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Treasury Outlines Framework For Regulatory Reform

Provides new Rules of the Road, focuses first on containing systemic risk

The crisis of the past 18 months has exposed critical gaps and weaknesses in our financial regulatory system. As risks built up, internal risk management systems, rating agencies and regulators simply did not understand or address critical behaviors until they had already resulted in catastrophic losses. These failures have caused a dramatic loss of confidence in our financial institutions and have contributed to severe recession. Our financial system failed to serve its historical purpose of helping families finance homes and college educations for their children or of providing affordable capital for entrepreneurs and innovators – enabling them to turn new ideas into jobs and growth that raise our living standards. The President's comprehensive regulatory reform is aimed at reforming and modernizing our financial regulatory system for the 21st century, providing stronger tools to prevent and manage future crises, and rebuilding confidence in the basic integrity of our financial system – for sophisticated investors and working families with 401(k)s alike.

As Secretary Geithner stated in his testimony today, "To address these failures will require comprehensive reform -- not modest repairs at the margin, but new rules of the road. The new rules must be simpler and more effectively enforced and produce a more stable system, that protects consumers and investors, that rewards innovation and that is able to adapt and evolve with changes in the financial market."

Four Broad Components of Comprehensive Regulatory Reform:

1. **Addressing Systemic Risk:** This crisis – and the cases of firms like Lehman Brothers and AIG – has made clear that certain large, interconnected firms and markets need to be under a more consistent and more conservative regulatory regime. It is not enough to address the potential insolvency of individual institutions – we must also ensure the stability of the system itself.
2. **Protecting Consumers and Investors:** It is crucial that when households make choices to invest their savings we have clear rules of the road that prevent manipulation and abuse. While outright fraud like that perpetrated by Bernie Madoff is already illegal, these cases highlight the need to strengthen enforcement and improve transparency for all investors. Lax regulation also left too many households exposed to deception and abuse when taking out home mortgage loans
3. **Eliminating Gaps in Our Regulatory Structure:** Our regulatory structure must assign clear authority, resources, and accountability for each of its key functions. We must not let turf wars or concerns about the shape of organizational charts prevent us from establishing a substantive system of regulation that meets the needs of the American people.
4. **Fostering International Coordination:** To keep pace with increasingly global markets, we must ensure that international rules for financial regulation are consistent with the high standards we will be implementing in the United States. Additionally, we will launch a new, three-pronged initiative to address prudential supervision, tax havens, and money laundering issues in weakly-regulated jurisdictions.

Today – A Focus on One of the Four Components of Regulatory Reform: Systemic Risk: In the coming weeks, Secretary Geithner will present detailed frameworks for each of these areas. Today, his testimony focused on systemic risk – both because financial stability is critical to economic recovery and growth, and because systemic risk is expected to be a primary focus for discussions at the G20 Leaders' Meeting in London on April 2.

Addressing The First Component of Regulatory Reform: Systemic Risk

1. **A Single Independent Regulator With Responsibility Over Systemically Important Firms and Critical Payment and Settlement Systems**

2. **Higher Standards on Capital and Risk Management for Systemically Important Firms**
3. **Registration of All Hedge Fund Advisers With Assets Under Management Above a Moderate Threshold**
4. **A Comprehensive Framework of Oversight, Protections and Disclosure for the OTC Derivatives Market**
5. **New Requirements for Money Market Funds to Reduce the Risk of Rapid Withdrawals**

I. A Single Independent Regulator with responsibility over Systemically Important Firms and Critical Payment and Settlement Systems:

While we strengthen prudential oversight for all firms, we must also create higher standards for all systemically important financial firms – regardless of whether they own a depository institution – to account for the risk that the distress or failure of such a firm could impose on the financial system and the economy. We will work with Congress to enact legislation that defines the characteristics of covered firms; sets objectives and principles for their oversight; and assigns responsibility for regulating these firms.

1) Defining a Systemically Important Firm: In identifying systemically important firms, we believe that the characteristics should include:

- The financial system's interdependence with the firm;
- The firm's size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding;
- The firm's importance as a source of credit for households, businesses, and governments and as a source of liquidity for the financial system.

2) Focusing On What Companies Do, Not the Form They Take: These institutions would not be limited to banks or bank holding companies, but could include any financial institution that was deemed to be systemically important in accordance with legislative requirements. These provisions will focus on what companies do and their potential for systemic risk – and no longer on the form they take – to determine who will regulate them.

3) Clarifying Regulatory Authority Over Payment and Settlement Activities: Federal authority for payment and settlement systems is incomplete and fragmented. Weaknesses in key funding and risk transfer markets, notably over-night and short term lending markets and OTC derivatives, increased uncertainty as major institutions such as Bear Stearns neared failure. This created a pathway for large financial institutions to spread financial distress between institutions and across borders.

- While some progress was made in the markets for CDS and other OTC derivatives under Secretary Geithner's leadership at the New York Fed, regulators have been forced to rely heavily on moral suasion to encourage market participants to strengthen these markets.
- We need to clarify and expand authority over these systems and activities, giving a single entity the ability to supervise, examine, and set prudential requirements for these critical parts of our financial system.

II. Higher Standards on Capital and Risk Management for Systemically Important Firms:

1. Setting More Robust Capital Requirements: Capital requirements for these firms must be more conservative than for other institutions and be sufficiently robust to be effective in a wider range of deeply adverse economic scenarios than is typically required.
2. Imposing Stricter Liquidity, Counterparty and Credit Risk Management Requirements: Supervisors will also need to impose liquidity, counterparty, and credit risk management requirements that are more stringent than for other financial firms. For instance, supervisors should apply more demanding liquidity constraints; and require that these firms are able to aggregate counter-party risk exposures on an enterprise-wide basis within a matter of hours.
3. Creating Prompt-Corrective Action Regime: The regulator of these entities will also need a prompt-corrective action regime that would allow the regulator to force protective actions as regulatory capital levels decline, similar to the powers of the FDIC with respect to its covered agencies.

III. Requiring All Hedge Funds Above A Certain Size to Register: U.S. law generally does not require hedge funds or other private pools of capital to register with a federal financial regulator, although some funds that trade commodity derivatives must register with the Commodity Futures Trading Commission and many funds register voluntarily with the Securities and Exchange Commission. As a result, there are no reliable, comprehensive data available to assess whether such funds individually or collectively pose a threat to financial stability. The Madoff episode is just one more reminder that, in order to protect investors, we must close gaps and weaknesses in the regulation and enforcement of broker-dealers, investment advisors and the funds they manage.

1. Requiring Registration of All Hedge Funds: All advisers to hedge funds (and other private pools of capital, including private equity funds and venture capital funds) whose assets under management exceed a certain threshold should be required to register with the SEC.
2. Mandating Investor and Counterparty Disclosure: All such funds advised by an SEC-registered investment adviser should be subject to investor and counterparty disclosure requirements and regulatory reporting requirements.
3. Providing Information Necessary to Assess Threats to Financial Stability: The regulatory reporting requirements for such funds should require reporting, on a confidential basis, information necessary to assess whether the fund or fund family is so large or highly leveraged that it poses a threat to financial stability.
4. Sharing Reports With Systemic Risk Regulator: The SEC should share the reports that it receives from the funds with the systemic risk regulator, which would then determine whether any hedge funds could pose a systemic threat and should be subjected to the prudential standards outlined above.

IV. A Comprehensive Framework of Oversight, Protection and Disclosure for the OTC Derivatives Market: The current financial crisis has been amplified by excessive risk-taking by certain insurance companies and poor counterparty credit risk management by many banks trading Credit Default Swaps on asset-backed securities. Neither counterparties to these trades nor regulators identified the risk that these complex products could threaten to bring down a company of the size and scope of AIG or the stability of the entire financial system, in part because these markets lacked transparency.

1. Regulating Credit Default Swaps and Over-the-Counter Derivatives for the First Time: In our proposed regulatory framework, the government will regulate the markets for credit default swaps and over-the-counter derivatives for the first time.
2. Instituting a Strong Regulatory and Supervisory Regime: We will subject all dealers in OTC derivative markets to a strong regulatory and supervisory regime as systemically important firms.
3. Clearing All Contracts Through Designated Central Counterparties: We will force all standardized OTC derivative contracts to be cleared through appropriately designed central counterparties (CCPs) and encourage greater use of exchange traded instruments. These CCPs will be subject to comprehensive settlement systems supervision and oversight, consistent with the authority outlined above.
4. Requiring Non-Standardized Derivatives to Be Subject to Robust Standards: We will require that all non-standardized derivatives contracts report to trade repositories and be subject to robust standards for documentation and confirmation of trades; netting; collateral and margin practices; and close-out practices.
5. Making Aggregate Data on Trading Volumes and Positions Available: Central counterparties and trade repositories will be required to make aggregate data on trading volumes and positions available to the public and make individual counterparty trade and position data available on a confidential basis to appropriate federal regulators.
6. Applying Robust Eligibility Requirements to All Market Participants: Finally, we will apply robust eligibility requirements and, where appropriate, standards of care; and will require that they meet recordkeeping and reporting requirements.

V. New Requirements for Money Market Funds to Reduce the Risk of Rapid Withdrawals: In the wake of Lehman Brothers' bankruptcy, we learned that even one of the most stable and least risky investment vehicles – money market mutual funds – was not safe from the failure of a systemically important institution. These funds are subject to strict regulation by the SEC and are billed as having a stable asset value – a dollar invested will always return the same amount. But when a major prime MMF "broke the buck," the event sparked a run on the entire prime MMF industry. The run resulted in severe liquidity pressures, not only on prime MMFs but also on financial and non-financial companies that relied significantly on MMFs for funding. In response, we commit to:

1. *Strengthening the Regulatory Framework Around Money Market Funds:*We believe that the SEC should strengthen the regulatory framework around MMFs in order to reduce the credit and liquidity risk profile of individual MMFs and to make the MMF industry as a whole less susceptible to runs.

VI. A Stronger Resolution Authority to Protect Against the Failure of Complex Institutions:

We must create a resolution regime that provides authority to avoid the disorderly liquidation of any nonbank financial firm whose failure would have serious adverse effects on the financial system or the U.S. economy. This authority should include:

1. *Covering Financial Institutions That May Pose Systemic Risks:*We must cover financial institutions that have the potential to pose systemic risks to our economy but that are not currently subject to the resolution authority of the FDIC. This would include bank and thrift holding companies and holding companies that control broker-dealers, insurance companies, and futures commission merchants, or any other financial firm that could pose substantial risk to our economy. This resolution authority would be undertaken through the following process:
 - i. *A Triggering Determination:*Before any of the emergency measures specified could be taken, the Secretary, upon the positive recommendations of both the Federal Reserve Board and the FDIC and in consultation with the President, would have to make a triggering determination that (1) the financial institution in question is in danger of becoming insolvent; (2) its insolvency would have serious adverse effects on economic conditions or financial stability in the United States; and (3) taking emergency action as provided for in the law would avoid or mitigate those adverse effects.
 - ii. *Choice Between Financial Assistance or Conservatorship/Receivership:*The Secretary and the FDIC would decide whether to provide financial assistance to the institution or to put it into conservatorship/receivership. This decision will be informed by the recommendations of the Federal Reserve Board and the appropriate federal regulatory agency (if different from the FDIC).
 - *Options for Financial Assistance:* The U.S. government would be permitted to utilize a number of different forms of financial assistance in order to stabilize the institution in question. These include making loans to the financial institution in question, purchasing its obligations or assets, assuming or guaranteeing its liabilities, and purchasing an equity interest in the institution.
 - *Options for Conservatorship/Receivership:*Depending on the circumstances, the FDIC and the Treasury would place the firm into conservatorship with the aim of returning it to private hands or a receivership that would manage the process of winding down the firm. The trustee of the conservatorship or receivership would have broad powers, including to sell or transfer the assets or liabilities of the institution in question, to renegotiate or repudiate the institution's contracts (including with its employees), and to deal with a derivatives book. A conservator would also have the power to restructure the institution by, for example, replacing its board of directors and its senior officers. None of these actions would be subject to the approval of the institution's creditors or other stakeholders.
 - iii. *Taking Advantage of FDIC/FHFA Models:*This authority is modeled on the resolution authority that the FDIC has under current law with respect to banks and that the Federal Housing Finance Agency has with regard to the GSEs. Here, conservatorships or receiverships aim to minimize the impact of the potential failure of the financial institution on the financial system and consumers as a whole, rather than simply addressing the rights of the institution's creditors as in bankruptcy.

2) *Requiring Covered Institutions to Fund the Resolution Authority:* The proposed legislation would create an appropriate mechanism to fund the limited exercise of these resolution authorities. This could take the form of a mandatory appropriation to the FDIC out of the general fund of the Treasury and/or through a scheme of assessments, ex ante or ex post, on the financial institutions covered by

the legislation. The government would also receive repayment from the redemption of any loans made to the financial institution in question, and from the ultimate sale of any equity interest taken by the government in the institution. The Deposit Insurance Fund will not be used to fund such assistance.