



# Financial Regulatory Reform and the 111<sup>th</sup> Congress

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## Summary

The financial regulatory reform being considered in the 111<sup>th</sup> Congress is the continuation of a policy debate beginning before the September 2008 financial panic. For example, Treasury Secretary Henry Paulson issued a blueprint for financial reform in March 2008. In September 2008, after this blueprint was issued but before congressional action, the financial system suffered severe distress as Lehman Brothers and AIG failed. This accelerated the review of financial regulation and refocused some of the policy debate on areas that experienced the most distress.

Treasury Secretary Timothy Geithner issued a new reform plan in June 2009. House committees initially reviewed many related bills on an issue-by-issue basis. House Financial Services Committee Chairman Barney Frank then consolidated proposals into a comprehensive bill, the Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173) and the House passed the bill on December 11, 2009. H.R. 4173 as passed by the House contains elements of H.R. 1728, H.R. 2571, H.R. 2609, H.R. 3126, H.R. 3269, H.R. 3817, H.R. 3818, H.R. 3890, and H.R. 3996. In April 2010, the Senate began consideration of Senator Christopher Dodd's bill, the Restoring American Financial Stability Act of 2010 (S. 3217). On May 20, 2010, The Senate passed the House companion measure, H.R. 4173, after substituting the Senate's bill language as amended.

One issue in financial reform is the potential reorganization of the financial system regulatory architecture. Currently, the United States has many regulators, some with overlapping jurisdictions, but many believe there are gaps in the oversight of some issues. This structure evolved largely in reaction to past financial crises, with new agencies and rules created to address the perceived causes of the particular financial problems at that time. One option would be to consolidate agencies that appear to have similar missions. Another option would be to remove regulatory authority on a particular topic from the multiple agencies that might address it within their area now, and establish a single agency to address that issue. For instance, a single consumer financial protection agency or a single systemic risk regulator could be created. Both the House and the Senate bills would create a single entity to focus on consumer financial protection and consolidate bank regulators by abolishing the Office of Thrift Supervision. Neither the House-passed nor the Senate-passed proposals would consolidate the securities and derivatives regulators or create a single systemic risk regulator. Both would create slightly differing councils of existing regulators to address systemic risk with authority to designate any entity as systemically significant and thus subject to oversight by the Federal Reserve.

Other issues of financial reform address particular sectors of the financial system or selected classes of market participants. For example, both the House-passed and the Senate-passed proposals would require more derivatives to be cleared through a regulated exchange and require additional reporting for derivatives that would remain in the over-the-counter market. There are several proposals to try to increase the amount of information available to regulators, investors, consumers, and financial institutions. Hedge funds would have increased reporting and registration requirements. Credit rating agencies would have to disclose additional information concerning their methodologies and potential conflicts of interest. A federal office would be created to collect insurance information. Institution-level regulatory agencies would have to share information about covered firms with systemic risk regulators. Proposed executive compensation and securitization reforms would attempt to reduce incentives to take excessive risks.

This report reviews issues related to financial regulation. It provides brief descriptions of the two main comprehensive reform bills in the 111<sup>th</sup> Congress that address these issues. This report will be updated to reflect congressional activity in financial regulatory reform.

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## Introduction

### Comprehensive Financial Reform Proposals

The 111<sup>th</sup> Congress has considered several proposals to reorganize financial regulators and to reform the regulation of financial markets and financial institutions. Following House committee markups on various bills addressing specific issues, House Financial Services Committee Chairman Barney Frank introduced the Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173) incorporating elements of numerous previous bills.<sup>1</sup> After two days of floor consideration, the House passed H.R. 4173 on December 11, 2009, on a vote of 232-202.

In the Senate, Chairman Christopher Dodd of the Senate Banking, Housing, and Urban Affairs Committee issued a single comprehensive committee print on November 16, 2009, the Restoring American Financial Stability Act of 2009.<sup>2</sup> This proposal was revised over the following months and a committee print of the Restoring American Financial Stability Act of 2010<sup>3</sup> was issued on March 15, 2010. This bill was amended in committee on March 22, 2010, and was reported as S. 3217 on April 15, 2010. The full Senate took up S. 3217 and amended it several times, finishing consideration on May 20, 2010, and incorporating S. 3217 as a substitute amendment to H.R. 4173. The Senate then passed its version of H.R. 4173 on a vote of 59-39.

In addition to Chairman Dodd's and Chairman Frank's bills, other proposals have been made but have not been scheduled for markup. For example, House Financial Services Committee Ranking Member Spencer Bachus introduced a comprehensive reform proposal, the Consumer Protection and Regulatory Enhancement Act (H.R. 3310), and offered a similar amendment (H.Amdt. 539) during House consideration of H.R. 4173.<sup>4</sup> The Treasury under previous Secretary Hank Paulson issued a "Blueprint for a Modernized Financial Regulatory Structure"<sup>5</sup> in March 2008, whereas the Obama Administration released "Financial Regulatory Reform: A New Foundation" in June 2009 and followed this white paper with specific legislative language, providing a base text for congressional consideration.<sup>6</sup> This report will focus on H.R. 4173 as passed by the House and S. 3217 as amended by the full Senate and incorporated into H.R. 4173.

Understanding the fabric of financial reform proposals requires some analysis both of the Panic of 2008, as well as of more enduring concerns about risks in the financial system. This report begins with that analysis.

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<sup>1</sup> Initially incorporated bills included H.R. 2609, H.R. 3126, H.R. 3269, H.R. 3817, H.R. 3818, H.R. 3890, and H.R. 3996.

<sup>2</sup> The Restoring American Financial Stability Act of 2009 committee print is available at [http://banking.senate.gov/public/\\_files/111609FullBillTextofTheRestoringAmericanFinancialStabilityActof2009.pdf](http://banking.senate.gov/public/_files/111609FullBillTextofTheRestoringAmericanFinancialStabilityActof2009.pdf).

<sup>3</sup> The Restoring American Financial Stability Act of 2010 committee print is available at [http://banking.senate.gov/public/\\_files/ChairmansMark31510AYO10306\\_xmlFinancialReformLegislationBill.pdf](http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf). The amendment adopted in committee is available at [http://banking.senate.gov/public/\\_files/032310MangersAmendmentAYO10627.pdf](http://banking.senate.gov/public/_files/032310MangersAmendmentAYO10627.pdf).

<sup>4</sup> See [http://republicans.financialservices.house.gov/index.php?option=com\\_content&task=view&id=601&Itemid=42](http://republicans.financialservices.house.gov/index.php?option=com_content&task=view&id=601&Itemid=42).

<sup>5</sup> "Blueprint for a Modernized Financial Regulatory Structure" U.S. Treasury, available at <http://www.treas.gov/press/releases/reports/Blueprint.pdf>.

<sup>6</sup> Treasury has created websites to track financial intervention and financial reform. See <http://ustreas.gov/initiatives/regulatoryreform/> and <http://www.financialstability.gov>.

## **The Panic of September 2008<sup>7</sup>**

Risks to the financial system as a whole are of heightened interest because of the financial disruptions during September 2008. As Treasury Secretary Timothy Geithner noted in written testimony delivered to the House Financial Services Committee on September 23, 2009, “The job of the financial system ... is to efficiently allocate savings and risk. Last fall, our financial system failed to do its job, and came precariously close to failing altogether.”<sup>8</sup> U.S. financial firms suffered heavy losses in 2007 and 2008 primarily because of declines in the value of mortgage-related assets. During the week of September 15, 2008, Merrill Lynch was sold in distress to Bank of America in a deal supported by the Federal Reserve (Fed) and Treasury, which has since become the subject of controversy. The Fed and Treasury failed to find a buyer for Lehman Brothers, which subsequently filed for bankruptcy, disrupting financial markets. A money market mutual fund (The Reserve Primary Fund) that held Lehman-related paper announced losses, triggering a run on other money market funds, and Treasury responded with a guarantee for money market funds. AIG, an insurance conglomerate with a securities subsidiary that specialized in financial derivatives including credit default swaps, was unable to post collateral related to its derivatives and securities lending activities. The Fed intervened with an \$85 billion loan to prevent bankruptcy and to ensure full payment to AIG’s counterparties. Congress approved the \$700 billion Troubled Asset Relief Program (TARP) on October 3, 2008, and the panic largely subsided after this, although full confidence in the financial system returned very slowly.

## **Issues for Regulatory Reform**

Several issues contained in financial reform proposals relate directly to the Panic of 2008. In regard to mortgage markets, one regulatory reform option would be to create an agency dedicated to regulating financial products offered to household consumers. Another option would be to extend mortgage regulation to non-bank lenders that were not covered by the underwriting guidances issued by bank regulators. In relation to Merrill Lynch and Lehman Brothers, one approach would be to supervise large interconnected financial institutions, regulate their assets, liabilities and counterparty concentrations, and provide more flexibility to an authority to unwind them outside of traditional bankruptcy proceedings. Regarding credit default swaps and other financial derivatives, one potential reform could be to mandate clearing and exchange trading of standardized derivative products and require greater transparency for non-standard derivatives traded over-the-counter. Another possible reform would be to establish a systemic regulator or council to monitor and regulate all concentrations of risk in the financial system.

Other issues within reform proposals relate to the fractured regulatory structure for the financial services industry, particularly commercial banks and thrifts, which has evolved into what some have characterized as a patchwork system. The United States has a dual banking system where both federal and state governments charter banks. There are multiple federal banking regulators plus the individual state regulators; each commercial bank or thrift, therefore, is likely to have at least two regulators—its chartering authority and its deposit insurer. In addition, if the institution

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<sup>7</sup> See, for example, “The Panic of 2008,” a speech given by Federal Reserve Governor Kevin Warsh on April 6, 2009, for discussion of aspects of typical financial panics and historical examples, available at <http://www.federalreserve.gov/newsevents/speech/warsh20090406a.htm>.

<sup>8</sup> Treasury Secretary Timothy F. Geithner, Written Testimony House Financial Services Committee, Financial Regulatory Reform, September 23, 2009, available at <http://www.ustreas.gov/press/releases/tg296.htm>.

is within a holding company complex or is a member of the Federal Reserve System, it will be subject to Fed regulations.<sup>9</sup> Other components of the financial services industry, such as insurance companies and investment banks, may be affiliated with commercial banks and thrifts within a holding company structure, with the holding company regulated at the federal level by either the Fed or the Office of Thrift Supervision (OTS), and the insurance or securities subsidiaries regulated by state insurance or securities regulators or, in the case of securities activities, the Securities and Exchange Commission (SEC). Should the dual banking system of state chartered and federal chartered banks be continued? Should there be a single bank regulator with examination and enforcement authority? Does the Fed's responsibility for overseeing components of the banking system enhance or detract from its monetary authority? Should there be an administrative system for resolving failing financial holding companies similar to that in existence for failing depository institutions, and, if so, within which agency? Should the securities regulator be combined with the derivatives regulator? Should there be an option for a federal charter in insurance?

Some are concerned that a patchwork of regulators may leave regulatory gaps, or might allow firms to “shop” for regulators resulting in weaker regulatory standards. Whether prompted by the recent crisis or as part of a more enduring concern, some have proposed comprehensive reform in part because of greater awareness that failures in one part of the financial sector can disrupt the system as a whole, as well as cause damage to the broader economy.

The remainder of this report provides greater detail on reform issues and proposals. Unless otherwise specified, “H.R. 4173” will refer to the House-passed version of H.R. 4173 and “S. 3217” will refer to S. 3217 as amended by the full Senate and incorporated into H.R. 4173.

## **Systemic Risk**

### **Policy Issues<sup>10</sup>**

Systemic risk refers to sources of instability for the financial system as a whole, often through “contagion” or “spillover” effects that individual firms cannot protect themselves against.<sup>11</sup> While regulators took systemic risk into account before the crisis, and systemic risk can never be eliminated, analysts have pointed to a number of ostensible weaknesses in the current regulatory regime's approach to systemic risk. First, there is no regulator with overarching responsibility for

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<sup>9</sup> In the United States, depository institutions, i.e., commercial banks, thrifts, and credit unions, are creatures of a dual banking system; they may be chartered and, therefore, primarily regulated by the chartering authority. Generally all depository institutions are subject to federal regulation. There are five federal regulators of depository institutions: (1) the Office of Comptroller of the Currency (OCC) charters national banks; (2) the Office of Thrift Supervision (OTS) charters federal thrifts and regulates both state and federal thrifts and thrift holding companies; (3) the Board of Governors of the Federal Reserve System (Fed) regulates state chartered banks which are members of the Federal Reserve System (FRS) and regulates, on a consolidated basis, bank holding companies and financial holding companies (4) the Federal Deposit Insurance Corporation (FDIC) insures state and federal commercial banks and thrifts and is the primary federal regulator of state-chartered banks which are not members of the Federal Reserve System; and (5) the National Credit Union Administration (NCUA) charters and regulates federal credit unions and regulates state-chartered credit unions which are federally insured.

<sup>10</sup> For more information, see CRS Report R40877, *Financial Regulatory Reform: Systemic Risk and the Federal Reserve*, by Marc Labonte.

<sup>11</sup> For an overview of systemic risk, see CRS Report R40417, *Macroprudential Oversight: Monitoring Systemic Risk in the Financial System*, by Darryl E. Getter.

mitigating systemic risk. Instead, some analysts argue that systemic risk can fester in the gaps in the regulatory system where one regulator's jurisdiction ends and another's begins. Second, the crisis revealed that liquidity crises and runs were not just a problem for depository institutions. Third, the crisis revealed that non-bank, highly leveraged "too big (or too interconnected) to fail" firms, such as Lehman Brothers and AIG, could be a source of systemic risk. Finally, there were concerns that the breakdown of different payment, clearing, and settlement (PCS) systems, most of which are unregulated, would be another source of systemic risk.

## **Legislation**

Neither H.R. 4173 nor S. 3217 would create a dedicated systemic risk regulator. Instead, both bills propose creating similar councils (called the Financial Services Oversight Council in the House bill and Financial Stability Oversight Council in the Senate bill). Each bill's council would be chaired by the Treasury Secretary and consist of the heads of federal regulatory agencies; the House bill's council also includes non-voting representatives of state insurance and state banking regulators whereas the Senate bill's council includes a presidentially appointed member familiar with insurance issues. The council in each bill would be authorized to identify and advise regulators on sources of systemic risk and overcome "regulatory gap" problems. In both bills, the council would identify systemically important financial firms, and the Fed would subject them to stricter prudential oversight and regulation. In addition, both bills include mechanisms by which the Fed would be empowered to curb the growth or reduce the size of large firms to prevent systemic risk. H.R. 4173 includes 15 to 1 leverage limits for systemically important firms. S. 3217 requires regulators to set minimum leverage limits and capital ratios for systemically important firms and bank holding companies on a consolidated basis.

H.R. 4173 allows, but does not require, the Fed to ban proprietary trading at systemically significant firms; S. 3217 bans commercial banks from proprietary trading and investing in hedge funds or private equity firms. The systemic risk titles of H.R. 4173 originated in the Financial Stability Improvement Act of 2009 (H.R. 3996). H.R. 3996 provided for payment, settlement, and clearing systems and activities deemed systemically important by the council to be regulated by the Fed. In committee consideration of H.R. 4173, an amendment was adopted that eliminated this section. S. 3217 contains PCS regulation similar to H.R. 3996 as introduced. Both bills would allow the FDIC to set up emergency liquidity programs for bank holding companies; in H.R. 4173 the FDIC's borrowing authority for this program would be capped at \$500 billion.

## **Federal Reserve Emergency Authority and Congressional Oversight**

### **Policy Issues<sup>12</sup>**

During the recent financial turmoil, the Fed engaged in unprecedented levels of emergency lending to non-bank financial firms through its authority under Section 13(3) of the Federal Reserve Act. This statute states that

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<sup>12</sup> See CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte.

in unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank ... to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange....<sup>13</sup>

Such loans can be made only if the targeted borrower is unable to obtain the needed credit through other banking institutions. In addition to the level of lending, the form of the lending has been novel, particularly the creation of three limited liability corporations controlled by the Fed, to which the Fed lent a total of \$72.6 billion to purchase assets from Bear Stearns and AIG. The Fed's recent actions under Section 13(3) have generated debate in Congress about whether measures are needed to amend the institution's emergency lending powers.

## **Legislation**

H.R. 4173 includes several provisions related to Federal Reserve lending authority. In particular, this legislation stipulates that, although the Fed may authorize a Federal Reserve Bank to make collateralized loans as part of a broadly available credit facility, it may not authorize a Federal Reserve Bank to lend to only a single and specific individual, partnership, or corporation. In addition, H.R. 4173 would remove most of the existing restrictions on Government Accountability Office (GAO) auditing of the Fed, and calls for a GAO audit. This bill would also require the Treasury Secretary to approve emergency lending by the Fed and would cap such lending at \$4 trillion.

Similar to H.R. 4173, S. 3217 stipulates that although the Fed may authorize a Federal Reserve Bank to make collateralized loans as part of broadly available credit, the Fed would be required to seek approval from the Treasury Secretary and would not be able to assist specific individuals, partnerships, or corporations on an individual basis. In addition, S. 3217 proposes granting to the GAO circumscribed audit authority of Federal Reserve actions initiated under Section 13(3), calls for an audit of the Fed's policy response to the crisis, and calls for the disclosure of Fed borrowers during the crisis. S. 3217 would also require presidential nomination and Senate confirmation of the New York Federal Reserve Bank President, and would prohibit firms regulated by the Fed from participating in the selection of directors of the regional Federal Reserve Banks.

## **Resolution Regime for Failing Firms**

### **Policy Issues<sup>14</sup>**

Most companies that fail in the United States are resolved in accordance with the bankruptcy code. However, depository banks that hold Federal Deposit Insurance Corporation (FDIC) insured deposits are subject to a special resolution regime, called a conservatorship or receivership. Under normal circumstances, bankruptcies are judicial in nature with no additional public resources available to support the process. However, the FDIC's conservatorship/receivership regime is a largely non-judicial, administrative process, which

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<sup>13</sup> 12 U.S.C. § 343.

<sup>14</sup> See CRS Report R40530, *Insolvency of Systemically Significant Financial Companies: Bankruptcy vs. Conservatorship/Receivership*, by David H. Carpenter.



requires the FDIC to resolve depositories such that the total to be expended will cost the Deposit Insurance Fund less than any other possible method. Under limited circumstances, the FDIC may waive this “least-cost resolution” requirement in order to minimize systemic risk.<sup>15</sup> Some believe that the speed and discretion available in the FDIC’s conservatorship/receivership regime is a useful model for resolving other types of systemically important financial firms. The collapse of Lehman Brothers (and the near collapse of AIG, Bear Stearns, and others) during the recent financial crisis has focused congressional attention on policy options for resolving systemically significant non-depository financial institutions.<sup>16</sup>

## Legislation

H.R. 4173 would establish new dissolution authority for systemically important financial companies (including bank holding companies, financial holding companies, and insurance holding companies and their non-depository and non-insurance company subsidiaries), modeled after the FDIC’s existing conservatorship/receivership regime for depository institutions with some notable distinctions. For instance, the proposed regime would place even more emphasis on the dissolution of the firm and, rather than explicitly prohibiting these firms from being resolved under the bankruptcy code (as is the case for depository institutions), financial firms could be resolved under the special regime “only if the failure and dissolution of such company under [the bankruptcy code] would be systemically destabilizing...”<sup>17</sup> The special resolution regime would be administered by the FDIC. The FDIC could be appointed only after the Fed, the Secretary of the Treasury, and either the FDIC, the SEC, or a state insurance regulator determine that the appointment would meet the requirements specified in the bill.<sup>18</sup> To provide financing for this new FDIC authority, H.R. 4173 would create a Systemic Dissolution Fund, which would be pre-funded by FDIC assessments on large financial companies and limited to a maximum size of \$150 billion. H.R. 4173 also would require large and interconnected companies to submit plans for their own shutdown should they become financially distressed.

S. 3217 would establish a resolution regime for certain systemically important financial institutions similar to the one that would be established under H.R. 4173 but with some particular differences. For instance, the companies eligible for the bill’s special resolution regime are different under the Senate bill. Only companies and their subsidiaries that are “predominately engaged in” financial activities are eligible for the resolution regime. Under the bill, a company is “predominately engaged in” financial activities if at least “85 percent of the total consolidated revenues of such company” derive from those activities determined by the Fed Board of Governors to be financial in nature under 12 U.S.C. §1843(k). Also, the Secretary of the Treasury would have to receive approval from a federal district court that the appointment of the FDIC as receiver over a failed institution meets the requirements of the bill unless the company’s board of directors approve of the appointment. The Senate bill would not establish a formal role for state insurance commissioners in the appointment process.

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<sup>15</sup> 12 U.S.C. § 1823(c)(4)(A).

<sup>16</sup> This overview of resolution regimes is adapted from CRS Report R40928, *Lehman Brothers and IndyMac: Comparing Resolution Regimes*, by David H. Carpenter.

<sup>17</sup> H.R. 4173 § 1604(b).

<sup>18</sup> The SEC would participate in the systemic risk determination if the financial company or an affiliate of the financial company is an SEC-registered broker or dealer. A state insurance regulator would participate in the systemic risk determination if the financial company or its affiliate is an insurance company.

The Orderly Liquidation Fund established by the Senate bill would not be pre-funded. Instead, the FDIC, upon being appointed receiver of a particular financial company, would be authorized to borrow funds from the Treasury subject to explicit caps based on the value of the failed firm's consolidated assets. If necessary to pay off such obligations to the Treasury, the FDIC would have the authority to assess claimants of the failed institution that received more through the receivership than they would have received had the failed firm been liquidated in bankruptcy, as well as with the power to assess certain large financial institutions (bank holding companies and non-bank financial companies with greater than \$50 billion in assets and other financial institutions supervised as systemically significant). The Senate bill also would modify certain rights of the failed firm's creditors to bring these rights into closer alignment with those provided under the bankruptcy code. Another important distinction between the House and Senate bills is that the Senate bill imposes a three-year time limit on any receivership with the possibility of up to two one-year extensions.

## **Securitization and Shadow Banking**

### **Policy Issues<sup>19</sup>**

Shadow banking refers to financial activity conducted either by non-banks or sponsored by banks off of their balance sheets. Securitization supports the shadow banking system. Securitization is the process of turning mortgages, credit card loans, and other debt into marketable securities. Securitizers acquire and pool many loans from primary lenders and then issue new securities based on the flow of payments through the pool. Securitization can allow banks to reduce the risk of their retained portfolio. Securitization also finances non-bank lenders specializing in mortgage loans, credit cards, and other loan products. If the risks of securitized products are accurately rated, then securitization can contribute to financial stability by shifting financial risk to those willing and able to bear it.

Securitization may have contributed to the housing bubble and financial turmoil in a variety of ways. Lenders planning to sell their loans have a reduced stake in the borrower's long-term capacity to repay the loan. Bank underwriting standards are subject to guidances issued by bank regulators because loans to risky borrowers might be unsafe and unsound for the banks themselves. These guidances, however, do not apply to non-bank mortgage lenders that are funded through securitization. Securitization was especially prevalent in the subprime mortgage market and the non-conforming California mortgage market, where loan defaults have been particularly severe.

Opaqueness in the shadow banking system may also have caused problems. When defaults rose among home buyers, the complexity of mortgage-backed securities made it more difficult to identify which firms would suffer the largest losses. Furthermore, a drop in the rating of a mortgage-backed security could require some holders to sell even though the security was still performing. In addition to holding the securities of non-bank subprime lenders, some banks also sponsored their own mortgage funding facilities off their balance sheets in special purpose vehicles. When the liquidity of mortgage-backed securities declined, some of these sponsoring banks had to pull the assets of such special purpose vehicles back on to their balance sheets and

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<sup>19</sup> See CRS Report RS22722, *Securitization and Federal Regulation of Mortgages for Safety and Soundness*, by Edward V. Murphy.

recognize more losses. Potential reforms include regulation of securitization both at the level of the original loan and in the way the products are constructed and offered to investors.

There are numerous proposals to realign incentives in the shadow banking system. One approach is to require loan securitizers to retain a portion of the long-term default risk. The retained risk is typically not allowed to be hedged. One possible advantage of this is that it may help preserve underwriting standards among lenders funded by securitization. Another possible advantage is that securitizers would share in the risks faced by many of the investors to whom they market their securities. A possible disadvantage is that if each step of the securitization chain must retain a portion of risk, then relatively little risk may ultimately be shifted out of the financial sector to investors. To the extent that securitization is used as a device to shift risk to those more willing and able to bear it, concentration of risk in the financial sector may be self-defeating.

Other approaches to reforming securitization include changes to accounting standards and to the liability of the secondary market participants. Accounting changes could require banks to report securitized loans on their balance sheets if the sponsoring bank retains a contingent liability to support the assets. To the extent that changes in financial reporting would affect bank capital requirements, such reforms could dampen any recovery of securitization because banks would have to keep more capital for a given volume of lending. Another approach would be to make secondary market purchasers liable for the acts of primary lenders.

## **Legislation**

H.R. 4173 would require that 5% of a securitization's risk be retained (and not hedged) by the parties involved in the securitization. Regulators may adjust this percentage under some circumstances. In May 2009, the House passed the Mortgage Reform and Anti-Predatory Lending Act (H.R. 1728), which would make secondary market purchasers liable for the acts of primary lenders under certain conditions. Secondary market purchasers could shield themselves from potential liability by only purchasing securities containing qualified mortgages. Qualified mortgages exclude certain categories of risky mortgages. Elements of H.R. 1728 were incorporated into H.R. 4173 by rule before it was considered on the House floor.

S. 3217 also contains reforms for securitization. In addition to revisions to the regulation of ratings agencies (discussed elsewhere in this report), the Senate bill would require risk retention similar to the House approach. The federal banking regulators are to jointly issue rules implementing a minimum 5% risk retention with the possibility of reducing this percentage for low credit risk assets. There is an exemption from the risk retention requirement for securities issued by subsidiaries as long as all of the securities issued by the subsidiary are held by an entity controlled by the parent company. Securitizers would be prohibited from hedging their retained risk. Regulators are to establish separate retention rules for different asset classes. Regulators would have the ability to provide for exemptions to the risk retention requirement pursuant to maintaining high underwriting standards and effective risk management. There is an exemption for certain "Qualified Residential Mortgages" that meet high underwriting standards. Regulators may allocate a portion of the risk retention requirement to loan originators after considering asset quality, incentives for imprudent lending, and the availability of consumer credit.

## **Consolidation of Bank Supervision**

### **Policy Issues<sup>20</sup>**

Commercial banks and similar institutions are subject to regulatory examination for safety and soundness. Depending on their charter, commercial banks, thrifts and credit unions may be examined by the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Reserve, the National Credit Union Administration (NCUA), or a state authority. State bank examiners often coordinate through the Conference of State Bank Supervisors. Federal bank examiners often conduct joint rulemaking, and coordinate through the Federal Financial Institutions Examinations Council (FFIEC).

The current system of multiple bank regulators may have problems, some of which could be mitigated by regulatory consolidation. Multiple regulators may find it challenging to implement consistent enforcement even if they employ joint rulemaking. To the extent that regulations are applied inconsistently, institutions may be able to choose the regulator that they feel will be the weakest or least intrusive. If so, then competition among the regulators for covered institutions (regulatory arbitrage) could lead to less effective financial supervision. Among the arguments against consolidation are that regulatory consolidation could change the traditional U.S. dual banking system in ways that put smaller banks at a disadvantage. Another potential argument for maintaining the current system is that competition among regulators could encourage the regulators to monitor each other, and alert policymakers if one regulator lowers standards.

A narrower point also could apply to the Fed, which both regulates bank holding companies and conducts monetary policy. Some argue that the Fed should concentrate on monetary policy and have fewer regulatory responsibilities, especially if the institution's independence is to be preserved. In contrast, the Fed argues that its bank regulation responsibilities provide it with helpful information for the conduct of monetary policy. The Fed also argues that its monetary policy role makes it uniquely positioned to respond to systemic events in the banking system.

### **Legislation**

H.R. 4173 as passed by the House preserves the Federal thrift charter but eliminates the Office of Thrift Supervision as a separate entity. Under the House bill, OTS' regulatory powers are transferred to a newly created Division of Thrift Supervision within the OCC and the Director of OTS is removed from various regulatory councils and boards. The Federal Reserve would retain most existing regulatory authority, including over bank holding companies, and gain authority over thrift holding companies. Both bills include a moratorium on new charters to companies such as industrial loan companies and unitary thrift holding companies, which under current law are able to mix commercial and banking activities without being subject to comprehensive federal oversight. The House bill would subject existing companies to regulation by the Fed, whereas the Senate bill would not.<sup>21</sup>

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<sup>20</sup> See CRS Report R41176, *Federal Financial Services Regulatory Consolidation: Structural Response to the 2007-2009 Financial Crisis*, by Walter W. Eubanks and CRS Report R40249, *Who Regulates Whom? An Overview of U.S. Financial Supervision*, by Mark Jickling and Edward V. Murphy.

<sup>21</sup> See CRS Report RL32767, *Industrial Loan Companies/Banks and the Separation of Banking and Commerce: Legislative and Regulatory Perspectives*, by N. Eric Weiss.

Under S. 3217, the Federal Reserve would regulate bank and thrift holding companies. The OTS would be eliminated, and its authority over federally chartered thrifts would be transferred to the OCC. Authority to grant new thrift charters is terminated. A thrift that becomes a bank will be able to keep its branches. The OCC would retain its authority over national banks and would have rulemaking authority for all thrifts, but would not have prudential supervisory responsibility for state chartered thrifts. The FDIC would become the primary prudential regulator of state banks and thrifts. The FDIC Board seat formerly held by the director of the OTS is given to the director of the new Consumer Bureau, not the chairman of the Federal Reserve.

## **Consumer Financial Protection<sup>22</sup>**

### **Policy Issues**

In the United States, depository institutions—banks, thrifts, and credit unions—are subject to comprehensive supervision, examination, and enforcement by a number of federal bank regulators. These regulators monitor the institutions that they supervise for both safety and soundness and for compliance with other federal laws, including the various federal consumer protection laws. Many non-depository financial companies, such as payday lenders and nonbank mortgage lenders, are primarily regulated by the states. However, the financial products that these non-depositories offer may still be subject to federal consumer protection laws, such as the Truth in Lending Act (TILA).<sup>23</sup> The Federal Reserve largely is charged with promulgating the regulations to implement the TILA and most other federal consumer protection laws, and the Federal Trade Commission (FTC) primarily is responsible for enforcing these laws against financial institutions that do not have a primary federal regulator.

In light of this fragmented system, some have proposed legislation that would consolidate consumer financial protection functions. These proposals raise policy questions regarding how best to balance safety and soundness regulation with consumer compliance. Although a loan that cannot be repaid is typically bad for both the borrower and the lender, there are some areas in which there can be a conflict between safety and soundness regulation and consumer protection. When a banking activity is profitable, safety and soundness regulators tend to look upon it favorably, since it enables the bank to meet capital requirements and withstand financial shocks. A consumer protection regulator, however, may look at such activity less favorably, especially if the profit is gained at the expense of consumers. Removing compliance authority from the federal bank regulators arguably may weaken the safety and soundness regulation of banks if, for example, the separation results in a less complete picture of bank operations for the prudential regulator. The Fed has argued that its role in consumer protection aids its other authorities, including bank supervision and systemic risk. On the other hand, some, including the Obama Administration, have argued that professional bank examiners are trained “to see the world through the lenses of institutions and markets, not consumers,”<sup>24</sup> and separating compliance and safety and soundness into different agencies is the best way to protect both consumers and

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<sup>22</sup> See CRS Report R40696, *Financial Regulatory Reform: Consumer Financial Protection Proposals*, by David H. Carpenter and Mark Jickling.

<sup>23</sup> 15 U.S.C. §§ 1601 *et seq.*

<sup>24</sup> U.S. Department of the Treasury, *Financial Regulatory Reform: A New Foundation*, June 2009, pg. 56, available at [http://www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf).

financial institutions. Depending on exactly what rules and regulations a new agency might implement, the cost and availability of credit could be affected.

## **Legislation**

H.R. 4173 would establish a new, independent executive agency, the Consumer Financial Protection Agency (CFPA), as the primary federal supervisor, examiner, and enforcer of federal consumer protection laws over many large banks and credit unions as well as over most nonbank financial companies. The CFPA would not be the primary examiner and enforcer of consumer compliance issues over banks and credit unions with \$10 billion or less in assets. Instead, these powers would remain with those institutions' safety and soundness regulators. However, the bill would provide a procedure by which the CFPA could (1) participate in the examination process conducted by the primary regulator and (2) assume the enforcement and examination powers over smaller depository institutions that have not been adequately supervised by a prudential regulator.

H.R. 4173 also would transfer to the CFPA rulemaking authority for many of the existing federal consumer protection laws, while also granting the Agency new rulemaking authority over an array of consumer financial products and activities. Under H.R. 4173, the safety and soundness powers over depository institutions would remain with the bank regulators. The CFPA would be required to coordinate certain compliance efforts with prudential regulators and generally consult with those regulators when prescribing regulations. H.R. 4173 establishes a process by which jurisdictional disputes between financial regulators, including the CFPA, could be settled by the Financial Services Oversight Council.<sup>25</sup>

S. 3217 would create a Bureau of Consumer Financial Protection (Bureau), which would have similar authorities as H.R. 4173's CFPA; however, there are a number of notable differences between the two proposals. For one, rather than creating a new, free-standing regulatory agency like in H.R. 4173, the Bureau would be established within the Fed. Although the Fed currently houses the consumer-focused Division of Consumer and Community Affairs, the Bureau would be more independent than the existing division. For example, the Bureau would be headed by a director that is appointed by the President, subject to the advice and consent of the Senate. The Bureau also would have greater independence than the Division of Consumer and Community Affairs in implementing its supervisory, enforcement, and rulemaking authorities. Additionally, the Bureau Director would have greater autonomy over its funding, although much of the Bureau's funding would have to be transferred from the Federal Reserve Board and be subject to certain limitations. The Bureau would not have the authority to order assessments on covered entities for general funding purposes, as proposed by H.R. 4173's CFPA.

Another distinction between S. 3217's Bureau and H.R. 4173's CFPA is that the Financial Stability Oversight Council, which would be established by the Senate bill and mainly comprised of the federal financial regulators, would have the ability to set aside a regulation prescribed by the Bureau if the regulation "would put the safety and soundness of the United States banking system or the stability of the financial system of the United States at risk." These powers would be in addition to the Financial Stability Oversight Council's authority to settle jurisdictional disputes among the federal financial regulators.

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<sup>25</sup> H.R. 4173 § 1002.

The authority of state attorneys general to enforce federal consumer protection laws and regulations also would differ under the two bills.

## **Derivatives**

### **Policy Issues<sup>26</sup>**

Derivatives are financial contracts whose value is linked to some underlying price or variable. Derivatives are traded on organized exchanges with central clearing houses that guarantee payment on all contracts, and in an unregulated over-the-counter (OTC) market, where credit risk is borne by the individual counterparties. The Commodity Futures Trading Commission (CFTC) regulates commodity futures and options on futures, while the Securities and Exchange Commission regulates options on securities.

The Commodity Futures Modernization Act of 2000 (CFMA)<sup>27</sup> largely exempted swaps and other derivatives in the over-the-counter market from regulation. The collapse of AIG in 2008 illustrated the risks of large OTC derivatives positions that are not backed by collateral or margin (as a central clearing house would require). If AIG had had to post margin on its credit default swap contracts, arguably it would not have been able to build a position so large as to threaten systemic stability and require a costly taxpayer bailout. Such disruptions in markets for financial derivatives during the recent crisis have led some to call for changes in derivatives regulation, particularly in the over-the-counter market.

Derivatives reform focuses on requiring the OTC markets to adopt features of the regulated markets, including mandatory clearing through derivatives clearing organizations, trading on exchanges or exchange-like facilities, registration of certain market participants, and the like. Current proposals include repeal of provisions exempting OTC derivatives from regulation.

### **Legislation**

H.R. 4173 and S. 3217 both mandate reporting, centralized clearing, and exchange-trading of OTC derivatives, but provide certain market participants with exemptions from some requirements. The bills require regulators to impose capital requirements on swap dealers and “major swap participants.” Both bills also designate the CFTC as the regulator for “swaps,” which include contracts based on interest rates, physical commodities, some credit default swaps, etc., and give the SEC authority over “security-based swaps,” including other credit default swaps and equity swaps.

Although generally similar, the bills differ in some key elements. For example, the Senate bill includes a provision in its Section 716 that would prohibit federal assistance to any swaps entity with respect to any swap, security-based swap, or other activity of the swaps entity. Federal assistance is defined to include access to the Federal Reserve’s discount window or advances from any Federal Reserve credit facility, FDIC insurance, and other types of assistance or guarantees enumerated in the bill, which, taken together, are crucial for depository institutions.

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<sup>26</sup>See CRS Report R40965, *Key Issues in Derivatives Reform*, by Rena S. Miller.

<sup>27</sup>P.L. 106-554, 114 Stat. 2763.

No similar provision exists in the derivatives title of the House bill. This Section 716 has provoked controversy. Some are concerned that it could in practice end up increasing systemic risk and weaken oversight of the financial system.<sup>28</sup>

Another important difference between the House and Senate bills is how they set up their exemptions from the mandatory clearing requirement, which has also dominated the political debate. The scope of the clearing exemption revolves around three questions: (1) which derivatives must be cleared? (2) which market players must clear their derivatives? and (3) can regulators impose margin requirements on derivatives that otherwise do not have to be cleared?

Both bills allow regulators substantial discretion in writing rules and defining terms. Because of this, it is impossible to say with precision how much of the currently unregulated over-the-counter derivatives market would be moved onto centralized clearing houses or would be traded on regulated exchanges under either bill.

Both bills include an automatic exemption from the clearing requirement if at least one party to the trade is an “end user.” The Senate bill establishes a category of non-financial participants called “commercial end users” who are exempt from clearing and exchange-trading requirements, while excluding from the exemption any businesses that are primarily financial in nature. The House bill does not explicitly use the term “end user.” Instead, it automatically exempts from the clearing and exchange-trading requirements trades in which one party is neither a major swap participant nor a swap dealer. The House bill, unlike the Senate bill, does not distinguish between financial and non-financial entities in its exemption, but allows regulators to determine what threshold of swap activity constitutes major swap activity, based on certain guidelines.

## **Credit Rating Agencies**

### **Policy Issues<sup>29</sup>**

Credit rating agencies provide investors with what many presume to be an informed perspective on the creditworthiness of bonds issued by a wide spectrum of entities, including corporations, sovereign nations, and municipalities. The grading of the creditworthiness is typically displayed in a letter hierarchical format: AAA commonly being the safest, with lower grades representing a greater level of risk. Credit rating agencies are typically paid by the issuers of the securities that are being rated by the agencies, which could be seen as a conflict of interest. In exchange for adhering to various reporting requirements, the SEC provides interested credit rating agencies with a Nationally Recognized Statistical Rating Organization (NRSRO) designation. The designation is important because a variety of state and federal laws and regulations reference NRSRO ratings.<sup>30</sup>

In recent years, credit rating agencies have come under increased public scrutiny following several alleged performance failures. For instance, during the recent housing boom cycle the three dominant agencies (Fitch, Moody’s and Standard & Poor’s) initially rated many mortgage-backed

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<sup>28</sup> See for example, the letter from Federal Reserve Chairman Ben Bernanke posted by *The Wall Street Journal* at <http://blogs.wsj.com/economics/2010/05/13/bernanke-letter-to-lawmakers-on-swaps-spin-off/>.

<sup>29</sup> See CRS Report R40613, *Credit Rating Agencies and Their Regulation*, by Gary Shorter and Michael V. Seitzinger.

<sup>30</sup> See CRS Report RS22519, *Credit Rating Agency Reform Act of 2006*, by Michael V. Seitzinger.



securities as AAA before sharply downgrading the securities as the sub-prime mortgage market collapsed, resulting in heavy losses for investors that relied on these ratings. The perceived agency failings have led to a focus on strengthening the accountability of credit rating agencies and reducing potential conflicts of interest that may compromise the integrity of their ratings.

## **Legislation**

H.R. 4173 and S. 3217 would both enhance the SEC's oversight over NRSROs and would require more disclosure regarding rating methodologies, assumptions and limitations.

H.R. 4173 would require NRSROs to adopt rating symbols that differentiate between ratings for structured products and other products, require financial regulatory agencies to review and remove certain credit ratings references, and mandate SEC registration for all issuer-pays rating agencies (rating agencies that are compensated by the issuers or arrangers of the securities that they rate). H.R. 4173 also would require financial regulators to remove references to, or reliance upon, credit ratings. In private legal actions against NRSROs, H.R. 4173 would establish the standard that it is sufficient that an NRSRO knowingly or recklessly failed to conduct a reasonable investigation of a rated security with respect to the facts that the rating relied upon. It also gives investors an additional right of private action where it can be established that the process an NRSRO used in determining a rating was grossly negligent and a substantial factor in the investor's economic loss.

S. 3217 authorizes the SEC to temporarily suspend or revoke NRSRO registration with respect to any particular class of security if it finds that the NRSRO lacks adequate financial and management resources to consistently provide accurate ratings. Because of two different floor amendments, S. 3217 would (1) remove references to the credit agencies in specific financial services laws, including the Securities Exchange Act of 1934, the Investment Company Act of 1940 and the Federal Deposit Insurance Act and (2) require the SEC to create a new self-regulatory organization, which would designate NRSROs as "qualified nationally recognized statistical rating organizations" regarding specific categories of structured finance products, and which would assign such qualified NRSROs to provide initial ratings to these products. In private legal actions against NRSROs, S. 3217 would provide that investors can bring actions against NRSROs for a knowing or reckless failure to conduct a reasonable investigation of the facts underlying a rating or to obtain analysis from an independent source.

## **Investor Protection**

### **Policy Issues**

The multi-billion dollar Madoff Ponzi scheme raised concerns over the effectiveness of the SEC's efforts to protect investors. Madoff's operation was a registered broker-dealer subject to both SEC and Financial Industry Regulatory Authority (FINRA, the self regulatory organization for broker-dealers) oversight, as well as a registered investment adviser subject to SEC oversight. Reform initiatives seek to improve the SEC's performance by providing it with more funding, and by amending the regulation of broker-dealers and investment advisers, and other similar agents.

Under current law, broker-dealers must make recommendations that are "suitable" to their customers, while investment advisers have a fiduciary duty to act in the customers' best interests, without regard to their own compensation, and with an affirmative duty to disclose any potential

conflicts of interest. The services provided by broker-dealers and investment advisers, however, often overlap—both can provide investment advice and there are some concerns that customers may falsely assume that the person advising them is committed to acting in their best interests.

## **Legislation**

H.R. 4173 requires the SEC to adopt rules specifying that the standard of conduct for broker-dealers shall be the same as the standard of conduct for investment advisers when providing a retail customer personalized investment advice about securities. It would require the SEC to write regulations defining that fiduciary standard of conduct. In contrast, S. 3217 requires the SEC to study the effectiveness of existing standards of care for broker-dealers and investment advisers regarding the provision of personalized investment advice and securities recommendations to retail customers. If the study concludes that gaps or redundancies exist between the groups, the agency is required to address these through rulemaking within two years of the bill's enactment.

H.R. 4173 and S. 3217 would expand the states' regulatory authority over investment advisers with assets of less than \$100 million, compared to the current \$25 million standard, reducing the number of regulated advisers under SEC jurisdiction. H.R. 4173 would also require SEC rulemaking in order to collect fees from investment advisers to pay for costs of inspections and examinations.

The SEC currently collects fees from sellers of corporate stock, issuers of stocks and bonds, and participants in tender offers. The fees go to an account available to congressional appropriators. Historically, the SEC's budget tends to be much less than total annual fee collections. H.R. 4173 would double SEC appropriations in five years to \$2.25 billion. Alternatively, S. 3217 would provide the SEC with a budget based on self-funding from its fee collections similar to other financial regulators like the FDIC.

Currently, publicly traded corporations with a market value of less than \$75 million generally enjoy a temporary exemption from Section 404 of the Sarbanes-Oxley Act of 2002, which requires publicly traded companies to audit their internal controls (a process aimed at ensuring the reliability of a firm's financial reporting).<sup>31</sup> The SEC has adopted rules to remove this exemption. H.R. 4173 would undo the SEC rulemaking, making permanent the exemption.

## **Hedge Funds**

### **Policy Issues<sup>32</sup>**

Hedge funds are not explicitly defined in federal securities law. They are generally described as privately organized, pooled investment vehicles administered by professional investment managers and not widely available to the public. Hedge funds whose primary investors are wealthy individuals or institutions are also distinguishable from investments such as mutual funds

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<sup>31</sup> See CRS Report RS22482, *Section 404 of the Sarbanes-Oxley Act of 2002 (Management Assessment of Internal Controls): Current Regulation and Congressional Concerns*, by Michael V. Seitzinger.

<sup>32</sup> See CRS Report R40783, *Hedge Funds: Legal Status and Proposals for Regulation*, by Kathleen Ann Ruane and Michael V. Seitzinger and CRS Report R40783, *Hedge Funds: Legal Status and Proposals for Regulation*, by Kathleen Ann Ruane and Michael V. Seitzinger.

by their pronounced use of leverage and their use of trading strategies based on short selling. The funds have a significant capital market presence. According to some estimates, they have been responsible for about one-fifth of the daily trading on the New York Stock Exchange and by some estimates have over a trillion dollars in assets.

Hedge funds can provide benefits to financial markets by enhancing liquidity and efficiency and by reallocating financial risk. Some potential risks inherent in the funds' large capital market footprint were revealed in 1998 when the hedge fund Long-Term Capital Management teetered on the brink of collapse. Concerns over the systemic implications of the large hedge fund's collapse resulted in the New York Fed engineering a multi-billion dollar rescue of the fund. Hedge funds have generally not been identified as contributors to the recent financial crisis. Because of concerns over possible systemic risks they may pose, however, some observers advocate more sweeping hedge fund regulation akin to the safety and soundness regulatory oversight of banks.

Under a current "private adviser" exemption, hedge fund managers, who do not hold themselves to be investment advisers and who have fewer than fifteen clients, are exempted from registering with the SEC as investment advisers under the Investment Advisers Act.<sup>33</sup> Although some hedge fund managers currently register voluntarily, there are concerns that the absence of comprehensive hedge fund data that would accompany mandatory fund registration deprives regulators of potentially critical information on the size and nature of the funds that could help them better understand the risks that they may pose to the economy.

## **Legislation**

H.R. 4173 and S. 3217 would both basically eliminate the "private adviser" exemption from registration as investment advisers, though they differ slightly as to the nature of the exemptions. H.R. 4173 would exempt venture capital funds, small business investment companies, and funds with less than \$150 million in assets. By contrast, S. 3217 would exempt venture capital funds, private equity funds, single family offices, and funds with less than \$100 million in assets. Both the House bill and the Senate bill would authorize the SEC to share the records of registered investment advisers with the systemic risk council for the purpose of evaluating systemic risk. Separately, H.R. 4173 would also require hedge funds with more than \$10 billion in assets under management to pay into the aforementioned \$150 billion Systemic Dissolution Fund.

## **Executive Compensation and Corporate Governance**

### **Policy Issues<sup>34</sup>**

The financial crisis has led to policy concerns about a possible link between excessive financial firm risk taking and executive compensation practices. Beginning in 2008, the Troubled Asset Relief Program subjected recipients to various executive pay restrictions and corporate governance requirements. In fall of 2009, as part of its safety and soundness regulatory oversight

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<sup>33</sup> 15 U.S.C. § 80b-1 *et seq.*

<sup>34</sup> See CRS Report RS22583, *Executive Compensation: SEC Regulations and Congressional Proposals*, by Michael V. Seitzinger and CRS Report R40762, *"Say on Pay" and Other Corporate Governance Reform Initiatives*, by Gary Shorter.

of banks, the Fed proposed to review bank pay structures to identify any compensation arrangements that provide incentives to take excessive risks that could threaten the banks' safety and soundness.<sup>35</sup> Such initiatives are significantly premised on the widely held belief that large financial firm pay structures contributed to excessive risk taking. However, at least one major academic study has raised questions concerning this premise.<sup>36</sup>

## **Legislation**

H.R. 4173 would require financial firms above a certain size to disclose to federal financial regulators incentive-based pay arrangements for the purpose of determining whether these are aligned with sound risk management. H.R. 4173 would also authorize federal financial regulators to prohibit incentive structures that encourage inappropriate risk-taking. H.R. 4173 would give shareholders a nonbinding vote on executive pay and golden parachute packages (known as "say on pay"). H.R. 4173 would authorize the SEC to prescribe rules for proxy access, the right of investors to use a company's proxy materials to nominate their own directors.

S. 3217 would amend the Bank Holding Company Act of 1956<sup>37</sup> to require the Fed, in consultation with the OCC and the FDIC, to establish standards that would prohibit as unsafe and unsound any bank holding company's compensation plan that (1) provides executive officers, employees, directors, or principal shareholders with excessive compensation, fees, or benefits; or (2) could result in material financial losses to the bank holding company. S. 3217 also contains a "say on pay" provision similar to H.R. 4173, but without shareholder approval of golden parachute pay packages. S. 3217 provides that the SEC "may" prescribe rules giving shareholders proxy access. Unlike H.R. 4173, which has no such provision, S. 3217 would also require the SEC to issue rules requiring that directors of companies listed on a national securities exchange who do not receive a majority of votes cast in an uncontested election must tender their resignations, which the board could then decide whether to accept or not to accept. Currently, corporate board members in most states are chosen by a form of voting known as plurality voting, which allows directors in uncontested elections to be re-elected by a single vote.

## **Insurance<sup>38</sup>**

### **Policy Issues**

Under the McCarran-Ferguson Act of 1945,<sup>39</sup> insurance regulation is generally left to the individual states. For several years prior to the financial crisis, some Members of Congress have introduced legislation to federalize insurance regulation along the lines of the dual regulation of the banking sector, although none of this legislation has reached the committee markup stage.<sup>40</sup>

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<sup>35</sup> See CRS Report R40540, *Executive Compensation Limits in Selected Federal Laws*, by Michael V. Seitzinger and Carol A. Pettit.

<sup>36</sup> Rudiger Fahlenbrach, Rene Stulz, and Rene M. Bank, "CEO Incentives and the Credit Crisis," *Charles A. Dice Center Working Paper No. 2009-13*, July 27, 2009, available at SSRN: <http://ssrn.com/abstract=1439859>.

<sup>37</sup> 12 U.S.C. § 1841, *et seq.*

<sup>38</sup> See CRS Report R41018, *Insurance and Financial Regulatory Reform in the 111<sup>th</sup> Congress*, by Baird Webel.

<sup>39</sup> 15 U.S.C. § 1011 *et seq.*

<sup>40</sup> See CRS Report R40771, *Insurance Regulation: Issues, Background, and Legislation in the 111<sup>th</sup> Congress*, by Baird (continued...)

The financial crisis, particularly the involvement of insurance giant AIG and the smaller monoline bond insurers, changed the tenor of the debate around insurance regulation, with increased emphasis on the systemic importance of some insurance companies. Although it could be argued that insurer involvement in the financial crisis demonstrates the need for full-scale federal regulation of insurance, to date the broad financial regulatory reform proposals have not included language implementing such a system. Instead, broad reform proposals have tended to include the creation of a somewhat narrower federal office focusing on gathering information on insurance and setting policy on international insurance issues. Reform proposals may also affect insurance through consumer protection or systemic risk provisions, though insurance is largely exempted from these aspects of the legislation as well.

## **Legislation**

H.R. 4173 and S. 3217 contain slightly differing versions of a federal office for insurance (Federal Insurance Office in H.R. 4173/Office of National Insurance in S. 3217). Both offices would be a newly created entity within the Treasury Department. (H.R. 4173's language originated in H.R. 2609 as amended.) This office would have limited preemptive power over state insurance laws in cases where the state laws result in differential treatment between U.S. and non-U.S. insurers and the case is covered by an existing international agreement. H.R. 4173 would completely exempt insurance from the Consumer Financial Protection Agency's oversight, a change from the original bill (H.R. 3126), which included title, credit, and mortgage insurance under the agency's oversight. The Senate bill would also exempt insurers from the new Bureau of Consumer Financial Protection. Under both H.R. 4173 and S. 3217, systemically significant insurers could be subject to regulation by the systemic risk regulator and to federal resolution authority. In addition, both H.R. 4173 and S. 3217 contain language from previous bills (H.R. 2571/S. 1363) addressing surplus lines and reinsurance.<sup>41</sup>

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<sup>41</sup> See CRS Report RS22506, *Surplus Lines Insurance: Background and Current Legislation*, by Baird Webel.

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