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# Sightlines

## ALERT

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## FSOC Identifies Priorities for Policy And Supervision in Annual Report

The Financial Stability Oversight Council<sup>1</sup>, a newly formed entity created by the Dodd-Frank Act, last week released its first [annual report](#). The congressionally mandated report provides insight into the upcoming priorities of the Council and its member agencies in areas that go beyond the requirements of the Dodd-Frank Act. The report makes recommendations in several categories:

### HEIGHTENED SUPERVISORY ATTENTION

The report recommends that the Council and member agencies give added focus in several areas by asking them to ensure that financial institutions:

- **Develop robust capital, liquidity, and resolution plans.**

Continuing a theme expressed by the Federal Reserve in its Comprehensive Capital Analysis and Review exercise, the Council urges large banks to improve their capital planning processes. The Federal Reserve expects large banks to take a comprehensive, forward-looking approach to capital planning, including submitting plans annually that encompass a minimum forward horizon of 24 months. Capital and liquidity planning should reflect a smooth transition to new global standards established by Basel.

Banking companies will no doubt receive more details about these expectations in upcoming weeks, when the Federal Reserve is expected to issue proposals that implement the Dodd-Frank Act's mandate to apply heightened standards on bank holding companies having \$50 billion or more in assets. A final regulation on resolution plans is also likely to be issued soon, which — taken together with the proposals on capital, liquidity, and stress testing — will significantly raise the bar on the supervisors' expectations for enterprise risk management and its components.

- **Improve interest rate risk management.**

The Council emphasized that financial institutions cannot assume the historically low interest rate environment that has prevailed for so long will continue. All market participants must

<sup>1</sup> As of the publication of the annual report, the voting members of the FSOC were: Timothy F. Geithner, Secretary of the Treasury; Ben S. Bernanke, Chairman of the Federal Reserve Board; John Walsh, Acting Comptroller of the Currency; Mary Schapiro, Chairman of the Securities & Exchange Commission; Martin J. Gruenberg, Acting Chairman of the Federal Deposit Insurance Corporation; Gary Gensler, Chairman of the Commodities Futures Trading Commission; Edward J. DeMarco, Acting Director of the Federal Housing Finance Agency; and Debbie Matz, Chairman of the National Credit Union Association. Two voting positions—Director of the Consumer Financial Protection Bureau and a presidentially appointed independent member with insurance expertise—were vacant at the time of the annual report. There are also five non-voting, or advisory, members.

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have robust processes to measure and manage interest rate risk, including identified steps to mitigate their exposure to changes in the structure of interest rates. Such planning is not only important for the safety and soundness of financial institutions, but for the stability of the system as a whole.

- **Maintain discipline in credit underwriting standards.**

The Council expressed concern that credit underwriting standards might be easing too much, particularly for certain products such as leveraged loans. Lenders and investors should be sure to undertake appropriate due diligence, and be alert for changes in underwriting standards that may allow borrowers to assume excessive debt burdens.

- **Employ due diligence regarding new products.**

The report notes that it would not be unexpected for new products to emerge that attempt to arbitrage new capital, liquidity, accounting, and other rules. Such new products could be highly complex and have performance characteristics not fully understood or tested, particularly under strained market conditions. The report mentions in particular exchange-traded funds and structured notes. Issuers and investors must ensure they understand the risks of new products, including how the risks might change under various market scenarios.

- **Keep pace with changes in market structure.**

The Council recommends that both regulators and market participants remain aware of ongoing changes in equity trading markets, such as the increased number of trading platforms and the rise of electronic trading. Firms' operational policies must factor in the evolving risks as well as promote the highest degree of integrity.

## **ADDITIONAL REFORMS NEEDED**

- **Eliminate most intraday credit exposure and reform collateral practices in the tri-party repo market.**

The report endorses the work of the Task Force on Tri-Party Repo Infrastructure<sup>2</sup> while recommending that regulators use their supervisory authority to ensure the Task Force meets its commitments promptly. The Council recommends that regulators take coordinated action to address several structural issues. These include enhancing dealer liquidity risk management practices, alleviating the propensity of cash investors to withdraw funding when risk surfaces, and implementing mechanisms to manage a dealer default. The report notes these reform efforts should work to eliminate intraday credit exposures of clearing banks to borrowers to the extent practicable and strengthen collateral management practices to improve stability. In response to the Council's recommendations, regulators may work with the industry to establish specific written commitments and timeframes to carry out these reforms, similar to their efforts in tackling reforms of the OTC derivatives market pre-Dodd-Frank.

- **Implement structural reforms to mitigate runs on money market funds.**

The report recommends that the Council examine and the SEC pursue further reform alternatives beyond those the SEC adopted last year to reduce susceptibility to money market fund runs. Specifically, the Council recommends consideration of (1) a mandatory floating net asset value (NAV), (2) capital buffers to absorb fund losses to sustain a stable NAV, and (3) deterrents to

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<sup>2</sup> The Task Force on Tri-Party Repo Infrastructure was formed in September 2009 under the auspices of the Payments Risk Committee, a private sector body sponsored by the Federal Reserve Bank of New York. The Task Force membership includes representatives from multiple types of market participants that participate in the tri-party repo market, as well as relevant industry associations.

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redemption. The Council's recommendations are instructive insofar as they signal the likely contents of an upcoming SEC rulemaking on the topic, as well as the Council's intention to play a continuing role in structural reforms of the industry.

- **Improve quality of mortgage servicing through national mortgage servicing standards.**

The Council recommends that regulators establish national mortgage servicing standards and promote alternative compensation models to enhance the integrity and efficiency of mortgage servicing and restore investor confidence. The standards should hold servicers to the same standards of care regardless of who owns the loans being serviced (i.e., whether the loans are held by the originator, sold, or securitized). Noting that the current flat-fee compensation structure does not provide incentives for servicers to invest time working with borrowers, the report recommends that Federal Housing Finance Agency and U.S. Department of Housing and Urban Development continue to coordinate a review of the structural flaws in the mortgage servicing compensation models and consider alternatives.

At least eight different agencies, including the Consumer Financial Protection Bureau, are working to craft a set of uniform mortgage servicing standards. Reportedly, the agencies have found it difficult to achieve a consensus and to rationalize the varying servicing standards already in use, such as those contained in the banking agencies' foreclosure-related consent orders and the HAMP program. There is no deadline for completion of these standards. In addition to regulatory efforts, legislation has been introduced in Congress on servicing standards.

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