

THE GLOBAL FINANCIAL CRISIS

A Plan for Regulatory Reform

May 2009



COMMITTEE ON CAPITAL MARKETS REGULATION

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EXECUTIVE SUMMARY

The Committee on Capital Markets Regulation offers this Report—a detailed plan for regulatory reform—in direct response to the most serious financial crisis of the past 80 years. The topics covered vary in degree of complexity, and wherever appropriate we have aimed to benefit our discussion with an empirical or otherwise objective analysis. Throughout each of these chapters, we make specific recommendations for critical changes in regulatory policy.

Several key themes emerge from our Report. The first theme is that our goal must be *effective* regulation. Although we recommend introducing regulation in some previously unregulated areas, the crisis has shown that the most precarious sectors of our financial system are those already subject to a great deal of regulation—regulation that has proven woefully ineffective. Our call to advance effective reform means that new or revised regulations should be based on solid principles—chief among them being the reduction of systemic risk. A second theme of this Report is the need to increase investor protection through greater transparency in the financial system. More information enables the market to price assets, risk, and other relevant inputs more accurately. Much of the present crisis can be attributed to a lack of critical information (and perhaps, in some cases, misinformation). The necessity of building a U.S. financial regulatory structure able to achieve these goals is a third theme of this Report. Simply put, our regulatory structure must be entirely reorganized in order to become more integrated and efficient. A final theme is that a global crisis demands a global solution. The U.S. financial system is best viewed as an integral part of the overall global financial system. No longer can the United States regulate in a vacuum. Coordination with other national regulators and cooperation with regional and international authorities is required.

This Report, however, is far more than a collection of abstract themes. Rather, we have designed the Report to serve as a clear roadmap for policymakers by setting forth 57 practical and specific recommendations for reform. We have noted in this Executive Summary where our recommendations are consistent with other recent and thoughtful proposals on financial regulatory reform.

Chapter 1: The Crisis and a Regulatory Approach

Before tackling the regulatory questions arising from the global financial crisis, we believe it is important to focus on two foundational matters. The first is the sheer gravity of the present crisis; the second is the overall regulatory approach the Committee believes policymakers should adopt going forward.

A. Severity of the Crisis

We are facing the most serious financial crisis since the Great Depression. The crisis has manifested itself in credit losses, writedowns, liquidity shocks, deflated property values, and a contraction of the real economy. We present data on the severity of the crisis in four broad categories: (1) U.S. loss estimates; (2) U.S. housing sector; (3) U.S. financial sector; and (4) global loss estimates.

In April 2009, the International Monetary Fund (IMF) estimated total near-term global losses on U.S. credit-related debt to be \$2.7 trillion. Growth forecasts in 2009 are negative across the board. Costs directly attributable to the crisis include new spending by the federal government, including the Troubled Assets Relief Program (TARP) (\$700 billion) and the stimulus package passed in February (\$787 billion).

In the housing sector, banks took advantage of low interest rates and securitization opportunities to institute relaxed lending standards that drove mortgage lending throughout the early part of the decade. While the number of households in the United States increased only marginally between 1990 and 2008, the aggregate mortgage debt outstanding more than quadrupled during that same period. Increased borrowing by U.S. households was partially offset by climbing asset prices. However, the period of rising property values came to a close after reaching a peak in Q2 2006, with home prices eventually falling by 27% by Q4 2008. The burst of the housing bubble has virtually eliminated construction and sales activity. American homeowners are also in trouble, with the percentage of delinquent mortgages at an all-time high while 20% of all mortgages are in a negative equity position.

The financial sector is still very unstable. During the last nine months, some of the most prominent banks and other financial institutions have failed or been acquired, bailed out, or placed in conservatorship. The wreckage on Wall Street and elsewhere stems in part from the explosive growth in complex and mispriced mortgage-related securities. From 2001 to 2003, total residential mortgage-backed security (RMBS) issuance nearly doubled from \$1.3 trillion to \$2.7 trillion. As the RMBS market cooled, the collateralized debt obligation (CDO) market took off. Global issuance of CDOs—re-securitizations of other forms of debt—more than tripled in the two-year period between Q1 2005 and Q1 2007. As the housing bubble burst, the market for these securities dried up and their values have plummeted. Shrinking balance sheets and shaken confidence in the financial sector have in turn weakened the demand for other types of debt, such as corporate bonds and commercial paper. At the same time, the price of insuring bank debt through credit default swaps has skyrocketed, reflecting investors' skepticism toward the creditworthiness of banks. Forced to shrink their balance sheets to satisfy regulatory capital requirements, banks have constrained lending. The result has been devastating for businesses and consumers seeking loans.

Although the U.S. subprime mortgage and other domestic markets were the first to absorb the devastating effects of a bursting global asset bubble, it was only a short

while before foreign markets realized similar effects. Global market capitalization fell 53% since its peak on October 31, 2007. The effects on the real economy are similarly striking. From 2000 to 2008, global growth averaged 4.1% a year. In March 2009, the World Economic Outlook database projected world output to be -1.0 to -0.5%, a striking decrease from 2008, when output was 3.2%. Further losses associated with the crisis arose as businesses around the world were forced to write down their assets. Approximately \$1.3 trillion has been lost since Q3 2007. The unemployment rate in the Euro zone was 8.9% in March 2009, compared to just 6.7% in March 2008. The global housing market has also suffered a sharp downturn. Since Q4 2007, the U.K. housing market has experienced a 17.6% decline. Total global CDO issuance peaked in Q2 2007 at \$179 billion, but fell precipitously to just \$5 billion in Q4 2008 – a 97.2% drop. The data makes clear that the financial crisis has become a global concern. Our probe into the severity of the current financial crisis serves as a critical point of reference for the analysis and recommendations set forth in this Report. Before offering our recommendations for effective regulatory reform, we believe it is first necessary to set forth some key principles of regulation.

B. Regulatory Principles

Effective regulatory reform can occur only when policymakers take account of fundamental regulatory principles. In the Committee's view, the most important of these principles is that regulation should reduce externalities – namely systemic risk. Systemic risk is the risk of collapse of an entire system or entire market, exacerbated by links and interdependencies, where the failure of a single entity or cluster of entities can cause a cascading failure. We recognize that there are at least five key externalities particular to financial markets that contribute to systemic risk. First, the spread of speculative information through the market can create the perception that economic difficulties impacting one financial institution will affect similarly situated firms. Second, customers of failed institutions may subsequently find themselves in a less friendly market when looking to re-direct their business. Third, there is considerable inter-connectedness between the financial institutions participating in modern financial markets, so that the failure of one firm can affect many others. Fourth, a negative spiral may be created by falling asset prices and resulting liquidity constrictions. Fifth, falling asset prices and liquidity crises could cause institutions to become reluctant to extend credit.

Regulation may be legitimately imposed for a variety of other reasons. Disclosure is important for investor welfare, given the potential for an individual investor to undertake a less-than-adequate investigation before making an investment decision. Further, improving the quality and methods of information dissemination is important in protecting consumers from instances of unfair, predatory, and fraudulent behavior. Regulation is also useful in mitigating the risk associated with an investor giving money to an agent on his or her behalf, with only very limited control over how this investment is directed. Regulation is likewise important for opening up access to the financial markets, permitting new entrants to join established players, and thereby

increasing competition. Finally, regulation can be used effectively to limit the influence of moral hazard due to state-provided safety nets and, in particular, to ensure that firms and capital suppliers are not permitted to take advantage of taxpayer support and engage in undue risk-taking.

A final principle of regulation applies to all the other principles as well – the cost-benefit rule. That is, a given regulation should be promulgated only when its benefits outweigh its costs. Furthermore, if different kinds of regulation can achieve the same benefit, the regulation with the least cost should be adopted.

Specific Recommendations

1. Regulate on Principle. We believe market outcomes should not be overridden unless there is a specific justification for government regulation. Such justifications may include:

- * externalities (the most important being systemic risk);
- * correction of information asymmetries;
- * principal-agent problems;
- * preservation of competition; and
- * limitation of moral hazard arising from government support of the financial system.

*This recommendation is broadly similar to reforms proposed in the following: Group of 30, Financial Reform (Jan. 2009); G-20, Enhancing Sound Regulation (Mar. 2009).**

2. Analyze the Costs and Benefits of Proposed Regulations. We believe a regulation should be promulgated only when its benefits outweigh its costs, and at the least possible cost.

This recommendation is broadly similar to reforms proposed in the following: Cong. Oversight Panel, Regulatory Reform (Jan. 2009); CRMPG III, Containing Systemic Risk (Aug. 2008).

* We have compared our 57 recommendations for regulatory reform with the proposals set forth in a number of other reports on financial regulation. A table reflecting our findings appears in Appendix 1.

Chapter 2: Reducing Systemic Risk

As mentioned in the previous chapter, the most compelling justification for financial regulation is the need to reduce externalities—particularly systemic risk. We now consider measures to reduce systemic risk across important sectors of the financial system. Specifically, we examine: (a) credit default swaps; (b) capital adequacy requirements; (c) the regulation of non-bank institutions (i.e., hedge funds, private equity firms, and money market mutual funds); and (d) the resolution process for insolvent financial institutions.

A. Credit Default Swaps

Credit derivatives are designed to measure and manage credit risks. Over the past decade, the international market for these instruments has grown dramatically. The principal instrument for credit derivatives is the credit default swap (CDS). CDS market participants pursue a number of objectives. First, CDSs allow lenders efficiently to hedge their exposure to credit losses. Second, a lender might decide to diversify the concentration of its loan portfolio by selling a CDS on a reference entity that it does not own. Finally, CDSs allow participants to take positive or negative credit views on specific reference entities.

Many assert the fall of Bear Stearns, the bankruptcy of Lehman Brothers, the government bailout of AIG, and the registration of several major broker/dealers as bank holding companies were in part a result of their activities in the CDS market. Consequently, some have questioned whether CDSs are bona fide financial instruments or merely a form of “gambling” that should be prohibited. In our view, CDSs are an important tool for measuring and diversifying credit risk. However, we recognize that the current CDS market has a significant potential for systemic risk through the chain reaction of counterparty defaults.

We believe centralized clearing is a crucial step toward reducing systemic risk on a global scale. In addition to limiting counterparty risk and eliminating obvious process and settlement problems, clearinghouses would enhance the liquidity and transparency of the CDS market by actively managing daily collateral requirements of—and the netting of positions between and among—clearinghouse members. In November 2008, the Federal Reserve Board, the CFTC, and the SEC signed a memorandum of understanding committing themselves to the establishment of centralized clearing organizations to consummate CDS transactions. The Treasury Department also recently pledged to subject all standardized OTC derivative contracts—particularly CDSs—to centralized clearing. Three U.S.-based entities are currently promoting centralized clearing solutions. European authorities have also undertaken centralized clearing efforts.

Although we support centralized clearing initiatives, key questions must be resolved. One of these is which particular CDSs would be subject to mandatory

clearing. In that regard, the Committee believes the most prudent course is erring on the side of over-inclusiveness. However, to the extent certain CDSs would remain outside the centralized clearing process, we agree with the Treasury Department's plans to subject them to robust disclosure and operational standards. Equally important, the Committee believes relevant counterparties should also compensate for the increased systemic risk of those contracts with a commensurate adjustment to their capital requirements. A second question is how many clearinghouses are optimal. Studies have demonstrated that, because of the systemic risk reduction due to multilateral netting, one or two centralized clearinghouses are more efficient than multiple clearinghouses. We therefore think that U.S., E.U., and other national policymakers should work to establish one or two clearing facilities that would operate globally.

A final question related to clearing is whether these global clearinghouses should be required to use transaction as well as quote data to mark the positions of their participants. The Committee believes that regulators, clearinghouses and other market participants deserve a complete picture of the market, made possible only when quotes are supplemented by post-trade transaction reporting in real-time. In short, we believe the quality of trade prices is a public good. To that end, the Committee recommends that regulators facilitate the adoption within the CDS market of an information-gathering computer model resembling the Trade Reporting and Compliance Engine (TRACE).

Apart from mandating centralized clearing for certain CDSs, the Treasury Department recently announced its intention to encourage greater use of exchange-traded instruments. This would aid in price formation and improve liquidity management for traders and the clearinghouse. The Committee would go even further, recommending that U.S., E.U., and other policymakers *require* the listing and trading of certain standardized high-volume CDSs, indexes, or single names on exchanges. We recognize, however, that there are several potential obstacles to the trading of CDSs on exchanges.

One issue is that CDSs traditionally have been customized products. This is particularly true with respect to size, maturity, and price. However, standardization has significantly increased and we would only recommend exchange trading for the most standardized contracts. There is the further problem that the trading volume in many single name CDSs may not be sufficient to support a trading business on an exchange, and we would thus only require the most heavily traded contracts to be traded on an exchange. Another concern is that the introduction of exchange-traded contracts would put CDSs into the hands of investors for whom credit derivatives are entirely inappropriate – CDSs may be perceived as far less complex and risky than they actually are. The potential loss of anonymity may be yet another obstacle to bolstering participation in an exchange-based CDS market. Finally, there could be resistance from the dealer community due to the likelihood of lower spreads resulting from exchange trading. Ultimately, we believe these hurdles can be surmounted.

We conclude that systemic risk arising from CDS transactions can be significantly reduced by a robust OTC market with centralized clearing and a TRACE-like reporting system that is complemented by a class of highly-liquid, exchange-traded CDSs. A complementary market for exchange-traded CDSs would provide a venue for broader participation for investors. Exchange trading would bring more price discovery, increased liquidity, and increased transparency to CDS transactions. While the clearinghouses have already made major strides in accomplishing these objectives, even more could be done through exchanges. With the real-time availability of both pre-trade quotes and post-trade contract prices, exchanges would provide an important source of price discovery that would complement the OTC market. Clearinghouses would additionally benefit from the increased liquidity stemming from exchanges in situations where members default and they are forced to close out their loss positions. Thus, exchanges would likely strengthen the role of clearinghouses in reducing systemic risk.

Specific Recommendations

3. Do Not Prohibit CDS Contracts. We strongly believe that CDSs are an important tool for measuring and diversifying credit risk. In that respect, a well-functioning CDS market can prevent – rather than produce – future global financial shocks. Consequently, we believe efforts by policymakers to prohibit CDS contracts altogether, or in part, would be counterproductive in reducing systemic risk. That said, we believe it is important for policymakers to study the impact of certain practices in the CDS market on corporate issuers and other relevant constituencies.

This recommendation is broadly similar to reforms proposed in the following: NASAA, Regulatory Reform Roundtable (Dec. 2008).

4. Mandate Centralized Clearing. We acknowledge that the CDS market has serious deficiencies – particularly when it comes to systemic risk. Among its shortcomings are its excessive counterparty risk, a lack of liquidity, and a lack of transparency in terms of transaction reporting. We therefore support the development of existing private sector initiatives, as well as the Treasury Department’s recent recommendation, for greater centralized clearing. We also encourage thoughtful discussion of whether all, or only certain, CDSs should be subject to mandatory clearing.

This recommendation is broadly similar to reforms proposed in the following: NASAA, Regulatory Reform Roundtable (Dec. 2008); The de Larosière Group, EU Financial Supervision (Feb. 2009); ICMBS, Fundamental Principles (Jan. 2009); U.K. FSA, Turner Review (Mar. 2009); Group of 30, Financial Reform (Jan. 2009); PWG, Progress Update (Oct. 2008); G-20, Enhancing Sound Regulation (Mar. 2009); CRMFG III, Containing Systemic Risk (Aug. 2008); FSF, Enhancing Market and Institutional Resilience (Oct. 2008).

5. Increase Capital Requirements for Non-Centrally Cleared CDSs. To the extent some CDSs would remain outside the centralized clearing process, we believe relevant counterparties should compensate for increased systemic risk of these contracts with a commensurate adjustment to their capital requirements.

This recommendation is broadly similar to reforms proposed in the following: Group of 30, Financial Reform (Jan. 2009); G-20, Enhancing Sound Regulation (Mar. 2009).

6. Improve Netting Capabilities. Although we think existing clearing initiatives represent an important first step toward the reduction of systemic risk, we suggest that policymakers consider applying mandatory clearing rules to other standardized types of derivatives beyond CDSs, as the clearing of all derivatives in one or two facilities is more efficient than the separate clearing of CDSs.

This recommendation is broadly similar to reforms proposed in the following: U.K. FSA, Turner Review (Mar. 2009).

7. Establish 1-2 International Clearing Facilities. We also believe that the establishment of one or two international clearing facilities subject to vigorous oversight would be the most effective means of reducing systemic risk on a global basis. We thus encourage U.S., E.U., and other national policymakers to work toward this common goal. Policymakers should consider whether there could be beneficial interactions between these global clearinghouses that would allow for even further netting.

This recommendation is broadly similar to reforms proposed in the following: Group of 30, Financial Reform (Jan. 2009); G-20, Enhancing Sound Regulation (Mar. 2009).

8. Adopt a CDS Reporting System. The Committee shares the Treasury Department's goal of requiring volume and position data to be made publicly available. To achieve that objective, the Committee recommends that regulators facilitate the adoption within the CDS market of a transaction reporting system, similar to the TRACE system for corporate bonds.

This recommendation is broadly similar to reforms proposed in the following: Cong. Oversight Panel, Regulatory Reform (Jan. 2009); G-20, Enhancing Sound Regulation (Mar. 2009); CRMPG III, Containing Systemic Risk (Aug. 2008).

9. Require a Class of Exchange-Listed CDSs. Rather than eliminate the OTC market, the Committee recommends that legislation be passed *requiring* – not simply encouraging – the listing and trading of certain standardized, high-volume CDSs on exchanges.

This recommendation is broadly similar to reforms proposed in the following: Cong. Oversight Panel, Regulatory Reform (Jan. 2009).

B. Regulation of Capital

Historically, capital regulation has been the dominant regulatory mechanism for constraining bank risk taking. By providing a cushion against losses, capital is supposed to act as a first line of defense against bank failures and their knock-on consequences for systemic risk. Yet, the existing capital regime – effectively established by the Basel Capital Accords – failed to prevent several of the largest U.S. and European financial institutions from failing or becoming distressed to the point where they needed to be bailed out by the government. Accordingly, we consider major structural

weaknesses in the regulatory capital framework, focusing on institutional coverage, calibration, timing effects, the risks of large institutions, framework design, and capital composition.

Institutional Coverage. Until the crisis, it was well understood that firms that were not regulated as banks (or thrifts), and subject to capital regulation, were excluded from the Fed's safety net. The Fed's emergency measures during the crisis have upended this understanding. These measures may have been justified by the exigent circumstances of the crisis, but they have created structural moral hazards and level playing field impediments to the extent that institutions with access to the Fed safety net are not subject to capital regulation. Looking beyond the crisis, we need to realign the institutional costs and benefits of capital regulation.

Calibration. Despite the critical role capital plays in the regulatory framework, existing capital requirements were set without an explicit link to a target solvency standard for individual banks or for the system as a whole. While an understandable reaction to the over-leveraging of the system would be to raise capital requirements across the board, the lack of empirical research on capital calibration suggests that the costs and benefits of higher bank capital requirements are uncertain.

Timing Effects. Another feature of the current regulatory capital framework is that minimum capital levels are fixed, whereas bank losses (or adverse earnings events) vary considerably over the economic cycle. The implication is that solvency standards are not constant during an economic cycle but are dependent on the "state of the world." The solvency level of a given capital requirement depends critically on the period over which it is calibrated and assumptions of the state of the world going forward. Given the cyclical nature of bank losses, the impact of a fixed capital requirement is to force banks to raise capital in the downturn as losses mount and capital levels are depleted. A key revision to the existing capital framework should be a shift to time-varying capital requirements. An alternative to letting capital requirements fall during a downturn would be to allow, or require, banks to hold some form of contingent capital that would be callable as losses mount.

Systemically Important Institutions. The crisis, so far, has disproportionately affected the largest U.S. financial institutions. At the same time, the initial TARP capital injections were also concentrated on the largest U.S. banks. Large institutions pose unique risks to the government because of their systemic consequences. As a result, large or important banks should be required to hold a larger capital buffer.

Framework Design. While Basel II was designed as a three pillar framework, the overriding emphasis of Basel II to date has been on minimum capital charges for credit, market, and operational risks imposed under Pillar I. Ironically, at the moment when capital has become an issue of survival for U.S. banks, the regulators seem to have backed away from Pillar I and imposed a Pillar II stress test to determine how much additional capital banks need to withstand the current economic downturn. Given the

inherent limitations of a rules-based approach, an enhanced Pillar II approach is not only appropriate in a crisis situation, but reflects a necessary rebalancing of the Basel framework. At the same time, a case can be made for greater reliance on Pillar III market mechanisms such as mandatory issuance of subordinated debt that would not be bailed out combined with a more robust disclosure regime of bank risks.

Capital Composition. While most of the debate about the Basel framework has focused on the risk assessment of individual banks—which is reflected in the denominator of the Basel capital ratio—the crisis has also raised new concerns about what “counts” as capital in the numerator of the ratio. At present the regulatory definition of Tier I capital is inconsistent with tangible common equity (TCE), the key accounting measure of shareholders’ exposure to losses. It is also different from Tier I Common, a new definition of capital used in the “stress test.” We need a new and consistent definition of capital going forward. As we state in Chapter 4, *infra*, this standard need not be consistent with U.S. GAAP.

Specific Recommendations

10. Adopt Standards for Institutional Coverage. The Committee believes that institutions that have the ability to borrow from the Fed in its lender of last resort role should be subject to some form of capital regulation. Such rules should differ for different activities, e.g., insurance versus banking. Capital rules should be the *quid pro quo* for protection by the Fed safety net.

11. Leave “Steady State” Risk-Based Capital Calibration Unchanged Pending Further Study. The Committee cautions against drawing the hasty conclusion that overall levels of bank capital should be raised (aside from the stress test capital requirements). There is a dearth of empirical work on capital regulation, and the costs and benefits of raising capital are uncertain. On the “do no harm” theory, we believe the most prudent approach for the present is to leave the “steady state” capital calibration unchanged absent compelling evidence that an increase in overall capital levels is warranted.

This recommendation is broadly similar to reforms proposed in the following: G-20, Enhancing Sound Regulation (Mar. 2009); CRMFG III, Containing Systemic Risk (Aug. 2008).

12. Adopt Counter-Cyclical Capital Ratios. The Committee believes counter-cyclical capital ratios can be achieved in two ways. First, we would encourage dynamic provisioning. This could be done without conflicting with existing securities regulation or accounting standards by providing that additional reserves over “known” losses did not run through the income statement but rather constituted a special appropriation of retained earnings. Secondly, one could require some form of contingent capital. Two promising proposals for contingent capital should be explored—one for catastrophic

insurance based on a systemic trigger,¹ and another for reverse convertible debentures based on a bank-specific market value trigger.²

This recommendation is broadly similar to reforms proposed in the following: The de Larosière Group, EU Financial Supervision (Feb. 2009); Cong. Oversight Panel, Regulatory Reform (Jan. 2009); ICMBS, Fundamental Principles (Jan. 2009); U.K. FSA, Turner Review (Mar. 2009); Group of 30, Financial Reform (Jan. 2009); G-20, Enhancing Sound Regulation (Mar. 2009); FSF, Enhancing Market and Institutional Resilience (Oct. 2008).

13. Hold Large Institutions to Higher Solvency Standards. Given the concentration of risks to the government and taxpayer, we recommend that large institutions be held to a higher solvency standard than other institutions, which means they should hold more capital per unit of risk. As a starting point, we propose a progressive safety margin that would subject U.S. “core” banks (e.g., those with assets greater than \$250 billion) to an additional capital buffer above current well-capitalized standards.

This recommendation is broadly similar to reforms proposed in the following: CFR, Reforming Capital Requirements (Apr. 2009); Cong. Oversight Panel, Regulatory Reform (Jan. 2009).

14. Focus Basel II Changes on Strengthening Pillars II and III. The Committee believes that enhancements to the Basel II framework should come primarily from bolstering Pillar II supervision and Pillar III disclosure and market mechanisms, rather than relying on Pillar I to “get it right.” We also think that serious consideration should be given to requiring banks to issue truly subordinated debt (not capable of being bailed out) combined with more robust disclosure of bank risk.

This recommendation is broadly similar to reforms proposed in the following: G-20, Enhancing Sound Regulation (Mar. 2009); CRMPG III, Containing Systemic Risk (Aug. 2008); IIF, Market Best Practices (July 2008).

15. Maintain and Strengthen the Leverage Ratio. We recognize that in the run-up to the crisis, the capital requirement that arguably performed the best was also the simplest metric – the leverage ratio. The Committee thus believes that a simple leverage ratio constraint should be retained in the United States, and, as proposed by the U.K.’s Financial Services Authority and the Financial Stability Forum (now the Financial Stability Board), adopted internationally. Consideration should also be given to whether the leverage ratio should be recalibrated in terms of common equity rather than total Tier I capital, as presently formulated.

This recommendation is broadly similar to reforms proposed in the following: Cong. Oversight Panel, Regulatory Reform (Jan. 2009); U.K. FSA, Turner Review (Mar. 2009); Group of 30, Financial Reform (Jan. 2009).

¹ Anil K. Kashyap et al., *Rethinking Capital Regulation*, prepared for Fed. Res. Bank Kansas City symposium on “Maintaining Stability in a Changing Financial System,” Jackson Hole, Wyo. (Aug. 21-23, 2008), available at

http://faculty.chicagobooth.edu/anil.kashyap/research/rethinking_capital_regulation_sep15.pdf.

² Mark J. Flannery, *No Pain, No Gain? Effecting Market Discipline via Reverse Convertible Debentures*, in *Capital Adequacy Beyond Basel: Banking Securities and Insurance* (Hal S. Scott ed., Oxford Univ. Press 2005).

C. Regulation of Non-Bank Financial Institutions

Hedge Funds

Although hedge funds have been around for some sixty years, it was not until the 1990s that these private pools of capital became major players in the global financial markets. During that period, the hedge fund industry grew more than a dozen-fold, from \$38.9 billion in 1990 to \$536.9 billion in 2001. By the summer of 2008, the industry had reached an apex of some 10,000 hedge funds with approximately \$2 trillion under management. We believe the key to considering hedge fund regulation is a non-superficial understanding of the role hedge funds play in the global financial markets—an understanding not only of the risks they pose, but also of the risks they mitigate.

The unique features of hedge funds have enabled them both to take on risks otherwise borne by traditional financial institutions, and to bring greater efficiency to the capital markets. On that account, hedge funds have in fact contributed to the overall stability of the financial system. Because hedge funds frequently bet against the market by shorting financial instruments and executing other contrarian strategies, they play a key role in reducing the emergence of financial bubbles that may culminate in market instability. Likewise, their active participation in the credit derivatives market enables them to reduce the risks borne by institutions closer to the center of the financial system. Finally, arbitrage strategies used by hedge funds and the sheer volume of their trading activity promote greater efficiency in the capital markets.

Nonetheless, we recognize that some hedge funds may pose a systemic risk to the financial system. That is particularly the case when a fund becomes very large, unsustainably levered, and exposes a number of large financial institutions to increased counterparty risk. Any effective regulatory regime should thus aim to curb this systemic risk while still enabling the hedge fund industry to continue to perform its critical role in providing liquidity, absorbing financial risks, and increasing the efficiency of the capital markets.

Specific Recommendations

16. Consider the Critical Role of Hedge Funds. The Committee believes any increased regulation of hedge funds for systemic risk must take into account the important role hedge funds play in providing liquidity, absorbing financial risks, and increasing the efficiency of the capital markets. Although we support hedge fund registration, we reject recent proposals seeking to force hedge funds publicly to disclose information that is otherwise proprietary. We likewise reject the imposition of bank-like capital requirements and other leverage requirements that would be ineffective and unsuitable for the diverse hedge fund industry.

This recommendation is broadly similar to reforms proposed in the following: NASAA, Regulatory Reform Roundtable (Dec. 2008); The de Larosière Group, EU Financial Supervision (Feb. 2009).

17. Adopt Confidential Reporting. The Committee recommends the adoption of a confidential reporting requirement pursuant to which each hedge fund would be required to register and provide a regulator with information relevant to the assessment of systemic risk. The statutory definition of “hedge fund” for purposes of this requirement should be consistent with existing statutory exemptions, and should include independently-operated funds as well as those that are part of or affiliated with investment banks and other financial institutions. Confidential reporting would involve information addressing, among other things, a fund’s liquidity needs, leverage, return correlations, risk concentrations, connectedness, and other relevant sensitivities. However, the regulator would bear the burden of demonstrating its need for the required information as well as its ability to use that information effectively. The regulator also would have limited authority to take prompt action in extreme situations where a hedge fund poses a clear and direct threat to market stability.

This recommendation is broadly similar to reforms proposed in the following: G-20, Enhancing Sound Regulation (Mar. 2009).

18. Provide the Fed with Temporary Regulatory Authority. Until the establishment of the USFSA, as described in Chapter 6, we recommend the Fed be given temporary responsibility for receiving and evaluating confidential information supplied by hedge funds. We think the recent proposal by the Treasury Department to require confidential disclosures by regulated hedge funds is a step in the right direction.

19. Facilitate Information Sharing Among National and Supranational Regulators. We encourage non-U.S. authorities to adopt similar requirements for hedge funds and to facilitate regulatory cooperation since the sharing of information between and among national and supranational regulators will result in a more complete picture of the systemic risks posed by individual hedge funds.

This recommendation is broadly similar to reforms proposed in the following: G-20, Enhancing Sound Regulation (Mar. 2009); GAO, Hedge Funds (Jan. 2008).

20. Introduce Structural Reforms to the Industry. The Committee encourages research into structural reforms that would increase the effectiveness of hedge fund operations and reduce an individual fund’s susceptibility to becoming an instability risk to the financial system.

This recommendation is broadly similar to reforms proposed in the following: ICMBS, Fundamental Principles (Jan. 2009); U.K. FSA, Turner Review (Mar. 2009).

Private Equity

Private Equity (PE) firms are partnerships that acquire ownership stakes in cash-generative commercial businesses like retailers, industrial companies, computer firms, and health care concerns. Because PE funds do not normally borrow, extend credit, serve as derivatives counterparties, or perform other functions normally associated with depository institutions, they could hardly be considered part of the oft-cited “shadow banking system.” The shadow institutions—including largely unregulated broker-

dealers, insurance companies, and banks' own off-balance sheet vehicles – played a central role in the current crisis because of the sheer magnitude of their borrowing, the short-term nature of their funding, and the volatility of the financial assets that borrowing was used to finance. All of these features of the current crisis are absent when it comes to PE-sponsored operating companies and nonfinancial businesses more generally.

To be sure, PE sponsors made greater use of debt to finance deals during the 2005-2007 period than they had in previous years, a fact that has caused some analysts to express concern that defaults at PE-sponsored companies will increase dramatically in the coming years. While some defaults are inevitable considering the difficult macroeconomic environment and refinancing constraints facing all companies, these companies have several important advantages relative to their public (or non-PE) competitors. First, Moody's Investors Service has found that troubled firms "backed by private equity have access to capital sources unavailable to strategic operators facing similar market constraints." Secondly, recent research completed by the World Economic Forum found that during periods of acute financial stress, productivity growth at PE-sponsored companies was 13.5 percentage points higher than productivity growth at comparable non-PE businesses. PE-owned companies also have flexibility provided by heavily involved boards that can act decisively to avoid a crisis. Finally, it is important to recognize that the failure of a portfolio company is unlikely to have knock-on effects to the larger financial system. Portfolio companies are broadly diversified across industries and neither PE funds nor portfolio companies are cross-collateralized. These factors, taken as a whole, demonstrate that PE firms pose little in the way of systemic risk. Apart from an information collection requirement to demonstrate that a given fund operates as a traditional buyout fund, we do not see a need for further regulation of this industry.

In addition, given the need for more capital in the banking and thrift sectors (depositories), the Committee endorses further relaxation on the ability of PE firms to acquire depositories. Under the Bank Holding Company Act (BHCA) an entity cannot own more than 25% of any class of voting securities without becoming a regulated bank holding company. Moreover, there is the issue of the Fed's "source of strength" doctrine, whereby an acquirer – a bank holding company (BHC) – must agree to protect the capital position of the bank, even with capital from its non-banking subsidiaries. The Savings and Loan Holding Company Act (SLHCA), like the BHCA, prohibits companies from controlling a thrift when the acquiring entity is engaged in non-financial activities. Both statutes present substantial barriers to PE firms seeking to provide needed capital to banks.

Specific Recommendations

21. Limit Regulation to Information Collection. The Committee believes that any new regulation of PE – beyond an information collection requirement to demonstrate that

the fund operates as a traditional buyout fund – would be difficult to defend intellectually, and thus believes such regulation would be undesirable.

This recommendation is broadly similar to reforms proposed in the following: CRMPG III, Containing Systemic Risk (Aug. 2008).

22. Relax Acquisition Standards under the BHCA and SLHCA. Given the need for more capital and talented management in the banking and thrift sector, the Committee recommends approval of the acquisition of banks by one or more PE funds without the need for a source of strength commitment extending beyond the banking silo of the PE fund complex. We further recommend amending the BHCA and SLHCA to permit a PE firm, whether or not it is managing or investing in commercial companies, to acquire a thrift or bank, provided there is adequate separation between the banking and commercial activities of the PE firm.

Money Market Mutual Funds

Since they began operations in the 1970s, money market mutual funds (MMMFs) have come to play an increasingly important role in the U.S. money markets. Offering a very low-risk, stable investment mechanism for retail as well as sophisticated investors, MMMFs also provide a key source of short-term liquidity for the secondary markets. A distinguishing feature of MMMFs is their historically stable share price, usually \$1.00 per share, which has facilitated their use as cash management devices as an alternative to banks. By law, MMMFs are limited to investing in high-quality, low risk assets with very short maturities, to best limit risks and thereby maintain this stable share price.

Despite their low-risk profile, the financial crisis, as it escalated in the wake of Lehman’s collapse, created tremendous instability for money market funds, drying up the flow of short-term liquidity they provided to the market. The Primary Reserve Fund was shown to have been exposed to increasingly risky Lehman commercial paper that, while giving it the competitive advantage gained from offering higher yields to its investors, nevertheless set the stage for large losses once Lehman fell. Significantly, as a result of the losses and the rush by investors to redeem their investments, the Primary Reserve Fund “broke the buck,” prompting further runs on other MMMFs. As a result of this increasing spread of systemic risk, the U.S. Government through the Treasury Department decided to guarantee the accounts of shareholders in MMMFs existing on the date the guarantee was issued.

The crisis has highlighted the need for a reform of the regulatory structure underpinning MMMFs. In particular, we recommend that MMMFs adopt better crisis management and more robust mechanisms for risk monitoring, transparency and analysis. In this regard, we endorse a number of proposals that recently have been put

forward by the Investment Company Institute.³ In addition, we note the possibility that the government support that is currently provided to guarantee certain shareholder accounts in MMMFs could continue into the future—either explicitly or implicitly—in view of their collective systemic importance. We believe that MMMFs must ultimately be required to compensate the taxpayer for any such protection provided going forward, and we invite policymakers to give further thought to formulating a suitable fee structure. As an alternative, there is a need to explore whether MMMFs might protect themselves through purchasing credit derivatives on themselves or issuing credit-linked notes that would absorb losses up to a certain percentage of NAV.

Specific Recommendations

23. Introduce Mechanisms for Crisis and Risk Management. The crisis has highlighted the systemic impact that MMMF operations can have and the requirements for regulatory improvements to reduce this risk. Accordingly, we recommend that procedures be introduced for better crisis management, transparency, risk evaluations, and monitoring. In that regard, we endorse the proposals recently advanced by the Investment Company Institute.

This recommendation is broadly similar to reforms proposed in the following: ICI, Money Market Report (Mar. 2009).

24. Study How to Compensate for Potentially Ongoing Taxpayer Support. We recommend that policymakers give further thought as to whether explicit or implicit government guarantees provided to support certain shareholder accounts in MMMFs will be available going forward in the event of a systemic crisis and, if so, determine how an appropriate government compensation structure can be devised. We also recommend studying the possible alternative of MMMFs protecting themselves by purchasing credit derivatives or issuing credit-linked notes that would absorb losses up to a specified percentage of NAV.

D. Resolution Process for Failed Financial Institutions

Recent market events have demonstrated both the strengths and weaknesses of current financial company insolvency regimes. Certain insolvencies have had a far greater systemic effect than others, partially because the law that governs the insolvency of a financial company depends on the company's form of organization. Specifically, the insolvency of banks insured by the Federal Deposit Insurance Corporation (the FDIC) is governed by the Federal Deposit Insurance Act (the FDI Act), the insolvency of registered broker-dealers is governed by the Securities Investor

³ Inv. Co. Inst., *Report of the Money Market Working Group* (Mar. 17, 2009).

Protection Act (SIPA), and the insolvency of most other financial companies is governed by the U.S. Bankruptcy Code (the Code).

The Committee believes the FDI Act enables regulators to more effectively combat systemic risk. Notably, it creates a flexible insolvency regime that provides for pre-resolution action, receivership and conservatorship, and many methods of resolution, including liquidation, open bank assistance, purchase and assumption transactions, and the establishment of bridge banks. This regime has been very successful in promoting stability in the banking system by reducing uncertainty for depositors and counterparties while successfully mitigating losses for banks, counterparties and the deposit insurance fund. However, the FDI Act regime is available only to resolve banks, excluding from coverage many systemically significant financial companies, including bank holding companies. One significant aspect of the FDI Act, as compared to the Code, is that it permits the transfer of certain derivatives and other qualified financial contracts (QFCs), to third parties, thus eliminating the downward spiral of prices that can result from a rush to liquidate collateral.

Recently, the Treasury proposed the creation of an additional insolvency regime with powers similar to those available under the FDI Act that can be invoked when a financial company's insolvency poses a systemic risk to market. A key feature of this proposal is its *ad hoc* determination of systemic risk. Companies are not designated as systemically significant in advance – instead, the relevant issue is whether the failure of a particular institution, at that particular point in time, would have systemic effects. This approach has the virtue of avoiding the moral hazard that would result from advance designation. But it also creates uncertainty as to which particular procedure would be used to deal with an insolvent institution.

While the Treasury proposal widens the scope of financial companies subject to an FDI Act-like resolution authority, it, too, excludes from coverage many systemically significant financial companies. Specifically, the proposed regime would apply to the holding companies of regulated entities (such as banks and broker-dealers) and many of their subsidiaries, but not the regulated entities themselves (which would continue to be covered by the FDI Act or SIPA). Also excluded from coverage are hedge funds, PE firms, and other non-holding company financial companies.

While we support Treasury's call for reform, we believe more is necessary. To that end, we recommend the implementation of a comprehensive Financial Company Resolution Act, applicable to all financial institutions, based on the FDI Act but drawing on important elements of the Code, SIPA and the Treasury proposal, that is applicable to *all* financial companies.

Similar national efforts to reform financial company insolvency regimes are underway abroad. However, attention also needs to be paid to the resolution of cross-border financial companies, particularly banks. International working groups at the World Bank, IMF, Bank for International Settlement, and elsewhere are currently

considering different approaches to the issue. An effective international framework for resolving cross-border banks would reduce the pressure on national banking regulators to ring fence the assets of a branch or subsidiary of a foreign bank in the event of its insolvency. This work is important and should be supported.

Specific Recommendations

25. Establish a Single Insolvency Regime Applicable to All Financial Companies.

The Committee recommends the creation of a comprehensive Financial Company Resolution Act, which would be applicable to *all* financial companies – not just those whose failure would be systemically important. Entity-specific provisions from existing insolvency regimes, such as depositor preference for banks and protections for the customers of broker-dealers and commodity brokers, should be incorporated into the proposed regime.

26. Provide Adequate Regulatory Flexibility. A single regulator should be vested with these resolution powers, preferably a newly established U.S. Financial Services Authority, as described in Chapter 6. The full range of resolution powers provided for under the FDI Act should be available under the new regime. At the same time, financial companies now eligible for protection under the Code should continue to be able to petition for reorganization as provided for under Chapter 11 of the Code, provided that the regulator is always empowered to convert such a proceeding into a receivership or conservatorship.

27. Apply the Least Cost Test. All resolutions, other than those that pose a systemic risk, should be subject to a least cost test. QFC transfer, as a low- or no-cost resolution strategy, should also be available in most cases.

28. Authorize Enhanced Resolution Powers for Systemic Risk. Enhanced resolution powers, including recapitalization, extending loans or guarantees, and “open institution assistance,” should be available to the designated regulator if the risk of insolvency of a particular financial company would pose a systemic risk.

29. Consider Financing Methods that Protect the Taxpayer. In creating a comprehensive insolvency regime of this kind, we urge policymakers to give adequate consideration to the methods of financing resolutions and creating incentives for cost effective resolutions. We think that, when enhanced resolution powers are employed for purposes of mitigating systemic risk, expenses incurred by the government should be recouped by imposing an *ex post* assessment on all covered financial companies. We believe this is the proper approach for financing systemically significant insolvency, the cost and occurrence of which are very difficult to predict. Under the Committee’s proposed insolvency regime, we anticipate that most non-systemically significant resolutions will be low-cost (i.e., the financial company will be liquidated or purchased

by another institution). However, thought should be given to how any expenses incurred during such a resolution should be provided for.

30. Consolidate or Coordinate Cross-Border Insolvency Proceedings. The insolvency of cross-border, multi-entity financial companies should be subject to a special, global regime or the insolvency proceedings occurring in various jurisdictions should be tightly coordinated. We endorse the work in this regard by the World Bank, IMF, Bank for International Settlements' Cross-Border Bank Resolution Group, and others.

Chapter 3: Reforming the Securitization Process

Securitization has played a significant role in the evolution of consumer and business finance. As discussed in Chapter 1, however, the global financial crisis has largely devastated the markets for securitized debt. Perhaps more importantly, the crisis has exposed critical flaws in the current operation of the securitization process. We believe there are several important steps to restoring confidence in the securitized debt markets. The first is to ensure that the incentives of the originators of mortgages and other consumer loans are properly aligned with the incentives of other participants in the securitization process. Next, we believe that increasing loan-level disclosures represents another, critical step toward meaningful reform. A final, crucial step in restoring confidence in the securitization markets is to regulate credit rating agencies (CRAs) to ensure the quality and integrity of the ratings regime.

A. Incentives of Originators

Insufficient alignment of interests between originators and investors in securitized residential mortgage assets, coupled with widespread use of nontraditional mortgage products and high risk lending practices, played a central role in creating the financial crisis. Many fault the widespread use in the United States of the “originate-to-distribute” model – making residential mortgage loans to borrowers for the purpose of selling them to investors in the capital markets via securitization. According to this view, incentives between lenders and investors diverged markedly as the former were not required to retain a sufficient portion of the risk associated with the loans that they securitized. As a result, lenders created unproven new mortgage products, relaxed credit standards, increased loan volumes and focused on earning fees from their loan origination and servicing activities rather than making high-quality, profitable loans. These effects were most visible in the subprime market but extended to mid-prime (Alt-A) and prime borrowers as well, occurring in both first-lien and second-lien products. To bring incentives between lenders and investors back into alignment, many regulators, academics and other commentators have called for originators to have more “skin in the game” going forward. Although incentive alignment issues are common to all types of securitization, our primary focus is on residential mortgage securitizations.

We posit that the principal avenues for aligning the economic interests of originators more closely with those of investors are (1) restricting or prohibiting originators from using certain high risk mortgage products and lending standards, (2) strengthening originator representations, warranties, and repurchase obligations, and (3) increasing originator risk retentions.

In the United States, policymakers have taken substantial steps to curtail high-risk mortgage products and lending practices. Banking regulators have moved beyond mandating greater risk management techniques to requiring that depository institutions adopt more robust credit underwriting procedures. In 2008, the Fed adopted amendments to Regulation Z prohibiting lenders from making higher-priced loans, such as those to sub-prime customers, without regard to a borrower's ability to repay from income and assets other than the home's value. Legislation currently working its way through the House of Representatives, the Mortgage Reform and Anti-Predatory Lending Act of 2009, would go even further, creating strong incentives – in the form of expanded legal liability and mandatory minimum risk retentions – for lenders to avoid the high-risk mortgage products and lending practices that led to the financial crisis. Although many important issues remain open in connection with the proposed House legislation, central to reforming the mortgage credit process under all of these initiatives is the requirement that lenders assess, verify and document the ability of borrowers to repay the loans that they are seeking. Many other new requirements also would apply.

The representations, warranties, and repurchase obligations made or undertaken by originators in the agreements through which securitization transactions are effected also constitute a potentially important alignment tool. Representations, warranties, and repurchase obligations serve a number of important purposes, including protecting the integrity of the data and other information on which securitizations are based. For a number of reasons, however, such contractual provisions have proven to be of little practical value to investors during the financial crisis as many originators went bankrupt or resisted efforts to enforce these provisions in order to preserve their own survival.

Mandating that originators retain a specified portion of the risk associated with the assets they are securitizing – keeping “skin in the game” – may be the farthest reaching and complex proposal currently under consideration. A growing body of empirical evidence supports the view that the ability to securitize residential mortgages, with relative ease prior to mid-2007, adversely affected lending standards as originators believed they would not be exposed to asset underperformance over the long term. To combat this misalignment, the European Commission and the U.S. House of Representatives have proposed different 5% minimum risk retention requirements. There are, however, a number of issues with any such proposals, including whether to tailor risk retentions to individual asset classes, to permit retentions to be hedged in some way, and to cast retentions as first loss layers, pro rata sharing of risk throughout a securitization's capital structure or some other form. The impact of minimum risk retention requirements on financial institutions and the economy is uncertain and

potentially significant given the large size of the securitized residential mortgage market. Lenders would be exposed to higher concentrations of risk to the housing sector and have to maintain additional capital in respect of their higher retentions, potentially limiting the supply of housing credit capacity and increasing its cost to consumers. Mandatory risk retentions also could lessen competition and consumer choice in mortgage providers. Many mortgage finance companies that recycle their capital and depend on warehouse or similar lines of credit—that must be repaid from securitization proceeds—may not be able to complete the progressive capital raises that would be necessary to remain in business.

Specific Recommendations

31. Prohibit or Restrict High-Risk Mortgage Products and Lending Practices from Entering the Securitization Market. Policymakers should prohibit or restrict high-risk mortgage products and lending practices, particularly insofar as access to the securitization markets is concerned. Regulators must go beyond merely pushing for better risk management practices and prescribe substantive rules governing residential mortgage products and underwriting. Such rules, however, should not eliminate product or lending practice diversity. Although important issues remain open, substantial progress is already being made by legislators and regulators. We believe no/low documentation residential mortgage loans—in which borrower income and assets are not adequately verified prior to the extension of credit—should be deemed unsafe and unsound practices, rendering them ineligible for securitization. In addition, we believe legislators and regulators should continue to assess the suitability of mortgage products and lending practices generally and for the securitization market. In particular, we recommend further study of approaches for better managing the risks associated with high loan-to-value ratios, home equity withdrawal through second-lien loans and risk layering to determine whether these practices should be prohibited or restricted in connection with securitization or otherwise.

This recommendation is broadly similar to reforms proposed in the following: NASAA, Regulatory Reform Roundtable (Dec. 2008).

32. Strengthen Representations, Warranties, and Repurchase Obligations. We support the development of broader, stronger representations, warranties, and repurchase obligations that represent a minimum industry standard, but this approach by itself is unlikely to achieve the desired alignment of interests between originators and investors. The principal limitation of relying on contractual rights to achieve such alignment is that they are contingent in nature, subject to potentially lengthy litigation to vindicate and highly dependent for their value on the originator's financial condition after events have already occurred. The ex post nature of contractual protections places inherent limitations on the degree of reliance that should be placed on them and their value as alignment tools.

33. Explore Minimum Risk Retention to Improve Incentive Alignment. We support efforts to explore measures to align the economic interests between originators and investors by requiring the former to retain a meaningful portion of the risk associated with the assets that they securitize. In our view, any minimum risk retention requirement must address (i) the risk and loss characteristics of the individual asset class to which it relates (i.e., not one standard for all asset classes), (ii) the amount of risk to be retained, (iii) where such retention resides in the securitization capital structure (e.g., first loss or pro rata), (iv) the duration such retention must be held, and (v) the extent to which the retained risk can be hedged. Allowing regulators the flexibility to modify and adapt minimum risk retention requirements over time as circumstances change is also desirable. To facilitate risk diversification, there should be coordination on such requirements at an international level so that institutions in one country can invest in securitizations originated in other countries. We do not believe, however, that present proposals for 5% net economic loss retention make sense for all securitizations. Further, they may have broad negative effects on the economy, including greater concentration of risk for financial institutions, higher capital requirements for lenders, increased borrowing costs for consumers, and reduced competition between depository institutions and finance company lenders.

This recommendation is broadly similar to reforms proposed in the following: Group of 30, Financial Reform (Jan. 2009); The de Larosière Group, EU Financial Supervision (Feb. 2009).

34. Enhance Disclosure of Retained Economic Interests. To enable investors to assess the degree of alignment they have with originators, regulators should require sponsors and originators to disclose the following information in public and private securitization offerings:

- * the amount of economic interest they will maintain in the securitization;
- * the location in the capital structure of all such retained economic interest;
- * the duration for which the economic interest will be retained;
- * the extent to which the sponsor or originator is able and intends to hedge such retained economic interest during the holding period; and
- * the amount of fee or other income to be earned by the sponsor or originator over the expected and legal life of the securitization.

B. Disclosure

The current financial crisis originated in the securitized debt markets, and securitized debt instruments issued and held by U.S. banks continue to drive significant writedowns. How did so many sophisticated investors—and issuers—so badly misprice the risk associated with securitized mortgage debt? One reason is that the disclosures made in connection with the issuance of mortgage-related securitized

debt—residential-mortgage backed securities (RMBS) and mortgage-related collateralized debt obligations (CDOs)—were inadequate, making it difficult for investors to independently assess credit risk. We analyze the availability of granular loan-level data both at issuance and on an ongoing basis with respect to RMBS and CDOs.

Under existing SEC regulation AB—addressing disclosure in connection with asset-backed securities—dealers issuing mortgage-backed securities may, but are not required to, provide granular loan-level data regarding the underlying mortgages. Using Inside Mortgage Finance, we identified the 3 largest issuances for each quarter of 2006 for three different types of RMBS—adjustable rate, Alt-A, and subprime. For each of the sample issues, we determined if a loan tape had been filed on EDGAR. We then compiled a list of the loan-level data fields required or recommended by ASF, Moody's, and S&P, and compared this with the data fields actually available on the loan tapes. The category with the most available information concerned loan-to-value. Having evaluated the availability of data on the loan tapes, we attempted to assess the significance to investors of the data that was not available by surveying analysts from money managers, hedge funds, insurers, GSEs, Wall Street banks, and mortgage insurers who specialize in RMBS. We conclude that numerous data fields considered essential by investors were simply not available to them.

In the secondary market, analysis of RMBS credit risk requires not just data regarding the underlying mortgages available at issuance, but also ongoing information regarding individual loan performance. Moody's only recently began requesting this information, and only limited loan-level data is made available on trustee websites and a few proprietary databases. CDOs present even more analytical complexity and the market for CDOs suffered an equally dramatic collapse as investors lost all confidence in their ability to price the risk associated with these instruments. We interviewed several CDO analysts regarding the possibility of drilling down to loan-level data for CDOs, and received somewhat conflicting assessments.

Based on our empirical research, we conclude that Regulation AB should be amended to require issuers of mortgage-backed securities to provide loan-level data. The SEC should set forth in its regulation the particular field of loan-level data that must be disclosed. This should be largely based on investor demand and inputs. The SEC should also immediately initiate a study to refine the standardized list of RMBS pool data required at inception and on an ongoing basis. This additional information would not only benefit investors in RMBS, but also investors in CDOs predicated on RMBS.

Because the enhanced disclosures we describe above will be useful only to the extent they are actually made, we also encourage the SEC to consider whether the less-than-300-holder exemption from the periodic reporting requirements of Section 15(d) of the Exchange Act was meant to apply to the typical RMBS issuance otherwise covered by Regulation AB. If so, it should seek a statutory change to remedy this problem. The

lack of ongoing disclosure of the value of RMBS pools significantly contributed to the financial crisis by making it difficult if not impossible for holders of RMBS securities to value their holdings. This contributed to systemic risk.

Finally, we acknowledge that the quality of disclosure is only as good as the veracity of the information presented—largely a function of the due diligence conducted by underwriters. The Committee intends to study how the due diligence process may be improved, and we encourage the SEC to do the same. Our call for improvements in the due diligence process should in no way be taken to imply that we believe existing standards of due diligence have not been satisfied in past offerings.

Specific Recommendations

35. Amend Regulation AB to Increase Loan-Level Disclosures. The Committee encourages policymakers to recognize the clear need and investor appetite for increased loan-level disclosures. More specifically, we recommend that Regulation AB be amended to require issuers of mortgage-backed securities to provide loan-level data. The SEC should set forth in its regulation the particular fields of loan-level data that must be disclosed. This should be largely based on investor demand and inputs.

36. Study Ways of Improving the Standardized Disclosure Package. We further recommend that the SEC immediately initiate a study to refine the standardized list of RMBS pool data required at inception and on an ongoing basis.

This recommendation is broadly similar to reforms proposed in the following: PWG, Progress Update (Oct. 2008); PWG, Policy Statement (Mar. 2008); CRMPG III, Containing Systemic Risk (Aug. 2008).

37. Revisit the Applicability of Section 15(d). We encourage the SEC to consider whether the less-than-300-holder exemption from the periodic reporting requirements of Section 15(d) was meant to apply to the typical RMBS issuance otherwise covered by Regulation AB and, if so, to seek statutory changes that would exempt RMBS issuance from its provisions.

C. Credit Rating Agencies

Credit rating agencies (CRAs) bear substantial responsibility for the current financial crisis. CRAs serve as gatekeepers to the global credit markets and consequently occupy a unique place in the financial system. The ratings provided by CRAs on structured finance securities facilitated the issuance of over \$6.5 trillion into the global credit markets between 2005 and 2007. Failure by the CRAs to assess accurately the risk associated with fixed income securities tied to U.S. residential mortgages played a significant role in catastrophic losses for investors and others who relied on their ratings. Key criticisms leveled at the CRAs include a lack of transparency of the ratings process, widespread conflicts of interest, confusion over the meaning of structured finance ratings and excessive reliance placed on their ratings by

investors due, in part, to the incorporation of ratings into various regulatory frameworks. While originators, banks, regulators and investors misjudged the risks associated with structured credit products, the breakdown in the global credit markets could not have occurred if the CRAs had performed properly.

Regulatory initiatives directed toward CRAs have come mainly from the International Organization of Securities Commissioners (IOSCO), the United States and the European Union. IOSCO developed a voluntary code of conduct for CRAs aimed at safeguarding the quality and integrity of the ratings process, maintaining CRA independence, avoiding conflicts of interest, and promoting transparency and timeliness in ratings disclosure. The first regulatory regime applicable to CRAs was created in the United States with the passage of the Credit Rating Agency Reform Act of 2006 (Reform Act). Under the Reform Act, CRAs may register with the SEC as nationally recognized statistical rating organizations (NRSROs). In addition to overseeing compliance by the NRSROs with their own procedures and methodologies for issuing and maintaining credit ratings, the SEC prescribes rules to avoid conflicts of interest. The European Union adhered to the IOSCO code of conduct until recently.

The financial crisis has brought forth vocal calls for reform of the rating process and increased regulation of CRAs. The G-20 leaders, IOSCO, the SEC and the European Commission all have called for improved regulation of CRAs. Responses to date include IOSCO strengthening its code of conduct, the SEC adopting new regulations applicable to NRSROs, and the European Union approving in April 2009 a comprehensive new regulatory framework applicable to CRAs that goes well beyond IOSCO and SEC standards. Although varying in degree and specificity, all of these new regulatory initiatives generally call for better disclosure about credit ratings, thus eliminating conflicts of interest and improving corporate governance. As increased regulation of CRAs is a given, the main challenge that lies ahead is how to coordinate the different approaches to achieve a better functioning credit rating system. Multiple layers of enforcement also pose significant problems in the regulation of CRAs. Toward these ends, we believe there are several key principles that should guide development of policy in this area, especially in view of the global nature of the CRAs and the markets they serve.

Specific Recommendations

38. Develop Globally Consistent Standards. We recommend that policymakers and regulators develop and apply standards of conduct and regulatory frameworks for CRAs that are consistent on a worldwide basis. Such an approach reflects that CRAs, like the markets and investors they serve, operate globally and affect capital markets worldwide. While there appears to be general consensus on the broad parameters of CRA regulation—registration of CRAs with regulatory bodies, disclosure of key rating processes and methodologies, and rules governing conflicts of interest—important differences remain, particularly between the United States and the European Union.

Having globally consistent standards of conduct and regulatory frameworks also will facilitate CRA compliance, reduce costs, and minimize complications from the extraterritorial application of laws to the largest CRAs, which are headquartered in the United States. If globally consistent standards and regulatory frameworks cannot be achieved, regulators should develop workable rules for recognizing and giving effect to credit ratings issued outside their jurisdictions in order to avoid undue fragmentation of the capital markets, a reduction in the range of investment choices, and restrictions on diversification.

This recommendation is broadly similar to reforms proposed in the following: U.K. FSA, Turner Review (Mar. 2009); Group of 30, Financial Reform (Jan. 2009); SIFMA, CRA Recommendations (July 2008); G-20, Enhancing Sound Regulation (Mar. 2009).

39. Vest Enforcement of CRA Regulation at the Highest Governmental Level. We believe responsibility for enforcing regulatory laws and rules applicable to CRAs should be vested exclusively at the highest governmental level within a jurisdiction. With 50 states and 27 Member States in the United States and European Union, respectively, the potential for multiple layers of enforcement, however well-intentioned, gives rise to an unworkable patchwork of legal risks, complexities and compliance costs for CRAs that could threaten their viability. Placing enforcement powers with the highest level of government would promote consistent enforcement of the regulatory standards within a jurisdiction and accord with the broad nature and impact of the activities of CRAs.

40. Avoid Governmental Interference in the Rating Determination Process. We encourage governments not to interfere with how CRAs determine or express their rating opinions. For capital markets to function most efficiently, CRAs should be free to develop their rating processes and methodologies as they see fit and to express their opinions – both in form and substance – as they determine.

This recommendation is broadly similar to reforms proposed in the following: ICMBS, Fundamental Principles (Jan. 2009).

41. Review References to Ratings in Regulatory Frameworks. We recommend that lawmakers and regulators carefully review the appropriateness of references to credit ratings in various regulatory frameworks to determine whether relying on such ratings is appropriate as compared to other alternatives. We caution that summary removal of all references to, or reliance upon, credit ratings in regulatory statutes and rules, is unwarranted and potentially counterproductive. New standards could be far more subjective, difficult to apply in practice, and result in inconsistent outcomes for both regulators and regulated institutions. In the absence of persuasive evidence that using credit ratings in regulations promotes an unhealthy over-reliance on them by market participants, legislators and regulators should consider incorporating references to credit ratings into regulatory frameworks on a case-by-case basis.

This recommendation is broadly similar to reforms proposed in the following: ICMBS, Fundamental Principles (Jan. 2009); PWG, Progress Update (Oct. 2008); PWG, Policy Statement (Mar. 2008); FSF, Enhancing Market and Institutional Resilience (Oct. 2008).

42. Increase Disclosure as to How Ratings Are Determined. We endorse the promulgation of regulations that would require greater disclosure of additional factual and other information on which credit ratings – particularly those of structured finance securities – are based in order to enhance the ability of investors and other market participants to assess and monitor ratings accuracy. In particular, CRAs should be required to make extensive disclosure of the criteria, methodologies, models, processes, key assumptions, and scenario analyses that they employ in rating all types of securities. Allowing for diverse views on credit risk from a broad range of investors will enable a more effective check on ratings accuracy than relying solely upon unsolicited ratings from other CRAs.

This recommendation is broadly similar to reforms proposed in the following: IOSCO, Credit Rating Agencies (May 2008); Cong. Oversight Panel, Regulatory Reform (Jan. 2009); ICMBS, Fundamental Principles (Jan. 2009); PWG, Progress Update (Oct. 2008); SIFMA, CRA Recommendations (July 2008); PWG, Policy Statement (Mar. 2008); G-20, Enhancing Sound Regulation (Mar. 2009); FSF, Enhancing Market and Institutional Resilience (Oct. 2008); IIF, Market Best Practices (July 2008).

Chapter 4: Enhancing Accounting Standards

We have examined two accounting issues raised by the financial crisis—the use of fair value accounting (FVA) and the requirements for consolidation. Traditionally, investments have been accounted for under the historical cost method, under which an asset is recorded at its purchase price. Throughout the asset’s life, it is held on the books without adjustments for inflation or temporary changes in valuation. In recent years, however, we have seen a shift to FVA in response to a need for more relevant financial information.

Under Financial Accounting Statement No. 157 (FAS 157), “fair value” is the price that would be received in an orderly transaction between market participants. Fair value can be determined using the market approach, the income approach, or the cost approach. Market approaches use prices and other data generated in transactions. Income approaches – aimed at deriving an asset’s credit or intrinsic value – use valuation techniques to discount future cash or earnings flows. The cost approach is often based on current replacement cost. By incorporating to varying degrees market, credit, and historical values, many believe FVA promotes greater objectivity, transparency, and relevance. Yet some accountants oppose FVA on the grounds of conservatism. Still, others argue that FVA may promote instability in the financial sector because normal seesawing of security prices causes fluctuations in companies’ balance sheets, which are amplified by the effects of leverage. Due to increasing concerns surrounding the utility of FVA in the current environment – particularly with respect to banks and financial institutions – several accounting academics, practitioners, and regulators have offered proposals to improve the approach.

The Committee believes FVA is itself a challenging concept, since it is very difficult to present a single “fair” value for an asset, particularly in inactive markets and distressed circumstances. When discussing or presenting “fair” value, regulators and

practitioners have traditionally referred to credit value, market value, or both. Credit value is an asset's intrinsic worth, as determined by the cash flow characteristics of the asset and its contractual provisions, while market value is the price at which an asset is trading in an observable exchange market. The concept of "fair value," as embodied in FASB's current guidance, conflates market value and credit value in a manner we believe is difficult for the investing public to comprehend. Both FASB and the International Accounting Standards Board (IASB) should jointly study how "fair value" accounting can be improved in the long-term.

Although it has not as yet revisited the concept of "fair value," FASB did recently formulate guidance for the use of FVA in valuing distressed assets in disorderly markets. However, FASB's guidance does not eliminate from FVA the merger of credit and market value inputs in a single presentation. Rather, the reporting entity would consider the weight of both kinds of inputs in valuing assets and liabilities in inactive or distressed markets.

The Committee believes that FASB should supplement its fair value standard by requiring preparers to disclose two additional balance sheet presentations that would enable investors to distinguish the influence of market and credit value inputs more explicitly. The dual presentation approach requires reporting institutions to disclose market value and credit value separately and independently of each other. The first presentation would reflect strict market value based on observable market inputs only, unadjusted for inactivity or distress. The second presentation would reflect credit value based on a fundamental appraisal of expected long-term performance established independently of market inputs. Investors can then use this information in reaching their own conclusions about a firm's financial position.

This dual-pronged presentation would supplement, not substitute for, FVA. Furthermore, it is responsive to the principle that disclosure should be more, not less, transparent and consistent in periods of financial crisis. With these two presentations, investors would receive the benefit of more transparent and detailed disclosure.

As for regulators, we think the Fed and the banking regulators should not be limited to following U.S. GAAP and should instead be free to choose another method (credit value, market value, or some combination of both) they deem appropriate. The rationale behind this approach is that regulators have a different objective than investors in their use of financial information and therefore different measurements of these assets for regulatory purposes may be appropriate. However, a third party determination should be made to insure that regulatory departures from U.S. GAAP are not undertaken for reasons of regulatory forbearance, as in the thrift crisis.

A second accounting issue we have examined involves the relevant rules on consolidation. Prior to, and during, the current crisis financial institutions used two different risky securitization vehicles for subprime debt, in order to remove it from their balance sheets: Qualified Special Purpose Entities (QSPEs), pursuant to FSP 140; and

Variable Interest Entities (VIEs), pursuant to FIN 46R. In response to the role played by these securitization vehicles in the financial crisis, FASB announced its intention to eliminate entirely the use of QSPEs as a method of avoiding consolidation and instead to focus on revising FIN 46R based on a “control” concept. The immediate impact of FIN 46R will be to increase the size of balance sheets and cause additional losses, as these consolidated assets are marked-to-market. This in turn will cause a deterioration in the leverage ratio of several banks. While the mark-to-market impact of consolidation will be limited by our first recommendation in this section, we fully support the effort to force consolidation where the bank controls the off-balance sheet vehicle.

Specific Recommendations

43. Study How FVA Can Be Improved. The Committee believes “fair value” accounting is a problematic standard in inactive or distressed markets because it conflates the concepts of market value and credit model value and may confuse investors. We do not believe the problem has been solved by FASB’s latest guidance. We recommend continuing to study how “fair value” accounting can be improved. We further recommend that this be done on a joint basis by FASB and IASB, so the two major accounting standard setters are consistent in their approach.

This recommendation is broadly similar to reforms proposed in the following: Group of 30, Financial Reform (Jan. 2009); PWG, Progress Update (Oct. 2008); G-20, Enhancing Sound Regulation (Mar. 2009).

44. Supplement FVA with Dual Presentation of Market and Credit Values. To supplement fair value reporting, the Committee proposes that FASB require an additional dual presentation of the balance sheet for Level 2 and Level 3 assets using credit value and market value independently of each other. Accompanying this dual presentation, firms should also disclose their underlying valuation methodologies. In the case of credit value, this includes sharing modeling techniques, estimates, assumptions, and risk factors. In the case of market value, the disclosures should reveal what market prices were actually relied on.

This recommendation is broadly similar to reforms proposed in the following: Group of 30, Financial Reform (Jan. 2009).

45. Allow The Fed to Use a Non-GAAP Methodology. As for regulatory accounting, the Committee believes the Fed should not be limited to following U.S. GAAP and should instead be free to choose another method (credit value, market value, or some combination of both) it deems appropriate. To reduce the risk of regulatory forbearance inherent in this proposal – a risk that led to the adoption of the FDICIA stringency test – an independent body (whose identity has not been determined by the Committee) should be established to check on the regulators’ choice of accounting methodology for purposes of judging capital adequacy.

46. Implement FIN46R. As for consolidation, we agree with the FIN 46R approach because it focuses on the issue of control.

Chapter 5: Regulation of Bank Activities

Banks and similar depository institutions lie at the heart of the global financial crisis. In addition to rethinking capital requirements and reforming the securitization process, the regulatory debate over banks raises key questions relating to bank activities. This chapter addresses two such questions. The first is whether we should return to the Glass-Steagall regime that prohibited the combination of banking, insurance, and securities activities within a single institution. The second question is whether the government should use its new-found leverage over weakened banks to direct their lending activities. We answer in the negative on both counts.

A. Return of Glass-Steagall

The Gramm-Leach-Bliley Act of 1999 (GLB), strongly endorsed by the Clinton Administration, repealed the Glass-Steagall Act of 1933 (GS), which prohibited the combination of banking, insurance, and securities activities within a single financial institution. During senatorial debates, several benefits were identified in favor of GLB. First, many believed the Act would increase competition within the financial services industry. Second, many argued that GLB would allow U.S. financial institutions to compete with foreign firms. Third, many believed GS had grown obsolete due to the ability of banks to largely circumvent its restrictions. All of these benefits remain valid today. Moreover, GLB was careful to make sure that only well-capitalized and well-managed banking organizations could engage in the newly authorized securities and insurance activities. It is up to the regulators to make sure these well-capitalized and well-managed requirements are complied with.

In the midst of the present crisis, some are calling for a return of Glass-Steagall. In light of the points mentioned above, we think this is the wrong approach. As of March 27, 2009 there were 610 BHCs that elected to be FHCs, 54 of which were foreign BHCs. In addition, over the last year, major combinations of banking and securities businesses have resulted from the purchase of major securities firms by banks. It would be disruptive, risky, and impractical for the banking sector to undo these combinations. The better policy response is to make sure the risks of whatever activities banks engage in are adequately capitalized and supervised for risk – not to prohibit particular activities.

Specific Recommendation

47. Refrain from Reimposing Glass-Steagall. Because the Gramm-Leach-Bliley Act has led to increased competition within the financial services industry and with foreign firms, and because the separation of banking from insurance and securities is

impractical, the Committee recommends that policymakers leave the Gramm-Leach-Bliley Act largely intact.

B. Directed Lending

Pursuant to the Troubled Assets Relief Program (TARP), Congress has authorized capital infusions into struggling institutions, with the Treasury Department becoming an investor in preferred shares and warrants in the stockholding of recipient companies. In addition, the Fed has made available a number of liquidity facilities in an attempt to encourage banks to borrow at lower than market rates to meet their liquidity needs and eventually revive their balance sheets. While neither TARP nor the Fed currently mandates that recipient firms use the funds to free up credit for main street consumers and businesses, the Treasury has come under scrutiny for not requiring banks to increase their lending activity.

In a number of other countries, government policies designed to influence or otherwise control the flow of credit have been implemented with a view toward achieving greater discipline in managing market volatility and to further state-approved social objectives. This policy is generally referred to as “directed lending.” While directed lending provides certain useful tools to policymakers, its longer-term use can prove problematic for the banking system and economy as a whole. In broad terms, the economic literature sets out three reasons why caution should be exercised in this area: (i) distorted allocation of resources and competition; (ii) potential agency risks and information asymmetries; and (iii) problematic exit strategies.

Specific Recommendation

48. Avoid Directed Lending. We believe regulators should not direct the lending policies of financial institutions.

Chapter 6: Reorganizing the U.S. Regulatory Structure

The Committee believes effective financial regulation going forward requires a reorganization of the current U.S. regulatory structure. Any decision regarding that structure must be uniquely tailored to the needs of the United States. However, it bears noting that the vast majority of other leading financial center countries have moved toward more consolidated financial oversight. A rapidly dwindling share of the world’s financial markets is supervised under the fragmented, sectoral model still employed by the United States.

We summarize the relative responsibilities we believe appropriate for the regulatory bodies in a system of consolidated oversight.⁴ The Fed would retain its exclusive control of monetary policy and its lender of last resort function as part of its key role in ensuring financial stability. As a consequence, we do not favor current proposals to vest systemic risk regulation in an interagency council comprising several existing regulatory agencies. We believe this important role should be retained by the Fed – and the Fed alone. One regulator needs the authority and accountability to regulate matters pertaining to systemic risk.

The U.S. Financial Services Authority (USFSA) would regulate all aspects of the financial system, including market structure and activities and safety and soundness for all financial institutions (and possibly consumer/investor protection with respect to financial products if this responsibility were lodged with the USFSA).

The Treasury Department would coordinate the work of the regulatory bodies. Treasury should also be responsible for the expenditure of public funds used to provide support to the financial sector. In addition, any existing Fed loans to the private sector that are uncollateralized or insufficiently collateralized should be transferred in an orderly fashion to the balance sheet of the federal government (through asset purchases by the Treasury from the Fed).

The United States should draw on the experiences of leading jurisdictions in devising a step-by-step regulatory consolidation process. We present three options for supervising financial institutions. The Fed could be placed in charge of supervising financial institutions determined to be “systemically important” and the USFSA could supervise all other institutions. Alternatively, the Fed could be placed in charge of supervising all financial institutions. Finally, the USFSA could be placed in charge of supervising all financial institutions. We also believe a vigorous consumer/investor protection body could exist either as a division within the USFSA or as a self-standing agency.

Specific Recommendations

49. Retain Two or Three Regulatory Bodies. We believe the United States should have only two, or at most, three independent regulatory bodies overseeing the financial

⁴ The summary and recommendations in this Report were issued by the Committee earlier this year. See Comm. Cap. Mkts. Reg., *Recommendations for Reorganizing the U.S. Regulatory Structure* (Jan. 14, 2009), available at <http://www.capmktreg.org/index.html>. Roel C. Campos joined the Committee after the release of our January 14, 2009 statement. As a consequence, the views expressed in this chapter do not reflect those of Mr. Campos.

system: the Fed, a newly-created independent USFSA, and possibly another new independent investor/consumer protection agency.

This recommendation is broadly similar to reforms proposed in the following: U.S. Treasury, Financial Regulatory Structure Blueprint (Mar. 2008); IIF, Market Best Practices (July 2008).

50. Increase the Role of the Fed. The Committee believes one regulator needs the authority and accountability to regulate matters pertaining to systemic risk, and that the one regulator should be the Fed. The Fed would retain its exclusive control over monetary policy and its lender of last resort function, as part of its key role in ensuring financial stability. In addition, because of its institutional expertise, its significant role in the Basel process and the demonstrated relation of capital requirements to financial stability, the Fed would set capital requirements for all financial institutions. It would also be responsible for other regulation directly related to systemic risk, like margin requirements. We oppose fragmentation of the “systemic risk regulator” into a council of regulators.

This recommendation is broadly similar to reforms proposed in the following: U.S. Treasury, Financial Regulatory Structure Blueprint (Mar. 2008); Group of 30, Financial Supervision (2008); ICMBS, Fundamental Principles (Jan. 2009); Group of 30, Financial Reform (Jan. 2009).

51. Establish the USFSA. The USFSA would regulate all aspects of the financial system, including market structure and activities and safety and soundness for all financial institutions (and possibly consumer/investor protection with respect to financial products if this responsibility were lodged with the USFSA). It would be comprised of all or part of the various existing regulatory agencies, such as the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), and the Commodities Futures Trading Commission (CFTC). The possible divisions of responsibility between the Fed and USFSA with respect to supervision for safety and soundness are discussed below.

52. Enhance the Role of the Treasury Department. The Treasury Department would coordinate the work of the Fed and USFSA. The Treasury would also be responsible for the expenditure of public funds used to provide support to the financial sector, as in the TARP. In addition, to preserve the independence and credibility of the Fed, existing Fed lending against no or inadequate collateral would be transferred to the Treasury, and future lending of this type would be done only by the Treasury Department. All such lending would be on the federal budget.

53. Study Supervisory Options. There are three options with respect to the supervision of financial institutions: (1) the Fed supervises all financial institutions determined to be “systemically important” and the USFSA supervises all other institutions; (2) the Fed supervises all financial institutions; or (3) the USFSA supervises all financial institutions. While we agree there are significant advantages to consolidated supervision, we do not endorse any of the three options. Instead, we present the advantages and disadvantages of each.

54. Protect Consumers and Investors. A vigorous consumer and investor protection body with respect to financial products should exist, either as a division within the USFSA or as a self-standing third independent agency. If part of the USFSA, Senate confirmation of the division/agency head would help ensure strong Congressional oversight and rigorous enforcement. The Committee has not reached consensus on which of these two alternatives would be preferable.

This recommendation is broadly similar to reforms proposed in the following: Council of Inst. Investors, Investor Perspectives (Sept. 2008); NASAA, Regulatory Reform Roundtable (Dec. 2008).

Chapter 7: Facilitating International Regulatory Cooperation

Most of the issues addressed in this Report reach well beyond the borders of any one country. Indeed, the international dimensions of the current financial crisis are so important that it is difficult to characterize this crisis as anything but global. In such an interconnected world, there is a particular need for an effective system of international financial oversight. We believe such a system would perform three distinct tasks. First, it would provide the capacity to harmonize basic global rules. Second, it would serve as an early warning system that could coordinate swift responses to brewing crises with systemic implications. And third, it would provide some sort of process for efficient dispute resolution when conflicts among regulatory regimes arise. These tasks are further developed below.

While it would be theoretically possible to harmonize financial regulation across borders through a formal international treaty, regulators have instead turned to so-called “regulatory networks” to deal with the increasing globalization of finance. But these industry-specific networks have failed to perform effectively during the current crisis. Accordingly, the Obama Administration and G-20 have suggested entrusting international regulatory oversight to the Financial Stability Board — “a network of networks” with powers beyond those of its predecessor, the Financial Stability Forum. We believe a newly strengthened Financial Stability Board is a good idea, so long as it is flexible and expert enough to harmonize baseline rules for the regulation of international finance while still taking a broad view of all the markets in which modern financial conglomerates participate.

As the current crisis exemplifies, a rapid response is crucial to a sustained economic recovery. While the G-20 itself may play an important role in both pushing harmonization and in responding to financial crises as they arise, more is needed. We, therefore, endorse the G-20’s plan to empower the IMF as a delegate agency that can do the work on the ground necessary to identify financial crises before they spread.

Regardless of the multi-lateral networks and institutions in place, problems are bound to arise when countries pursue different approaches to financial regulation, as evidenced most recently by Britain and Iceland’s war of words over who should take responsibility for failed Icelandic banks doing business in the United Kingdom. Even if

a minimum level of harmonization were successful, issues would still come about when countries pursued different regulations to the same activity. When such conflicts inevitably occur, there must be some system for resolving them. In preparation for these expected disagreements, we believe governments ought to strengthen their “Regulatory Dialogues,” if only to maintain open lines of communication between their high-level officials.

Specific Recommendations

55. Support Global Regulatory Forums. The Committee endorses the establishment of a newly strengthened Financial Stability Board, provided it is flexible and expert enough to harmonize baseline rules for the regulation of international finance while still taking a broad view of all the markets in which modern financial conglomerates participate.

This recommendation is broadly similar to reforms proposed in the following: Group of 30, Financial Supervision (2008); The de Larosière Group, EU Financial Supervision (Feb. 2009); Cong. Oversight Panel, Regulatory Reform (Jan. 2009); ICMBS, Fundamental Principles (Jan. 2009); G-20, Enhancing Sound Regulation (Mar. 2009); FSF, Enhancing Market and Institutional Resilience (Oct. 2008).

56. Enable the IMF to Play an Early Warning Role. The G-20 has indicated that it may delegate much of the task of early warning for financial crises to the IMF; we endorse this though we note that it will continue to require adequate resources if it is to perform this task well.

This recommendation is broadly similar to reforms proposed in the following: ICMBS, Fundamental Principles (Jan. 2009); G-20, Enhancing Sound Regulation (Mar. 2009); The de Larosière Group, EU Financial Supervision (Feb. 2009).

57. Strengthen Regulatory Dialogues. We believe the various regional “Regulatory Dialogues” and, in particular, that of the United States and Europe, need to be strengthened to resolve transnational regulatory disputes.

This recommendation is broadly similar to reforms proposed in the following: Cong. Oversight Panel, Regulatory Reform (Jan. 2009); G-20, Enhancing Sound Regulation (Mar. 2009); FSF, Enhancing Market and Institutional Resilience (Oct. 2008); The de Larosière Group, EU Financial Supervision (Feb. 2009).

