

TABLE OF CONTENTS

Introduction.....#

Summary of Recommendations#

I. Promote Robust Supervision and Regulation of Financial Firms#

II. Establish Comprehensive Regulation of Financial Markets.....#

III. Protect Consumers and Investors from Financial Abuse.....#

IV. Provide the Government with the Tools it Needs to Manage Financial Crises#

**V. Raise International Regulatory Standards and Improve International
Cooperation#**

INTRODUCTION

Over the past two years we have faced the most severe financial crisis since the Great Depression. Americans across the nation are struggling with unemployment, failing businesses, falling home prices, and declining savings. These challenges have forced the government to take extraordinary measures to revive our financial system so that people can access loans to buy a car or home, pay for a child's education, or finance a business.

The roots of this crisis go back decades. Years without a serious economic recession bred complacency among financial intermediaries and investors. Financial challenges such as the near-failure of Long-Term Capital Management and the Asian Financial Crisis had minimal impact on economic growth in the U.S., which bred exaggerated expectations about the resilience of our financial markets and firms. Rising asset prices, particularly in housing, hid weak credit underwriting standards and masked the growing leverage throughout the system.

At some of our most sophisticated financial firms, risk management systems did not keep pace with the complexity of new financial products. The lack of transparency and standards in markets for securitized loans helped to weaken underwriting standards. Market discipline broke down as investors relied excessively on credit rating agencies. Compensation practices throughout the financial services industry rewarded short-term profits at the expense of long-term value.

Households saw significant increases in access to credit, but those gains were overshadowed by pervasive failures in consumer protection, leaving many Americans with obligations that they did not understand and could not afford.

While this crisis had many causes, it is clear now that the government could have done more to prevent many of these problems from growing out of control and threatening the stability of our financial system. Gaps and weaknesses in the supervision and regulation of financial firms presented challenges to our government's ability to monitor, prevent, or address risks as they built up in the system. No regulator saw its job as protecting the economy and financial system as a whole. Existing approaches to bank holding company regulation focused on protecting the subsidiary bank, not on comprehensive regulation of the whole firm. Investment banks were permitted to opt for a different regime under a different regulator, and in doing so, escaped adequate constraints on leverage. Other firms, such as AIG, owned insured depositories, but escaped the strictures of serious holding company regulation because the depositories that they owned were technically not "banks" under relevant law.

We must act now to restore confidence in the integrity of our financial system. The lasting economic damage to ordinary families and businesses is a constant reminder of the urgent need to act to reform our financial regulatory system and put our economy on track to a sustainable recovery. We must build a new foundation for financial regulation and supervision that is simpler and more effectively enforced, that protects consumers and investors, that rewards innovation and that is able to adapt and evolve with changes in the financial market.

In the following pages, we propose reforms to meet five key objectives:

Financial Regulatory Reform: A New Foundation

(1) Promote robust supervision and regulation of financial firms. Financial institutions that are critical to market functioning should be subject to strong oversight. No financial firm that poses a significant risk to the financial system should be unregulated or weakly regulated. We need clear accountability in financial oversight and supervision. We propose:

- A new Financial Services Oversight Council of financial regulators to identify emerging systemic risks and improve interagency cooperation.
- New authority for the Federal Reserve to supervise all firms that could pose a threat to financial stability, even those that do not own banks.
- Stronger capital and other prudential standards for all financial firms, and even higher standards for large, interconnected firms.
- A new National Bank Supervisor to supervise all federally chartered banks.
- Elimination of the federal thrift charter and other loopholes that allowed some depository institutions to avoid bank holding company regulation by the Federal Reserve.
- The registration of advisers of hedge funds and other private pools of capital with the SEC.

(2) Establish comprehensive supervision of financial markets. Our major financial markets must be strong enough to withstand both system-wide stress and the failure of one or more large institutions. We propose:

- Enhanced regulation of securitization markets, including new requirements for market transparency, stronger regulation of credit rating agencies, and a requirement that issuers and originators retain a financial interest in securitized loans.
- Comprehensive regulation of all over-the-counter derivatives.
- New authority for the Federal Reserve to oversee payment, clearing, and settlement systems.

(3) Protect consumers and investors from financial abuse. To rebuild trust in our markets, we need strong and consistent regulation and supervision of consumer financial services and investment markets. We should base this oversight not on speculation or abstract models, but on actual data about how people make financial decisions. We must promote transparency, simplicity, fairness, accountability, and access. We propose:

- A new Consumer Financial Protection Agency to protect consumers across the financial sector from unfair, deceptive, and abusive practices.
- Stronger regulations to improve the transparency, fairness, and appropriateness of consumer and investor products and services.
- A level playing field and higher standards for providers of consumer financial products and services, whether or not they are part of a bank.

(4) *Provide the government with the tools it needs to manage financial crises.* We need to be sure that the government has the tools it needs to manage crises, if and when they arise, so that we are not left with untenable choices between bailouts and financial collapse. We propose:

- A new regime to resolve nonbank financial institutions whose failure could have serious systemic effects.
- Revisions to the Federal Reserve's emergency lending authority to improve accountability.

(5) *Raise international regulatory standards and improve international cooperation.* The challenges we face are not just American challenges, they are global challenges. So, as we work to set high regulatory standards here in the United States, we must ask the world to do the same. We propose:

- International reforms to support our efforts at home, including strengthening the capital framework; improving oversight of global financial markets; coordinating supervision of internationally active firms; and enhancing crisis management tools.

In addition to substantive reforms of the authorities and practices of regulation and supervision, the proposals contained in this report entail a significant restructuring of our regulatory system. We propose the creation of a Financial Services Oversight Council, chaired by Treasury and including the heads of the principal federal financial regulators as members. We also propose the creation of two new agencies. We propose the creation of the Consumer Financial Protection Agency, which will be an independent entity dedicated to consumer protection in credit, savings, and payments markets. We also propose the creation of the National Bank Supervisor, which will be a single agency with separate status in Treasury with responsibility for federally chartered depository institutions. To promote national coordination in the insurance sector, we propose the creation of an Office of National Insurance within Treasury.

Under our proposal, the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) would maintain their respective roles in the supervision and regulation of state-chartered banks, and the National Credit Union Administration (NCUA) would maintain its authorities with regard to credit unions. The Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) would maintain their current responsibilities and authorities as market regulators, though we propose to harmonize the statutory and regulatory frameworks for futures and securities.

The proposals contained in this report do not represent the complete set of potentially desirable reforms in financial regulation. More can and should be done in the future. We focus here on what is essential: to address the causes of the current crisis, to create a more stable financial system that is fair for consumers, and to help prevent and contain potential crises in the future. (*For a detailed list of recommendations, please see Summary of Recommendations following the Introduction.*)

These proposals are the product of broad-ranging individual consultations with members of the President's Working Group on Financial Markets, Members of Congress,

academics, consumer and investor advocates, community-based organizations, the business community, and industry and market participants.

I. Promote Robust Supervision and Regulation of Financial Firms

In the years leading up to the current financial crisis, risks built up dangerously in our financial system. Rising asset prices, particularly in housing, concealed a sharp deterioration of underwriting standards for loans. The nation's largest financial firms, already highly leveraged, became increasingly dependent on unstable sources of short-term funding. In many cases, weaknesses in firms' risk-management systems left them unaware of the aggregate risk exposures on and off their balance sheets. A credit boom accompanied a housing bubble. Taking access to short-term credit for granted, firms did not plan for the potential demands on their liquidity during a crisis. When asset prices started to fall and market liquidity froze, firms were forced to pull back from lending, limiting credit for households and businesses.

Our supervisory framework was not equipped to handle a crisis of this magnitude. To be sure, most of the largest, most interconnected, and most highly leveraged financial firms in the country were subject to some form of supervision and regulation by a federal government agency. But those forms of supervision and regulation proved inadequate and inconsistent.

First, capital and liquidity requirements were simply too low. Regulators did not require firms to hold sufficient capital to cover trading assets, high-risk loans, and off-balance sheet commitments, or to hold increased capital during good times to prepare for bad times. Regulators did not require firms to plan for a scenario in which the availability of liquidity was sharply curtailed.

Second, on a systemic basis, regulators did not take into account the harm that large, interconnected, and highly leveraged institutions could inflict on the financial system and on the economy if they failed.

Third, the responsibility for supervising the consolidated operations of large financial firms was split among various federal agencies. Fragmentation of supervisory responsibility and loopholes in the legal definition of a "bank" allowed owners of banks and other insured depository institutions to shop for the regulator of their choice.

Fourth, investment banks operated with insufficient government oversight. Money market mutual funds were vulnerable to runs. Hedge funds and other private pools of capital operated completely outside of the supervisory framework.

To create a new foundation for the regulation of financial institutions, we will promote more robust and consistent regulatory standards for all financial institutions. Similar financial institutions should face the same supervisory and regulatory standards, with no gaps, loopholes, or opportunities for arbitrage.

We propose the creation of a Financial Services Oversight Council, chaired by Treasury, to help fill gaps in supervision, facilitate coordination of policy and resolution of disputes, and identify emerging risks in firms and market activities. This Council would

include the heads of the principal federal financial regulators and would maintain a permanent staff at Treasury.

We propose an evolution in the Federal Reserve's current supervisory authority for BHCs to create a single point of accountability for the consolidated supervision of all companies that own a bank. All large, interconnected firms whose failure could threaten the stability of the system should be subject to consolidated supervision by the Federal Reserve, regardless of whether they own an insured depository institution. These firms should not be able to escape oversight of their risky activities by manipulating their legal structure.

Under our proposals, the largest, most interconnected, and highly leveraged institutions would face stricter prudential regulation than other regulated firms, including higher capital requirements and more robust consolidated supervision. In effect, our proposals would compel these firms to internalize the costs they could impose on society in the event of failure.

II. Establish Comprehensive Regulation of Financial Markets

The current financial crisis occurred after a long and remarkable period of growth and innovation in our financial markets. New financial instruments allowed credit risks to be spread widely, enabling investors to diversify their portfolios in new ways and enabling banks to shed exposures that had once stayed on their balance sheets. Through securitization, mortgages and other loans could be aggregated with similar loans and sold in tranches to a large and diverse pool of new investors with different risk preferences. Through credit derivatives, banks could transfer much of their credit exposure to third parties without selling the underlying loans. This distribution of risk was widely perceived to reduce systemic risk, to promote efficiency, and to contribute to a better allocation of resources.

However, instead of appropriately distributing risks, this process often concentrated risk in opaque and complex ways. Innovations occurred too rapidly for many financial institutions' risk management systems; for the market infrastructure, which consists of payment, clearing and settlement systems; and for the nation's financial supervisors.

Securitization, by breaking down the traditional relationship between borrowers and lenders, created conflicts of interest that market discipline failed to correct. Loan originators failed to require sufficient documentation of income and ability to pay. Securitizers failed to set high standards for the loans they were willing to buy, encouraging underwriting standards to decline. Investors were overly reliant on credit rating agencies. Credit ratings often failed to accurately describe the risk of rated products. In each case, lack of transparency prevented market participants from understanding the full nature of the risks they were taking.

The build-up of risk in the over-the-counter (OTC) derivatives markets, which were thought to disperse risk to those most able to bear it, became a major source of contagion through the financial sector during the crisis.

We propose to bring the markets for all OTC derivatives and asset-backed securities into a coherent and coordinated regulatory framework that requires transparency and improves market discipline. Our proposal would impose record keeping and reporting

requirements on all OTC derivatives. We also propose to strengthen the prudential regulation of all dealers in the OTC derivative markets and to reduce systemic risk in these markets by requiring all standardized OTC derivative transactions to be executed in regulated and transparent venues and cleared through regulated central counterparties.

We propose to enhance the Federal Reserve's authority over market infrastructure to reduce the potential for contagion among financial firms and markets.

Finally, we propose to harmonize the statutory and regulatory regimes for futures and securities. While differences exist between securities and futures markets, many differences in regulation between the markets may no longer be justified. In particular, the growth of derivatives markets and the introduction of new derivative instruments have highlighted the need for addressing gaps and inconsistencies in the regulation of these products by the CFTC and SEC.

III. Protect Consumers and Investors from Financial Abuse

Prior to the current financial crisis, a number of federal and state regulations were in place to protect consumers against fraud and to promote understanding of financial products like credit cards and mortgages. But as abusive practices spread, particularly in the market for subprime and nontraditional mortgages, our regulatory framework proved inadequate in important ways. Multiple agencies have authority over consumer protection in financial products, but for historical reasons, the supervisory framework for enforcing those regulations had significant gaps and weaknesses. Banking regulators at the state and federal level had a potentially conflicting mission to promote safe and sound banking practices, while other agencies had a clear mission but limited tools and jurisdiction. Most critically in the run-up to the financial crisis, mortgage companies and other firms outside of the purview of bank regulation exploited that lack of clear accountability by selling mortgages and other products that were overly complicated and unsuited to borrowers' financial situation. Banks and thrifts followed suit, with disastrous results for consumers and the financial system.

This year, Congress, the Administration, and financial regulators have taken significant measures to address some of the most obvious inadequacies in our consumer protection framework. But these steps have focused on just two, albeit very important, product markets – credit cards and mortgages. We need comprehensive reform.

For that reason, we propose the creation of a single regulatory agency, a Consumer Financial Protection Agency (CFPA), with the authority and accountability to make sure that consumer protection regulations are written fairly and enforced vigorously. The CFPA should reduce gaps in federal supervision and enforcement; improve coordination with the states; set higher standards for financial intermediaries; and promote consistent regulation of similar products.

Consumer protection is a critical foundation for our financial system. It gives the public confidence that financial markets are fair and enables policy makers and regulators to maintain stability in regulation. Stable regulation, in turn, promotes growth, efficiency, and innovation over the long term. We propose legislative, regulatory, and

administrative reforms to promote transparency, simplicity, fairness, accountability, and access in the market for consumer financial products and services.

We also propose new authorities and resources for the Federal Trade Commission to protect consumers in a wide range of areas.

Finally, we propose new authorities for the Securities and Exchange Commission to protect investors, improve disclosure, raise standards, and increase enforcement.

IV. Provide the Government with the Tools it Needs to Manage Financial Crises

Over the past two years, the financial system has been threatened by the failure or near failure of some of the largest and most interconnected financial firms. Our current system already has strong procedures and expertise for handling the failure of banks, but when a bank holding company or other nonbank financial firm is in severe distress, there are currently only two options: obtain outside capital or file for bankruptcy. During most economic climates, these are suitable options that will not impact greater financial stability.

However, in stressed conditions it may prove difficult for distressed institutions to raise sufficient private capital. Thus, if a large, interconnected bank holding company or other nonbank financial firm nears failure during a financial crisis, there are only two untenable options: obtain emergency funding from the US government as in the case of AIG, or file for bankruptcy as in the case of Lehman Brothers. Neither of these options is acceptable for managing the resolution of the firm efficiently and effectively in a manner that limits the systemic risk with the least cost to the taxpayer.

We propose a new authority, modeled on the existing authority of the FDIC, that should allow the government to address the potential failure of a bank holding company or other nonbank financial firm when the stability of the financial system is at risk.

In order to improve accountability in the use of other crisis tools, we also propose that the Federal Reserve Board receive prior written approval from the Secretary of the Treasury for emergency lending under its “unusual and exigent circumstances” authority.

V. Raise International Regulatory Standards and Improve International Cooperation

As we have witnessed during this crisis, financial stress can spread easily and quickly across national boundaries. Yet, regulation is still set largely in a national context. Without consistent supervision and regulation, financial institutions will tend to move their activities to jurisdictions with looser standards, creating a race to the bottom and intensifying systemic risk for the entire global financial system.

The United States is playing a strong leadership role in efforts to coordinate international financial policy through the G-20, the Financial Stability Board, and the Basel Committee on Banking Supervision. We will use our leadership position in the international community to promote initiatives compatible with the domestic regulatory reforms described in this report.

Financial Regulatory Reform: A New Foundation

We will focus on reaching international consensus on four core issues: regulatory capital standards; oversight of global financial markets; supervision of internationally active financial firms; and crisis prevention and management.

At the April 2009 London Summit, the G-20 Leaders issued an eight-part declaration outlining a comprehensive plan for financial regulatory reform.

The domestic regulatory reform initiatives outlined in this report are consistent with the international commitments the United States has undertaken as part of the G-20 process, and we propose stronger regulatory standards in a number of areas.

SUMMARY OF RECOMMENDATIONS

Please refer to the main text for further details

I. PROMOTE ROBUST SUPERVISION AND REGULATION OF FINANCIAL FIRMS

A. Create a Financial Services Oversight Council

1. *We propose the creation of a Financial Services Oversight Council to facilitate information sharing and coordination, identify emerging risks, advise the Federal Reserve on the identification of firms whose failure could pose a threat to financial stability due to their combination of size, leverage, and interconnectedness (hereafter referred to as a Tier 1 FHC), and provide a forum for resolving jurisdictional disputes between regulators.*
 - a. *The membership of the Council should include (i) the Secretary of the Treasury, who shall serve as the Chairman; (ii) the Chairman of the Board of Governors of the Federal Reserve System; (iii) the Director of the National Bank Supervisor; (iv) the Director of the Consumer Financial Protection Agency; (v) the Chairman of the SEC; (vi) the Chairman of the CFTC; (vii) the Chairman of the FDIC; and (viii) the Director of the FHFA.*
 - b. *The Council should be supported by a permanent, full-time expert staff at Treasury. The staff should be responsible for providing the Council with the information and resources it needs to fulfill its responsibilities.*
2. *Our legislation will propose to give the Council the authority to gather information from any financial firm and the responsibility for referring emerging risks to the attention of regulators with the authority to respond.*

B. Implement Heightened Consolidated Supervision and Regulation of All Large, Interconnected Financial Firms

1. *Any financial firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed (Tier 1 FHC) should be subject to robust consolidated supervision and regulation, regardless of whether the firm owns an insured depository institution.*
2. *The Federal Reserve Board should have the authority and accountability for consolidated supervision and regulation of Tier 1 FHCs.*
3. *Our legislation will propose criteria that the Federal Reserve must consider in identifying Tier 1 FHCs.*
4. *The prudential standards for Tier 1 FHCs – including capital, liquidity and risk management standards – should be stricter and more conservative than those applicable to other financial firms to account for the greater risks that their potential failure would impose on the financial system.*
5. *Consolidated supervision of a Tier 1 FHC should extend to the parent company and to all of its subsidiaries – regulated and unregulated, U.S. and*

foreign. Functionally regulated and depository institution subsidiaries of a Tier 1 FHC should continue to be supervised and regulated primarily by their functional or bank regulator, as the case may be. The constraints that the Gramm-Leach-Bliley Act (GLB Act) introduced on the Federal Reserve's ability to require reports from, examine, or impose higher prudential requirements or more stringent activity restrictions on the functionally regulated or depository institution subsidiaries of FHCs should be removed.

- 6. Consolidated supervision of a Tier 1 FHC should be macroprudential in focus. That is, it should consider risk to the system as a whole.*
- 7. The Federal Reserve, in consultation with Treasury and external experts, should propose recommendations by October 1, 2009 to better align its structure and governance with its authorities and responsibilities.*

C. Strengthen Capital and Other Prudential Standards For All Banks and BHCs

- 1. Treasury will lead a working group, with participation by federal financial regulatory agencies and outside experts that will conduct a fundamental reassessment of existing regulatory capital requirements for banks and BHCs, including new Tier 1 FHCs. The working group will issue a report with its conclusions by December 31, 2009.*
- 2. Treasury will lead a working group, with participation by federal financial regulatory agencies and outside experts, that will conduct a fundamental reassessment of the supervision of banks and BHCs. The working group will issue a report with its conclusions by October 1, 2009.*
- 3. Federal regulators should issue standards and guidelines to better align executive compensation practices of financial firms with long-term shareholder value and to prevent compensation practices from providing incentives that could threaten the safety and soundness of supervised institutions. In addition, we will support legislation requiring all public companies to hold non-binding shareholder resolutions on the compensation packages of senior executive officers, as well as new requirements to make compensation committees more independent.*
- 4. Capital and management requirements for FHC status should not be limited to the subsidiary depository institution. All FHCs should be required to meet the capital and management requirements on a consolidated basis as well.*
- 5. The accounting standard setters (the FASB, the IASB, and the SEC) should review accounting standards to determine how financial firms should be required to employ more forward-looking loan loss provisioning practices that incorporate a broader range of available credit information. Fair value accounting rules also should be reviewed with the goal of identifying changes that could provide users of financial reports with both fair value information and greater transparency regarding the cash flows management expects to receive by holding investments.*

6. *Firewalls between banks and their affiliates should be strengthened to protect the federal safety net that supports banks and to better prevent spread of the subsidy inherent in the federal safety net to bank affiliates.*

D. Close Loopholes in Bank Regulation

1. *We propose the creation of a new federal government agency, the National Bank Supervisor (NBS), to conduct prudential supervision and regulation of all federally chartered depository institutions, and all federal branches and agencies of foreign banks.*
2. *We propose to eliminate the federal thrift charter, but to preserve its interstate branching rules and apply them to state and national banks.*
3. *All companies that control an insured depository institution, however organized, should be subject to robust consolidated supervision and regulation at the federal level by the Federal Reserve and should be subject to the nonbanking activity restrictions of the BHC Act. The policy of separating banking from commerce should be re-affirmed and strengthened. We must close loopholes in the BHC Act for thrift holding companies, industrial loan companies, credit card banks, trust companies, and grandfathered “nonbank” banks.*

E. Eliminate the SEC’s Programs for Consolidated Supervision

The SEC has ended its Consolidated Supervised Entity Program, under which it had been the holding company supervisor for companies such as Lehman Brothers and Bear Stearns. We propose also eliminating the SEC’s Supervised Investment Bank Holding Company program. Investment banking firms that seek consolidated supervision by a U.S. regulator should be subject to supervision and regulation by the Federal Reserve.

F. Require Hedge Funds and Other Private Pools of Capital to Register

All advisers to hedge funds (and other private pools of capital, including private equity funds and venture capital funds) whose assets under management exceed some modest threshold should be required to register with the SEC under the Investment Advisers Act. The advisers should be required to report information on the funds they manage that is sufficient to assess whether any fund poses a threat to financial stability.

G. Reduce the Susceptibility of Money Market Mutual Funds (MMFs) to Runs

The SEC should move forward with its plans to strengthen the regulatory framework around MMFs to reduce the credit and liquidity risk profile of individual MMFs and to make the MMF industry as a whole less susceptible to runs. The President’s Working Group on Financial Markets should prepare a report assessing whether more fundamental changes are necessary to further reduce the MMF industry’s susceptibility to runs, such as eliminating the ability of a MMF to use a stable net asset value or requiring MMFs to obtain access to reliable emergency liquidity facilities from private sources.

H. Enhance Oversight of the Insurance Sector

Our legislation will propose the establishment of the Office of National Insurance within Treasury to gather information, develop expertise, negotiate international agreements, and coordinate policy in the insurance sector. Treasury will support proposals to modernize and improve our system of insurance regulation in accordance with six principles outlined in the body of the report.

I. Determine the Future Role of the Government Sponsored Enterprises

Treasury and the Department of Housing and Urban Development, in consultation with other government agencies, will engage in a wide-ranging initiative to develop recommendations on the future of Fannie Mae and Freddie Mac, and the Federal Home Loan Bank system. We need to maintain the continued stability and strength of the GSEs during these difficult financial times. We will report to the Congress and the American public at the time of the President's 2011 Budget release.

II. ESTABLISH COMPREHENSIVE REGULATION OF FINANCIAL MARKETS

A. Strengthen Supervision and Regulation of Securitization Markets

- 1. Federal banking agencies should promulgate regulations that require originators or sponsors to retain an economic interest in a material portion of the credit risk of securitized credit exposures.*
- 2. Regulators should promulgate additional regulations to align compensation of market participants with longer term performance of the underlying loans.*
- 3. The SEC should continue its efforts to increase the transparency and standardization of securitization markets and be given clear authority to require robust reporting by issuers of asset backed securities (ABS).*
- 4. The SEC should continue its efforts to strengthen the regulation of credit rating agencies, including measures to promote robust policies and procedures that manage and disclose conflicts of interest, differentiate between structured and other products, and otherwise strengthen the integrity of the ratings process.*
- 5. Regulators should reduce their use of credit ratings in regulations and supervisory practices, wherever possible.*

B. Create Comprehensive Regulation of All OTC Derivatives, Including Credit Default Swaps (CDS)

All OTC derivatives markets, including CDS markets, should be subject to comprehensive regulation that addresses relevant public policy objectives: (1) preventing activities in those markets from posing risk to the financial system; (2) promoting the efficiency and transparency of those markets; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.

C. Harmonize Futures and Securities Regulation

The CFTC and the SEC should make recommendations to Congress for changes to statutes and regulations that would harmonize regulation of futures and securities.

D. Strengthen Oversight and of Systemically Important Payment, Clearing, and Settlement Systems and Related Activities

We recommend that Congress grant the Federal Reserve responsibility and authority to conduct oversight of systemically important payment, clearing and settlement systems, and activities of financial firms.

E. Strengthen Settlement Capabilities and Liquidity Resources of Systemically Important Payment, Clearing, and Settlement Systems

We recommend that Congress grant the Federal Reserve authority to provide systemically important payment, clearing, and settlement systems access to Reserve Bank accounts, financial services, and the discount window.

III. PROTECT CONSUMERS AND INVESTORS FROM FINANCIAL ABUSE

A. Create a New Consumer Financial Protection Agency

1. *We propose to create a single primary federal consumer protection supervisor to protect consumers of credit, savings, payment, and other consumer financial products and services, and to regulate providers of such products and services.*
2. *The CFPA should have broad jurisdiction to protect consumers in consumer financial products and services such as credit, savings, and payment products.*
3. *The CFPA should be an independent agency with stable, robust funding.*
4. *The CFPA should have sole rule-making authority for consumer financial protection statutes, as well as the ability to fill gaps through rule-making.*
5. *The CFPA should have supervisory and enforcement authority and jurisdiction over all persons covered by the statutes that it implements, including both insured depositories and the range of other firms not previously subject to comprehensive federal supervision, and it should work with the Department of Justice to enforce the statutes under its jurisdiction in federal court.*
6. *The CFPA should pursue measures to promote effective regulation, including conducting periodic reviews of regulations, an outside advisory council, and coordination with the Council.*
7. *The CFPA's strong rules would serve as a floor, not a ceiling. The states should have the ability to adopt and enforce stricter laws for institutions of all types, regardless of charter, and to enforce federal law concurrently with respect to institutions of all types, also regardless of charter.*
8. *The CFPA should coordinate enforcement efforts with the states.*

Financial Regulatory Reform: A New Foundation

9. *The CFPA should have a wide variety of tools to enable it to perform its functions effectively.*
 10. *The Federal Trade Commission should also be given better tools and additional resources to protect consumers.*
- B. Reforms of Consumer Protection**
1. *Transparency. We propose a new proactive approach to disclosure. The CFPA will be authorized to require that all disclosures and other communications with consumers be reasonable: balanced in their presentation of benefits, and clear and conspicuous in their identification of costs, penalties, and risks.*
 2. *Simplicity. We propose that the regulator be authorized to define standards for “plain vanilla” products that are simpler and have straightforward pricing. The CFPA should be authorized to require all providers and intermediaries to offer these products prominently, alongside whatever other lawful products they choose to offer.*
 3. *Fairness. Where efforts to improve transparency and simplicity prove inadequate to prevent unfair treatment and abuse, we propose that the CFPA be authorized to place tailored restrictions on product terms and provider practices, if the benefits outweigh the costs. Moreover, we propose to authorize the Agency to impose appropriate duties of care on financial intermediaries.*
 4. *Access. The Agency should enforce fair lending laws and the Community Reinvestment Act and otherwise seek to ensure that underserved consumers and communities have access to prudent financial services, lending, and investment.*
- C. Strengthen Investor Protection**
1. *The SEC should be given expanded authority to promote transparency in investor disclosures.*
 2. *The SEC should be given new tools to increase fairness for investors by establishing a fiduciary duty for broker-dealers offering investment advice and harmonizing the regulation of investment advisers and broker-dealers.*
 3. *Financial firms and public companies should be accountable to their clients and investors by expanding protections for whistleblowers, expanding sanctions available for enforcement, and requiring non-binding shareholder votes on executive pay plans.*
 4. *Under the leadership of the Financial Services Oversight Council, we propose the establishment of a Financial Consumer Coordinating Council with a broad membership of federal and state consumer protection agencies, and a permanent role for the SEC’s Investor Advisory Committee.*

5. *Promote retirement security for all Americans by strengthening employment-based and private retirement plans and encouraging adequate savings.*

IV. PROVIDE THE GOVERNMENT WITH THE TOOLS IT NEEDS TO MANAGE FINANCIAL CRISES

A. Create a Resolution Regime for Failing BHCs, Including Tier 1 FHCs

We recommend the creation of a resolution regime to avoid the disorderly resolution of failing BHCs, including Tier 1 FHCs, if a disorderly resolution would have serious adverse effects on the financial system or the economy. The regime would supplement (rather than replace) and be modeled on to the existing resolution regime for insured depository institutions under the Federal Deposit Insurance Act.

B. Amend the Federal Reserve’s Emergency Lending Authority

We will propose legislation to amend Section 13(3) of the Federal Reserve Act to require the prior written approval of the Secretary of the Treasury for any extensions of credit by the Federal Reserve to individuals, partnerships, or corporations in “unusual and exigent circumstances.”

V. RAISE INTERNATIONAL REGULATORY STANDARDS AND IMPROVE INTERNATIONAL COOPERATION

A. Strengthen the International Capital Framework

We recommend that the BCBS continue to modify and improve Basel II by refining the risk weights applicable to the trading book and securitized products, introducing a supplemental leverage ratio, and improving the definition of capital by the end of 2009. We also urge the BCBS to complete an in-depth review of the Basel II framework to mitigate its procyclical effects.

B. Improve the Oversight of Global Financial Markets

We urge national authorities to promote the standardization and improved oversight of credit derivative and other OTC derivative markets, in particular through the use of central counterparties, along the lines of the G-20 commitment, and to advance these goals through international coordination and cooperation.

C. Enhance Supervision of Internationally Active Financial Firms

We recommend that the FSB and national authorities implement G-20 commitments to strengthen arrangements for international cooperation on supervision of global financial firms through establishment and continued operational development of supervisory colleges.

D. Reform Crisis Prevention and Management Authorities and Procedures

We recommend that the BCBS expedite its work to improve cross-border resolution of global financial firms and develop recommendations by the end of 2009. We further urge national authorities to improve information-sharing

arrangements and implement the FSB principles for cross-border crisis management.

E. Strengthen the Financial Stability Board (FSB)

We recommend that the FSB complete its restructuring and institutionalize its new mandate to promote global financial stability by September 2009.

F. Strengthen Prudential Regulations

We recommend that the BCBS take steps to improve liquidity risk management standards for financial firms and that the FSB work with the BIS and standard setters to develop macroprudential tools.

G. Expand the Scope of Regulation

- 1. Determine the appropriate Tier 1 FHC definition and application of requirements for foreign financial firms.*
- 2. We urge national authorities to implement by the end of 2009 the G-20 commitment to require hedge funds or their managers to register and disclose appropriate information necessary to assess the systemic risk they pose individually or collectively*

H. Introduce Better Compensation Practices

In line with G-20 commitments, we urge each national authority to put guidelines in place to align compensation with long-term shareholder value and to promote compensation structures do not provide incentives for excessive risk taking. We recommend that the BCBS expediently integrate the FSB principles on compensation into its risk management guidance by the end of 2009.

I. Promote Stronger Standards in the Prudential Regulation, Money Laundering/Terrorist Financing, and Tax Information Exchange Areas

- 1. We urge the FSB to expeditiously establish and coordinate peer reviews to assess compliance and implementation of international regulatory standards, with priority attention on the international cooperation elements of prudential regulatory standards.*
- 2. The United States will work to implement the updated ICRG peer review process and work with partners in the FATF to address jurisdictions not complying with international AML/CFT standards.*

J. Improve Accounting Standards

- 1. We recommend that the accounting standard setters clarify and make consistent the application of fair value accounting standards, including the impairment of financial instruments, by the end of 2009.*
- 2. We recommend that the accounting standard setters improve accounting standards for loan loss provisioning by the end of 2009 that would make it more forward looking, as long as the transparency of financial statements is not compromised.*

Financial Regulatory Reform: A New Foundation

3. *We recommend that the accounting standard setters make substantial progress by the end of 2009 toward development of a single set of high quality global accounting standards.*

K. Tighten Oversight of Credit Rating Agencies

We urge national authorities to enhance their regulatory regimes to effectively oversee credit rating agencies (CRAs), consistent with international standards and the G-20 Leaders' recommendations.

I. PROMOTE ROBUST SUPERVISION AND REGULATION OF FINANCIAL FIRMS

In the years leading up to the current financial crisis, risks built up dangerously in our financial system. Rising asset prices, particularly in housing, concealed a sharp deterioration of underwriting standards for loans. The nation's largest financial firms, already highly leveraged, became increasingly dependent on unstable sources of short-term funding. In many cases, weaknesses in firms' risk-management systems left them unaware of the aggregate risk exposures on and off their balance sheets. A credit boom accompanied a housing bubble. Taking access to short-term credit for granted, firms did not plan for the potential demands on their liquidity during a crisis. When asset prices started to fall and market liquidity froze, firms were forced to pull back from lending, limiting credit for households and businesses.

Our supervisory framework was not equipped to handle a crisis of this magnitude. To be sure, most of the largest, most interconnected, and most highly leveraged financial firms in the country were subject to some form of supervision and regulation by a federal government agency. But those forms of supervision and regulation proved inadequate and inconsistent.

First, capital and liquidity requirements were simply too low. Regulators did not require firms to hold sufficient capital to cover trading assets, high-risk loans, and off-balance sheet commitments, or to hold increased capital during good times to prepare for bad times. Regulators did not require firms to plan for a scenario in which the availability of liquidity was sharply curtailed.

Second, on a systemic basis, regulators did not take into account the harm that large, interconnected, and highly leveraged institutions could inflict on the financial system and on the economy if they failed.

Third, the responsibility for supervising the consolidated operations of large financial firms was split among various federal agencies. Fragmentation of supervisory responsibility and loopholes in the legal definition of a "bank" allowed owners of banks and other insured depository institutions to shop for the regulator of their choice.

Fourth, investment banks operated with insufficient government oversight. Money market mutual funds were vulnerable to runs. Hedge funds and other private pools of capital operated completely outside of the supervisory framework.

To create a new foundation for the regulation of financial institutions, we will promote more robust and consistent regulatory standards for all financial institutions. Similar financial institutions should face the same supervisory and regulatory standards, with no gaps, loopholes, or opportunities for arbitrage.

We propose the creation of a Financial Services Oversight Council, chaired by Treasury, to help fill gaps in supervision, facilitate coordination of policy and resolution of disputes, and identify emerging risks in firms and market activities. This Council would include the heads of the principal federal financial regulators and would maintain a permanent staff at Treasury.

We propose an evolution in the Federal Reserve's current supervisory authority for BHCs to create a single point of accountability for the consolidated supervision of all companies that own a bank. All large, interconnected firms whose failure could threaten the stability of the system should be subject to consolidated supervision by the Federal Reserve, regardless of whether they own an insured depository institution. These firms should not be able to escape oversight of their risky activities by manipulating their legal structure.

Under our proposals, the largest, most interconnected, and highly leveraged institutions would face stricter prudential regulation than other regulated firms, including higher capital requirements and more robust consolidated supervision. In effect, our proposals would compel these firms to internalize the costs they could impose on society in the event of failure.

A. Create a Financial Services Oversight Council

- 1. We propose the creation of a Financial Services Oversight Council to facilitate information sharing and coordination, identify emerging risks, advise the Federal Reserve on the identification of firms whose failure could pose a threat to financial stability due to their combination of size, leverage, and interconnectedness (hereafter referred to as a Tier 1 FHC), and provide a forum for discussion of cross-cutting issues among regulators.***

We propose the creation of a permanent Financial Services Oversight Council (Council) to facilitate interagency discussion and analysis of financial regulatory policy issues to support a consistent well-informed response to emerging trends, potential regulatory gaps, and issues that cut across jurisdictions.

The membership of the Council should include (i) the Secretary of the Treasury, who shall serve as the Chairman; (ii) the Chairman of the Board of Governors of the Federal Reserve System; (iii) the Director of the National Bank Supervisor (NBS) (Described below in Section I.D.); (iv) the Director of the Consumer Financial Protection Agency (Described below in Section III.A.); (v) the Chairman of the Securities and Exchange Commission (SEC); (vi) the Chairman of the Commodity Futures Trading Commission (CFTC); (vii) the Chairman of the Federal Deposit Insurance Corporation (FDIC); and (viii) the Director of the Federal Housing Finance Agency (FHFA). To fulfill its mission, we propose to create an office within Treasury that will provide full-time, expert staff support to the missions of the Council.

The Council should replace the President's Working Group on Financial Markets and have additional authorities and responsibilities with respect to systemic risk and coordination of financial regulation. We propose that the Council should:

- facilitate information sharing and coordination among the principal federal financial regulatory agencies regarding policy development, rulemakings, examinations, reporting requirements, and enforcement actions;
- provide a forum for discussion of cross-cutting issues among the principal federal financial regulatory agencies; and

- identify gaps in regulation and prepare an annual report to Congress on market developments and potential emerging risks.

The Council should have authority to recommend firms that will be subject to Tier 1 FHC supervision and regulation. The Federal Reserve should also be required to consult with the Council in setting material prudential standards for Tier 1 FHCs and in setting risk-management standards for systemically important payment, clearing, and settlement systems and activities. As described below, a subset of the Council's membership should be responsible for determining whether to invoke resolution authority with respect to large, interconnected firms.

2. *Our legislation will propose to give the Council the authority to gather information from any financial firm and the responsibility for referring emerging risks to the attention of regulators with the authority to respond.*

The jurisdictional boundaries among new and existing federal financial regulatory agencies should be drawn carefully to prevent mission overlap, and each of the federal financial regulatory agencies generally should have exclusive jurisdiction to issue and enforce rules to achieve its mission. Nevertheless, many emerging financial products and practices will raise issues relating to systemic risk, prudential regulation of financial firms, and consumer or investor protection.

To enable the monitoring of emerging threats that activities in financial markets may pose to financial stability, we propose that the Council have the authority, through its permanent secretariat in Treasury, to require periodic and other reports from any U.S. financial firm solely for the purpose of assessing the extent to which a financial activity or financial market in which the firm participates poses a threat to financial stability. In the case of federally regulated firms, the Council should, wherever possible, rely upon information that is already being collected by members of the Council in their role as regulators.

B. Implement Heightened Consolidated Supervision and Regulation of All Large, Interconnected Financial Firms

1. *Any financial firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed (Tier 1 FHC) should be subject to robust consolidated supervision and regulation, regardless of whether the firm owns an insured depository institution.*

The sudden failures of large U.S.-based investment banks and of American International Group (AIG) were among the most destabilizing events of the financial crisis. These companies were large, highly leveraged, and had significant financial connections to the other major players in our financial system, yet they were ineffectively supervised and regulated. As a consequence, they did not have sufficient capital or liquidity buffers to withstand the deterioration in financial conditions that occurred during 2008. Although most of these firms owned federally insured depository institutions, they chose to own depository institutions that are not considered "banks" under the Bank Holding Company

(BHC) Act. This allowed them to avoid the more rigorous oversight regime applicable to BHCs.

We propose a new, more robust supervisory regime for any firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed. Such firms, which we identify as Tier 1 Financial Holding Companies (Tier 1 FHCs), should be subject to robust consolidated supervision and regulation, regardless of whether they are currently supervised as BHCs.

2. The Federal Reserve Board should have the authority and accountability for consolidated supervision and regulation of Tier 1 FHCs.

We propose that authority for supervision and regulation of Tier 1 FHCs be vested in the Federal Reserve Board, which is by statute the consolidated supervisor and regulator of all bank holding companies today. As a result of changes in corporate structure during the current crisis, the Federal Reserve already supervises and regulates all major U.S. commercial and investment banks on a firm-wide basis. The Federal Reserve has by far the most experience and resources to handle consolidated supervision and regulation of Tier 1 FHCs.

The Council should play an important role in recommending the identification of firms that will be subject to regulation as Tier 1 FHCs. The Federal Reserve should also be required to consult with the Council in setting material prudential standards for Tier 1 FHCs.

The ultimate responsibility for prudential standard-setting and supervision for Tier 1 FHCs must rest with a single regulator. The public has a right to expect that a clearly identifiable entity, not a committee of multiple agencies, will be answerable for setting standards that will protect the financial system and the public from risks posed by the potential failure of Tier 1 FHCs. Moreover, a committee that included regulators of specific types of financial institutions such as commercial banks or broker-dealers (functional regulators) may be less focused on systemic needs and more focused on the needs of the financial firms they regulate. For example, to promote financial stability, the supervisor of a Tier 1 FHC may hold that firm's subsidiaries to stricter prudential standards than would be required by the functional regulator, whose focus is only on keeping that particular subsidiary safe.

Diffusing responsibility among several regulators would weaken incentives for effective regulation in other ways. For example, it would weaken both the incentive for and the ability of the relevant agencies to act in a timely fashion – creating the risk that clearly ineffective standards remain in place for long periods.

The Federal Reserve should fundamentally adjust its current framework for supervising all BHCs in order to carry out its new responsibilities effectively with respect to Tier 1 FHCs. For example, the focus of BHC regulation would need to expand beyond the safety and soundness of the bank subsidiary to include the activities of the firm as a whole and the risks the firm might pose to the financial system. The Federal Reserve would also need to develop new supervisory approaches for activities that to date have not been significant activities for most BHCs.

3. *Our legislation will propose criteria that the Federal Reserve must consider in identifying Tier 1 FHCs.*

We recommend that legislation specify factors that the Federal Reserve must consider when determining whether an individual financial firm poses a threat to financial stability. Those factors should include:

- the impact the firm’s failure would have on the financial system and the economy;
- the firm’s combination of size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding; and
- the firm’s criticality as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the financial system.

We propose that the Federal Reserve establish rules, in consultation with Treasury, to guide the identification of Tier 1 FHCs. The Federal Reserve, however, should be allowed to consider other relevant factors and exercise discretion in applying the specified factors to individual financial firms. Treasury would have no role in determining the application of these rules to individual financial firms. This discretion would allow the regulatory system to adapt to inevitable innovations in financial activity and in the organizational structure of financial firms. In addition, without this discretion, large, highly leveraged, and interconnected firms that should be subject to consolidated supervision and regulation as Tier 1 FHCs might be able to escape the regime. For instance, if the Federal Reserve were to treat as a Tier 1 FHC only those firms with balance-sheet assets above a certain amount, firms would have incentives to conduct activities through off-balance sheet transactions and in off-balance sheet vehicles. Flexibility is essential to minimizing the risk that an “AIG-like” firm could grow outside the regulated system.

In identifying Tier 1 FHCs, the Federal Reserve should analyze the systemic importance of a firm under stressed economic conditions. This analysis should consider the impact the firm’s failure would have on other large financial institutions, on payment, clearing and settlement systems, and on the availability of credit in the economy. In the case of a firm that has one or more subsidiaries subject to prudential regulation by other federal regulators, the Federal Reserve should be required to consult with those regulators before requiring the firm to be regulated as a Tier 1 FHC. The Federal Reserve should regularly review the classification of firms as Tier 1 FHCs. The Council should have the authority to receive information from its members and to recommend to the Federal Reserve that a firm be designated as a Tier 1 FHC, as described above.

To enable the Federal Reserve to identify financial firms other than BHCs that require supervision and regulation as Tier 1 FHCs, we recommend that Congress authorize the Federal Reserve to collect periodic and other reports from all U.S. financial firms that meet certain minimum size thresholds. The Federal Reserve’s authority to require reports from a financial firm would be limited to reports that contain information reasonably necessary to determine whether the firm is a Tier 1 FHC. In the case of firms that are subject to federal regulation, the Federal Reserve should have access to relevant reports

submitted to other regulators, and its authority to require reports should be limited to information that cannot be obtained from reports to other regulators.

The Federal Reserve also should have the ability to examine any U.S. financial firm that meets certain minimum size thresholds if the Federal Reserve is unable to determine whether the firm's financial activities pose a threat to financial stability based on regulatory reports, discussions with management, and publicly available information. The scope of the Federal Reserve's examination authority over a financial firm would be strictly limited to examinations reasonably necessary to enable the Federal Reserve to determine whether the firm is a Tier 1 FHC.

4. The prudential standards for Tier 1 FHCs – including capital, liquidity and risk management standards – should be stricter and more conservative than those applicable to other financial firms to account for the greater risks that their potential failure would impose on the financial system.

Tier 1 FHCs should be subject to heightened supervision and regulation because of the greater risks their potential failure would pose to the financial system. At the same time, given the important role of Tier 1 FHCs in the financial system and the economy, setting their prudential standards too high could constrain long-term financial and economic growth. Therefore, the Federal Reserve, in consultation with the Council, should set prudential standards for Tier 1 FHCs to maximize financial stability at the lowest cost to long-term financial and economic growth.

Tier 1 FHCs should, at a minimum, be required to meet the qualification requirements for FHC status (as revised in this proposal and discussed in more detail below).

Capital Requirements. Capital requirements for Tier 1 FHCs should reflect the large negative externalities associated with the financial distress, rapid deleveraging, or disorderly failure of each firm and should, therefore, be strict enough to be effective under extremely stressful economic and financial conditions. Tier 1 FHCs should be required to have enough high-quality capital during good economic times to keep them above prudential minimum capital requirements during stressed economic times. In addition to regulatory capital ratios, the Federal Reserve should evaluate a Tier 1 FHC's capital strength using supervisory assessments, including assessments of capital adequacy under severe stress scenarios and assessments of the firm's capital planning practices, and market-based indicators of the firm's credit quality.

Prompt Corrective Action. Tier 1 FHCs should be subject to a prompt corrective action regime that would require the firm or its supervisor to take corrective actions as the firm's regulatory capital levels decline, similar to the existing prompt corrective action regime for insured depository institutions established under the Federal Deposit Insurance Corporation Improvement Act (FDICIA).

Liquidity Standards. The Federal Reserve should impose rigorous liquidity risk requirements on Tier 1 FHCs that recognize the potential negative impact that the financial distress, rapid deleveraging, or disorderly failure of each firm would have on the financial system. The Federal Reserve should put in place a robust process for

continuously monitoring the liquidity risk profiles of these institutions and their liquidity risk management processes.

Federal Reserve supervision should promote the full integration of liquidity risk management of Tier 1 FHCs into the overall risk management of the institution. The Federal Reserve should also establish explicit internal liquidity risk exposure limits and risk management policies. Tier 1 FHCs should have sound processes for monitoring and controlling the full range of their liquidity risks. They should regularly conduct stress tests across a variety of liquidity stress scenarios, including short-term and protracted scenarios and institution-specific and market-wide scenarios. The stress tests should incorporate both on- and off-balance sheet exposures, including non-contractual off-balance sheet obligations.

Overall Risk Management. Supervisory expectations regarding Tier 1 FHCs' risk-management practices must be in proportion to the risk, complexity, and scope of their operations. These firms should be able to identify firm-wide risk concentrations (credit, business lines, liquidity, and other) and establish appropriate limits and controls around these concentrations. In order to credibly measure and monitor risk concentrations, Tier 1 FHCs must be able to identify aggregate exposures quickly on a firm-wide basis.

Market Discipline and Disclosure. To support market evaluation of a Tier 1 FHC's risk profile, capital adequacy, and risk management capabilities, such firms should be required to make enhanced public disclosures.

Restrictions on Nonfinancial Activities. Tier 1 FHCs that do not control insured depository institutions should be subject to the full range of prudential regulations and supervisory guidance applicable to BHCs. In addition, the long-standing wall between banking and commerce – which has served our economy well – should be extended to apply to this new class of financial firm. Accordingly, each Tier 1 FHC also should be required to comply with the nonfinancial activity restrictions of the BHC Act, regardless of whether it controls an insured depository institution. We propose that a Tier 1 FHC that has not been previously subject to the BHC Act should be given five years to conform to the existing activity restrictions imposed on FHCs by the BHC Act.

Rapid Resolution Plans. The Federal Reserve also should require each Tier 1 FHC to prepare and continuously update a credible plan for the rapid resolution of the firm in the event of severe financial distress. Such a requirement would create incentives for the firm to better monitor and simplify its organizational structure and would better prepare the government, as well as the firm's investors, creditors, and counterparties, in the event that the firm collapsed. The Federal Reserve should review the adequacy of each firm's plan regularly.

- 5. Consolidated supervision of a Tier 1 FHC should extend to the parent company and to all of its subsidiaries – regulated and unregulated, U.S. and foreign. Functionally regulated and depository institution subsidiaries of a Tier 1 FHC should continue to be supervised and regulated primarily by their functional or bank regulator, as the case may be. The constraints that the Gramm-Leach-Bliley Act (GLB Act) introduced on the Federal Reserve's ability to require reports from, examine, or impose higher***

prudential requirements or more stringent activity restrictions on the functionally regulated or depository institution subsidiaries of FHCs should be removed.

The financial crisis has demonstrated the crucial importance of having a consolidated supervisor and regulator for all Tier 1 FHCs with a deep understanding of the operations of each firm. The crisis has made clear that threats to a consolidated financial firm and threats to financial stability can emerge from any business line and any subsidiary. It is not reasonable to hold the functional regulator of a single subsidiary responsible for identifying or managing risks that cut across many different subsidiaries and business lines.

The GLB Act impedes the Federal Reserve's ability, as a consolidated supervisor, to obtain information from or impose prudential restrictions on subsidiaries of a BHC that already have a primary supervisor, including banks and other insured depository institutions; SEC-registered broker-dealers, investment advisers and investment companies; entities regulated by the CFTC; and insurance companies subject to supervision by state insurance supervisors. By relying solely on other supervisors for information and for ensuring that the activities of the regulated subsidiary do not cause excessive risk to the financial system, these restrictions also make it difficult to take a truly firm-wide perspective on a BHC and to execute its responsibility to protect the system as a whole.

To promote accountability in supervision and regulation, the Federal Reserve should have authority to require reports from and conduct examinations of a Tier 1 FHC and all its subsidiaries, including those that have a primary supervisor. To the extent possible, information should be gathered from reports required or exams conducted by other supervisors. The Federal Reserve should also have the authority to impose and enforce more stringent prudential requirements on the regulated subsidiary of a Tier 1 FHC to address systemic risk concerns, but only after consulting with that subsidiary's primary federal or state supervisor and Treasury.

6. Consolidated supervision of a Tier 1 FHC should be macroprudential in focus. That is, it should consider risk to the system as a whole.

Prudential supervision has historically focused on the safety and soundness of individual financial firms, or, in the case of BHCs, on the risks that an organization's non-depository subsidiaries pose to its depository institution subsidiaries. The financial crisis has demonstrated that a narrow supervisory focus on the safety and soundness of individual financial firms can result in a failure to detect and thwart emerging threats to financial stability that cut across many institutions or have other systemic implications. Going forward, the consolidated supervisor of Tier 1 FHCs should continue to employ enhanced forms of its normal supervisory tools, but should supplement those tools with rigorous assessments of the potential impact of the activities and risk exposures of these companies on each other, on critical markets, and on the broader financial system.

The Federal Reserve should continuously analyze the connections among the major financial firms and the dependence of the major financial markets on such firms, in order to track potential impact on the broader financial system. To conduct this analysis, the

Federal Reserve should require each Tier 1 FHC to regularly report the nature and extent to which other major financial firms are exposed to it. In addition, the Federal Reserve should constantly monitor the build-up of concentrations of risk across all Tier 1 FHCs that may collectively threaten financial stability – even though no single firm, viewed in isolation, may appear at risk.

7. The Federal Reserve, in consultation with Treasury and external experts, should propose recommendations by October 1, 2009 to better align its structure and governance with its authorities and responsibilities.

This report proposes a number of major changes to the formal powers and duties of the Federal Reserve System, including the addition of several new financial stability responsibilities and a reduction in its consumer protection role. These proposals would put into effect the biggest changes to the Federal Reserve’s authority in decades.

For that reason, we propose a comprehensive review of the ways in which the structure and governance of the Federal Reserve System affect its ability to accomplish its existing and proposed functions. This review should include, among other things, the governance of the Federal Reserve Banks and the role of Reserve Bank boards in supervision and regulation. This review should be led by the Federal Reserve Board, but to promote a diversity of views within and without government, Treasury and a wide range of external experts should have substantial input into the review and resulting report. Once the report is issued, Treasury will consider the recommendations in the report and will propose any changes to the governance and structure of the Federal Reserve that are appropriate to improve its accountability and its capacity to achieve its statutory responsibilities.

C. Strengthen Capital and Other Prudential Standards Applicable to All Banks and BHCs

1. Treasury will lead a working group, with participation by federal financial regulatory agencies and outside experts, that will conduct a fundamental reassessment of existing regulatory capital requirements for banks and BHCs, including new Tier 1 FHCs. The working group will issue a report with its conclusions by December 31, 2009.

Capital requirements have long been the principal regulatory tool to promote the safety and soundness of banking firms and the stability of the banking system. The capital rules in place at the inception of the financial crisis, however, simply did not require banking firms to hold enough capital in light of the risks the firms faced. Most banks that failed during this crisis were considered well-capitalized just prior to their failure.

The financial crisis highlighted a number of problems with our existing regulatory capital rules. Our capital rules do not require institutions to hold sufficient capital against implicit exposures to off-balance sheet vehicles, as was made clear by the actions many institutions took to support their structured investment vehicles, asset-backed commercial paper programs, and advised money market mutual funds. The capital rules provide insufficient coverage for the risks of trading assets and certain structured credit products.

In addition, many of the capital instruments that comprised the capital base of banks and BHCs did not have the loss-absorption capacity expected of them.

The financial crisis has demonstrated the need for a fundamental review of the regulatory capital framework for banks and BHCs. This review should be comprehensive and should cover all elements of the framework, including composition of capital, scope of risk coverage, relative risk weights, and calibration. In particular, the review should include:

- proposed changes to the capital rules to reduce procyclicality, for example, by requiring all banks and BHCs to hold enough high-quality capital during good economic times to keep them above prudential minimum capital requirements during stressed times;
- analysis of the costs, benefits, and feasibility of allowing banks and BHCs to satisfy a portion of their regulatory capital requirements through the issuance of contingent capital instruments (such as debt securities that automatically convert into common equity in stressed economic circumstances) or through the purchase of tail insurance against macroeconomic risks;
- proposed increases in regulatory capital requirements on investments and exposures that pose high levels of risk under stressed market conditions, including in particular: (i) trading positions; (ii) equity investments; (iii) credit exposures to low-credit-quality firms and persons; (iv) highly rated asset-backed securities (ABS) and mortgage-backed securities (MBS); (v) explicit and implicit exposures to sponsored off-balance sheet vehicles; and (vi) OTC derivatives that are not centrally cleared; and
- recognition of the importance of a simpler, more transparent measure of leverage for banks and BHCs to supplement the risk-based capital measures.

As a general rule, banks and BHCs should be subject to a risk-based capital rule that covers all lines of business, assesses capital adequacy relative to appropriate measures of the relative risk of various types of exposures, is transparent and comparable across firms, and is credible and enforceable.

We also support the Basel Committee's efforts to improve the Basel II Capital Accord, as discussed in Section V.

2. Treasury will lead a working group, with participation by federal financial regulatory agencies and outside experts, that will conduct a fundamental reassessment of the supervision of banks and BHCs. The working group will issue a report with its conclusions by October 1, 2009.

As noted above, many of the large and complex financial firms that failed or approached the brink of failure in the recent financial crisis were subject to supervision and regulation by a federal government agency. Ensuring that financial firms do not take excessive risks requires the establishment and enforcement of strong prudential rules. Financial firms, however, often can navigate around generally applicable rules. A strong supervisor is

needed to enforce rules and to monitor individual firms' risk taking and risk management practices.

The working group will undertake a review and analysis of lessons learned about banking supervision and regulation from the recent financial crisis, addressing issues such as:

- how to effectively conduct continuous, on-site supervision of large, complex banking firms;
- what information supervisors must obtain from regulated firms on a regular basis;
- how functional and bank supervisors should interact with consolidated holding company supervisors;
- how federal and state supervisors should coordinate with foreign supervisors in the supervision of multi-national banking firms;
- the extent to which supervision of smaller, simpler banking firms should differ from supervision of larger, more complex firms;
- how supervisory agencies should be funded and structured, keeping in mind that the funding structure can seriously impact regulatory competition and potentially lead to regulatory capture; and
- the costs and benefits of having supervisory agencies that also conduct other governmental functions, such as deposit insurance, consumer protection, or monetary policy.

3. *Federal regulators should issue standards and guidelines to better align executive compensation practices of financial firms with long-term shareholder value and to prevent compensation practices from providing incentives that could threaten the safety and soundness of supervised institutions. In addition, we will support legislation requiring all public companies to hold non-binding shareholder resolutions on the compensation packages of senior executive officers, as well as new requirements to make compensation committees more independent.*

Among the many significant causes of the financial crisis were compensation practices. In particular, incentives for short-term gains overwhelmed the checks and balances meant to mitigate against the risk of excess leverage. We will seek to better align compensation practices with the interests of shareholders and the stability of firms and the financial system through the following five principles. First, compensation plans should properly measure and reward performance. Second, compensation should be structured to account for the time horizon of risks. Third, compensation practices should be aligned with sound risk management. Fourth, golden parachutes and supplemental retirement packages should be reexamined to determine whether they align the interests of executives and shareholders. Finally, transparency and accountability should be promoted in the process of setting compensation.

As part of this effort, Treasury will support federal regulators, including the Federal Reserve, the SEC, and the federal banking regulators in laying out standards on

compensation for financial firms that will be fully integrated into the supervisory process. These efforts recognize that an important component of risk management involves properly aligning incentives, and that properly designed compensation practices for both executives and employees are a necessary part of ensuring safety and soundness in the financial sector. We will also ask the President's Working Group on Financial Markets (and the Council when it is established to replace the PWG) to perform a review of compensation practices to monitor their impact on risk-taking, with a focus on identifying whether new trends might be creating risks that would otherwise go unseen.

These standards will be supplemented by increased disclosure requirements from the SEC as well as proposed legislation in two areas to increase transparency and accountability in setting executive compensation.

First, we will work with Congress to pass "say on pay" legislation – further discussed in a later section – that will require all public companies to offer an annual non-binding vote on compensation packages for senior executive officers.

Additionally, we will propose legislation giving the SEC the power to require that compensation committees are more independent. Under this legislation, compensation committees would be given the responsibility and the resources to hire their own independent compensation consultants and outside counsel. The legislation would also direct the SEC to create standards for ensuring the independence of compensation consultants, providing shareholders with the confidence that the compensation committee is receiving objective, expert advice.

- 4. Capital and management requirements for FHC status should not be limited to the subsidiary depository institution. All FHCs should be required to meet the capital and management requirements on a consolidated basis as well.***

The GLB Act currently requires a BHC to keep its subsidiary depository institutions "well-capitalized" and "well-managed" in order to qualify as a financial holding company (FHC) and thereby engage in riskier financial activities such as merchant banking, insurance underwriting, and securities underwriting and dealing. The GLB Act does not, however, require an FHC to be "well-capitalized" or "well-managed" on a consolidated basis. As a result, many of the BHCs that were most active in volatile capital markets activities were not held to the highest consolidated regulatory capital standard available.

We propose that, in addition to the current FHC eligibility requirements, all FHCs should be required to achieve and maintain well-capitalized and well-managed status on a consolidated basis. The specific capital standards should be determined in line with the results of the capital review recommended previously in this report.

- 5. The accounting standard setters – the Financial Accounting Standards Board (FASB), the International Accounting Standards Board (IASB), and the SEC – should review accounting standards to determine how financial firms should be required to employ more forward-looking loan loss provisioning practices that incorporate a broader range of available credit***

information. Fair value accounting rules also should be reviewed with the goal of identifying changes that could provide users of financial reports with both fair value information and greater transparency regarding the cash flows management expects to receive by holding investments.

Certain aspects of accounting standards have had procyclical tendencies, meaning that they have tended to amplify business cycles. For example, during good times, loan loss reserves tend to decline because recent historical losses are low. In determining their loan loss reserves, firms should be required to be more forward-looking and consider factors that would cause loan losses to differ from recent historical experience. This would likely result in recognition of higher provisions earlier in the credit cycle. During the current crisis, such earlier loss recognition could have reduced procyclicality, while still providing necessary transparency to users of financial reports on changes in credit trends. Similarly, the interpretation and application of fair value accounting standards during the crisis raised significant procyclicality concerns.

6. Firewalls between banks and their affiliates should be strengthened to protect the federal safety net that supports banks and to better prevent spread of the subsidy inherent in the federal safety net to bank affiliates.

Sections 23A and 23B of the Federal Reserve Act are designed to protect a depository institution from suffering losses in its transactions with affiliates. These provisions also limit the ability of a depository institution to transfer to its affiliates the subsidy arising from the institution's access to the federal safety net, which includes FDIC deposit insurance, access to Federal Reserve liquidity, and access to Federal Reserve payment systems. Sections 23A and 23B accomplish these purposes by placing quantitative limits and collateral requirements on certain covered transactions between a bank and an affiliate and by requiring all financial transactions between a bank and an affiliate to be performed on market terms. The Federal Reserve administers these statutory provisions for all depository institutions and has the power to provide exemptions from these provisions.

The recent financial crisis has highlighted, more clearly than ever, the value of the federal subsidy associated with the banking charter, as well as the related value to a consolidated financial firm of owning a bank. Although the existing set of firewalls in sections 23A and 23B are strong, the framework can and should be strengthened further.

Holes in the existing set of federal restrictions on transactions between banks and their affiliates should be closed. Specifically, we propose that regulators should place more effective constraints on the ability of banks to engage in over-the-counter (OTC) derivatives and securities financing transactions with affiliates. In addition, covered transactions between banks and their affiliates should be required to be fully collateralized throughout the life of the transactions. Moreover, the existing federal restrictions on transactions between banks and affiliates should be applied to transactions between a bank and all private investment vehicles sponsored or advised by the bank. The Federal Reserve's discretion to provide exemptions from the bank/affiliate firewalls also should be limited.

Finally, the Federal Reserve and the federal banking agencies should tighten the supervision and regulation of potential conflicts of interest generated by the affiliation of banks and other financial firms, such as proprietary trading units and hedge funds.

D. Closing Loopholes in Bank Regulation

- 1. We propose the creation of a new federal government agency, the National Bank Supervisor (NBS), to conduct prudential supervision and regulation of all federally chartered depository institutions, and all federal branches and agencies of foreign banks.***

One clear lesson learned from the recent crisis was that competition among different government agencies responsible for regulating similar financial firms led to reduced regulation in important parts of the financial system. The presence of multiple federal supervisors of firms that could easily change their charter led to weaker regulation and became a serious structural problem within our supervisory system.

We propose to establish a single federal agency dedicated to the chartering and prudential supervision and regulation of national banks and federal branches and agencies of foreign banks. This agency would take over the prudential responsibilities of the Office of the Comptroller of the Currency, which currently charters and supervises nationally chartered banks and federal branches and agencies of foreign banks, and responsibility for the institutions currently supervised by the Office of Thrift Supervision, which supervises federally chartered thrifts and thrift holding companies. As described below, we propose to eliminate the thrift charter. The nature and extent of prudential supervision and regulation of a federally chartered depository institution should no longer be a function of whether a firm conducts its business as a national bank or a federal thrift.

To accomplish its mission effectively, the NBS should inherit the OCC's and OTS's authorities to require reports, conduct examinations, impose and enforce prudential requirements, and conduct overall supervision. The new agency should be given all the tools, authorities, and financial, technical, and human resources needed to ensure that our federally chartered banks, branches, and agencies are subject to the strongest possible supervision and regulation.

The NBS should be an agency with separate status within Treasury and should be led by a single executive.

Under our proposal, the Federal Reserve and the FDIC would maintain their respective roles in the supervision and regulation of state-chartered banks, and the National Credit Union Administration (NCUA) would maintain its authorities for credit unions.

- 2. We propose to eliminate the federal thrift charter, but to preserve its interstate branching rules and apply them to state and national banks.***

Federal Thrift Charter

Congress created the federal thrift charter in the Home Owners' Loan Act of 1933 in response to the extensive failures of state-chartered thrifts and the collapse of the broader financial system during the Great Depression. The rationale for federal thrifts as a specialized class of depository institutions focused on residential mortgage lending made

sense at the time but the case for such specialized institutions has weakened considerably in recent years. Moreover, over the past few decades, the powers of thrifts and banks have substantially converged.

As securitization markets for residential mortgages have grown, commercial banks have increased their appetite for mortgage lending, and the Federal Home Loan Bank System has expanded its membership base. Accordingly, the need for a special class of mortgage-focused depository institutions has fallen. Moreover, the fragility of thrifts has become readily apparent during the financial crisis. In part because thrifts are required by law to focus more of their lending on residential mortgages, thrifts were more vulnerable to the housing downturn that the United States has been experiencing since 2007. The availability of the federal thrift charter has created opportunities for private sector arbitrage of our financial regulatory system. We propose to eliminate the charter going forward, subject to reasonable transition arrangements.

Supervision and Regulation of National and State Banks

Our efforts to simplify and strengthen weak spots in our system of federal bank supervision and regulation will not end with the elimination of the federal thrift charter. Although FDICIA and other work by the federal banking agencies over the past few decades have substantially improved the uniformity of the regulatory framework for national banks, state member banks, and state nonmember banks, more work can and should be done in this area. To further minimize arbitrage opportunities associated with the multiple remaining bank charters and supervisors, we propose to further reduce the differences in the substantive regulations and supervisory policies applicable to national banks, state member banks, and state nonmember banks. We also propose to restrict the ability of troubled banks to switch charters and supervisors.

Interstate Branching

Federal thrifts enjoyed the unrestricted ability to branch across state lines. Banks do not always have that ability. Although many states have enacted legislation permitting interstate branching, many other states continue to require interstate entry only through the acquisition of an existing bank. This limitation on interstate branching is an obstacle to interstate operations for all banks and creates special problems for community banks seeking to operate across state lines.

We propose the elimination of the remaining restrictions on interstate branching by national and state banks. Interstate banking and branching is good for consumers, good for banks, and good for the broader economy. Permitting banks to expand across state lines improves their geographical diversification and, consequently, their resilience in the face of local economic shocks. Competition through interstate branching also makes the banking system more efficient – improving consumer and business access to banking services in under-served markets, and increasing convenience for customers who live or work near state borders.

We propose that states should not be allowed to prevent de novo branching into their states, or to impose a minimum requirement on the age of in-state banks that can be

acquired by an out-of-state banking firm. All consumer protections and deposit concentration caps with respect to interstate banking should remain.

- 3. All companies that control an insured depository institution, however organized, should be subject to robust consolidated supervision and regulation at the federal level by the Federal Reserve and should be subject to the nonbanking activity restrictions of the BHC Act. The policy of separating banking from commerce should be re-affirmed and strengthened. We must close loopholes in the BHC Act for thrift holding companies, industrial loan companies, credit card banks, trust companies, and grandfathered “nonbank” banks.***

The BHC Act currently requires, as a general matter, that any company that owns an insured depository institution must register as a BHC. BHCs are subject to consolidated supervision and regulation by the Federal Reserve and are subject to the nonbanking activity restrictions of the BHC Act. However, companies that own an FDIC-insured thrift, industrial loan company (ILC), credit card bank, trust company, or grandfathered depository institution are not required to become BHCs.

Companies that own a thrift are required to submit to a more limited form of supervision and regulation by the OTS; companies that own an ILC, special-purpose credit card bank, trust company, or grandfathered depository institution are not required to submit to consolidated supervision and regulation of any kind.

As a result, by owning depository institutions that are not considered “banks” under the BHC Act, some investment banks (including the now defunct Bear Stearns and Lehman Brothers), insurance companies (including AIG), finance companies, commercial companies, and other firms have been able to obtain access to the federal safety net, while avoiding activity restrictions and more stringent consolidated supervision and regulation by the Federal Reserve under the BHC Act.

By escaping the BHC Act, these firms generally were able to evade effective, consolidated supervision and the long-standing federal policy of separating banking from commerce. Federal law has long prevented commercial banks from affiliating with commercial companies because of the conflicts of interest, biases in credit allocation, risks to the safety net, concentrations of economic power, and regulatory and supervisory difficulties generated by such affiliations. This policy has served our country well, and the wall between banking and commerce should be retained and strengthened. Such firms should be given five years to conform to the existing activity restrictions imposed by the BHC Act

In addition, these firms were able to build up excessive balance-sheet leverage and to take off-balance sheet risks with insufficient capital buffers because of the limited consolidated supervision and weaker or non-existent consolidated capital requirements at the holding company level. Their complex structures made them hard to supervise. Some of the very largest of these firms failed during the current crisis or avoided failure during the crisis only as a result of receiving extraordinary government support. In fact, some of these firms voluntarily chose to become BHCs, subject to Federal Reserve

supervision, in part to address concerns by creditors regarding the effectiveness of the alternative regulatory frameworks.

Thrift Holding Companies

Elimination of the thrift charter will eliminate the separate regime of supervision and regulation of thrift holding companies. Significant differences between thrift holding company and BHC supervision and regulation have created material arbitrage opportunities. For example, although the Federal Reserve imposes leverage and risk-based capital requirements on BHCs, the OTS does not impose any capital requirements on thrift holding companies, such as AIG. The intensity of supervision also has been greater for BHCs than thrift holding companies. Finally, although BHCs generally are prohibited from engaging in commercial activities, many thrift holding companies established before the GLB Act in 1999 qualify as unitary thrift holding companies and are permitted to engage freely in commercial activities. Under our plan, all thrift holding companies would become BHCs and would be fully regulated on a consolidated basis.

Industrial Loan Companies

Congress added the ILC exception to the BHC Act in 1987. At that time, ILCs were small, special-purpose banks that primarily engaged in the business of making small loans to industrial workers and had limited deposit-taking powers. Today, however, ILCs are FDIC-insured depository institutions that have authority to offer a full range of commercial banking services. Although ILCs closely resemble commercial banks, their holding companies can avoid the restrictions of the BHC Act – including consolidated supervision and regulation by the Federal Reserve – by complying with a BHC exception. Formation of an ILC has been a common way for commercial companies and financial firms (including large investment banks) to get access to the federal bank safety net but avoid the robust governmental supervision and activity restrictions of the BHC Act. Under our plan, holding companies of ILCs would become BHCs.

Credit Card Banks

Congress also added the special-purpose credit card bank exception to the BHC Act in 1987. Companies that own a credit card bank can avoid the restrictions of the BHC Act, engage in any commercial activity, and completely avoid consolidated supervision and regulation. Many of these companies use their bank to offer private-label cards to retail customers. They use their bank charter primarily to access payment systems and avoid state usury laws.

The credit card bank exception in the BHC Act provides significant competitive advantages to its beneficiaries. Credit card banks are also more vulnerable to conflicts of interest than most other banks because of their common status as captive financing units of commercial firms. A substantial proportion of the credit card loans made by such a bank provide direct benefits to its parent company. As with ILCs, the loophole for special-purpose credit card banks creates an unwarranted gap in the separation of banking and commerce and creates a supervisory “blind spot” because Federal Reserve supervision does not extend to the credit card bank holding company. Under our plan, holding companies of credit card banks would become BHCs.

Trust Companies

The BHC Act also exempts from the definition of “bank” an institution that functions solely in a trust or fiduciary capacity if: (i) all or substantially all of the institution’s deposits are in trust funds and are received in a bona fide fiduciary capacity; (ii) the institution does not accept demand deposits or transaction accounts or make commercial loans; and (iii) the institution does not obtain payment services or borrowing privileges from the Federal Reserve. Although these FDIC-insured trust companies enjoy less of the federal bank subsidy than full-service commercial banks, they do obtain material benefits from their status as FDIC-insured depository institutions. As a result, they should be treated as banks for purposes of the BHC Act, and their parent holding companies should be supervised and regulated as BHCs. Under our plan, holding companies of trust companies would become BHCs.

“Nonbank Banks”

When Congress amended the definition of “bank” in the BHC Act in 1987, it grandfathered a number of companies that controlled depository institutions that became a “bank” solely as a result of the 1987 amendments. As a result, the holding companies of these so-called “nonbank banks” are not treated as BHCs for purposes of the BHC Act. Although few of these companies remain today, there is no economic justification for allowing these companies to continue to escape the activity restrictions and consolidated supervision and regulation requirements of the BHC Act. Under our plan, holding companies of “nonbank banks” would become BHCs.

E. Eliminate the SEC’s Programs for Consolidated Supervision

The SEC has ended its Consolidated Supervised Entity Program, under which it had been the holding company supervisor for companies such as Lehman Brothers and Bear Stearns. We propose also eliminating the SEC’s Supervised Investment Bank Holding Company program. Investment banking firms that seek consolidated supervision by a U.S. regulator should be subject to supervision and regulation by the Federal Reserve.

Section 17(i) of the Securities Exchange Act of 1934 (Exchange Act), enacted as part of the GLB Act, requires the SEC to permit investment bank holding companies to elect for consolidated supervision by the SEC. In 2004, the SEC adopted two consolidated supervision regimes for companies that own an SEC-registered securities broker or dealer – one for “consolidated supervised entities” (CSEs) and the other for “supervised investment bank holding companies” (SIBHCs). The major stand-alone investment banks (and several large commercial banking organizations) opted into either the CSE regime or the SIBHC regime. The stand-alone investment banks that opted into one of these regimes generally did so to demonstrate to European regulators that they were subject to consolidated supervision by a U.S. federal regulator.

The two regimes were substantially the same, although the CSE structure was designed for the largest securities firms. Under both regimes, supervised entities are required to submit to SEC examinations and to comply with SEC requirements on reporting, regulatory capital calculation, internal risk management systems, and recordkeeping.

In light of the failure or acquisition of three of the major stand-alone investment banks supervised as CSEs, and the transformation of the remaining major investment banks into BHCs supervised by the Federal Reserve, the SEC abandoned its voluntary CSE regime in the fall of 2008. The SIBHC regime, required by section 17(i) of the Exchange Act, remains in place, with only one entity currently subject to supervision under that regime.

The SEC's remaining consolidated supervision program for investment bank holding companies should be eliminated. Investment banking firms that seek consolidated supervision by a U.S. regulator should be subject to comprehensive supervision and regulation by the Federal Reserve.

F. Require Hedge Funds and Other Private Pools of Capital to Register

All advisers to hedge funds (and other private pools of capital, including private equity funds and venture capital funds) whose assets under management exceed some modest threshold should be required to register with the SEC under the Investment Advisers Act. The advisers should be required to report information on the funds they manage that is sufficient to assess whether any fund poses a threat to financial stability.

In recent years, the United States has seen explosive growth in a variety of privately-owned investment funds, including hedge funds, private equity funds, and venture capital funds. Although some private investment funds that trade commodity derivatives must register with the CFTC, and many funds register voluntarily with the SEC, U.S. law generally does not require such funds to register with a federal financial regulator. At various points in the financial crisis, de-leveraging by hedge funds contributed to the strain on financial markets. Since these funds were not required to register with regulators, however, the government lacked reliable, comprehensive data with which to assess this sort of market activity. In addition to the need to gather information in order to assess potential systemic implications of the activity of hedge funds and other private pools of capital, it has also become clear that there is a compelling investor protection rationale to fill the gaps in the regulation of investment advisors and the funds that they manage.

Requiring the SEC registration of investment advisers to hedge funds and other private pools of capital would allow data to be collected that would permit an informed assessment of how such funds are changing over time and whether any such funds have become so large, leveraged, or interconnected that they require regulation for financial stability purposes.

We further propose that all investment funds advised by an SEC-registered investment adviser should be subject to recordkeeping requirements; requirements with respect to disclosures to investors, creditors, and counterparties; and regulatory reporting requirements. The SEC should conduct regular, periodic examinations of such funds to monitor compliance with these requirements. Some of those requirements may vary across the different types of private pools. The regulatory reporting requirements for such funds should require reporting on a confidential basis of the amount of assets under management, borrowings, off-balance sheet exposures, and other information necessary to assess whether the fund or fund family is so large, highly leveraged, or interconnected

that it poses a threat to financial stability. The SEC should share the reports that it receives from the funds with the Federal Reserve. The Federal Reserve should determine whether any of the funds or fund families meet the Tier 1 FHC criteria. If so, those funds should be supervised and regulated as Tier 1 FHCs.

G. Reduce the Susceptibility of Money Market Mutual Funds (MMFs) to Runs

The SEC should move forward with its plans to strengthen the regulatory framework around MMFs to reduce the credit and liquidity risk profile of individual MMFs and to make the MMF industry as a whole less susceptible to runs. The President's Working Group on Financial Markets should prepare a report assessing whether more fundamental changes are necessary to further reduce the MMF industry's susceptibility to runs, such as eliminating the ability of a MMF to use a stable net asset value or requiring MMFs to obtain access to reliable emergency liquidity facilities from private sources.

When the aggressive pursuit of higher yield left one MMF vulnerable to the failure of Lehman Brothers and the fund “broke the buck,” it sparked a run on the entire MMF industry. This run resulted in severe liquidity pressures, not only on prime MMFs but also on banks and other financial institutions that relied significantly on MMFs for funding and on private money market participants generally. The run on MMFs was stopped only by introduction of Treasury's Temporary Guarantee Program for MMFs and new Federal Reserve liquidity facilities targeted at MMFs.

Even after the run stopped, for some time MMFs and other money market investors were unwilling to lend other than at very short maturities, which greatly increased liquidity risks for businesses, banks, and other institutions. The vulnerability of MMFs to breaking the buck and the susceptibility of the entire prime MMF industry to a run in such circumstances remains a significant source of systemic risk.

The SEC should move forward with its plans to strengthen the regulatory framework around MMFs. In doing so, the SEC should consider: (i) requiring MMFs to maintain substantial liquidity buffers; (ii) reducing the maximum weighted average maturity of MMF assets; (iii) tightening the credit concentration limits applicable to MMFs; (iv) improving the credit risk analysis and management of MMFs; and (v) empowering MMF boards of directors to suspend redemptions in extraordinary circumstances to protect the interests of fund shareholders.

These measures should be helpful, as they should enhance investor protection and mitigate the risk of runs. However, these measures should not, by themselves, be expected to prevent a run on MMFs of the scale experienced in September 2008. We propose that the President's Working Group on Financial Markets (PWG) should prepare a report considering fundamental changes to address systemic risk more directly. Those changes could include, for example, moving away from a stable net asset value for MMFs or requiring MMFs to obtain access to reliable emergency liquidity facilities from private sources. For liquidity facilities to provide MMFs with meaningful protection against runs, the facilities should be reliable, scalable, and designed in such a way that drawing on the facilities to meet redemptions would not disadvantage remaining MMF

shareholders. The PWG should complete the report by September 15, 2009. Due to the short time-frame and the work that is currently on-going, we believe that this report should be conducted by the PWG, rather than the proposed Council, which we propose to be created through legislation.

The SEC and the PWG should carefully consider ways to mitigate any potential adverse effects of such a stronger regulatory framework for MMFs, such as investor flight from MMFs into unregulated or less regulated money market investment vehicles or reductions in the term of money market liabilities issued by major financial and non-financial firms.

H. Enhance Oversight of the Insurance Sector

Our legislation will propose the establishment of the Office of National Insurance within Treasury to gather information, develop expertise, negotiate international agreements, and coordinate policy in the insurance sector. Treasury will support proposals to modernize and improve our system of insurance regulation in accordance with six principles outlined in the body of the report.

Insurance plays a vital role in the smooth and efficient functioning of our economy. By insulating households and businesses against unforeseen loss, insurance facilitates the efficient deployment of resources and provides stability, certainty and peace of mind. The current crisis highlighted the lack of expertise within the federal government regarding the insurance industry. While AIG's main problems were created outside of its traditional insurance business, significant losses arose inside its state-regulated insurance companies as well.

Insurance is a major component of the financial system. In 2008, the insurance industry had \$5.7 trillion in assets, compared with \$15.8 trillion in the banking sector. There are 2.3 million jobs in the insurance industry, making up almost a third of all financial sector jobs. For over 135 years, insurance has primarily been regulated by the states, which has led to a lack of uniformity and reduced competition across state and international boundaries, resulting in inefficiency, reduced product innovation, and higher costs to consumers. Beyond a few specific areas where the federal government has a statutory responsibility, such as employee benefits, terrorism risk insurance, flood insurance, or anti-money laundering, there is no standing federal entity that is accountable for understanding and monitoring the insurance industry. Given the importance of a healthy insurance industry to the well functioning of our economy, it is important that we establish a federal Office of National Insurance (ONI) within Treasury, and that we develop a modern regulatory framework for insurance.

The ONI should be responsible for monitoring all aspects of the insurance industry. It should gather information and be responsible for identifying the emergence of any problems or gaps in regulation that could contribute to a future crisis. The ONI should also recommend to the Federal Reserve any insurance companies that the Office believes should be supervised as Tier 1 FHCs. The ONI should also carry out the government's existing responsibilities under the Terrorism Risk Insurance Act.

In the international context, the lack of a federal entity with responsibility and expertise for insurance has hampered our nation's effectiveness in engaging internationally with

other nations on issues related to insurance. The United States is the only country in the International Association of Insurance Supervisors (IAIS – whose membership includes insurance regulators and supervisors of over 190 jurisdictions) that is not represented by a federal insurance regulatory entity able to speak with one voice. In addition, the European Union has recently passed legislation that will require a foreign insurance company operating in its member states to be subject to supervision in the company's home country comparable to the supervision required in the EU. Accordingly, the ONI will be empowered to work with other nations and within the IAIS to better represent American interests, have the authority to enter into international agreements, and increase international cooperation on insurance regulation.

Treasury will support proposals to modernize and improve our system of insurance regulation. Treasury supports the following six principles for insurance regulation:

1. *Effective systemic risk regulation with respect to insurance.* The steps proposed in this report, if enacted, will address systemic risks posed to the financial system by the insurance industry. However, if additional insurance regulation would help to further reduce systemic risk or would increase integration into the new regulatory regime, we will consider those changes.
2. *Strong capital standards and an appropriate match between capital allocation and liabilities for all insurance companies.* Although the current crisis did not stem from widespread problems in the insurance industry, the crisis did make clear the importance of adequate capital standards and a strong capital position for all financial firms. Any insurance regulatory regime should include strong capital standards and appropriate risk management, including the management of liquidity and duration risk.
3. *Meaningful and consistent consumer protection for insurance products and practices.* While many states have enacted strong consumer protections in the insurance marketplace, protections vary widely among states. Any new insurance regulatory regime should enhance consumer protections and address any gaps and problems that exist under the current system, including the regulation of producers of insurance. Further, any changes to the insurance regulatory system that would weaken or undermine important consumer protections are unacceptable.
4. *Increased national uniformity through either a federal charter or effective action by the states.* Our current insurance regulatory system is highly fragmented, inconsistent, and inefficient. While some steps have been taken to increase uniformity, they have been insufficient. As a result there remain tremendous differences in regulatory adequacy and consumer protection among the states. Increased consistency in the regulatory treatment of insurance – including strong capital standards and consumer protections – should enhance financial stability, increase economic efficiency and result in real improvements for consumers.
5. *Improve and broaden the regulation of insurance companies and affiliates on a consolidated basis, including those affiliates outside of the traditional insurance business.* As we saw with respect to AIG, the problems of associated affiliates

outside of a consolidated insurance company's traditional insurance business can grow to threaten the solvency of the underlying insurance company and the economy. Any new regulatory regime must address the current gaps in insurance holding company regulation.

6. *International coordination.* Improvements to our system of insurance regulation should satisfy existing international frameworks, enhance the international competitiveness of the American insurance industry, and expand opportunities for the insurance industry to export its services.

I. Determine the Future Role of the Government Sponsored Enterprises

Treasury and the Department of Housing and Urban Development, in consultation with other government agencies, will engage in a wide-ranging initiative to develop recommendations on the future of Fannie Mae and Freddie Mac, and the Federal Home Loan Bank system. We need to maintain the continued stability and strength of the GSEs during these difficult financial times. We will report to the Congress and the American public at the time of the President's 2011 Budget release.

The 2008 Housing and Economic Recovery Act (HERA) reformed and strengthened the GSEs' safety and soundness regulation by creating the Federal Housing Finance Agency (FHFA), a new independent regulator for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

HERA provided FHFA with authority to develop regulations on the size and composition of the Fannie Mae and Freddie Mac investment portfolios, set capital requirements, and place the companies into receivership. FHFA is also required to issue housing goals for each of the regulated enterprises with respect to single-family and multi-family mortgages. In addition, HERA provided temporary authority for Treasury to purchase securities or other obligations of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks through December 31, 2009. The purpose of this authority is to preserve the stability of the financial market, prevent disruption to the availability of mortgage finance, and protect taxpayers.

The growing stress in the mortgage markets over the last two years reduced the capital positions of Fannie Mae and Freddie Mac. In September 2008, FHFA placed Fannie Mae and Freddie Mac under conservatorship, and Treasury began to exercise its GSE assistance authorities in order to promote the stability and strength of the GSEs during these difficult financial times.

Treasury and the Department of Housing and Urban Development, together with other government agencies, will engage in a wide-ranging process and seek public input to explore options regarding the future of the GSEs, and will report to the Congress and the American public at the time of the President's 2011 budget.

Financial Regulatory Reform: A New Foundation

There are a number of options for the reform of the GSEs, including: (i) returning them to their previous status as GSEs with the paired interests of maximizing returns for private shareholders and pursuing public policy home ownership goals; (ii) gradual wind-down of their operations and liquidation of their assets; (iii) incorporating the GSEs' functions into a federal agency; (iv) a public utility model where the government regulates the GSEs' profit margin, sets guarantee fees, and provides explicit backing for GSE commitments; (v) a conversion to providing insurance for covered bonds; (vi) and the dissolution of Fannie Mae and Freddie Mac into many smaller companies.

II. ESTABLISH COMPREHENSIVE REGULATION OF FINANCIAL MARKETS

The current financial crisis occurred after a long and remarkable period of growth and innovation in our financial markets. New financial instruments allowed credit risks to be spread widely, enabling investors to diversify their portfolios in new ways and enabling banks to shed exposures that had once stayed on their balance sheets. Through securitization, mortgages and other loans could be aggregated with similar loans and sold in tranches to a large and diverse pool of new investors with different risk preferences. Through credit derivatives, banks could transfer much of their credit exposure to third parties without selling the underlying loans. This distribution of risk was widely perceived to reduce systemic risk, to promote efficiency, and to contribute to a better allocation of resources.

However, instead of appropriately distributing risks, this process often concentrated risk in opaque and complex ways. Innovations occurred too rapidly for many financial institutions' risk management systems; for the market infrastructure, which consists of payment, clearing and settlement systems; and for the nation's financial supervisors.

Securitization, by breaking down the traditional relationship between borrowers and lenders, created conflicts of interest that market discipline failed to correct. Loan originators failed to require sufficient documentation of income and ability to pay. Securitizers failed to set high standards for the loans they were willing to buy, encouraging underwriting standards to decline. Investors were overly reliant on credit rating agencies. Credit ratings often failed to accurately describe the risk of rated products. In each case, lack of transparency prevented market participants from understanding the full nature of the risks they were taking.

The build-up of risk in the over-the-counter (OTC) derivatives markets, which were thought to disperse risk to those most able to bear it, became a major source of contagion through the financial sector during the crisis.

We propose to bring the markets for all OTC derivatives and asset-backed securities into a coherent and coordinated regulatory framework that requires transparency and improves market discipline. Our proposal would impose record keeping and reporting requirements on all OTC derivatives. We also propose to strengthen the prudential regulation of all dealers in the OTC derivative markets and to reduce systemic risk in these markets by requiring all standardized OTC derivative transactions to be executed in regulated and transparent venues and cleared through regulated central counterparties.

We propose to enhance the Federal Reserve's authority over market infrastructure to reduce the potential for contagion among financial firms and markets.

Finally, we propose to harmonize the statutory and regulatory regimes for futures and securities. While differences exist between securities and futures markets, many differences in regulation between the markets may no longer be justified. In particular, the growth of derivatives markets and the introduction of new derivative instruments have highlighted the need for addressing gaps and inconsistencies in the regulation of these products by the CFTC and SEC.

A. Strengthen Supervision and Regulation of Securitization Markets

The financial crisis was triggered by a breakdown in credit underwriting standards in subprime and other residential mortgage markets. That breakdown was enabled by lax or nonexistent regulation of nonbank mortgage originators and brokers. But the breakdown also reflected a broad relaxation in market discipline on the credit quality of loans that originators intended to distribute to investors through securitizations rather than hold in their own loan portfolios.

We propose several initiatives to address this breakdown in market discipline: changing the incentive structure of market participants; increasing transparency to allow for better due diligence; strengthening credit rating agency performance; and reducing the incentives for over-reliance on credit ratings.

1. Federal banking agencies should promulgate regulations that require originators or sponsors to retain an economic interest in a material portion of the credit risk of securitized credit exposures.

One of the most significant problems in the securitization markets was the lack of sufficient incentives for lenders and securitizers to consider the performance of the underlying loans after asset backed securities (ABS) were issued. Lenders and securitizers had weak incentives to conduct due diligence regarding the quality of the underlying assets being securitized. This problem was exacerbated as the structure of ABS became more complex and opaque. Inadequate disclosure regimes exacerbated the gap in incentives between lenders, securitizers and investors.

The federal banking agencies should promulgate regulations that require loan originators or sponsors to retain five percent of the credit risk of securitized exposures. The regulations should prohibit the originator from directly or indirectly hedging or otherwise transferring the risk it is required to retain under these regulations. This is critical to prevent gaming of the system to undermine the economic tie between the originator and the issued ABS.

The federal banking agencies should have authority to specify the permissible forms of required risk retention (for example, first loss position or pro rata vertical slice) and the minimum duration of the required risk retention. The agencies also should have authority to provide exceptions or adjustments to these requirements as needed in certain cases, including authority to raise or lower the five percent threshold and to provide exemptions from the “no hedging” requirement that are consistent with safety and soundness. The agencies should also have authority to apply the requirements to securitization sponsors rather than loan originators in order to achieve the appropriate alignment of incentives contemplated by this proposal.

2. Regulators should promulgate additional regulations to align compensation of market participants with longer term performance of the underlying loans.

The securitization process should provide appropriate incentives for participants to best serve the interests of their clients, the borrowers and investors. To do that, the compensation of brokers, originators, sponsors, underwriters, and others involved in the

securitization process should be linked to the longer-term performance of the securitized assets, rather than only to the production, creation or inception of those products.

For example, as proposed by Financial Accounting Standards Board (FASB), Generally Accepted Accounting Principles (GAAP) should be changed to eliminate the immediate recognition of gain on sale by originators at the inception of a securitization transaction and instead require originators to recognize income over time. The proposed changes should also require many securitizations to be consolidated on the originator's balance sheet and their asset performance to be reflected in the originator's consolidated financial statements.

Similar performance-based, medium-to-long term approaches to securitization fees should enhance incentives for market participants to focus on underwriting standards. For example, the fees and commissions received by loan brokers and loan officers, who otherwise have no ongoing relationship with the loans they generate, should be disbursed over time and should be reduced if underwriting or asset quality problems emerge over time.

Sponsors of securitizations should be required to provide assurances to investors, in the form of strong, standardized representations and warranties, regarding the risk associated with the origination and underwriting practices for the securitized loans underlying ABS.

3. The SEC should continue its efforts to increase the transparency and standardization of securitization markets and be given clear authority to require robust reporting by issuers of asset backed securities (ABS).

The SEC is currently working to improve and standardize disclosure practices by originators, underwriters, and credit rating agencies involved in the securitization process. Those efforts should continue. To strengthen those efforts, the SEC should be given clear authority to require robust ongoing reporting by ABS issuers.

Investors and credit rating agencies should have access to the information necessary to assess the credit quality of the assets underlying a securitization transaction at inception and over the life of the transaction, as well as the information necessary to assess the credit, market, liquidity, and other risks of ABS. In particular, the issuers of ABS should be required to disclose loan-level data (broken down by loan broker or originator). Issuers should also be required to disclose the nature and extent of broker, originator and sponsor compensation and risk retention for each securitization.

We urge the industry to complete its initiatives to standardize and make transparent the legal documentation for securitization transactions to make it easier for market participants to make informed investment decisions. With respect to residential mortgage-backed securities, the standards should include clear and uniform rules for servicers to modify home mortgage loans under appropriate circumstances, if such modifications would benefit the securitization trust as a whole.

Finally, the SEC and the Financial Industry Regulatory Authority (FINRA) should expand the Trade Reporting and Compliance Engine (TRACE), the standard electronic trade reporting database for corporate bonds, to include asset-backed securities.

- 4. *The SEC should continue its efforts to strengthen the regulation of credit rating agencies, including measures to require that firms have robust policies and procedures that manage and disclose conflicts of interest, differentiate between structured and other products, and otherwise promote the integrity of the ratings process.***

Credit rating agencies should be required to maintain robust policies and procedures for managing and disclosing conflicts of interest and otherwise ensuring the integrity of the ratings process.

Credit rating agencies should differentiate the credit ratings that they assign to structured credit products from those they assign to unstructured debt. Credit Rating Agencies should also publicly disclose credit rating performance measures for structured credit products in a manner that facilitates comparisons across products and credit ratings and that provides meaningful measures of the uncertainty and potential volatility associated with credit ratings.

Credit rating agencies should also publicly disclose, in a manner comprehensible to the investing public, precisely what risks their credit ratings are designed to assess (for example, likelihood of default and/or loss severity in event of default), as well as material risks not reflected in the ratings. Such disclosure should highlight how the risks of structured products, which rely on diversification across a large number of individual loans to protect the more senior investors, differ fundamentally from the risks of unstructured corporate debt.

Credit rating agencies should disclose sufficient information about their methodologies for rating structured finance products, including qualitative reviews of originators, to allow users of credit ratings and market observers to reach their own conclusions about the efficacy of the methodologies. Credit rating agencies should also disclose to the SEC any unpublished rating agency data and methodologies.

- 5. *Regulators should reduce their use of credit ratings in regulations and supervisory practices, wherever possible.***

Where regulators use credit ratings in regulations and supervisory practices, they should recognize the potential differences in performance between structured and unstructured credit products with the same credit rating.

Risk-based regulatory capital requirements should appropriately reflect the risk of structured credit products, including the concentrated systematic risk of senior tranches and re-securitizations and the risk of exposures held in highly leveraged off-balance sheet vehicles. They should also minimize opportunities for firms to use securitization to reduce their regulatory capital requirements without a commensurate reduction in risk.

B. Create Comprehensive Regulation of All OTC Derivatives, Including Credit Default Swaps (CDS)

OTC derivatives markets, including CDS markets, should be subject to comprehensive regulation that addresses relevant public policy objectives: (1) preventing activities in those markets from posing risk to the financial system;

(2) promoting the efficiency and transparency of those markets; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.

One of the most significant changes in the world of finance in recent decades has been the explosive growth and rapid innovation in the market for financial derivatives. Much of this development has occurred in the market for OTC derivatives, which are not executed on regulated exchanges. In 2000, the Commodity Futures Modernization Act (CFMA) explicitly exempted OTC derivatives, to a large extent, from regulation by the Commodity Futures Trading Commission. In addition, the law limited the SEC's authority to regulate certain types of OTC derivatives. As a result, the market for OTC derivatives has largely gone unregulated.

The downside of this lax regulatory regime for OTC derivatives – and, in particular, for credit default swaps (CDS) – became disastrously clear during the recent financial crisis. In the years prior to the crisis, many institutions and investors had substantial positions in CDS – particularly CDS that were tied to asset backed securities (ABS), complex instruments whose risk characteristics proved to be poorly understood even by the most sophisticated of market participants. At the same time, excessive risk taking by AIG and certain monoline insurance companies that provided protection against declines in the value of such ABS, as well as poor counterparty credit risk management by many banks, saddled our financial system with an enormous – and largely unrecognized – level of risk.

When the value of the ABS fell, the danger became clear. Individual institutions believed that these derivatives would protect their investments and provide return, even if the market went down. But, during the crisis, the sheer volume of these contracts overwhelmed some firms that had promised to provide payment on the CDS and left institutions with losses that they believed they had been protected against. Lacking authority to regulate the OTC derivatives market, regulators were unable to identify or mitigate the enormous systemic threat that had developed.

Government regulation of the OTC derivatives markets should be designed to achieve four broad objectives: (1) preventing activities in those markets from posing risk to the financial system; (2) promoting the efficiency and transparency of those markets; (3) preventing market manipulation, fraud, and other market abuses; and (4) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties. To achieve these goals, it is critical that similar products and activities be subject to similar regulations and oversight.

To contain systemic risks, the Commodities Exchange Act (CEA) and the securities laws should be amended to require clearing of all standardized OTC derivatives through regulated central counterparties (CCPs). To make these measures effective, regulators will need to require that CCPs impose robust margin requirements as well as other necessary risk controls and that customized OTC derivatives are not used solely as a means to avoid using a CCP. For example, if an OTC derivative is accepted for clearing by one or more fully regulated CCPs, it should create a presumption that it is a standardized contract and thus required to be cleared.

All OTC derivatives dealers and all other firms whose activities in those markets create large exposures to counterparties should be subject to a robust and appropriate regime of prudential supervision and regulation. Key elements of that robust regulatory regime must include conservative capital requirements (more conservative than the existing bank regulatory capital requirements for OTC derivatives), business conduct standards, reporting requirements, and conservative requirements relating to initial margins on counterparty credit exposures. Counterparty risks associated with customized bilateral OTC derivatives transactions that should not be accepted by a CCP would be addressed by this robust regime covering derivative dealers. As noted above, regulatory capital requirements on OTC derivatives that are not centrally cleared also should be increased for all banks and BHCs.

The OTC derivatives markets should be made more transparent by amending the CEA and the securities laws to authorize the CFTC and the SEC, consistent with their respective missions, to impose recordkeeping and reporting requirements (including an audit trail) on all OTC derivatives. Certain of those requirements should be deemed to be satisfied by either clearing standardized transactions through a CCP or by reporting customized transactions to a regulated trade repository. CCPs and trade repositories should be required to, among other things, make aggregate data on open positions and trading volumes available to the public and make data on any individual counterparty's trades and positions available on a confidential basis to the CFTC, SEC, and the institution's primary regulators.

Market efficiency and price transparency should be improved in derivatives markets by requiring the clearing of standardized contracts through regulated CCPs as discussed earlier and by moving the standardized part of these markets onto regulated exchanges and regulated transparent electronic trade execution systems for OTC derivatives and by requiring development of a system for timely reporting of trades and prompt dissemination of prices and other trade information. Furthermore, regulated financial institutions should be encouraged to make greater use of regulated exchange-traded derivatives. Competition between appropriately regulated OTC derivatives markets and regulated exchanges would make both sets of markets more efficient and thereby better serve end-users of derivatives.

Market integrity concerns should be addressed by making whatever amendments to the CEA and the securities laws which are necessary to ensure that the CFTC and the SEC, consistent with their respective missions, have clear, unimpeded authority to police and prevent fraud, market manipulation, and other market abuses involving all OTC derivatives. The CFTC also should have authority to set position limits on OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets. Requiring CCPs, trade repositories, and other market participants to provide the CFTC, SEC, and institutions' primary regulators with a complete picture of activity in the OTC derivatives markets will assist those regulators in detecting and deterring all such market abuses.

Current law seeks to protect unsophisticated parties from entering into inappropriate derivatives transactions by limiting the types of counterparties that could participate in those markets. But the limits are not sufficiently stringent. The CFTC and SEC are

reviewing the participation limits in current law to recommend how the CEA and the securities laws should be amended to tighten the limits or to impose additional disclosure requirements or standards of care with respect to the marketing of derivatives to less sophisticated counterparties such as small municipalities.

C. Harmonize Futures and Securities Regulation

The CFTC and the SEC should make recommendations to Congress for changes to statutes and regulations that would harmonize regulation of futures and securities.

The broad public policy objectives of futures regulation and securities regulation are the same: protecting investors, ensuring market integrity, and promoting price transparency. While differences exist between securities and futures markets, many differences in regulation between the markets are no longer justified. In particular, the growth of derivatives markets and the introduction of new derivative instruments have highlighted the need for addressing gaps and inconsistencies in the regulation of these products by the CFTC and SEC.

Many of the instruments traded on the commodity and securities exchanges and in the over-the-counter markets have attributes that may place the instrument within the purview of both regulatory agencies. One result of this jurisdictional overlap has been that economically equivalent instruments may be regulated by two agencies operating under different and sometimes conflicting regulatory philosophies and statutes. For example, many financial options and futures products are similar (and, indeed, the returns to one often can be replicated with the other). Under the current federal regulatory structure, however, options on a security are regulated by the SEC, whereas futures contracts on the same underlying security are regulated jointly by the CFTC and SEC.

In many instances the result of these overlapping yet different regulatory authorities has been numerous and protracted legal disputes about whether particular products should be regulated as futures or securities. These disputes have consumed significant agency resources that otherwise could have been devoted to the furtherance of the agency's mission. Uncertainty regarding how an instrument will be regulated has impeded and delayed the launch of exchange-traded equity, equity index, and credit event products, as litigation sorted out whether a particular product should be regulated as a futures contract or as a security. Eliminating jurisdictional uncertainties and ensuring that economically equivalent instruments are regulated in the same manner, regardless of which agency has jurisdiction, would remove impediments to product innovation.

Arbitrary jurisdictional distinctions also have unnecessarily limited competition between markets and exchanges. Under existing law, financial instruments with similar characteristics may be forced to trade on different exchanges that are subject to different regulatory regimes. Harmonizing the regulatory regimes would remove such distinctions and permit a broader range of instruments to trade on any regulated exchange. Permitting direct competition between exchanges also would ensure that plans to bring OTC derivatives trading onto regulated exchanges or regulated transparent electronic trading systems would promote rather than retard competition. Greater competition would make

these markets more efficient, which would benefit users of the markets, including investors and risk managers.

We also will need greater coordination and harmonization between these agencies as we move forward. The CEA currently provides that funds trading in the futures markets register as Commodity Pool Operators (CPO) and file annual financials with the CFTC. Over 1300 CPOs, including many of the largest hedge funds, are currently registered with and make annual filings with the CFTC. It will be important that the CFTC be able to maintain its enforcement authority over these entities as the SEC takes on important new responsibilities in this area.

Pursuant to the CEA, the CFTC currently employs a “principles-based approach” to regulation of exchanges, clearing organizations, and intermediaries, while pursuant to the securities laws; the SEC employs a “rules-based approach.” Efforts at harmonization should seek to build a common foundation for market regulation through agreement by the two agencies on principles of regulation that are significantly more precise than the CEA’s current “core principles.” The new principles need to be sufficiently precise so that market practices that violate those principles can be readily identified and subjected to enforcement actions by regulators. At the same time, they should be sufficiently flexible to allow for innovations by market participants that are consistent with the principles. For example, the CFTC has indicated that it is willing to recommend adopting as core principles for clearing organizations key elements of international standards for central counterparty clearing organizations (the CPSS-IOSCO standards), which are considerably more precise than the current CEA core principles for CFTC regulated clearing organizations.

Harmonization of substantive futures and securities regulation for economically equivalent instruments also should require the development of consistent procedures for reviewing and approving proposals for new products and rulemakings by self-regulatory organizations (SROs). Here again, the agencies should strike a balance between their existing approaches. The SEC should recommend requirements to respond more expeditiously to proposals for new products and SRO rule changes and should recommend expansion of the types of filings that should be deemed effective upon filing, while the CFTC should recommend requiring prior approval for more types of rules and allowing it appropriate and reasonable time for approving rules that require prior approval.

The harmonization of futures and securities laws for economically equivalent instruments would not require eliminating or modifying provisions relating to futures and options contracts on agricultural, energy, and other physical commodity products. There are important protections related to these markets which must be maintained and in certain circumstances enhanced in applicable law and regulation.

We recommend that the CFTC and the SEC complete a report to Congress by September 30, 2009 that identifies all existing conflicts in statutes and regulations with respect to similar types of financial instruments and either explains why those differences are essential to achieve underlying policy objectives with respect to investor protection, market integrity, and price transparency or makes recommendations for changes to

statutes and regulations that would eliminate the differences. If the two agencies cannot reach agreement on such explanations and recommendations by September 30, 2009, their differences should be referred to the new Financial Services Oversight Council. The Council should be required to address such differences and report its recommendations to Congress within six months of its formation.

D. Strengthen Oversight and Functioning of Systemically Important Payment, Clearing, and Settlement Systems and Related Activities

We propose that the Federal Reserve have responsibility and authority to conduct oversight of systemically important payment, clearing and settlement systems, and activities of financial firms.

A key determinant of the risk posed by the interconnectedness of financial institutions is the strength or weakness of arrangements for settling payment obligations and financial transactions between banks and other financial institutions. Where such arrangements are strong they can help guard against instability in times of crisis. Where they are weak they can be a major source of financial contagion, transmitting a financial shock from one firm or market to many other firms and markets.

When major financial institutions came under significant financial stress during 2008, policymakers were extremely concerned that weaknesses in settlement arrangements for certain financial transactions, notably tri-party repurchase agreements and OTC derivatives, would be a source of contagion. For several years prior to 2008, the Federal Reserve had worked with other regulators and market participants to strengthen those arrangements. In the case of CDS and other OTC derivatives, significant progress was achieved, notably the cessation of unauthorized assignments of trades, reductions of backlogs of unconfirmed trades, and efforts to compress portfolios of outstanding trades. Still, progress was slow and insufficient.

Progress in strengthening payment and settlement arrangements is inherently difficult because improvements in such arrangements require collective action by market participants. Existing federal authority over such arrangements is incomplete and fragmented. In such circumstances, the Federal Reserve and other regulators have been forced to rely heavily on moral suasion to encourage market participants to take such collective actions. The criticality of such arrangements and the slow progress in strengthening certain key infrastructure arrangements indicates a need for clear and comprehensive federal authority for oversight focused on the risk management of systemically important payment, clearing, and settlement systems and of systemically important payment, clearing, and settlement activities of financial firms.

Responsibility and authority for ensuring consistent oversight of all systemically important payment, clearing, and settlement systems and activities should be assigned to the Federal Reserve. The Federal Reserve has long played a role in the supervision, oversight, development, and operation of payment, clearing, and settlement systems. It also has played a leading role in developing international standards for payment, clearing, and settlement systems. As the central bank, it inherently has a special interest in promoting the safety and efficiency of such systems, because they are important to the liquidity of financial institutions and the implementation of monetary policy. The

authority we propose to give to the Federal Reserve should supplement rather than replace the existing authority of regulators of clearing and settlement systems and prudential regulators of financial firms.

Systemically Important Systems

We will propose legislation that broadly defines the characteristics of systemically important payment, clearing, and settlement systems (covered systems) and sets objectives and principles for their oversight. We propose that Congress direct the Federal Reserve, in consultation with the Council, to identify covered systems and to set risk management standards for their operation. We will propose legislation that defines a covered system as a payment, clearing, or settlement system the failure or disruption of which could create or increase the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threatening the stability of the financial system.

The Federal Reserve should have authority to collect information from any payment, clearing, or settlement system for the purpose of assessing whether the system is systemically important. In the case of a system that is subject to comprehensive regulation by a federal market regulator (the CFTC or the SEC), the market regulator will remain the primary regulator of the system. The Federal Reserve should first seek to obtain the information it needs from the primary regulator, but may request additional information directly from the system if it is determined that the information is not currently collected by or available to the primary regulator.

The risk management standards imposed by the Federal Reserve on covered systems should require such systems to have consistent and robust policies and practices for ensuring timely settlement by the systems across a range of extreme but plausible scenarios. The standards for such systems should be reviewed periodically by the Federal Reserve, in consultation with the Council, and should take into account relevant international standards.

A covered system should be subject to regular, consistent, and rigorous on-site safety and soundness examinations as well as prior reviews of changes to its rules and operations in order to ensure that the amended rules and operations meet the applicable risk management standards. If a system is subject to comprehensive regulation by a federal market regulator (CFTC or SEC), the market regulator should lead those exams and reviews. The Federal Reserve should have the right to participate in the exams, including in the determination of their scope and methodology, and should be consulted on rule changes that affect the system's risk management. The Federal Reserve and the market regulator should regularly conduct joint assessments of the system's adherence to the applicable risk management standards.

If a covered system's risk management policies and practices do not meet the applicable standards, the Federal Reserve should have adequate authority to compel corrective actions by the system. If a covered system is subject to comprehensive regulation by a federal market regulator (CFTC or SEC), the market regulator should have primary authority for enforcement. If the Federal Reserve concludes that corrective actions are necessary, it should recommend those actions to the market regulator. If the Federal

Reserve and the market regulator cannot agree on the need for enforcement action, the Federal Reserve should have emergency authority to take enforcement action but only after consultation with the Council, which should attempt to mediate the agencies' differences.

The Federal Reserve should have authority to require a covered system to submit reports for the purpose of enabling the Federal Reserve to assess the risk that the system's operations pose to the financial system and to assess the safety and soundness of the system. In the case of a covered system that is subject to comprehensive regulation by a federal market regulator, the Federal Reserve should have access to relevant reports submitted to that regulator, but its authority to require reports should be limited to information that cannot be obtained from reports to the other regulator.

Systemically Important Activities

We will propose legislation that broadly defines the characteristics of systemically important payment, clearing, and settlement activities of financial firms (covered activities) and sets objectives and principles for their conduct. We propose that Congress direct the Federal Reserve, in consultation with the Council, to identify covered activities and to set risk management standards for their conduct by financial firms. We propose that Congress define a covered activity as a payment, clearing, or settlement activity of financial firms the failure or disruption of which could create or increase the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threatening the stability of the financial system.

If the Federal Reserve has reason to believe that a payment, clearing, or settlement activity is systemically important, it should have authority to collect information from any financial firm engaged in that activity for the purpose of assessing whether the activity is systemically important. In the case of a firm that is subject to federal regulation, the Federal Reserve should have access to relevant reports submitted to other regulators and its authority to require reports should be limited to information that cannot be obtained from reports to other regulators.

Compliance by financial firms with standards established by the Federal Reserve with respect to a systemically important activity will be administratively enforceable by the firm's primary federal regulator (if applicable). The Federal Reserve, however, will have back-up examination and administrative enforcement authority with respect to such standards.

The Federal Reserve should have authority to require financial firms engaged in a covered activity to submit reports with respect to the firm's conduct of such activity. In the case of a firm that is subject to federal regulation, the Federal Reserve should have access to relevant reports submitted to other regulators, and its authority to require reports should be limited to information that cannot be obtained from reports to other regulators.

E. Strengthen Settlement Capabilities and Liquidity Resources of Systemically Important Payment, Clearing, and Settlement Systems

We recommend that Congress grant the Federal Reserve authority to provide systemically important payment, clearing, and settlement systems access to Reserve Bank accounts, financial services, and the discount window.

The safety and efficiency of financial institutions and markets depend critically on the strength of the infrastructure of the financial system—the payment, clearing, and settlement systems that are used to clear and settle financial transactions. In particular, confidence in financial markets and financial market participants depends critically on the ability of the payment, clearing, and settlement systems used by the markets to meet their financial obligations to participants without delay. Many systemically important payment, clearing, and settlement systems currently depend on commercial banks to perform critical payment and other financial services and to provide them with the liquidity necessary to convert margin and other collateral into funds when necessary to complete settlement. These dependencies create the risk that a systemically important system may be unable to meet its obligations to participants when due because the bank on which it relies for such services (or another market participant) is unable or unwilling to provide the liquidity the system needs. During the recent financial crisis some systemically important settlement systems have encountered performance and other issues with their banks. At the same time, many market participants have had trouble obtaining liquidity by pledging or selling collateral, even the forms that are most liquid under normal circumstances.

The risk posed by such impediments to timely settlement would be eliminated by providing (where not already available under other authorities) direct access to Reserve Bank accounts and financial services and to the discount window for payment, clearing, and settlement systems that the Federal Reserve, in consultation with the Council, has identified as systemically significant. Discount window access for such systems should be for emergency purposes, such as enabling the system to convert noncash margin and collateral assets to liquid settlement funds in the event that one of the system's participants fails to settle its obligations to the system and the system's contingency plans for converting collateral into cash fail to perform as expected on the day of a participant default. Systemically important systems would be expected to meet applicable standards for liquidity risk management for such systems, which generally require systemically important systems to maintain sufficient liquid financial resources to make timely payments, notwithstanding a default by the participant to which the system has the largest exposure under extreme but plausible market conditions.

III. PROTECT CONSUMERS AND INVESTORS FROM FINANCIAL ABUSE

Prior to the current financial crisis, a number of federal and state regulations were in place to protect consumers against fraud and to promote understanding of financial products like credit cards and mortgages. But as abusive practices spread, particularly in the market for subprime and nontraditional mortgages, our regulatory framework proved inadequate in important ways. Multiple agencies have authority over consumer protection in financial products, but for historical reasons, the supervisory framework for enforcing those regulations had significant gaps and weaknesses. Banking regulators at the state and federal level had a potentially conflicting mission to promote safe and sound banking practices, while other agencies had a clear mission but limited tools and jurisdiction. Most critically in the run-up to the financial crisis, mortgage companies and other firms outside of the purview of bank regulation exploited that lack of clear accountability by selling mortgages and other products that were overly complicated and unsuited to borrowers' financial situation. Banks and thrifts followed suit, with disastrous results for consumers and the financial system.

This year, Congress, the Administration, and financial regulators have taken significant measures to address some of the most obvious inadequacies in our consumer protection framework. But these steps have focused on just two, albeit very important, product markets – credit cards and mortgages. We need comprehensive reform.

For that reason, we propose the creation of a single regulatory agency, a Consumer Financial Protection Agency (CFPA), with the authority and accountability to make sure that consumer protection regulations are written fairly and enforced vigorously. The CFPA should reduce gaps in federal supervision and enforcement; improve coordination with the states; set higher standards for financial intermediaries; and promote consistent regulation of similar products.

Consumer protection is a critical foundation for our financial system. It gives the public confidence that financial markets are fair and enables policy makers and regulators to maintain stability in regulation. Stable regulation, in turn, promotes growth, efficiency, and innovation over the long term. We propose legislative, regulatory, and administrative reforms to promote transparency, simplicity, fairness, accountability, and access in the market for consumer financial products and services.

We also propose new authorities and resources for the Federal Trade Commission to protect consumers in a wide range of areas.

Finally, we propose new authorities for the Securities and Exchange Commission to protect investors, improve disclosure, raise standards, and increase enforcement.

A. Create a New Consumer Financial Protection Agency

We propose the creation of a single federal agency, the Consumer Financial Protection Agency, dedicated to protecting consumers in the financial products and services markets, except for investment products and services already regulated by the SEC or

CFTC. We recommend that the CFPA be granted consolidated authority over the closely related functions of writing rules, supervising and examining institutions' compliance, and administratively enforcing violations. The CFPA should reduce gaps in federal supervision; improve coordination among the states; set higher standards for financial intermediaries; and promote consistent regulation of similar products. Nothing in this proposal is intended to constrain the Attorney General's current authorities to enforce the law or direct litigation on behalf of the United States.

The CFPA should give consumer protection an independent seat at the table in our financial regulatory system. Consumer protection is a critical foundation for our financial system. It gives the public confidence that financial markets are fair and enables policy makers and regulators to maintain stability in regulation. Stable regulation, in turn, promotes growth, efficiency, and innovation over the long term. Consumer protection cannot live up to this role, however, unless the financial system develops and sustains a culture that places a high value on helping responsible consumers thrive and treating all consumers fairly.

The spread of unsustainable subprime mortgages and abusive credit card contracts highlighted a serious shortcoming of our present regulatory infrastructure. It too easily allows consumer protection values to be overwhelmed by other imperatives – whether short-term gain, innovation for its own sake, or keeping up with the competition. To instill a genuine culture of consumer protection and not merely of legal compliance in our financial institutions, we need first to instill that culture in the federal regulatory structure. For the public to have confidence that consumer protection is important to regulators, there must be clear accountability in government for this task.

The current system of regulation does not meet these needs. Oversight of federally supervised institutions for compliance with consumer protection, fair lending, and community reinvestment laws is fragmented among four agencies. This makes coordination of supervisory policies difficult, slows responses to emerging consumer protection threats, and creates opportunities for regulatory arbitrage, where firms choose their regulator according to which entity will be least restrictive.

The Federal Trade Commission has a clear mission to protect consumers but generally lacks jurisdiction over the banking sector and has limited tools and resources to promote robust compliance of nonbank institutions. Mortgage companies not owned by banks fall into a regulatory “no man's land” where no regulator exercises leadership and state attorneys general are left to try to fill the gap. State and federal bank supervisory agencies' primary mission is to ensure that financial institutions act prudently, a mission that, in appearance if not always in practice, often conflicts with their consumer protection responsibilities.

In addition, the systems, expertise, and culture necessary for the federal banking agencies to perform their core missions and functions are not conducive to sustaining over the long term a federal consumer protection program that is vigorous, balanced, and creative. These agencies are designed, and their professional staff is trained, to see the world through the lenses of institutions and markets, not consumers. Recent Federal Reserve

regulations have been strong, but quite late in coming. Moreover, they do not ensure that the federal banking agencies will remain committed to consumer protection.

We do not propose a new regulatory agency because we seek more regulation, but because we seek better regulation. The very existence of an agency devoted to consumer protection in financial services will be a strong incentive for institutions to develop strong cultures of consumer protection. The core of such an agency can be assembled reasonably quickly from discrete operations of other agencies. Most rule writing authority is concentrated in a single division of the Federal Reserve, and three of the four federal banking agencies have mostly or entirely separated consumer compliance supervision from prudential supervision. Combining staff from different agencies is not simple, to be sure, but it will bring significant benefits for responsible consumers and institutions, as well as for the market for consumer financial services and products.

- 1. We propose to create a single primary federal consumer protection supervisor to protect consumers of credit, savings, payment, and other consumer financial products and services, and to regulate providers of such products and services.***

Creating a single federal agency (the CFPA) with supervisory, examination, and enforcement authority for protecting consumers would better promote accountability and help prevent regulatory arbitrage. A federally supervised institution would no longer be able to choose its supervisor based on any consideration of real or perceived differences in agencies' approaches to consumer protection supervision and enforcement.

The CFPA should also have the ability to act comprehensively to address emerging consumer protection concerns. For example, under the current fragmented structure, the federal banking agencies took until December 2005 to propose, and then until June 2007 to finalize, supervisory guidance on consumer protection concerns about subprime and nontraditional mortgages; the worst of these mortgages were originated in 2005 and 2006. A single agency, such as the CFPA, could have acted much more quickly and potentially saved many more consumers, communities, and institutions from significant losses.

- 2. The CFPA should have broad jurisdiction to protect consumers in consumer financial products and services such as credit, savings, and payment products.***

We propose that the CFPA's jurisdiction should cover consumer financial services and products such as credit, savings and payment products and related services, as well as the institutions that issue, provide, or service these products and provide services to the entities that provide the financial products. The mission of the CFPA would be to help ensure that:

- consumers have the information they need to make responsible financial decisions;
- consumers are protected from abuse, unfairness, deception, or discrimination;

- consumer financial services markets operate fairly and efficiently with ample room for sustainable growth and innovation; and
- traditionally underserved consumers and communities have access to lending, investment and financial services.

3. *The CFPA should be an independent agency with stable and robust funding.*

The CFPA should be structured to promote its independence and accountability. The CFPA will have a Director and a Board. The Board should represent a diverse set of viewpoints and experiences. At least one seat on the Board should be reserved for the head of a prudential regulator.

The CFPA should have a stable funding stream, which could come in part from fees assessed on entities and transactions across the financial sector, including bank and non-bank institutions and other providers of covered products and services. We look forward to working with Congress to create an agency that is strong, robust, and accountable.

The CFPA should be allowed to appoint and compensate officers and professional, financial and technical staff on terms commensurate with those currently used by other independent financial regulatory agencies.

4. *The CFPA should have sole rule-making authority for consumer financial protection statutes, as well as the ability to fill gaps through rule-making.*

The CFPA should have sole authority to promulgate and interpret regulations under existing consumer financial services and fair lending statutes, such as the Truth in Lending Act (TILA), Home Ownership and Equity Protection Act (HOEPA), Real Estate Settlement and Procedures Act (RESPA), Community Reinvestment Act (CRA), Equal Credit Opportunity Act (ECOA), and Home Mortgage Disclosure Act (HMDA), and the Fair Debt Collection Practices Act (FDCPA). The CFPA should be given similar rulemaking authority under any future consumer protection laws addressing the consumer credit, savings, collection or payment markets.

These laws generally contain broad grants of authority to adopt and enforce rules. But questionable practices may arise in the gaps between these laws or just beyond their boundaries. To promote consistent protection, we propose to vest in the CFPA broad authority to adopt tailored protections – such as disclosures or restrictions on contract terms or sales practices – against unfairness, abuse, or deception, subject to the notice and comment procedures of the Administrative Procedure Act. These protections would apply to any entity that engages in providing a covered financial product or service, including intermediaries such as mortgage brokers, as well as entities that provide services related to consumer debt, such as debt collectors and debt buyers. We also propose that the CFPA should have authority to craft appropriate exemptions from its regulations.

Many of the existing consumer protection statutes contain private rights of action. We do not propose disturbing these longstanding arrangements. In some cases we may seek legislation to increase statutory damages.

Various measures would help ensure that the CFPA's rulemaking reflects an appropriate and balanced array of considerations. Promoting access to financial services is a core part of the CFPA's mission. Therefore, our proposed legislation requires the CFPA to consider the costs to consumers of existing or new regulations, including any potential reduction in consumers' access to financial services, as well as the benefits. It also requires the CFPA to review regulations periodically to assess whether they should be strengthened, adjusted, or scaled back. The CFPA would be required to consult with other federal regulators to promote consistency with prudential, market, and systemic objectives. Our proposal to allocate one of the CFPA's five board seats to a prudential regulator would facilitate appropriate coordination.

5. The CFPA should have supervisory and enforcement authority and jurisdiction over all persons covered by the statutes that it implements, including both insured depositories and the range of other firms not previously subject to comprehensive federal supervision, and it should work with the Department of Justice to enforce the statutes under its jurisdiction in federal court.

We propose that the CFPA have supervisory, examination, and enforcement authority over all entities subject to its regulations, including regulations implementing consumer protection, fair lending, and community reinvestment laws, as well as entities subject to selected statutes for which existing rule-writing authority does not exist or is limited (e.g., Fair Housing Act to the extent it covers mortgages, the Credit Repair Organization Act, the Fair Debt Collection Practices Act, and provisions of the Fair Credit Reporting Act).

The CFPA should assume from the federal prudential regulators all responsibilities for supervising banking institutions for compliance with consumer regulations, whether federally chartered or state chartered and supervised by a federal banking regulator. The CFPA's jurisdiction should extend to bank affiliates that are not currently supervised by a federal regulator. The CFPA should also be required to notify prudential regulators of major matters and share confidential examination reports with them. These agencies, in turn, should be required to refer potential compliance matters to the CFPA and should be authorized to take action if the CFPA fails to act; the same should hold for state supervisors of state-chartered institutions.

The Community Reinvestment Act (CRA) is unique among the panoply of consumer protection and fair lending laws. The CFPA should maintain a group of examiners specially trained and certified in community development to conduct CRA examinations of larger institutions.

The CFPA should also have supervisory and enforcement authority over nonbanking institutions, although the states should be the first line of defense. In its discretion, the CFPA should exercise the full range of supervisory authorities over nonbanking institutions within its jurisdiction, including supervision, information collection and on-site examination. The CFPA should also have the full range of enforcement powers over such institutions, including subpoena authority for documents and testimony, with capacity to compel production by court order. If a state enforcement agency brings an action against an institution within the CFPA's jurisdiction for a violation of one of the

CFPA's regulations, the CFPA should have the ability to intervene in the action for all purposes, including appeals. The CFPA, moreover, should also be able to request that the U.S. Attorney General bring any action necessary to enforce its subpoena authority or to bring any other enforcement action on its behalf in the appropriate court.

The CFPA should be able to promote compliance by publishing supervisory guidance indicating how it intends to administer the laws it implements. The CFPA should also be able to use other creative tools to promote compliance, such as publishing best and worst practices based on surveys, mystery shopping, and information collected from supervision and investigations.

With respect to enforcement, the CFPA will cooperate closely with the Department of Justice. As in other areas of the law, the Department of Justice will also have independent authority to enforce violations of the statutes administered by the CFPA. In addition, the CFPA shall be authorized to share data with the Department of Justice to support enforcement of statutes administered by the CFPA as well as other statutes, such as civil rights statutes, enforced by the Department.

6. The CFPA should pursue measures to promote effective regulation, including conducting periodic reviews of regulations, an outside advisory council, and coordination with the Council.

To promote accountability, the CFPA should be required to complete a regulatory study of each newly enacted regulation at least every three years after the effective date. The study will assess the effectiveness of the enacted regulation in meeting its stated goals, and will allow for public comment on recommendations for expanding, modifying, or eliminating the regulation. For example, these reviews should include mandatory assessments of consumers' ability to understand and use current disclosures and the adequacy of these disclosures to communicate key information that consumers need about the costs and risks of new products. The CFPA should also review existing regulations (such as those implementing TILA), as time and priorities allow, for the same purpose.

Second, we propose the establishment of an outside advisory panel, akin to the Federal Reserve's Consumer Advisory Council, to promote the CFPA's accountability and provide useful information on emerging industry practices. Members of this Council should have deep experience in financial services and community development and be selected to promote a diversity of views on the Council.

Third, the CFPA should work with other agencies through the Council to promote consistent treatment of similar products and to help ensure that no product goes unregulated merely because of uncertainty over jurisdiction. Through this Council, the CFPA should coordinate its efforts with the SEC, the CFTC, and other state and federal regulators to promote consistent, gap-free coverage of consumer and investor products and services. These agencies will report to Congress on their work and will be responsible for joint initiatives where appropriate.

7. The CFPA's strong rules would serve as a floor, not a ceiling. The states should have the ability to adopt and enforce stricter laws for institutions of

all types, regardless of charter, and to enforce federal law concurrently with respect to institutions of all types, also regardless of charter.

Today, states typically retain authority under federal consumer protection and fair lending statutes to adopt stricter laws, so long as they do not conflict with federal law. We do not propose disturbing these long-standing arrangements. Federal rules promulgated by the CFPB under a pre-existing statute or its own organic rulemaking authority should override weaker state laws, but states should be free to adopt stricter laws. In addition, we propose that states should have concurrent authority to enforce regulations of the CFPB.

We propose that federally chartered institutions be subject to nondiscriminatory state consumer protection and civil rights laws to the same extent as other financial institutions. This would restore a fairer and more measured approach to the roles of the states with respect to federally chartered institutions. We also propose that states should be able to enforce these laws, as well as regulations of the CFPB, with respect to federally chartered institutions, subject to appropriate arrangements with prudential supervisors. With respect to state banks supervised by a federal prudential regulator, the CFPB will be the primary consumer compliance supervisor at the federal level.

8. The CFPB should coordinate enforcement efforts with the states.

Maintaining consistency among fifty states' supervisory and enforcement efforts will always remain a significant challenge, but the CFPB's concurrent supervisory and enforcement powers should place it in a position to help. The CFPB should assume responsibility for federal efforts to help the states unify and strengthen standards for registering and improving the quality of providers and intermediaries.

For example, the CFPB should administer the SAFE Act, under which it would set standards for registering and licensing any type of institution that originates mortgages. At present, the authority to administer the act is splintered among many federal agencies. Among other things, the CFPB should be authorized to set higher minimum net worth requirements for originators so that they will have resources to stand behind the strong representations and warranties we are proposing they be required to make.

We further propose that the CFPB be authorized to establish or facilitate registration and licensing regimes for other financial service providers and intermediaries, such as debt collectors, debt counselors or mortgage modification outfits. The CFPB and state enforcement agencies should be able to use registration systems to help weed out bad actors wherever they may operate.

Insufficient resources were devoted to enforcement during the mortgage boom. Periods of rapid market growth are precisely the time when government needs to be more vigilant. Resources have been increased significantly to address the inevitable fraudulent activities that are associated with the fallout of the mortgage crisis. When financial services markets begin to grow again, it is critical that funding at the federal and state levels be adequate to meet the challenge.

9. *The CFPA should have a wide variety of tools to enable it to perform its functions effectively.*

Research and Data. Empirical evidence is critical to a well designed regulatory structure. The CFPA should have authority to collect information through the supervisory process as well as through specific data collection statutes, such as the Home Mortgage Disclosure Act. The CFPA should use this information to improve regulations, promote compliance, and encourage community development. The CFPA should also establish a robust research and statistics department to conduct and promote research across the full range of consumer protection, fair lending, and community development finance issues. The CFPA would need the resources to acquire proprietary databases and collect and process its own data.

Complaints. Complaint data are an important barometer of consumer protection concerns and must be continuously communicated to the persons responsible for consumer regulation, enforcement, and supervision. Currently, however, many consumers do not know where to file a complaint about financial services because of the balkanized regulatory structure. The CFPA should have responsibility for collecting and tracking complaints about consumer financial services and facilitating complaint resolution with respect to federally-supervised institutions. Other federal supervisory agencies should refer any complaints they receive on consumer issues to the CFPA; complaint data should be shared across agencies. The states should retain primary responsibility for tracking and facilitating resolution of complaints against other institutions, and the CFPA should seek to coordinate exchanges of complaint data with state regulators.

Financial education. The CFPA should play a leading role in efforts to educate consumers about financial matters, to improve their ability to manage their own financial affairs, and to make their own judgments about the appropriateness of certain financial products. Additionally, the CFPA should review and streamline existing financial literacy and education initiatives government-wide.

Community Affairs. The CFPA's community affairs function should promote community development investment and fair and impartial access to credit. It should engage in a wide variety of activities to help financial institutions, community-based organizations, government entities, and the public understand and address financial services issues that affect low and middle-income people across various geographic regions.

10. *To improve incentives for compliance, the CFPA should have authority to restrict or ban mandatory arbitration clauses.*

Many consumers do not know that they often waive their rights to trial when signing form contracts in taking out a loan, and that a private party dependent on large firms for their business will decide the case without offering the right to appeal or a public review of decisions. The CFPA should be directed to gather information and study mandatory arbitration clauses in consumer financial services and products contracts to determine to what extent, and in what contexts, they promote fair adjudication and effective redress. If the CFPA determines that mandatory arbitration fails to achieve these goals, it should be

required to establish conditions for fair arbitration, or, if necessary, to ban mandatory arbitration clauses in particular contexts, such as mortgage loans.

11. *The Federal Trade Commission should be given better tools to protect consumers.*

The Federal Trade Commission (FTC) plays a critical role in protecting consumers across the full range of products and services. While the FTC's primary authority for financial product and services protections should be transferred to the CFPB, the FTC should retain backup authority with the CFPB for the statutes for which the FTC currently has jurisdiction. We propose that the FTC should retain authority for dealing with fraud in the financial marketplace, including the sale of services like advance fee loans, credit repair, debt negotiation, and foreclosure rescue/loan modification fraud, but also provide such authority to the CFPB.

The FTC should also remain the lead federal consumer protection agency on matters of data security, with front-end privacy protection on financial issues moved to the CFPB.

We also urge Congress to give the FTC the tools and human, financial, and technical resources it needs to do its job effectively by substantially increasing its capacity to protect consumers in all areas of commerce that remain under its authority. For example, the FTC should be authorized to conduct rulemakings for unfair and deceptive practices under standard notice and comment procedures, and to obtain civil penalties for unfair and deceptive practices.

B. Reforms of Consumer Protection

We propose a series of recommendations for legislation, regulations, and administrative measures by the CFPB to reform consumer protection based on principles of transparency, simplicity, fairness, accountability, and access for all.

- 1. *Transparency. We propose a new proactive approach to disclosure. The CFPB will be authorized to require that all disclosures and other communications with consumers be reasonable: balanced in their presentation of benefits, and clear and conspicuous in their identification of costs, penalties, and risks.***

We propose the following initiatives to improve the transparency of consumer product and service disclosures.

Make all mandatory disclosure forms clear, simple, and concise, and test them regularly.

Mandatory disclosure forms should be clear, simple, and concise. This means the CFPB should make judgments about which risks and costs should be highlighted and which need not be. Consumers should verify their ability to understand and use disclosure forms with qualitative and statistical tests.

A regulator is typically limited to testing disclosures in a "laboratory" environment. A product provider, however, has the capacity to test disclosures in the field, which can produce more robust and relevant results. For example, a credit card provider can try two different methods to disclose the same product risk and determine which was more

effective by surveying consumers and evaluating their behaviors. We propose that the CFPA should be authorized to establish standards and procedures, including appropriate immunity from liability, for providers to conduct field tests of disclosures.

In particular, mortgage disclosures are due for significant reform. The Department of Housing and Urban Development (HUD) and the Federal Reserve have made progress in this regard. HUD, for example, recently developed new RESPA disclosures, and the Federal Reserve is testing new TILA disclosures. The CFPA, having authority over both TILA and RESPA, should have the responsibility to develop and test a single, integrated federal mortgage disclosure that provides consumers with the simplicity they deserve, and reduces regulatory burdens on providers. This provision should not, however, delay or affect current efforts to achieve a single federal disclosure for TILA and RESPA.

Require that disclosures and other communications with consumers be reasonable.

Disclosure mandates for consumer credit and other financial products are typically very technical and detailed. This approach lets the regulator determine which information must be emphasized and helps ensure that disclosures are standard and comparable. Flaws in this approach, however, were made clear by the spread of new and complex credit card plans and mortgages that preceded the credit crisis. The growth in the types of risks stemming from these products far outpaced the ability of disclosure regulations to keep up. Indeed, a regulator must take time to update mandatory disclosures because of the need for consumer testing and public input, and it is unduly burdensome to require the entire industry to update its disclosures too frequently. In addition to detailed rules, we propose a principles-based approach to disclosure.

We propose a regime strict enough to keep disclosures standard throughout the marketplace, yet flexible enough to adapt to new products. Our proposed legislation authorizes the CFPA to impose a duty on providers and intermediaries to require that communications with the consumer are reasonable, not merely technically compliant and non-deceptive.

Reasonableness includes balance in the presentation of risks and benefits, as well as clarity and conspicuousness in the description of significant product costs and risks. This is a higher standard than merely refraining from deception. Moreover, reasonableness does not mean a litany of every conceivable risk, which effectively obscures significant risks. It means identifying conspicuously the more significant risks. It means providing consumers with disclosures that help them to understand the consequences of their financial decisions.

The CFPA should be authorized to apply the duty of reasonableness to communications with or to the consumer, as appropriate, including marketing materials and solicitations. The CFPA should determine the appropriate scope of this duty. A provider or intermediary should be subject to administrative action, but not civil liability, if its communications violate this duty.

The CFPA also should be authorized to apply the duty of reasonableness to mandatory disclosures. The regulator typically sets requirements for disclosure for mainstream products and services. If a new product emerges that the regulator did not anticipate, the

mandatory disclosure may not adequately disclose a major risk of the product. A deficient but compliant mandatory disclosure may lull the consumer into a false sense of security, undermining the very purpose of a disclosure mandate. It is not fair or efficient to make the consumer bear the cost of disclosures that are out of date. Nor is it reasonable to expect that the regulator will have the capacity to update disclosures on a real-time basis. Therefore, we propose that providers should share with the regulator the burden of updating mandatory disclosures when they introduce new products.

The CFPA should be authorized to implement a process under which a provider, acting reasonably and in good faith, could obtain the equivalent of a “no action” letter for disclosure and other communications for a new product. For example, the CFPA could adopt a procedure under which a provider petitions the CFPA for a determination that its product’s risks were adequately disclosed by the mandatory model disclosure or marketing materials. The CFPA could approve use of the mandatory model or marketing materials, or provide a waiver, admissible in court to defend against a claim, for varying the model disclosure. As a further example, if the CFPA failed to respond in a timely fashion, the provider could proceed to market without fear of administrative sanction on that basis. The provider could potentially shorten the mandatory waiting period if it submitted empirical evidence, according to prescribed standards, that its marketing materials and the mandatory disclosure adequately disclosed relevant risks. The CFPA should have authority to adapt and adjust its standards and procedures to seek to maximize the benefits of product innovation while minimizing the costs.

Harness technology to make disclosures more dynamic and relevant to the individual consumer.

Disclosure rules today assume disclosures are on paper and follow a prescribed content, format, and timing; the consumer has no ability to adapt content, timing, or format to her needs. The CFPA should harness technology to make disclosures more dynamic and adaptable to the needs of the individual consumer. New technology can be costly, and the CFPA should consider those costs, but it should also consider that spinoff benefits from new technology can be hard to quantify and could be substantial.

Disclosures should show consumers the consequences of their financial decisions. For example, the recently enacted Credit CARD Act of 2009 requires issuers to show the total cost and time for repayment if a consumer paid only the minimum due each month, and it further requires issuers to show the amount a consumer would have to pay in order to pay off the balance in three years. Technology enhances the ability to tailor this disclosure, and an internet calculator would permit the consumer to select a different period, or input a payment amount above the minimum. Such calculators are common on the internet. The CFPA should mandate a calculator disclosure in circumstances where the CFPA determines the benefits to consumers outweigh the costs. It should also mandate or encourage calculator disclosures for mortgages to assist with comparison shopping. For example, a calculator that shows the costs of a mortgage based on the consumer’s expectations for how long she will stay in the home may reveal a more significant difference between two products than appears on standard paper disclosures.

Technology can also help consumers better manage their use of credit by providing information and options at the most relevant times to them. For example, the CFPB should have authority, after considering the costs and benefits of such a measure, to require issuers to warn consumers who use a debit card at the point of sale or ATM machines that doing so would overdraw their account. The CFPB should also promote adoption of innovations in point-of-sale technology, such as allowing consumers who use a credit card to choose a payment plan for the purchase.

- 2. *Simplicity.* We propose that the regulator be authorized to define standards for “plain vanilla” products that are simpler and have straightforward pricing. The CFPB should be authorized to require all providers and intermediaries to offer these products prominently, alongside whatever other lawful products they choose to offer.**

Even if disclosures are fully tested and all communications are properly balanced, product complexity itself can lead consumers to make costly errors. A careful regulatory approach can tilt the scales in favor of simpler, less risky products while preserving choice and innovation.

“Plain vanilla” mortgages, whether they have fixed or adjustable interest rates, should be easy for consumers to understand. They should not include prepayment penalties and should be underwritten to fully document income, collect escrow for taxes and insurance, and have predictable payments. These products are also easy to compare because they can be differentiated by a single, simple characteristic, the interest rate. We propose that the government do more to promote “plain vanilla” products. The CFPB should be authorized to define standards for such products and require firms to offer them alongside whatever other lawful products a firm chooses to offer.

The Federal Reserve Board issued final regulations last year, which take effect in October, that impose extra protections and higher penalties on “alternative” or “higher cost” loans, that is, mortgages that are not “plain vanilla”. The CFPB should assume responsibility for this regulation. The CFPB should consider whether to add other types of mortgages to the class that receive additional scrutiny and higher penalties, considering the complexity of the mortgage itself, such as negative amortization features, and the performance of the loan type. It should leave in the class that doesn’t have these extra protections only products that meet a plain vanilla test. The CFPB should use survey methods to determine whether consumers who obtained the product type in the marketplace demonstrated awareness and understanding of the product and its risks, such as the risk of payment shock and of the balance exceeding the value of the house. The CFPB should also consider access to credit and costs to consumers of stricter regulations.

The CFPB should be authorized to use a variety of measures to help ensure alternative mortgages were obtained only by consumers who understood the risks and could manage them. For example, the CFPB could impose a strong warning label on all alternative products; require providers to have applicants fill out financial experience questionnaires; or require providers to obtain the applicant’s written “opt-in” to such products. Originators and purchasers of “plain vanilla” mortgages should enjoy a strong presumption that the products are suitable and affordable for the borrower. Originators

and purchasers of alternative products should not enjoy such a presumption, and they should be subject to significantly higher penalties for violations.

- 3. Fairness. Where efforts to improve transparency and simplicity prove inadequate to prevent unfair treatment and abuse, we propose that the CFPB be authorized to place tailored restrictions on product terms and provider practices, if the benefits outweigh the costs. Moreover, we propose to authorize the CFPB to impose appropriate duties of care on financial intermediaries.***

In recent years, the principle that product and service providers should treat consumers fairly has been too often honored only in the breach. The mortgage and credit card markets have demonstrated convincingly the need for rules that require fair contracts and practices and remove or reduce perverse and hidden incentives to take advantage of consumers.

The excessive complexity of many mortgage products created an opportunity to take advantage of consumers' lack of awareness and understanding of product risks. Mortgage originators received direct incentives to exploit this opportunity. They were paid for loan volume rather than loan performance and paid more for loans with higher interest rates and riskier terms. As noted in Section II, the securitization model, without appropriate regulation or transparency, exacerbated these problems by eroding the capacity and incentives for originators, securitizers, and investors to ensure that loans were viable.

In the credit card market, the opacity of increasingly complicated products led major card issuers to migrate almost uniformly to unfavorable methods for assessing fees and interest that could easily trap a responsible consumer in debt. Competition did not force these methods out, because consumers were not aware of them or could not understand them, and issuers did not find it profitable to offer contract terms that were transparent to consumers. For a variety of reasons, regulators have not brought enforcement actions under existing law.

We propose the following measures to promote fair treatment of consumers:

Give the CFPB authority to regulate unfair, deceptive, or abusive acts or practices.

As mortgages and credit cards illustrate, even seemingly "simple" financial products remain complicated to large numbers of Americans. As a result, in addition to meaningful disclosure, there must also be standards for appropriate business conduct and regulations that help ensure providers do not have undue incentives to undermine those standards. Accordingly, the Federal Reserve recently responded to unfair mortgage practices with regulations imposing affordability requirements on subprime loans, and the House recently passed a strong, comprehensive predatory lending bill. Congress, moreover, recently improved credit card contract regulation by passing the Credit CARD Act of 2009.

As described above, the CFPB should assume the statutory authorities to regulate unfair, deceptive, and abusive acts or practices for all credit, savings, and payment products.

The legal standards for these authorities are generally well-established and would require the CFPA to develop a record and weigh costs and benefits before exercising these authorities. The mortgage and credit card cases demonstrate clearly that properly tailored restrictions not only benefit individual consumers, but also institutions and markets by increasing consumer confidence and promoting more effective competition.

The CFPA should also have authority to address overly complex financial contracts. For example, the CFPA should be authorized to consider whether mortgage regulations require strengthening. The CFPA could determine that prepayment penalties should be banned for certain types of products, such as subprime or nontraditional mortgages, or for all products, because the penalties make loans too complex for the least sophisticated consumers or those least able to shop effectively. The CFPA could adopt a “life of loan” approach to regulating mortgages that provides a consumer adequate protections through servicing and loss mitigation stages. The CFPA should also be authorized to ban often-invisible side payments to mortgage originators – so called yield spread premiums or overages – that are tied to the borrower receiving worse terms than she qualifies for, if the CFPA finds that disclosure is not an adequate remedy. These payments incentivize originators to steer consumers to higher-priced or inappropriate mortgages. In addition, the CFPA could consider requiring that originators receive a portion of their compensation over time, contingent on loan performance, rather than in a lump sum at origination.

Give the CFPA authority to impose empirically justified and appropriately tailored duties of care on financial intermediaries.

Impartial advice represents one of the most important financial services consumers can receive. Currently, debt counselors advise distressed and vulnerable borrowers on how to manage and reduce their debts. Mortgage brokers often advertise their trustworthiness as advisors on difficult mortgage decisions. When these intermediaries accept side payments from product providers, they can compromise their ability to be impartial. Consumers, however, may retain faith that the intermediary is working for them and placing their interests above his or her own, even if the conflict of interest is disclosed. Accordingly, in some cases consumers may reasonably but mistakenly rely on advice from conflicted intermediaries. It is unfair for intermediaries to take advantage of that trust.

To address this problem, we propose granting the CFPA authority to impose carefully crafted duties of care on financial intermediaries. For example, the CFPA could impose a duty of care to counteract an intermediary’s patent conflict of interest, or to align an intermediary’s conduct with consumers’ reasonable expectations as demonstrated by empirical evidence. The CFPA could also consider imposing on originators a requirement to disclose material information such as the consumer’s likely ability to qualify for a lower interest rate based on her risk profile. In that regard, the CFPA could impose on mortgage brokers a duty of best execution with respect to available mortgage loans and a duty to determine affordability for borrowers.

The CFPA should apply consistent regulation to similar products.

Fairness, effective competition, and efficient markets require consistent regulatory treatment for similar products. For example, similar disclosure treatment for similar products enables consumers to make informed choices based on a full appreciation of the nature and risks of the product and enables providers to compete fairly and vigorously. Ensuring consistency will require judgment on the part of the CFPA because products often have hybrid features and could fall under different statutes that call for different treatment. The CFPA should assess consumers' understanding and perception of such products. In some cases, it may be appropriate to align the regulation of the products more closely with consumers' perceptions. In other cases, however, consumers' perceptions may reflect a failure of existing regulations to properly inform consumers about a product. In that case, regulations should be revised to frame the presentation of the product more appropriately.

One example is overdraft protection plans. These are a form of consumer credit, and consumers often use them as substitutes for other forms of credit such as payday loans, credit card cash advances, and traditional overdraft lines of credit. However, overdraft protection plans have not been regulated as credit, and, as a result, consumers may not overtly think of the plans as credit. Consumers may not, therefore, take the same care in their use of overdrafts that they take with other, more overt credit products. The CFPA would be authorized by existing statutes to regulate overdraft protection more like a credit product, with Truth in Lending disclosures as appropriate. The CFPA could also prohibit charging for overdraft coverage under a plan unless the consumer has "opted in" to the plan, just as the Credit CARD Act prohibits over-the-limit fees unless the consumer has "opted in" to over-the-limit coverage. It could also require affirmative consent at point of sale with debit transactions or at an ATM machine before collecting an "overdraft fee".

4. Access. *The Agency should enforce fair lending laws and the Community Reinvestment Act and otherwise seek to ensure that underserved consumers and communities have access to prudent financial services, lending, and investment.*

A critical part of the CFPA's mission should be to promote access to financial services, especially for households and communities that traditionally have had limited access. This focus will also help ensure that the CFPA fully internalizes the value of preserving access to financial services and weighs that value against other values when it considers new consumer protection regulations.

Rigorous application of the Community Reinvestment Act (CRA) should be a core function of the CFPA. Some have attempted to blame the subprime meltdown and financial crisis on the CRA and have argued that the CRA must be weakened in order to restore financial stability. These claims and arguments are without any logical or evidentiary basis. It is not tenable that the CRA could suddenly have caused an explosion in bad subprime loans more than 25 years after its enactment. In fact, enforcement of CRA was weakened during the boom and the worst abuses were made by firms not covered by CRA. Moreover, the Federal Reserve has reported that only six percent of all

the higher-priced loans were extended by the CRA-covered lenders to lower income borrowers or neighborhoods in the local areas that are the focus of CRA evaluations.

The appropriate response to the crisis is not to weaken the CRA; it is rather to promote robust application of the CRA so that low-income households and communities have access to responsible financial services that truly meet their needs. To that end, we propose that the CFPB should have sole authority to evaluate institutions under the CRA. While the prudential regulators should have the authority to decide applications for institutions to merge, the CFPB should be responsible for determining the institution's record of meeting the lending, investment, and services needs of its community under the CRA, which would be part of the merger application.

The CFPB should also vigorously enforce fair lending laws to promote access to credit. Furthermore, the CFPB should maintain a fair lending unit with attorneys, compliance specialists, economists, and statisticians. The CFPB should have primary fair lending jurisdiction over federally supervised institutions and concurrent authority with the states over other institutions. Its comprehensive jurisdiction should enable it to develop a holistic, integrated approach to fair lending that targets resources to the areas of greatest risk for discrimination.

To promote fair lending enforcement, as well as community investment objectives, the CFPB should have authority to collect data on mortgage and small business lending. Critical new fields should be added to HMDA data such as a universal loan identifier that permits tying HMDA data to property databases and proprietary loan performance databases, a flag for loans originated by mortgage brokers, information about the type of interest rate (e.g., fixed vs. variable), and other fields that the mortgage crisis has shown to be of critical importance.

C. Strengthen the framework for investor protection by focusing on principles of transparency, fairness, and accountability

In the Securities and Exchange Commission (SEC), we already have an experienced federal supervisor with comprehensive responsibilities for protecting investors against fraud and abuse. In the wake of the scandals associated with the current financial crisis, including Ponzi schemes such as the Madoff affair, the SEC has already begun to strengthen and streamline its enforcement process and to expand resources for enforcement in the FY2010 budget. It has streamlined the process of obtaining formal orders that grant the staff subpoena power and begun a review of its technology and processes to assess risk and manage leads for potential fraud and abuse. The SEC is also using its existing authority to make improvements in investor protections.

We propose the following measures to modernize the financial regulatory structure and improve the SEC's ability to protect investors, focusing on principles of transparency, fairness, and accountability.

1. The SEC should be given expanded authority to promote transparency in disclosures to investors.

To promote transparency, we propose revisions in the federal securities laws to enable the SEC to improve the timing and quality of disclosures to investors.

The SEC should be authorized to require that certain disclosures (including a summary prospectus) be provided to investors at or before the point of sale, if it finds that such disclosures would improve investor understanding of the particular financial products, and their costs and risks. Currently, most prospectuses (including the mutual fund summary prospectus) are delivered with the confirmation of sale, *after* the sale has taken place. Without slowing the pace of transactions in modern capital markets, the SEC should require that adequate information is given to investor to make informed investment decisions.

The SEC can better evaluate the effectiveness of investor disclosures if it can meaningfully engage in consumer testing of those disclosures. The SEC should be better enabled to engage in field testing, consumer outreach and testing of disclosures to individual investors, including by providing budgetary support for those activities.

2. The SEC should be given new tools to promote fair treatment of investors.

We propose the following initiatives to empower the SEC to increase fairness for investors:

Establish a fiduciary duty for broker-dealers offering investment advice and harmonize the regulation of investment advisers and broker-dealers.

Retail investors face a large array of investment products and often turn to financial intermediaries – whether investment advisors or brokers-dealers – to help them manage their investments. However, investment advisers and broker-dealers are regulated under different statutory and regulatory frameworks, even though the services they provide often are virtually identical from a retail investor’s perspective.

Retail investors are often confused about the differences between investment advisers and broker-dealers. Meanwhile, the distinction is no longer meaningful between a disinterested investment advisor and a broker who acts as an agent for an investor; the current laws and regulations are based on antiquated distinctions between the two types of financial professionals that date back to the early 20th century. Brokers are allowed to give “incidental advice” in the course of their business, and yet retail investors rely on a trusted relationship that is often not matched by the legal responsibility of the securities broker. In general, a broker-dealer’s relationship with a customer is not legally a fiduciary relationship, while an investment adviser is legally its customer’s fiduciary.

From the vantage point of the retail customer, however, an investment adviser and a broker-dealer providing “incidental advice” appear in all respects identical. In the retail context, the legal distinction between the two is no longer meaningful. Retail customers repose the same degree of trust in their brokers as they do in investment advisers, but the legal responsibilities of the intermediaries may not be the same

The SEC should be permitted to align duties for intermediaries across financial products. Standards of care for all broker-dealers when providing investment advice about securities to retail investors should be raised to the fiduciary standard to align the legal framework with investment advisers. In addition, the SEC should be empowered to examine and ban forms of compensation that encourage intermediaries to put investors

into products that are profitable to the intermediary, but are not in the investors' best interest.

New legislation should bolster investor protections and bring important consistency to the regulation of these two types of financial professionals by:

- requiring that broker-dealers who provide investment advice about securities to investors have the same fiduciary obligations as registered investment advisers;
- providing simple and clear disclosure to investors regarding the scope of the terms of their relationships with investment professionals; and
- prohibiting certain conflict of interests and sales practices that are contrary to the interests of investors.

The SEC should study the use of mandatory arbitration clauses in investor contracts.

Broker-dealers generally require their customers to contract at account opening to arbitrate all disputes. Although arbitration may be a reasonable option for many consumers to accept after a dispute arises, mandating a particular venue and up-front method of adjudicating disputes – and eliminating access to courts – may unjustifiably undermine investor interests. We recommend legislation that would give the SEC clear authority to prohibit mandatory arbitration clauses in broker-dealer and investment advisory accounts with retail customers. The legislation should also provide that, before using such authority, the SEC would need to conduct a study on the use of mandatory arbitration clauses in these contracts. The study shall consider whether investors are harmed by being unable to obtain effective redress of legitimate grievances, as well as whether changes to arbitration are appropriate.

3. *Financial firms and public companies should be accountable to their clients and investors.*

Expand protections for whistleblowers.

The SEC should gain the authority to establish a fund to pay whistleblowers for information that leads to enforcement actions resulting in significant financial awards. Currently, the SEC has the authority to compensate sources in insider trading cases; that authority should be extended to compensate whistleblowers that bring well-documented evidence of fraudulent activity. We support the creation of this fund using monies that the SEC collects from enforcement actions that are not otherwise distributed to investors.

Expand sanctions available in enforcement actions and harmonize liability standards.

Improved sanctions would better enable the SEC to enforce the federal securities laws. We support the SEC in pursuing authority to impose collateral bars against regulated persons across all aspects of the industry rather than in a specific segment of the industry. The interrelationship among the securities activities under the SEC's jurisdiction, the similar grounds for exclusion from each, and the SEC's overarching responsibility to regulate these activities support the imposition of collateral bars.

The SEC also proposes amending the federal securities laws to provide a single explicit standard for primary liability to replace various circuits' formulations of different "tests" for primary liability.

Require non-binding shareholder votes on executive compensation packages.

Public companies should be required to implement "say on pay" rules, which require shareholder votes on executive compensation packages. While such votes are non-binding, they provide a strong message to management and boards and serve to support a culture of performance, transparency, and accountability in executive compensation. Shareholders are often concerned about large corporate bonus plans in situations in which they, as the company's owners, have experienced losses. Currently, these decisions are often not directly reviewed by shareholders – leaving shareholders with limited rights to voice their concerns about compensation through an advisory vote.

To facilitate greater communication between shareholders and management over executive compensation, public companies should include on their proxies a nonbinding shareholder vote on executive compensation. Legislation that would authorize SEC "say on pay" rules for all public companies could help restore investor trust by promoting increased shareholder participation and increasing accountability of board members and corporate management. It would provide shareholders of all public U.S. companies with the same rights that are accorded to shareholders in many other countries.

4. Under the leadership of the Financial Services Oversight Council, we propose the establishment of a Financial Consumer Coordinating Council and a permanent role for the SEC's Investor Advisory Committee.

To address potential gaps in consumer and investor protection and to promote best practices across different markets, we propose to create a coordinating council of the heads of the SEC, Federal Trade Commission, the Department of Justice, and the Consumer Financial Protection Agency or their designees, and other state and federal agencies. The Coordinating Council should meet at least quarterly to identify gaps in consumer protection across financial products and facilitate coordination of consumer protection efforts. Congress should help ensure the effectiveness of the Coordinating Council for the benefit of consumers by:

- empowering the Council to establish mechanisms for state attorneys general, consumer advocates, and others to make recommendations to the Council on issues to be considered or gaps to be filled;
- requiring the Council to report to Congress and the member agencies semi-annually with recommendations for legislative and regulatory changes to improve consumer and investor protection, and with updates on progress made on prior recommendations; and
- empowering the Council to sponsor studies or engage in consumer testing to identify gaps, share information and find solutions for improving consumer protection across a range of financial products.

The SEC has recently established an Investor Advisory Committee, made up of a diverse group of well-respected investors, to advise on the SEC's regulatory priorities, including issues concerning new products, trading strategies, fee structures, and the effectiveness of disclosure. The Investor Advisory Committee should be made permanent by statute.

5. *Promote retirement security for all Americans by strengthening employment-based and private retirement plans and encouraging adequate savings.*

Congress should enact the "Automatic IRA" and a strengthened saver's credit.

For many years, until the current recession, the personal saving rate in the United States has been exceedingly low. In addition, tens of millions of U.S. households have not placed themselves on a path to become financially prepared for retirement. In order to address this problem, the President has proposed two innovative initiatives in his 2010 Budget: (1) introducing an "Automatic IRA" (with opt-out) for employees whose employers do not offer a plan; and (2) increasing tax incentives for retirement savings for families that earn less than \$65,000 by modifying the "saver's credit" and making it refundable. Together these initiatives will expand plan coverage, combat inertia, and increase incentives to save.

Under the "Automatic IRA" plan, employers in business for at least two years that have 10 or more employees would be required to offer an automatic IRA option (with opt-out), under which regular payroll-deduction contributions would be made to an IRA. Employers would not have to choose or arrange default investments. Instead, a low-cost, standard type of default investment and a handful of standard, low-cost investment alternatives would be prescribed by statute or regulation.

The modified saver's credit would be fully refundable and deposited automatically in the individual's qualified retirement plan account or IRA. These changes make the saver's credit more like a matching contribution, enhancing the likelihood that the credit would be saved. The proposal would offer a meaningful saving incentive to tens of millions of additional households while simplifying the current complex structure of the credit and raising the eligibility income threshold to cover millions of additional moderate-income taxpayers.

Improve retirement security through employee-directed workplace retirement plans, automatic IRAs and other measures.

Employee-directed workplace retirement plans (such as 401(k)s) and Automatic IRAs should be governed by the same core principles that inform our comprehensive approach to consumer and investor protection in the retail marketplace. Plans should be *transparent*, providing information about the risks, returns, and costs of different investment choices in terms that real people can use to make decisions. They should be as *simple* as possible, designed to make savings and investment decisions easy, such as by offering the convenience of automation. They should be *fair* and free from conflicts of interest (such as those that can affect third party providers) that could harm employees. Plan sponsors and others who provide services to the plan or to individual employees (such as the management of employee investments) should be *accountable* and subject to

appropriate oversight. Finally, high-quality plans that make savings and investment easy should be *accessible* to all workers.

There are a number of other critical issues in the area of retirement security that need to be addressed. We should explore ways to encourage the use of automatic features to increase participation and improve saving and investment behavior in 401(k) plans, and restore more lifetime income throughout the retirement system – in defined benefit plans, defined contribution plans, and IRAs. We should aim to reduce costs, such as investment fees. We should investigate how to better preserve savings for retirement, reducing “leakage” from retirement plans. Finally, we should explore means of strengthening the defined benefit plan system.

IV. PROVIDE THE GOVERNMENT WITH THE TOOLS IT NEEDS TO MANAGE FINANCIAL CRISES

Over the past two years, the financial system has been threatened by the failure or near failure of some of the largest and most interconnected financial firms. Our current system already has strong procedures and expertise for handling the failure of banks, but when a bank holding company or other nonbank financial firm is in severe distress, there are currently only two options: obtain outside capital or file for bankruptcy. During most economic climates, these are suitable options that will not impact greater financial stability.

However, in stressed conditions it may prove difficult for distressed institutions to raise sufficient private capital. Thus, if a large, interconnected bank holding company or other nonbank financial firm nears failure during a financial crisis, there are only two untenable options: obtain emergency funding from the US government as in the case of AIG, or file for bankruptcy as in the case of Lehman Brothers. Neither of these options is acceptable for managing the resolution of the firm efficiently and effectively in a manner that limits the systemic risk with the least cost to the taxpayer.

We propose a new authority, modeled on the existing authority of the FDIC, that should allow the government to address the potential failure of a bank holding company or other nonbank financial firm when the stability of the financial system is at risk.

In order to improve accountability in the use of other crisis tools, we also propose that the Federal Reserve Board receive prior written approval from the Secretary of the Treasury for emergency lending under its “unusual and exigent circumstances” authority.

A. Create a resolution regime for failing BHCs, Including Tier 1 FHCs

We recommend the creation of a resolution regime to avoid the disorderly resolution of failing BHCs, including Tier 1 FHCs, if a disorderly resolution would have serious adverse effects on the financial system or the economy. The regime would supplement (rather than replace) and be modeled on to the existing resolution regime for insured depository institutions under the Federal Deposit Insurance Act.

The federal government’s responses to the impending bankruptcy of Bear Stearns, Lehman Brothers, and AIG were complicated by the lack of a statutory framework for avoiding the disorderly failure of nonbank financial firms, including affiliates of banks or other insured depository institutions. In the absence of such a framework, the government’s only avenue to avoid the disorderly failures of Bear Stearns and AIG was the use of the Federal Reserve’s lending authority. And this mechanism was insufficient to prevent the bankruptcy of Lehman Brothers, an event which served to demonstrate how disruptive the disorderly failure of a nonbank financial firm can be to the financial system and the economy.

For these reasons, we propose the creation of a resolution regime to allow for the orderly resolution of failing BHCs, including Tier 1 FHCs, in situations where the stability of the financial system is at risk.

This resolution regime should not replace bankruptcy procedures in the normal course of business. Bankruptcy is and will remain the dominant tool for handling the failure of a BHC, unless the special resolution regime is triggered because of concerns about financial stability.

The proposed resolution regime is modeled on the “systemic risk exception” contained within the existing FDIC resolution regime. This exception allows the FDIC to depart from the least cost resolution standard, when financial stability is at risk. Like that authority, the authority that we propose here would be only for extraordinary times and would be subject to very strict governance and control procedures.

We propose a formal process for deciding whether use of this special resolution regime is necessary for a particular firm and determining the form that the resolution process for the firm should take. The process could be initiated by Treasury or the Federal Reserve. In addition, the process could be initiated by the FDIC, or, by the SEC, when the largest subsidiary of the failing firm is a broker-dealer or securities firm.

The authority to decide whether to resolve a failing firm under the special resolution regime should be vested in Treasury, which could invoke the authority only after consulting with the President and only upon the written recommendation of two-thirds of the members of the Federal Reserve Board and two-thirds of the members of the FDIC Board. But, if the largest subsidiary of the firm (measured by total assets) is a broker-dealer, then FDIC Board approval is not required and two-thirds of the commissioners of the SEC must approve. If the failing firm includes an insurance company, the Office of National Insurance within Treasury will provide consultation to the Federal Reserve and FDIC Boards on insurance specific matters.

To invoke this authority, Treasury should have to determine that: (1) the firm is in default or in danger of defaulting; (2) the failure of the firm and its resolution under otherwise applicable law would have serious adverse effects on the financial system or the economy; and (3) use by the government of the special resolution regime would avoid or mitigate these adverse effects.

The authority to decide how to resolve a failing firm under the special resolution regime should also be vested in Treasury. The tools available to Treasury should include the ability to establish conservatorship or receivership for a failing firm. The regime also should provide for the ability to stabilize a failing institution (including one that is in conservatorship or receivership) by providing loans to the firm, purchasing assets from the firm, guaranteeing the liabilities of the firm, or making equity investments in the firm. We propose that, in choosing among available tools, Treasury should consider the effectiveness of an action for mitigating potential adverse effects on the financial system or the economy, the action’s cost to the taxpayers, and the action’s potential for increasing moral hazard.

Treasury generally should appoint the FDIC to act as conservator or receiver, in cases where it has decided to establish conservatorship or receivership. Treasury should have the authority to appoint the SEC as conservator or receiver when the largest subsidiary of the failing firm, measured by total assets, is a broker-dealer or securities firm. The conservator or receiver should coordinate with foreign authorities that may be involved in

the resolution of subsidiaries of the firm located in foreign jurisdictions. The existing customer protections provided to insured depositors, customers of broker-dealers and futures commission merchants, and insurance policyholders under federal or state law should be maintained.

The conservator or receiver of the firm should have broad powers to take action with respect to the financial firm. For example, it should have the authority to take control of the operations of the firm or to sell or transfer all or any part of the assets of the firm in receivership to a bridge institution or other entity. That should include the authority to transfer the firm's derivatives contracts to a bridge institution and thereby avoid termination of the contracts by the firm's counterparties (notwithstanding any contractual rights of counterparties to terminate the contracts if a receiver is appointed). The conservator or receiver should also have the power to renegotiate or repudiate the firm's contracts, including contracts with its employees.

The entity acting as conservator or receiver should be authorized to borrow from Treasury when necessary to finance exercise of the authorities under the resolution regime, and Treasury should be authorized to issue public debt to finance any such loans. The costs of any such loans should be paid from the proceeds of assessments on BHCs. Such assessments should be based on the total liabilities (other than liabilities that are assessed to fund other federal or state insurance schemes).

In addition, in light of the FDIC's role in the proposed special resolution regime for BHCs, the FDIC should have the authority to obtain any examination report prepared by the Federal Reserve with respect to any BHC, and should have back-up examination authority over BHCs.

B. Amend the Federal Reserve's Emergency Lending Authority

We will propose legislation to amend Section 13(3) of the Federal Reserve Act to require the prior written approval of the Secretary of the Treasury for any extensions of credit by the Federal Reserve to individuals, partnerships, or corporations in "unusual and exigent circumstances."

Section 13(3) of the Federal Reserve Act provides that in "unusual and exigent circumstances" the Federal Reserve Board, upon a vote of five or more members, may authorize a Federal Reserve Bank to lend to any individual, partnership, or corporation. The only constraints on such lending are that any such loans must be guaranteed or secured to the satisfaction of the Reserve Bank and that the Reserve Bank must obtain evidence that the borrower is unable to obtain "adequate credit accommodations" from banks.

During the recent financial crisis, the Federal Reserve Board has used this authority on several occasions to protect the financial system and the economy. It has lent to individual financial institutions to avoid their disorderly failure (e.g. AIG). It has created liquidity facilities to bolster confidence and liquidity in numerous sectors (e.g., investment banks, MMFs, commercial paper issuers). Further, it has created liquidity facilities designed to revive the securitization markets and thereby restore lending to consumers and businesses whose access to credit was dependent on those markets.

Financial Regulatory Reform: A New Foundation

The Federal Reserve Board currently has authority to make such loans without the approval of the Secretary of the Treasury. In practice, in each instance during the crisis in which it has used its Section 13(3) authority it has sought and received the approval of the Secretary. Indeed, the liquidity facilities designed to revive the securitization markets have involved use of TARP funds to secure the 13(3) loans and the facilities were jointly designed by the Federal Reserve and Treasury.

The Federal Reserve's Section 13(3) authority should be subject to prior written approval of the Secretary of Treasury for lending under Section 13(3) to provide appropriate accountability going forward.

V. RAISE INTERNATIONAL REGULATORY STANDARDS AND IMPROVE INTERNATIONAL COOPERATION

As we have witnessed during this crisis, financial stress can spread easily and quickly across national boundaries. Yet, regulation is still set largely in a national context. Without consistent supervision and regulation, financial institutions will tend to move their activities to jurisdictions with looser standards, creating a race to the bottom and intensifying systemic risk for the entire global financial system.

The United States is playing a strong leadership role in efforts to coordinate international financial policy through the G-20, the Financial Stability Board, and the Basel Committee on Banking Supervision. We will use our leadership position in the international community to promote initiatives compatible with the domestic regulatory reforms described in this report.

We will focus on reaching international consensus on four core issues: regulatory capital standards; oversight of global financial markets; supervision of internationally active financial firms; and crisis prevention and management.

At the April 2009 London Summit, the G-20 Leaders issued an eight-part declaration outlining a comprehensive plan for financial regulatory reform.

The domestic regulatory reform initiatives outlined in this report are consistent with the international commitments the United States has undertaken as part of the G-20 process, and we propose stronger regulatory standards in a number of areas.

A. Strengthen the International Capital Framework

We recommend that the BCBS continue to modify and improve Basel II by refining the risk weights applicable to the trading book and securitized products, introducing a supplemental leverage ratio, and improving the definition of capital by the end of 2009. We also urge the BCBS to complete an in-depth review of the Basel II framework to mitigate its procyclical effects.

In 1988, the BCBS developed the Basel Accord to provide a framework to strengthen banking system safety and soundness through internationally consistent bank regulatory capital requirements. As weaknesses in the original Basel Accord became increasingly apparent, the BCBS developed a new accord, known as Basel II. The United States has not fully implemented Basel II, but the international financial crisis has already demonstrated weaknesses in the Basel II framework.

We support the BCBS's efforts to address these weaknesses. In particular, we support the BCBS's efforts to improve the regulatory capital framework for trading book and securitization exposures by 2010.

Second, we urge the BCBS to strengthen the definition of regulatory capital to improve the quality, quantity, and international consistency of capital. We urge the BCBS to issue guidelines to harmonize the definition of capital by the end of 2009, and develop recommendations on minimum capital levels in 2010.

Third, we urge the BCBS to develop a simple, transparent, non-model based measure of leverage, as recommended by the G-20 Leaders.

Fourth, we urge the Financial Stability Board (FSB), BCBS, and the Committee on the Global Financial System (CGFS), in coordination with accounting standard setters, to implement by the end of 2009 the G-20's recommendations to mitigate procyclicality, including a requirement for banks to build capital buffers in good times that they can draw down when conditions deteriorate. This is consistent with our proposal in Section I that banks and BHCs should have enough high-quality capital during good economic times to keep them above prudential minimum capital requirements during stressed economic circumstances.

B. Improve the Oversight of Global Financial Markets

We urge national authorities to promote the standardization and improved oversight of credit derivative and other OTC derivative markets, in particular through the use of central counterparties, along the lines of the G-20 commitment, and to advance these goals through international coordination and cooperation.

The G-20 Leaders agreed to promote the standardization and central clearing of credit derivatives and called on industry to develop an action plan in that regard by autumn 2009. Market participants within the United States have already created standardized contracts for use in North America that meet the G-20 commitment. Several central counterparties have also been established globally to clear credit derivatives.

In Section II, we propose regulations for the Over-the-Counter (OTC) derivatives market that go beyond G-20 commitments. Given the global nature of financial markets, the United States must continue to work with our international counterparts to raise international standards for OTC derivatives markets, further integrate our financial market infrastructures, and avoid measures that may result in market fragmentation.

C. Enhance Supervision of Internationally Active Financial Firms

We recommend that the FSB and national authorities implement G-20 commitments to strengthen arrangements for international cooperation on supervision of global financial firms through establishment and continued operational development of supervisory colleges.

The financial crisis highlighted the need for an ongoing mechanism for cross-border information sharing and collaboration among international regulators of significant global financial institutions.

At the recommendation of the G-20 Leaders, supervisors have established "supervisory colleges" for the thirty most significant global financial institutions. The supervisory colleges for all thirty firms have met at least once. Supervisors will establish additional colleges for other significant cross-border firms. The FSB will review the colleges' activities for lessons learned once the colleges have garnered sufficient experience.

D. Reform Crisis Prevention and Management Authorities and Procedures

We recommend that the BCBS expedite its work to improve cross-border resolution of global financial firms and develop recommendations by the end of 2009. We further urge national authorities to improve information-sharing arrangements and implement the FSB principles for cross-border crisis management.

Cross-Border Resolution of Financial Firms

The current financial crisis has affected banks and nonbank financial firms without regard to their legal structure, domicile, or location of customers. Many of the ailing financial institutions are large, have complex internal structures and activities, and operate in multiple nations. The global financial system is more interconnected than it has ever been.

Currently, neither a common procedure nor a complete understanding exists of how countries can intervene in the failure of a large financial firm and how those actions might interact with resolution efforts of other countries. For instance, countries differ on close-out netting rules for financial transactions or deposits. National regulatory authorities are inclined to protect the assets within their own jurisdictions, even when doing so can have spillover effects for other countries.

Many countries do not have effective systems for resolving bank failures, which has forced policy makers to employ sub-optimal, ad hoc responses to failing financial firms.

As discussed above, the United States already has in place a robust resolution regime for insured depository institutions. Moreover, we are proposing to create a resolution regime that provides sufficient authority to avoid the disorderly resolution of any firm whose failure would have systemic implications.

The G-20 welcomed continued efforts by the International Monetary Fund (IMF), FSB, World Bank, and BCBS to develop an international framework for cross-border bank resolutions.

The United States and its international counterparts should work together to improve mechanisms for the cross-border resolution of financial firms by:

- creating a flexible set of powers for resolution authorities to provide for continuity of systemically significant functions, such as the ability to transfer assets, contracts, and operations to other firms or a bridge institution; the ability to create and operate short-term bridge institutions; the immediate authority to resolve a failed institution; and more predictable and consistent closure thresholds;
- furthering the development of mechanisms for cross-border information sharing among relevant regulatory authorities and increasing the understanding of how the various national resolution regimes for cross-border bank and nonbank financial firms interact with each other;
- implementing reforms to enhance the effectiveness and efficiency of crisis management and resolutions under the currently prevailing ‘separate entity’

approach. The BCBS should initiate further work on the feasibility and desirability of moving towards the development of methods for allocating the financial burden associated with the failure of large, multinational financial firms to maximize resolution options; and

- further enhancing the effectiveness of existing rules for the clearing and settlement of cross-border financial contracts and large value payments transactions, including by providing options for the maintenance of contractual relationships during insolvency, such as through the bridge institution option available in U.S. bank receivership law.

Crisis Management Principles

National regulators, including U.S. regulators, are implementing the FSB principles for cross-border crisis management endorsed by the G-20 Leaders. The home country regulators for each major international financial institution will be responsible for ensuring that the group of authorities with a common interest in a particular financial institution will meet at least annually.

In addition to the four above-mentioned core priorities, the United States is committed to implementing the rest of the regulatory reform agenda that the G-20 Leaders adopted at their Summit in April. The United States will host the third leaders' summit in Pittsburgh in September 2009, and would like to see progress made on the rest of the issues addressed in the *G-20 Declaration on Strengthening the Financial System*, outlined below.

E. Strengthen the Financial Stability Board

We recommend that the FSB complete its restructuring and institutionalize its new mandate to promote global financial stability by September 2009.

At the London Summit, the G-20 Leaders called for the reconstitution of the FSF, originally created in 1999. The FSF, now called the FSB, expanded its membership to include all G-20 members, and the G-20 Leaders strengthened the FSB's mandate to promote financial stability. Under its strengthened mandate, the FSB will assess financial system vulnerabilities, promote coordination and information exchange among authorities, advise and monitor best practices to meet regulatory standards, set guidelines for and support the establishment of supervisory colleges, and support cross-border crisis management and contingency planning.

F. Strengthen Prudential Regulations

We recommend that the BCBS improve liquidity risk management standards for financial firms and that the FSB work with the Bank for International Settlements (BIS) and standard setters to develop macroprudential tools.

The BCBS and national authorities should develop, by 2010, a global framework for promoting stronger liquidity buffers at financial institutions, including cross-border institutions.

The FSB should work with the BIS and international standard setters to develop macroprudential tools and provide a report to the G-20 by autumn 2009.

G. Expand the Scope of Regulation

1. Identify Foreign Financial Firms that are Tier 1 FHCs. Determine the appropriate Tier 1 FHC definition and application of requirements for foreign financial firms.

As discussed above in Section I, we propose that a stricter regime of supervision and regulation apply to Tier 1 FHCs than to other BHCs. This regime should include, among other things, stronger capital, liquidity and risk management standards for Tier 1 FHCs than for other BHCs. Similarly, the G-20 Leaders agreed in April that “all systemically important financial institutions, markets, and instruments should be subject to an appropriate degree of regulation and oversight.”

In consultation with Treasury, the Federal Reserve should develop rules to guide the identification of foreign financial firms as Tier 1 FHCs based on whether their U.S. operations pose a threat to financial stability. This evaluation should be similar to that used to identify domestic Tier 1 FHCs. The Federal Reserve could consider applying the criteria to the world-wide operations of the foreign firm. The Federal Reserve could also choose to apply the criteria only to the U.S. operations of the foreign firm or to those operations of the foreign firm that affect the U.S. financial markets. Several options are available for foreign financial firms.

In determining which foreign firms are subject to the Tier 1 FHC regime, the Federal Reserve should give due regard to the principle of national treatment and equality of competitive opportunity between foreign-based firms operating in the United States and U.S.-based firms. The Federal Reserve should also consider the implications of these determinations for international agreements negotiated by the executive branch. Under our proposal, Treasury would not play a role in the application of these rules to specific firms.

In addition, the new “well-capitalized” and “well-managed” tests for FHC status proposed in this report should apply to foreign financial institutions operating in the United States in a manner comparable to that of U.S. owned financial institutions, while taking into account the difference in their legal forms (such as branch) from their U.S. counterparts.

Under the current Gramm Leach Bliley (GLB) Act regime, a foreign bank that owns or controls a U.S. bank must comply with the same requirements as a domestic BHC to achieve FHC status, namely, all the U.S. subsidiary banks of the BHC or foreign bank must be “well-capitalized” and “well-managed.” A foreign bank that does not own or control a U.S. bank, but instead operates through a branch, agency, or commercial lending company located in the United States must itself be “well-capitalized” and “well managed” if it elects to become an FHC. If a foreign bank operates in the United States through branches and subsidiary banks, both the foreign parent bank and its U.S. subsidiary bank must be “well-capitalized” and “well-managed” if the foreign bank elects to become an FHC.

Although we propose to change the FHC eligibility requirements in this report, we do not propose to dictate the manner in which those requirements are applied to foreign financial firms with U.S. operations. We propose to permit the Federal Reserve, in consultation with Treasury, to determine how to apply these new requirements to foreign banks that seek FHC status. The Federal Reserve should also make its determination giving due regard to the principle of national treatment and equality of competitive opportunity.

- 2. *Expand Regulation to Hedge Funds. We urge national authorities to implement by the end of 2009 the G-20 commitment to require hedge funds or their managers to register and disclose appropriate information necessary to assess the systemic risk they pose individually or collectively.***

The G-20 Leaders agreed to require registration of hedge funds or their managers subject to threshold limits and to require hedge funds to disclose appropriate information on an ongoing basis to allow supervisors to assess the systemic risk they pose individually or collectively. Our regulatory reform proposal expands upon the G-20's recommendations to include registration of advisors to other private pools of capital, along with recordkeeping and additional disclosure requirements to investors, creditors and counterparties.

H. Introduce Better Compensation Practices

In line with G-20 commitments, we urge each national authority to put guidelines in place to align compensation with long-term shareholder value and to promote compensation structures do not provide incentives for excessive risk taking. We recommend that the BCBS expediently integrate the FSB principles on compensation into its risk management guidance by the end of 2009.

The financial crisis highlighted the problems associated with compensation structures that do not take into consideration risk and firms' goals over the longer term. In April, the G-20 Leaders endorsed the principles on compensation in significant financial institutions developed by the FSB to align compensation structures with firms' long-term goals and prudent risk taking.

Consistent with that commitment, we propose in this report that federal regulators issue standards for compensation practices by banks and BHCs.

I. Promote Stronger Standards in the Prudential Regulation, Money Laundering/Terrorist Financing, and Tax Information Exchange Areas

The United States is committed to working diligently to raise both U.S. and global regulatory standards, improving and coordinating implementation of those standards, and thereby closing geographic regulatory gaps.

In advance of the G-20 London Summit, Secretary Geithner put forward the U.S. "Trifecta" initiative to raise international standards in areas of prudential supervision, tax information exchange, and anti-money laundering/terrorist financing (AML/CFT) through greater use of objective assessments, due diligence, and objective peer reviews. The G-20 London Summit Declaration endorsed the U.S. initiative.

- 1. We urge the FSB to expeditiously establish and coordinate peer reviews to assess compliance and implementation of international regulatory standards, with priority attention on the international cooperation elements of prudential regulatory standards.***

As part of the U.S. initiative, the FSB began joint work with international standard setters (the BCBS, the International Association of Insurance Supervisors, and the International Organization of Securities Commissions—IOSCO) and with the IMF to expand the use of assessments and peer reviews. The FSB and standard setters should build upon existing applicable processes already in use by standard setters in order to assess compliance. The FSB is focusing particular attention on assessing compliance with those standards related to information exchange and international cooperation.

- 2. The United States will work to implement the updated ICRG peer review process and work with partners in the FATF to address jurisdictions not complying with international AML/CFT standards.***

The International Cooperation Review Group (ICRG) of the Financial Action Task Force (FATF) is responsible for engaging with non-compliant jurisdictions and recommending application of countermeasures by the FATF. The United States is co-chair, with Italy, of the ICRG and is leading efforts to revise and strengthen the procedures used to select jurisdictions for further scrutiny. FATF will finalize the revision of ICRG assessment procedures at its upcoming plenary meeting at the end of June.

J. Improve Accounting Standards

- 1. We recommend that the accounting standard setters clarify and make consistent the application of fair value accounting standards, including the impairment of financial instruments, by the end of 2009.***

The G-20 Leaders directed the accounting standard setters to improve the standards for the valuation of financial instruments and to reduce the complexity of financial instrument accounting. The International Accounting Standards Board (IASB) undertook a project to develop by July 2009 a new financial measurement standard that would replace International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*, the fair value measurement standard under International Financial Reporting Standards (IFRS), and reduce the complexity of accounting standards.

In addition, the Financial Accounting Standards Board (FASB) and IASB have provided additional guidance on fair value measurement. The standard setters are also evaluating the recommendations provided by the Financial Crisis Advisory Group (“FCAG”), a high level advisory group that standard setters established in December 2008.

In response to FASB’s recent changes to its impairment standard for debt securities, the IASB has committed to making improvements to its own impairment requirements as part of its comprehensive financial instrument project, slated for an exposure draft by October 2009. Moreover, the IASB has also committed to work with FASB as part of its comprehensive financial instrument project to promote global consistency in impairment approaches.

- 2. *We recommend that the accounting standard setters improve accounting standards for loan loss provisioning by the end of 2009 that would make it more forward looking, as long as the transparency of financial statements is not compromised.***

In its April 2009 report addressing procyclicality in the financial system, the FSB determined that earlier recognition of loan losses by financial firms could have reduced the procyclical effect of write-downs in the current crisis. The FSB recommended that the accounting standard setters issue a statement that the current incurred loss approach to loan loss provisions allows for more judgment than banks currently exercise.

The FSB also recommended that the accounting standard setters give consideration to alternative conceptual approaches to loan loss recognition, such as a fair value model, an expected loss model, and dynamic provisioning.

As directed by the FSB and G-20 Leaders, accounting standard setters continue to evaluate the issue of loan loss provisioning, including developing an expected loss model to replace the current incurred loss model.

- 3. *We recommend that the accounting standard setters make substantial progress by the end of 2009 toward development of a single set of high quality global accounting standards.***

The G-20 Leaders agreed that the accounting standard setters should make substantial progress toward a single set of high quality global accounting standards by the end of 2009. The IASB and FASB have engaged in extensive efforts to converge IFRS and U.S. Generally Accepted Accounting Principles (GAAP) to minimize or eliminate differences in the two sets of accounting standards. Last year, the IASB and FASB reiterated their objective of achieving broad convergence of IFRS and U.S. GAAP by the end of 2010, which is a necessary precondition under the SEC's proposed roadmap to adopt IFRS. Currently, the SEC is considering comments submitted on its proposed roadmap that sets forth several milestones that could lead to the eventual use of IFRS by all U.S. issuers.

K. Tighten Oversight of Credit Rating Agencies

We urge national authorities to enhance their regulatory regimes to effectively oversee credit rating agencies (CRAs), consistent with international standards and the G-20 Leaders' recommendations.

As discussed above, the performance of CRAs, particularly their ratings of mortgage-backed securities and other asset-backed securities, contributed significantly to the financial crisis.

The G-20 Leaders pledged to undertake more effective oversight of the activities of CRAs. Specifically, national authorities should register and oversee all CRAs whose ratings are used for regulatory purposes consistent with the IOSCO Code of Conduct Fundamentals for CRAs by the end of 2009.

Moreover, all national authorities should enforce compliance with their oversight regime to promote adequate practices and procedures for managing conflicts of interest in CRAs and to maintain the transparency and quality of the ratings process. The G-20 Leaders

also called for the CRAs to differentiate ratings for structured products and provide full disclosure on performance measures and ratings methodologies.

The U.S. regulatory regime for CRAs is consistent with IOSCO's Code of Conduct for CRAs. Moreover, Treasury proposed, consistent with the G-20's recommendations, that the SEC continue its efforts to tighten the regulation of CRAs along a number of dimensions, including through public disclosures of performance measures and methodologies and better differentiation of structured credit from other credit products.

Given the important role played by CRAs in our financial markets, the United States will continue to work with our international counterparts to promote consistency of national oversight regimes across jurisdictions and that national authorities engage in appropriate information sharing, as called for by the G-20 Leaders.