulated or supervised by the agency to establish and implement internal risk control practices and procedures that are designed to detect and prevent violations of laws, regulations, and other supervisory requirements.

(2) Open and On-Going Engagement. – The policy statement shall encourage an open and on-going engagement between the agency and the financial services firms regulated or supervised by the agency, and shall include transparent regulatory incentives for compliance with applicable law and regulations by financial services, as well as penalties for non-compliance, that are based upon the risk posed by, and performance of, a financial services firm.

(3) Self-Reporting. – The policy statement shall encourage financial services firms regulated or supervised by the agency to self-report violations of applicable laws, regulations, or other supervisory requirements, and shall include appropriate incentives for a financial services firm to self-report an apparent violation of law, regulation, or other supervisory requirement.

(4) Self-Correction. – The policy statement shall encourage financial services firms regulated or supervised by the agency to self-correct violations of applicable laws, regulations, or other supervisory requirements, and, subject to such limitations as the agency deems necessary to protect the safety and soundness of a financial services firm and the interests of consumers, the policy statement shall provide for the agency to give a financial services firm a notice of the violation and an opportunity to take corrective action before the agency decides to bring an enforcement action.

(5) Continuum of Actions. – The policy statement shall identify the range of enforcement actions the agency may bring in response to a violation of law, regulation, or other supervisory requirement, and, subject to such limitations as a regulator deems necessary to protect the safety and soundness of a financial services firm and the interests of consumers, the policy statement shall provide that the agency shall impose enforcement actions in a continuum that begins with the least severe sanction or penalty and gradually escalates to the most severe sanction or penalty.

(6) Mitigating Factors. – The policy statement shall identify the factors the agency will consider in determining whether to bring an enforcement action against a financial services firm regulated or supervised by the agency.

(7) Fair Notice. – The policy statement shall ensure that a financial services firm regulated or supervised by the agency has sufficient prior notice of any law, regulation, or other supervisory requirement upon which an enforcement action may be based;

(8) Investigations. – The policy statement shall specify the agency's practices and procedures related to investigations, shall require the agency to notify a financial services firm within 10 days of completing an investigation, and shall require the agency to review the status of all open investigations on a semi-annual basis and determine if such matter should remain open or be closed.

(c) Public Comment. – Each federal financial regulatory agency that is represented on the Financial Services Oversight Council shall seek public comment in developing the policy statement required by this section.

(d) Prudential Supervision Defined. – For purposes of this Act, the term “prudential supervision” means a form of supervision that –

(1) is designed to ensure compliance by a financial services firm with applicable laws, regulations, and other supervisory requirements;

(2) is based upon an open and on-going engagement between a financial regulatory agency and a financial services firm;

(3) encourages a financial services firm to establish and maintain sound internal controls;

(4) promotes and acknowledges self-identification and self-correction of compliance problems by a financial services firm;

(5) recognizes and distinguishes among financial services firms based upon their risk profile; and

(6) includes transparent regulatory incentives designed to promote compliance with laws, regulations, and other supervisory requirements by financial services firms.

SEC. 114. ADMINISTRATIVE MATTERS.

(a) Communications Between Divisions. – Each federal financial regulatory agency that is represented on the Financial Services Oversight Council shall establish practices and procedures that encourage the enforcement and non-enforcement personnel of such agency to communicate and coordinate actions so that financial services firms regulated or supervised by the agency are encouraged to self-report violations of applicable laws, regulations, and other supervisory requirements and to self-correct those violations.

(b) Training and Incentives. – Each federal financial regulatory agency that is represented on the Financial Services Oversight Council shall establish –

(1) a training program for enforcement and non-enforcement personnel that explains and promotes the application of prudential supervision by such personnel; and

(2) incentive programs for all personnel to apply prudential supervision in the exercise of their duties.

(c) Publication of Supervisory Policies and Procedures. – Each federal financial regulatory agency that is represented on the Financial Services Oversight Council shall make its examination manual and other supervisory policies and procedures available to the public, and shall post such materials on its web site.

SEC. 115. OMBUDSMAN FOR PRUDENTIAL SUPERVISION.

(a) Ombudsman. – Each federal financial regulatory agency that is represented on the Financial Services Oversight Council shall appoint an Ombudsman for prudential supervision who shall report directly to the head or board of such agency, as applicable.

(b) Duties of Ombudsman. – The Ombudsman appointed under subsection (a) shall –

(1) ensure that the agency has adopted practices and procedures that encourage financial services firms supervised or regulated by such agency to present compliance questions to the agency and to self-identify and self-correct violations of laws, regulations or other supervisory requirements;

(2) advise and guide financial services firms regulated or supervised by the agency through the process of self-reporting violations of applicable laws, regulations or other supervisory requirements;

(3) act as a liaison between the agency and a financial services firm regulated or supervised by the agency with respect to any problem the firm may have in dealing with the agency;

(4) ensure that a financial services firm that engage in the self-reporting of violations of laws, regulations and other supervisory requirements are given due credit by non-enforcement and enforcement personnel of the agency;

(5) ensure that the agency has adopted practices and procedures to train enforcement and non-enforcement personnel to apply prudential supervision in the exercise of their duties, and to provide incentives for doing so;

(6) ensure that the agency has established practices and procedures that promote communications between the enforcement and non-enforcement personnel of the agency; and

(7) maintain the privilege of confidential communications between a financial services firm and the Ombudsman, unless such privilege is waived by the firm.

(c) Limitation. – In carrying out the duties under subsection (b), the Ombudsman shall utilize personnel of the agency to the extent practicable, and nothing in this section is intended to replace, alter or diminish the activities of any other ombudsman or similar office that otherwise exists within such agency.

(d) Report. – Each year, the Ombudsman for a federal financial regulatory agency shall submit a report for inclusion in the annual report of such agency. Such report shall –

(1) describe the activities of the Ombudsman during the preceding year; and

(2) include solicited comments and evaluations from financial services firms regulated or supervised by the agency with respect to the effectiveness of the Ombudsman's activities."

**Attachment C**

**FFIEC Subcommittee**

111th CONGRESS
2nd Session

**H.R. XXXX**

To provide for the establishment of a Subcommittee on Financial Services Information Technology, Security, and Privacy within the Federal Financial Institutions Examination Council, and for other purposes.

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**IN THE HOUSE OF REPRESENTATIVES**

**September ___, 2009**

________ introduced the following bill; which was referred to the Committee on Financial Services.

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**A BILL**

To provide for the establishment of a Subcommittee on Financial Services Information Technology, Security, and Privacy within the Federal Financial Institutions Examination Council, and for other purposes.

> *Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,*

**Sec. 1. Short Title.—**This Act may be cited as the “Financial Services Information Technology, Security and Privacy Act of 2009”.

**Sec. 2. Amendments to the Federal Financial Institutions Examination Council Act of 1978 –** The Federal Financial Institutions Examination Council Act of 1978 (12 U.S.C. 3301 et seq.) is amended by adding the following new sections at the end thereof:

> “Section 3312. Establishment, Purpose, and Operations of the Subcommittee on Financial Services Information Technology, Security, and Privacy. –

"(a) Establishment of the Subcommittee. -- There shall be established, within the Council, a subcommittee to be known as the "Subcommittee on Financial Services Information Technology, Security, and Privacy," which shall consist of the members of the Council, the Chair of the Federal Trade Commission, and the Chair of the Securities and Exchange Commission.

"(b) Purpose-- The purpose of the Subcommittee shall be to ensure –

"(1) that regulations and supervisory guidance related to information technology, security, and privacy are uniform in design and application, and

"(2) that financial institutions have sufficient opportunity to provide input on the development of such regulations and supervisory guidance.

"(c) Chairmanship. -- The Chairmanship of the Subcommittee will rotate among the members of the Subcommittee on an annual basis, with the Chair of the Federal Trade Commission serving as the initial Chair of the Subcommittee.

"(d) Rules of Operation. -- The Subcommittee will establish rules of operation and administration. Such rules shall provide that –

"(1) any proposed and final regulations and any supervisory guidance developed by the Subcommittee may not be issued without the approval of a majority of the members of the Subcommittee, and if so approved, such regulation or guidance shall be issued jointly by all of the agencies represented on the Subcommittee;

"(2) the Chairs of the Federal Trade Commission and the Securities and Exchange Commission shall be full voting members of the subcommittee with rights and authority equal to all other members of the Subcommittee, but will have no authority with respect to any other matter within the scope of the Council's authority, unless such authority derives from other laws of the United States; and

"(3) in developing any regulation, guidance, or manual, the Subcommittee shall seek input from the legal, compliance, examination, and consumer protection divisions of each of the agencies represented on the Subcommittee, and from the Advisory Working Group, described in Section 3314.

"(e) Staff – The Subcommittee shall appoint such staff as may be necessary to carry out the function of this Act, consistent with the appointment and compensation practices of the Council.

"Sec. 3313. Functions of the Subcommittee on Financial Services Information Technology, Security, and Privacy.

"(a) Monitor. – The Subcommittee shall monitor developments related to information technology, security and privacy and the impact of such developments on financial institutions.

"(b) Regulations –

"(1) Advance Notice of Proposed Rulemaking -- The Subcommittee shall be responsible for developing regulations on information technology, security and privacy matters affecting financial institutions. Any proposed regulation shall be issued in the form of an advance notice of proposed rulemaking.

"(2) Final Regulation – Following a review of comments received in response to an advance notice of proposed rulemaking, the Subcommittee may issue a final rule.

"(c) Supervisory Guidance. – The Subcommittee may issue supervisory guidance on information technology, security and privacy matters affecting financial institutions.

"(d) Compliance – Enforcement of the regulations and supervisory guidance approved by the Subcommittee shall remain within the jurisdiction of each of the agencies represented on the Subcommittee, and the Subcommittee shall have no independent enforcement or supervisory authority.

"Sec. 3314. Advisory Working Group.

"(a) Establishment. – The Subcommittee shall establish an Advisory Working Group to advise and consult with the Subcommittee in the exercise of its functions.

"(b) Membership and Term. -- The Advisory Working Group shall consist of no more than 12 members selected by the Subcommittee. In selecting the members of the Advisory Working Group, the Subcommittee shall seek to assemble experts in information technology, security and privacy. Membership shall be equally divided between individuals who represent consumers, financial institutions, and providers of services to financial institutions. Members shall serve for a period of two years.

"(c) Meetings. -- The Advisory Working Group shall meet from time to time at the call of the Subcommittee, but, at a minimum, shall meet at least four times a year.

"(d) Compensation and Travel Expenses. – Members of the Advisory Working Group shall –

"(1) be entitled to receive compensation at a rate fixed by the Subcommittee while attending meetings of the Advisory Working Group, including travel time; and

"(2) be allowed travel expenses, including transportation and subsistence, while away from their homes or regular places of business.

"Sec. 3315. Manuals and Training.

"(a) Training Manual -- Utilizing relevant personnel from the agencies represented on the Subcommittee, the Subcommittee shall prepare a training manual for examiners and other supervisory personnel to ensure that regulations and supervisory guidance on information technology, security and privacy are uniformly enforced by all agencies.

"(b) Compliance Manual -- Utilizing relevant personnel from the agencies represented on the Subcommittee, the Subcommittee shall prepare a compliance manual whenever any regulation or supervisory guidance related to information technology, security and privacy is finalized, and shall ensure that such manual is readily available to financial institutions.

"(c) Examiner Training Programs. -- The Subcommittee shall establish joint training programs for supervisory personnel responsible for enforcing compliance with information technology, security and privacy regulations and supervisory guidance."

**Sec. 3. Definitions.** – For purposes of this Act, the term –

(1) "financial institution" means –

(A) an institution that is engaged in an activity that is financial in nature, as that term is defined in Section 4(k)(4) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)), or

(B) an institution that provides services to an institution engaged in an activity that is financial in nature; and

(C) such institution is supervised or regulated by one or more of the agencies represented on the Subcommittee on Financial Services Information Technology, Security, and Privacy of the Federal Financial Institutions Examination Council.

(2) "information technology" means the use of computers and software to manage financial information maintained by a financial institution;

(3) "privacy" means the freedom from unauthorized intrusion into financial information maintained by a financial institution; and

(4) "security" means the protection afforded the confidentiality, integrity, and availability of financial information maintained by a financial institution.

**Sec. 4. Rule of Construction**. – Nothing in this Act shall be construed to exempt any agency represented on the Subcommittee on Financial Services Information Technology, Security, and Privacy of the Federal Financial Institutions Examination Council from complying with the Administrative Procedures Act (5 U.S.C. 1001 et seq.)

## Attachment D

## Conceptual Framework for a
## Market Stability Oversight Authority

**Need for a Market Stability Oversight Authority:** The U.S. financial markets are interconnected, nationally and internationally. Banks, broker-dealers, insurance companies, finance companies, hedge funds, and other regulated and unregulated financial services firms are continuously and mutually engaged in a variety of lending, investment, trading, and other financial transactions. Yet, under our existing financial regulatory structure, no single agency has the authority to look across all sectors of the financial services industry and all markets to evaluate risks posed by these interconnections.

Our existing financial regulatory system is based upon the model of "functional" regulation, in which separate agencies are responsible for separate parts of the financial services industry. We have separate national regulators for banks, savings associations, credit unions, broker-dealers, and futures firms. We have fifty plus insurance regulators at the state level, but no federal regulator for the insurance industry. We also have some financial services firms, such as state licensed mortgage lenders, that are subject to different regulation.

The on-going crisis in our nation's financial markets has demonstrated the limitations of our functional regulatory system in today's highly interconnected financial system. Critical gaps in regulation and the inconsistent regulation and supervision of firms engaged in comparable actions permitted the development of activities and practices that undermined the stability and integrity of our nation's financial system.

Accordingly, the Financial Services Roundtable supports the creation of a federal market stability oversight authority to oversee our nation's financial services firms and financial markets and identify and address risks that could threaten the stability and integrity of our financial system and the economy. The following is our proposed conceptual framework for a market stability oversight authority.

**Part of Comprehensive Reform:** A market stability oversight authority should be established as part of the comprehensive restructuring our of nation's financial system. The market stability oversight authority should not be just another layer of regulation added to the existing system; it should not be a "super-regulator". Absent an immediate, systemic threat, the market stability oversight authority should be required to work with and through other financial regulators, including a national insurance regulator. A national insurance regulator is needed to give the federal government a better understanding and role in the supervision of this key part of our nation's financial services sector.

**Long-term Stability and Integrity of Financial System:** The purpose of a market stability oversight authority should be to promote the long-term stability and integrity of the nation's financial markets and financial services firms by identifying and addressing significant risks to the financial system as a whole.

**Oversight of All Financial Markets and Firms:** A market stability oversight authority should be authorized to oversee all types of all financial markets and all financial services firms, whether regulated or unregulated. A market stability oversight authority should not focus on financial services firms based upon size. The designation of "systemically significant financial services firms" would have unintended competitive consequences and increase moral hazard as these firms would be deemed too big to fail.

**Systemic Risk Defined:** Systemic risk should be defined as an activity or practice that crosses financial markets or financial services firms, and, which if left unaddressed, would have a significant, material adverse effect on financial services firms, financial markets, or the U.S. economy.

**Balance Risk and Innovation:** A market stability oversight authority should balance the identification of activities or practices that pose a systemic risk against the need for continuing market innovation and competitiveness. A market stability oversight authority should not stifle innovation, or preclude isolated failures. Innovation is a key to economic growth and new job creation.

**Risk-Based Focus**: A market stability oversight authority should focus attention on factors that present the greatest potential for systemic risk, such as excessive concentrations of assets or liabilities, rapid growth in assets or liabilities, high leverage, a mismatch between long-term assets and short-term liabilities, currency mismatch, and regulatory gaps. A market stability oversight authority should not focus attention on products or practices that pose little or no systemic risk.

**Designation of the Federal Reserve Board as Market Stability Oversight Authority:** The Federal Reserve Board should be designated as the nation's market stability oversight authority. Such a designation is a natural complement to the Board's existing role as the nation's central bank and lender of last resort. To perform this responsibility, the Board should be –

- **Staff.** Authorized to expand its staff to include experts in all types of financial activities, practices, and markets;
- **Governance.** Required to establish a governance structure for this new role to minimize any potential conflicts with its existing responsibilities; and
- **Advisory Board.** Authorized to establish an Advisory Council on Market Stability to review activities and practices that may pose a systemic risk, balanced against the need for continuing market innovation and competitiveness. The Advisory Council should include representatives of domestic and international financial services firms doing business in the United States as well as representatives of consumers of financial services.

**Functions of Market Stability Oversight Authority:** To identify, prevent, and mitigate systemic risk, the Board should be authorized to –

- **Data collection and analysis.** Collect and analyze data from other financial regulators and individual financial services firms to understand potential or existing systemic risks in the financial system. Data on individual firms should be treated as confidential supervisory information.
- **Market surveillance**. Establish a surveillance system for activities and practices to detect early crisis warning signs and vulnerabilities, conduct scenario planning, and develop contingency planning with other prudential financial regulators across all financial markets.

- **Examinations.** Examine individual financial services firms. If a firm is regulated by another national or state financial regulator, such examinations should be coordinated with such regulator. Examination results should be treated as confidential supervisory information.
- **Reports and notices.** Issue, as necessary, reports and public notices on activities or practices that may pose a systemic risk.
- **Non-emergency actions.** Make recommendations to other regulators and Congress to address activities and practices that could pose a systemic risk, but do not pose an immediate systemic risk.
- **Recommendations to other regulators.** Whenever the Board identifies a practice or activity that could pose a systemic risk and such practice or activity is within the jurisdiction of another national or state financial regulator, the Board should issue a finding and recommend appropriate preventive actions to the other regulator. The Board also should submit any such findings and recommendations to the Congress and the Financial Markets Coordinating Council (FMCC). If the other regulator disagrees with the Board's finding and recommendation, then the regulator can submit its own findings and recommendations to the Congress and the FMCC.
- **Recommendations to Congress.** If the Board identifies an activity or practice that could pose a systemic risk, and such activity or practice is not subject to regulation or supervision by another regulator, the Board should make a recommendation to Congress on how best to regulate and supervise such activity or practice in the future.
- **Emergency actions.** Take unilateral actions to address activities or practices, which the Board determines pose an immediate, systemic risk, and which could not be addressed in a timely fashion if the Board were to recommend actions by any other regulator. Such unilateral actions would include the power to issue orders or regulations affecting actions or practices of individual firms or categories of firms. Such unilateral actions should be approved by a super majority of the Board, and they should be agreed to by the Secretary of the Treasury, who must consult with the President. Such unilateral actions also should be reported immediately to Congress. This authority would be in addition to the Board's existing authority under section 13(3) of the Federal Reserve Act to extend credit to financial or non-financial institutions in "unusual and exigent" circumstances. The Board should retain that authority.
- **Regulatory consultation.** Maintain an on-going dialogue with other domestic and international financial regulators.
- **Reports to Congress.** Issue a report to Congress on a semi-annual basis that describes how it has performed the functions enumerated above.

ATTACHMENT E

HPC GSE PRINCIPLES

*Principle 1. In the near-term, the Federal Government should continue to support Fannie Mae and Freddie Mac and the secondary mortgage market.*

In order to ensure liquidity for mortgage finance during the financial crisis, Congress, the Treasury Department, and the Federal Reserve have provided an unprecedented level of support for the GSEs and the secondary mortgage market. FHA has provided liquidity for the origination and sale of loans targeted to low- and moderate-income borrowers. The Federal Government's support for the GSEs and the secondary market should continue for the near-term to ensure the strength of the mortgage market and the uninterrupted availability of mortgage finance.

*Principle 2. All participants in the secondary mortgage market should take actions to maintain the integrity of the market.*

The financial crisis has demonstrated the need for all participants in the secondary mortgage market to take appropriate actions to maintain the integrity of the market. Additionally, the crisis has reinforced the need for each participant in the chain between the borrower and the investor to be responsible for making independent credit risk management decisions.

*Principle 3. The secondary mortgage market and a securitization process are vital to mortgage finance, and the GSEs, or some successor entities, are needed to perform this function.*

The securitization of mortgage loans created a broad and liquid market for many traditional mortgage products including the 30-year, fixed-rate mortgage. Historically, securitization of these mortgage loans has been conducted by the GSEs, which developed the programs and expertise required to convert individual mortgage loans into mortgage backed securities. While some recent activities of the GSEs related to non-traditional mortgage loans resulted in large losses, their traditional securitization models are successful in providing low-cost mortgage funds in a safe and sound manner. In order to meet the demand for traditional mortgage products going forward, it is essential that the GSEs, or some successors to the GSEs, continue to facilitate the securitization process for such mortgage loans.

*Principle 4. Consideration should be given to separating the functions performed by the GSEs.*

Traditionally, the GSEs have performed four functions in the secondary mortgage market: (1) they have facilitated the process of efficiently transforming mortgage loans into standardized and highly liquid mortgage back securities (securitization); (2) they have facilitated an active market in mortgage backed securities by acting as credit risk guarantor of these instruments (credit enhancement); (3) they have invested in whole loans and mortgage backed securities to help maintain liquidity in the mortgage markets (portfolios); and (4) they have supported a secondary market in mortgage loans to borrowers in certain income categories and locations (housing goals). Reform of the structure of the GSEs should consider the potential advantages and disadvantages of separating these functions in different entities. However, because these functions are interconnected, any such separation should be approached carefully. Additionally, separate functions could be subject to different ownership structures.

*Principle 5. Separation of the functions of the GSEs should accommodate different ownership structures.*

In recent years, the interests of shareholders came into conflict with the mission of the GSEs. Yet, private sector investors can provide a layer of financial protection for the government, promote market discipline, attract management talent, and promote innovative practices. Therefore, it may be appropriate to have different ownership structures for the different functions performed by the GSEs. Depending on the specific function, the ownership structure may be most appropriately addressed through private capital or public ownership. Privately owned entities should be subject to comprehensive, prudential regulation and supervision by an independent federal agency in order to ensure that management balances its duty to shareholders with appropriate risk management.

*Principle 6. The core mission of the GSEs, or their successors, should be to provide liquidity for traditional mortgage products.*

Multiple and conflicting missions contributed to the current financial problems of the GSEs. Going forward, the core mission of the GSEs, or their successors, should be to provide liquidity, in a safe and sound manner, for prudently underwritten conventional mortgage products. These products include various forms of fixed-rate mortgages (e.g., 15- or 30-year loans), and adjustable rate mortgages underwritten to their fully indexed rate at the time of origination. Support for such traditional products is critical to maintain a flow of mortgage credit to consumers that is understandable to borrowers and investors, and less prone to default. Any additions to this core mission should be authorized by the regulator only after the securitization of traditional products has been running smoothly for some period of time, and only after careful consideration of any possible conflicts with the core mission of the GSEs, or their successors.

*Principle 7. The GSEs should not be required to meet specific housing goals.*

The statutorily-mandated affordable housing goals had the unintended effect of motivating practices by the GSEs that harmed many borrowers as well as the financial condition of the GSEs. Nonetheless, the GSEs or their successors should be required to support safe and sustainable mortgage products for all categories of borrowers, including low- and moderate-income borrowers, first-time homebuyers with lower cash down payments, and multifamily properties, as long as such loans are subject to prudent underwriting standards. Liquidity support for other categories of borrowers should be provided by FHA and other federal and state programs specifically designed for that purpose.

*Principle 8. The Federal Government should provide explicit support for securities issued by the GSEs or their successors.*

To ensure that consumers have uninterrupted access to reasonably priced mortgages, the Federal Government should explicitly guarantee the performance of GSE issued mortgage backed securities.

Federal support for these securities should be the minimum amount necessary to provide investors with confidence in these securities without creating perverse incentives. Consequently, any Federal Government guarantee should be placed directly on the mortgage backed securities, and not on the general liabilities of the GSEs or their successors. Careful consideration should be given as to where in the credit capital structure this guarantee should be placed (i.e., in a first-, mezzanine-, or remote-loss position) and the federal guarantee should be triggered only after private capital has been exhausted. To further reduce investor confusion, once an appropriate guarantee is established for any particular security, it should be in the form of a binding contractual agreement and not be subject to unilateral modification or repeal.

*Principle 9. The process of securitization does require the maintenance of a limited portfolio of mortgages or mortgage backed securities.*

However, it is important that such a portfolio not detract from the core securitization functions of the GSEs, or create any unnecessary financial risks to these entities. Therefore, any portfolios maintained by the GSEs, or their successors, should be limited in size and held only for liquidity purposes or to facilitate the development of new products, and not for profit purposes.

*Principle 10. The Federal Government should act as the ultimate liquidity backstop for the mortgage market.*

It is important to maintain the liquidity of the mortgage market in periods of economic stress. During the recent financial crisis the ability of the GSEs to perform this function was constrained by their financial condition. Going forward, the Federal Government should acknowledge that it will continue to act as the "ultimate liquidity backstop" for the mortgage markets in periods of severe economic stress by stepping into the market and absorbing the losses.

*Principle 11. A single mortgage backed security should be considered.*

Differences in some of the key terms of the mortgage backed securities issued by Fannie Mae and Freddie Mac fragmented the market pricing for such securities and may have unnecessarily increased the cost of mortgage loans for some borrowers. Therefore, consideration should be given to the creation of a common form of MBS for loans guaranteed by the GSEs or their successors. Under this construct, securities collateralized by FHA insured loans should remain separate and distinct from the securities issued by the GSEs or their successors.

*Principle 12. The securities issued by the GSEs or their successors should be transparent.*

Transparency is important to shareholders and investors. Therefore, going forward, the securities issued by the GSEs or their successors should be subject to appropriate public disclosure requirements. However, care must be taken not to disrupt the “to be announced” (TBA) market, which lenders use to control risk. One of the efficiencies of the TBA securities is exemption from SEC registration requirements and we would advocate that this exemption be retained.