

The Dodd-Frank Act requires the Council to make annual recommendations to: (1) enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets; (2) promote market discipline; and (3) maintain investor confidence. In this section, we discuss the ongoing work of the Council, its members, and the private sector to address these important mandates and lay out concrete recommendations.

3.1 Reforms to Address Structural Vulnerabilities

Reforming Structural Vulnerabilities in Wholesale Short-Term Funding Markets

Stable wholesale short-term funding markets are a critical component of a well-functioning financial system, but if they suffer disruptions, these markets can rapidly spread shocks across financial institutions. The Council continues to be particularly focused on structural vulnerabilities in money market funds (MMFs) and the tri-party repo market, as follows.

Money Market Funds

The Council continues to support the implementation of structural reforms to mitigate the run risk in MMFs. Specifically, these reforms are intended to address the structural features of MMFs that caused a run on prime MMFs and the freezing of the short-term credit markets after the Reserve Primary Fund was unable to maintain a stable net asset value (NAV) in September 2008. In 2010, the SEC adopted MMF reforms designed to make MMF portfolios more resilient by improving credit quality standards, reducing maturities, and—for the first time—instituting liquidity requirements. The 2010 reforms appear to be working as designed and meeting the intended goals. However, the SEC’s 2010 reforms did not address—and were not intended to address—two core characteristics of MMFs that continue to contribute to their susceptibility to destabilizing runs. First, MMFs have no mechanism to absorb a sudden loss in the value of a portfolio security, without threatening the stable \$1.00 NAV. Second, there continues to be a “first mover advantage” in MMFs, which can lead investors to redeem at the first indication of any perceived threat to the value or liquidity of the MMF.

SEC Chairman Schapiro recommended two alternative reforms to address these remaining structural fragilities. They are (1) a mandatory floating NAV; and/or (2) a capital buffer to absorb losses, possibly combined with a redemption restriction to reduce the incentive to exit the fund. The Council supports this effort and recommends that the SEC publish structural reform options for public comment and ultimately adopt reforms that address MMFs’ susceptibility to runs.

In addition, the OCC issued a proposed rulemaking in April 2012 that would partially align the requirements for short-term bank common and collective investment funds (STIFs) with the SEC’s revisions to Rule 2a-7 under the Investment Company Act. In an effort to impose comparable standards on

comparable financial activities, the Council further recommends that, where applicable, its members align regulation of cash management vehicles similar to MMFs within their regulatory jurisdiction to limit the susceptibility of these vehicles to run risk.

Tri-Party Repo Market

The elimination of most intraday credit exposure and the reform of collateral practices in the tri-party repo market continues to be an area of intense focus for the Council. The Tri-Party Repo Infrastructure Reform Task Force was formed in September 2009 in response to the financial crisis. Before being disbanded in February 2012, the Task Force accomplished a number of changes in process and practice that laid a foundation for future risk reduction, including: (1) moving the daily unwind of some repos from 8:30 a.m. to 3:30 p.m., which shortens the period of credit exposure; (2) introducing automated collateral substitution; and (3) introducing three-way trade confirmation functionality. While important, these changes do not meaningfully reduce reliance on intraday credit from the clearing banks.

The industry has indicated that elimination of intraday credit associated with tri-party settlement will be a multi-year effort. The Council views this proposed timeline as unacceptable to achieve timely substantive reductions in risk. The Council recommends that the industry implement near-term steps to reduce intraday credit usage within the next 6 to 12 months and an iterative strategy over six-month increments to continue both to reduce intraday credit substantially and to implement improvements in risk-management practices across all market participants. In addition, the Council recommends that regulators and industry participants work together to define standards for collateral management in tri-party repo markets, particularly for lenders, such as MMFs, that have legal or operational restrictions on the instruments that they can hold.

Customer Protection Standards and Segregation of Customer Assets

Financial intermediaries hold customer assets for a variety of purposes, such as maintaining cash balances prior to investment and as margin. Intermediaries are able to increase efficiencies and lower costs for their customers by investing, and earning a return on, these customer assets. However, appropriate limits on the ways in which intermediaries can use these assets, including customer segregation rules, are a necessary part of strong customer protection standards that contribute to market integrity and confidence. Customer protection standards also help ensure the prompt return of assets to customers in the event of a financial intermediary's insolvency. Recent developments highlight the importance of such standards, including protection standards for trading in foreign markets, that are well-understood by market participants and enforced by regulators.

The CFTC and SEC recently took a number of actions to maintain strong standards for customer protection. Specifically, in December 2011, the CFTC amended its rules to add additional safeguards to the processes whereby customer funds may be invested by derivatives clearing organizations and futures commission merchants. In addition, in February 2012, the CFTC adopted new

standards to protect the collateral posted by customers clearing swaps through futures commission merchants on derivatives clearing organizations. Further, the SEC recently reopened the comment period on a 2007 proposal to amend certain customer protection rules.

The Council recommends that regulators continue to take steps to enforce existing customer protection standards and to enhance such standards going forward, particularly in light of the reforms to the swaps market introduced by the Dodd-Frank Act. The Council further recommends that regulators consider strengthening regulations governing the holding and protection of customer funds deposited for trading on foreign futures markets.

Clearinghouse Risk Management

The Dodd-Frank Act mandates central clearing of standardized swaps to mitigate the counterparty risk inherent in bilateral, over-the-counter (OTC) transactions. Although central clearing decreases counterparty risk, it also increases the concentration and operational risks presented by a clearinghouse standing between the two sides of numerous transactions.

The Dodd-Frank Act provides various tools that can be used to address this increased concentration risk. For example, the Council is authorized to designate financial market utilities as systemically important, which subjects such utilities to heightened risk-management standards. As discussed in more detail in Section 6, the Council recently designated a number of financial market utilities. The CFTC and SEC also took actions to further strengthen clearinghouse risk-management standards. For example, in November 2011, the CFTC adopted new risk-management standards for derivatives clearing organizations and the SEC continues to work to finalize rules on risk-management standards for clearing agencies.

The Council recommends that regulators continue to seek ways to strengthen the risk-management standards for clearinghouses and to work together to monitor clearinghouse practices across their respective jurisdictions to determine industry best practices that could be followed more broadly.

3.2 Heightened Risk Management and Supervisory Attention

Robust Capital and Liquidity Planning

Capital and liquidity buffers form the most fundamental protection for the broader financial system and the economy against unexpected risks or failures of risk management at financial institutions. Consistent with the Council's 2011 report, considerable progress has been made over the past 12 months on robust capital and liquidity planning at U.S. financial institutions. In addition to carrying out the 2012 Comprehensive Capital Analysis and Review (CCAR) exercise, the Federal Reserve proposed enhanced prudential standards, including capital and liquidity planning requirements, for the largest bank holding companies and for nonbank financial companies designated by the Council. Jointly with the FDIC and OCC, the Federal Reserve released supervisory guidance on stress testing for all banking organizations with total consolidated

assets over \$10 billion in May 2012. In June 2012, the Federal Reserve, FDIC, and OCC invited public comment on three proposed rules that would implement in the United States the Basel III and other regulatory capital reforms and the changes required by the Dodd-Frank Act. Concurrently, the agencies also approved a final rule to implement changes to the market risk capital rule.

The Council recommends continued interagency coordination on regulation to help ensure enhanced capital planning and robust capital buffers for financial institutions. The Council also recommends continued research and development of stress-test methodologies to reflect evolution of the financial markets.

On liquidity planning, supervisors and private sector risk managers should closely monitor the risks inherent in short-term funding of longer-term assets. Although this practice is an essential function of the financial system, institutions should refrain from over-reliance on wholesale short-term funding where it could create additional vulnerabilities in extreme but plausible stress scenarios. In 2010, the federal banking agencies, state bank regulators, and the NCUA issued a policy statement on funding and liquidity risk management that addressed the importance of cash flow projections, diversified funding sources, stress testing, a cushion of liquid assets, and a formal, well-developed contingency funding plan as primary tools for measuring and managing liquidity risk. In late 2011, the Federal Reserve proposed a rule to require enhanced risk management of funding and liquidity risk by U.S. bank holding companies with total consolidated assets of \$50 billion or more. In addition, the Basel III liquidity framework augments these expectations and proposes thresholds for short-term and longer-term funding resilience. The Council recommends that financial institutions take particular care to construct their funding models to be resilient to disruptions in wholesale short-term funding markets.

Effective Resolution Plans

Effective resolution plans for the largest financial institutions are important supervisory tools to address the operational and legal complexity of these firms on an ongoing basis, as well as to implement the new orderly liquidation authority. Last fall, the Federal Reserve Board and the FDIC approved a final rule that requires bank holding companies with total consolidated assets of \$50 billion or more and nonbank financial companies designated by the Council to develop, maintain, and periodically submit resolution plans, also known as “living wills.” The FDIC also issued another rule requiring FDIC-insured depository institutions with assets of \$50 billion or more to file resolution plans. Taken together, these resolution plan requirements will improve efficiencies, risk management, and contingency planning. The Council recommends that firms use these plans to reduce organizational complexity to facilitate orderly resolution under the bankruptcy code.

Bolster Resilience to Interest Rate Shifts

While the ongoing environment of low interest rates supports the economic recovery, it can also pose particular challenges for financial institutions by compressing net interest margins and inducing losses on products with guaranteed returns, leading such institutions to pursue riskier investment

strategies in an effort to “reach for yield.” Often, such strategies only show their negative consequences when a shift occurs in interest rates or credit conditions. Banking regulators and the NCUA, working with the Federal Financial Institutions Examination Council (FFIEC), released an advisory on Interest Rate Risk Management in January 2010 and provided additional clarification on this advisory through the issuance of an FAQ in January 2012. This guidance recommends stress testing for: (1) instantaneous and significant changes in the level of interest rates; (2) substantial changes in rates over time; (3) changes in the relationships among key market rates; and (4) changes in the slope and the shape of the yield curve. The NCUA also issued a final rule in January 2012 aimed at mitigating interest rate risk in credit unions.

The Council recommends that regulatory agencies and private sector risk managers continue their scrutiny of how potential changes in interest rates could adversely affect the risk profiles of financial firms and recommends using extreme but plausible interest rate scenarios in stress testing.

Maintain Discipline in Complex Trading Strategies, Underwriting, and New Financial Products

Events in the past year, including the publicly announced trading loss at JPMorgan Chase, demonstrate the importance of robust risk management when addressing complex trading strategies, illiquid positions, or concentrated exposures to areas of heightened risk. Such risk-management practices include: strong and clear lines of authority, reporting, and oversight; rigorous and ongoing validation of models used to design, execute, and control trading strategies; a formal process for changes to approved models; appropriate risk limits and metrics; and strong capital buffers. The Council recommends that financial institutions’ senior management establish, and directors approve, strong risk-management and reporting structures to help ensure that risks are assessed independently and at appropriately senior levels. The Council further recommends that institutions establish clear accountability for failures of risk management.

While these examples highlight the importance of risk management in trading strategies, similar dynamics operate in maintaining disciplined credit underwriting standards and in vetting emerging financial products. In its 2011 Report, the Council noted the importance of maintaining discipline in credit underwriting standards and responding appropriately when there are signs that loan terms may allow borrowers to take on excessive risk. The 2011 Report also highlighted leveraged lending as an area for continued monitoring. While there was a pull-back in leveraged lending during the crisis, volumes have since increased while underwriting practices have deteriorated. In response to these trends, the federal banking agencies in March 2012 issued for comment revised and strengthened supervisory guidance to govern leveraged transactions financed by banks. The Council recommends that oversight of all of these activities continue to form an ongoing focus of supervisors’ efforts and the Council’s monitoring of the financial system.

High-Speed Trading

High-speed trading activities, combined with automated mechanisms for the generation, transmission, and matching of orders, represent technological developments that require particular attention. Speed and automation confer important advantages to financial markets. However, potential operational, credit, transmission, and other risks require careful monitoring. This is particularly true for markets that have limited experience with high-speed and algorithmic trading or where regulatory circuit breakers are not in place. In its 2011 Annual Report, the Council stressed the importance of keeping pace with competitive and technological developments in financial markets. The SEC and CFTC have taken a number of steps to address potential risks, such as facilitating improved audit trails for surveillance use by regulatory authorities, and requiring risk controls that pause or halt trading in securities and futures markets, including a new “limit up-limit down” for equity securities (described further in Section 6). For example, in July 2012, the SEC adopted a rule requiring the self-regulatory organizations (SROs) to develop a plan to create a consolidated audit trail that would provide for a centralized order tracking system—capturing customer and order event information for orders in exchange-listed equities and equity options, across all markets, from the time of order inception, through routing, cancellation, modification, or execution. This single tracking system would enable regulators to monitor trading that is widely dispersed across a variety of market centers. The Council supports these efforts by the two Commissions. More generally, the Council recognizes that acceleration in the speed and automation of trade execution requires a parallel acceleration in trading risk management and controls. The Council recommends that the CFTC and SEC consider error control and risk-management standards for exchanges, clearing firms, and other market participants that are relevant for a high-speed trading environment. The Council also recommends that the CFTC and SEC continue to track developments in current and evolving market structure and analyze the need for policy responses when appropriate.

Issues Related to Cybersecurity

The quickly evolving cyber threat environment requires strengthening the ongoing collaboration and coordination among financial regulators and private entities in the financial sector. The Council recommends continued engagement by financial regulators with both public and private sector organizations to identify and respond to emerging cyber threats against the financial system. The development of mechanisms for sharing information related to cyber threats and vulnerabilities should continue to be explored. Regulators should continue to take steps to help ensure that information security standards for financial institutions are appropriate to the current threat environment, and that examinations assess institutions’ performance against those standards.

3.3 Housing Finance Reforms

Reforms to the Housing Finance System

The U.S. housing finance system has required extraordinary federal government support over the past several years. Since September 2008, Freddie Mac and Fannie Mae (the government-sponsored enterprises, or GSEs) have been in

conservatorship under FHFA. Even today, nearly four years later, approximately 90 percent of newly issued mortgages carry some form of government support, and the market continues to lack sufficient private capital to back residential mortgage credit risk.

During the past year, certain member agencies of the Council worked on a framework for housing reform that facilitates increased private sector involvement, while protecting consumers from abuses and reducing taxpayer exposures. In early 2012, FHFA released a Strategic Plan for the GSEs to develop approaches to mortgage finance infrastructure that could support any potential path towards broader housing reform going forward. The Strategic Plan is designed to reduce the GSEs' risk profile and to increase incentives for the private sector to absorb mortgage credit risk through improved pricing and enhanced risk sharing. At the same time, it preserves a role for the GSEs in mitigating credit losses from the legacy book and providing foreclosure alternatives to borrowers.

In addition, the CFPB is working toward implementing important Dodd-Frank Act rules to help ensure that lenders make a reasonable determination, based on verified information, that a consumer has the ability to repay a loan. Such provisions can help protect consumers from many of the abuses that led up to the crisis and can improve transparency and confidence in the mortgage markets.

Member agencies of the Council are also working to promote more efficient markets for residential mortgage-backed securities (RMBS). In particular, the SEC continues to consider appropriate disclosure rules for RMBS, forming part of its Regulation AB, which will provide private market participants with more transparent information about the assets underlying RMBS. Enhanced clarity and guidelines for asset-backed securities, including securitization of residential mortgages, is also the goal of work by five Council member agencies, along with the U.S. Department of Housing and Urban Development (HUD), on the Dodd-Frank Act's risk retention rule.

All of these efforts are important near-term steps to encourage private capital to take on additional mortgage credit risk. Nonetheless, additional certainty is necessary about the future of housing finance infrastructure and related policy issues to further promote the return of private capital. In particular, there do not yet exist broadly agreed-upon standards to characterize the quality and consistency of mortgage underwriting. Such standards are necessary to support the valuation and liquidity of mortgage-backed instruments. There continue to be non-uniform foreclosure practices across different states. And there remains uncertainty about the legal liability of a mortgage securitizer should a loan fail to conform to representations and warranties that were made about specific loan characteristics.

Treasury and HUD, in their joint white paper on longer-term housing finance reform released in February 2011, put forth a range of options for the government's role in a privatized system of housing finance. Treasury continues to evaluate these options and continues to pursue working with Congress on these issues to support a safer and more robust long-term housing finance system.

The Council recommends continued work to develop a long-term housing finance reform framework that supports the central role of private capital and the emphasis on consumer and investor protections in any future housing finance system. It is critical for the Council members, HUD, and Congress to continue their work to develop standards and best practices. In addressing these issues, Council members should be mindful of the important role of housing in the economy, the nascent recovery, and household finances and act to balance these concerns. As the Council members, HUD, and Congress continue their work to establish a new and lasting system for housing finance, it is critical to address the weaknesses that became evident in the recent housing crisis.

Mortgage Servicing Standards and Servicer Compensation Reform

The Council continues to focus on the need for national mortgage servicing standards and servicer compensation reform to strengthen confidence in the mortgage market. The lack of clear servicing standards in the period leading up to the housing crisis led to problems in assisting borrowers to avoid foreclosure, inappropriate servicing practices, and additional losses for investors.

In early 2011, the federal prudential banking regulators, along with HUD, FHFA, and Treasury, formed an interagency working group to address the need for fair, clear, and uniform national servicing standards. This followed an earlier review by the Federal Reserve, OCC, and FDIC of major servicers that resulted in supervisory consent orders that are now being implemented by the largest mortgage servicers. Also in April 2011, FHFA announced the Servicing Alignment Initiative for Fannie Mae and Freddie Mac, which produced a consistent set of protocols for servicing mortgages from the onset of delinquency. In February 2012, the federal government (led by the Department of Justice, together with Treasury and HUD) and 49 states reached a \$25 billion settlement with the nation's five largest mortgage servicers to address mortgage loan servicing and foreclosure abuses. The CFPB joined the interagency working group in July 2011, and in April 2012 provided a public outline of its plans for mortgage servicing regulations, with formal rules expected to be proposed for comment this summer.

In addition, in September 2011, the Joint Mortgage Servicing Compensation Initiative, launched by FHFA, released a discussion document seeking comments on two alternative servicing compensation structures for servicing single-family mortgages. The current structure of mortgage servicing compensation could have contributed to an underinvestment in servicing capacity and greater concentration in the mortgage servicing industry. One proposal would establish a reserve account within the current compensation structure that could be used to increase servicing capacity in times of stress. The other proposal would create a new fee-for-service compensation structure to better align incentives and reduce the capital intensity of mortgage servicing assets.

Mortgage servicing standards can contribute to long-term servicing improvements for all borrowers and other participants in the mortgage market. The Council recommends that the FHFA, HUD, CFPB, and the other agencies, as necessary, develop comprehensive mortgage servicing standards that require consistent and transparent processes for consumers and promote efficient alternatives to

foreclosure where appropriate. In addition, the Council recommends continued efforts to implement compensation structures that align the incentives of mortgage servicing with those of borrowers and other participants in the mortgage market.

3.4 Progress on Implementation and Coordination of Financial Reform

The Dodd-Frank Act

In the two years since the Dodd-Frank Act became law, members of the Council and their agencies have proposed and finalized a substantial number of rules implementing provisions of the Act, and they continue to work on additional rules in a coordinated manner. The reforms in the Dodd-Frank Act strengthen the resilience of the financial system and provide a clear agenda for the regulatory community to address vulnerabilities exposed in the recent crisis. As described in Section 6, the Dodd-Frank Act establishes new protections for financial consumers and investors. It improves financial markets through designation of and enhanced risk-management standards for systemically important financial market utilities. It provides for private fund adviser registration and reporting and imposes constraints on risk as well as transparency requirements for derivatives markets. In conjunction with international agreements on consistent global prudential standards, the Dodd-Frank Act will require financial firms to operate with larger capital and liquidity buffers and better risk controls, and it requires firms to submit resolution plans to the FDIC, Federal Reserve, and the Council. Finally, the Dodd-Frank Act provides important new authority to resolve a large, complex financial institution in an orderly manner.

Finalizing the rulemakings under the Dodd-Frank Act and implementing the required changes effectively will require close coordination among the regulatory community and open dialogue with the public and industry. To meet the challenges of designing and enforcing these new rules, the resources dedicated to financial oversight must increase. Regulatory agencies must have sufficient resources to attract and retain talented individuals, acquire needed data, develop the requisite analytic capabilities, and invest in systems to monitor market activity and enforce the new rules. The Council recommends complete and expeditious implementation of the Dodd-Frank Act, along with the provision of the resources needed to accomplish this essential task.

International Coordination

In its 2011 Annual Report, the Council stressed the importance of international financial regulatory coordination. Financial markets are global in scope, while regulation proceeds at the national level. To promote a level global playing field and to diminish the risk of having capital flow to the jurisdiction with the least restrictive regulatory regime, it is essential to have internationally strong and consistent regulations that form a coherent and effective whole, while allowing an appropriate degree of autonomy for individual countries to accommodate their own particular needs. It is particularly important for international regulators to consistently apply strong, well-calibrated standards for the critical areas of capital, liquidity, derivatives, central clearing, and failure resolution.

Considerable progress has been made over the past year on coordinating regulatory principles internationally. National regulators continue to implement the Basel III standards; and in June 2012, the Federal Reserve, OCC, and FDIC jointly issued the finalized market risk capital rules, as well as three notices of proposed rulemaking (NPR), that would replace the agencies' current capital requirements with requirements consistent with aspects of Basel II, Basel 2.5 and Basel III. The translation of these international agreements to domestic regulation is a key step in the regulatory reform efforts and is critical for enhancing the resiliency of regulated financial institutions and the financial system more generally.

Furthermore, the Basel Committee established the assessment methodology and a capital surcharge framework for globally systemically important banks (G-SIBs) in November 2011 to enhance their loss absorbency capacity and reduce the probability of their failure. This methodology comprises five broad categories of size, interconnectedness, lack of readily available substitutes for the services provided, global (cross-jurisdictional) activity, and complexity. In the same month, the Financial Stability Board (FSB) issued the Key Attributes of Effective Resolution Regimes for Financial Institutions, which was endorsed by the G-20 leaders and is intended to provide international standards for national recovery and resolution planning regimes. Specifically, it addresses the "too-big-to-fail" problem by making it possible to resolve any financial institution in an orderly manner without exposing the taxpayer to the risk of loss.

In addition, the final version of the Principles for Financial Market Infrastructures (PFMI), issued by the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO), was published in April 2012. The PFMI covers payments systems, central counterparties, securities settlement systems, and other financial utilities, and provides an updated set of international standards on issues such as governance, risk management, financial resources, liquidity, and operational robustness. These principles are especially important as the international community moves to implement the G-20 commitment to central clearing and reporting of OTC derivatives. In insurance, the International Association of Insurance Supervisors updated the Insurance Core Principles in October of last year. These principles provide a global framework for the supervision and regulation of the insurance sector.

The Council recommends continued international coordination of Basel III implementation, with an aim towards consistent and rigorous definitions of capital and risk weights across countries. The Council also recommends the continued development of international standards and national implementation for margin, central clearing, and reporting of OTC derivatives; and that supervision and regulation of financial market utilities (FMUs) embody the principles articulated in the PFMI. In addition, the Council recommends continued efforts to develop strong and internationally consistent procedures for the supervision and regulation of global systemically important financial institutions, including appropriate capital and liquidity requirements and internationally accepted resolution regimes for such institutions. The Council

strongly encourages international implementation and enhanced international coordination among home and host jurisdictions regarding recovery and resolution planning.

Data Resources and Analytics

The Council recommends that improvement in data standards should be a high priority for financial firms as part of their risk-management process and for the regulatory community—not just in the United States but globally. The development of the Legal Entity Identifier is a valuable first step, one that will help to identify precisely the parties to particular financial transactions. It will also enable a more accurate and consistent understanding of legal entity hierarchies, which is essential for effective counterparty risk management. The Council recommends that the Office of Financial Research (OFR) continue to work with the member agencies to promote and establish, where necessary, data standards for identification of legal entities, financial products, and transactions, and to improve the access to and aggregation of data by the regulators. Finally, the Council recommends that cross-border exchange of supervisory data among supervisors and regulators continue to be facilitated in a manner that safeguards the confidentiality and privilege of such information, in order to help provide comprehensive oversight of financial institutions with a global reach and improve coordination on financial stability.

