TESTIMONY OF
T. TIMOTHY RYAN, JR.
PRESIDENT AND CEO OF THE
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

HEARING ON:

"SYSTEMIC REGULATION, PRUDENTIAL MATTERS, RESOLUTION AUTHORITY AND SECURITIZATION"

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I. Introduction

Chairman Frank, Ranking Member Bachus, members of the Committee:

My name is Tim Ryan and I am President and CEO of the Securities Industry and Financial Markets Association ("SIFMA").[1] Thank you for your invitation to testify at this important hearing. My testimony will focus on the proposals for systemic risk regulation, with special emphasis on the proposal for resolution authority over systemically important non-bank financial institutions. I will also discuss the FDIC's proposals for extending resolution authority to all bank holding companies, as well as the proposal to impose activities restrictions on systemically important financial institutions that do not control a bank.

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers locally and globally through offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at http://www.sifma.org.)

Finally, I will touch on securitization reform. On Tuesday, this Committee and the Administration released a discussion draft of the Financial Stability Improvement Act of 2009, which updates the Administration's earlier proposals (the "Discussion Draft"). While my testimony today reflects changes contained in the recent release, we look forward to commenting further on the Act and may supplement this testimony to discuss the revised proposals.

It has been just over a year since panic swept the global financial system, resulting in free falling markets during September and October of last year. Government authorities around the world responded aggressively to this panic, placing Fannie Mae and Freddie Mac into conservatorship, allowing Lehman Brothers to fail, and rescuing AIG, the Royal Bank of Scotland, Lloyds TSB, Fortis, Dexia and other major financial groups. Congress played a key role in this response by passing sweeping legislation, including the Housing and Economic Recovery Act of 2008, the Emergency Economic Stabilization Act of 2008 and the American Recovery and Reinvestment Act of 2009. Those efforts have largely succeeded in stabilizing the financial system. But that stability is fragile and the economy continues to have many other weaknesses, including high unemployment and residential foreclosure rates.

Congress and the Administration have correctly recognized that ending the free fall and stabilizing the system is only half the battle. In order to avoid future financial crises of this magnitude, or at least reduce their frequency and severity, we need to strengthen our regulatory infrastructure so that it can focus on macro-prudential issues as well as it can focus on micro-prudential issues. If we do this job right, not only will we reduce the likelihood of future crises, but we can also eliminate the weaknesses that give rise to the need or temptation to bail out financial institutions that may otherwise be considered "too big or complex to fail." Regulatory reform, correctly implemented, will also restore market and investor confidence, and contribute to financial and economic stability.

We believe that the systemic risk proposals, including the Discussion Draft's proposal on resolution authority for systemically important financial institutions, are critical keys to achieving these goals. As a result, we strongly support many of the proposal's concepts, but we believe some important changes need to be made to the draft legislation, especially with regard to the proposed resolution authority. With the appropriate changes, these policies can achieve their goals without producing any unnecessary, and presumably unintended, adverse consequences.

SIFMA has been, and is strongly committed to continuing to be, a constructive voice in this critically important public policy dialogue to restore confidence in our domestic and global financial system. Our members understand the value that a well-designed and implemented regulatory system brings to minimizing systemic risk. We believe that a global effort is required to develop such a regulatory system with common principles that limit regulatory arbitrage between and among nations.

II. Systemic Risk Proposals

The trouble with financial panics is not only the direct harm they do to the financial system and investors, but also the negative externalities that a weakened financial system imposes on the rest of the economy. A strong financial system facilitates the sort of prudent risk-taking by businesses and investors necessary for a vibrant modern economy. It produces positive benefits in the form of widely available credit at desirable rates, deep and liquid trading markets, accurate asset prices, safe ways to preserve money and other assets for future use, favorable conditions for prudent business investing and healthy consumer spending and other benefits to the economy as a whole. When the public has confidence in the financial system, the interplay between the financial system and the rest of the economy has a multiplier effect on the supply of money and credit available. Thus, every dollar printed by the central bank or introduced into the economy by government spending is multiplied into an amount of money and credit available in the economy many times the initial dollar. These features of a healthy financial system foster economic growth, capital formation, business investments in capital, individual investments and savings, consumer spending and full employment.

When a financial panic occurs, the public and lending institutions lose confidence in the financial system, and so the amount of credit available severely contracts. This contraction of credit results in negative consequences to the rest of the economy in the form of excessive pessimism and risk reductions, reduced business investing, reduced consumer spending and increased unemployment. It is therefore critical to have a regulatory infrastructure that avoids panics, and their negative consequences, while allowing the financial system to operate properly in providing a healthy amount of credit and other positive benefits to the market. We believe that a systemic risk regulator will go a long way to address the weaknesses in our current system and reduce the likelihood and severity of future panics.

A. Interrelated Nature of the Proposals

The Discussion Draft's proposals for a systemic risk regulator, enhanced prudential supervision and regulation, resolution authority for systemically important financial institutions, securitization reform and enhanced risk management of systemically important payment, clearance and settlement systems are all part of an interrelated package of proposals aimed at reducing systemic risk and strengthening our financial system. These proposals are the missing elements in our current financial regulatory infrastructure that have the most potential to prevent, or at least reduce the likelihood or severity, of the sort of financial panic we experienced last September and October, which led to most of the harm done to the financial system. Each element is dependent on the existence and shape of the other elements in order for the whole to work properly.

Each of these elements plays a critical role in preventing, or at least reducing the likelihood or severity, of a future financial crisis. We support the proposal for a Financial Services Oversight Council, with the Treasury Secretary as the Chair, and in which the Federal Reserve has a substantial role. The proposal for a systemic risk regulator should provide the authority for a single federal agency or a council of federal agencies to gather information from every financial institution operating in our economy, regardless of charter and whether the financial institution is otherwise subject to federal regulation and supervision. This power should give that single agency or council access to a wealth of information that no federal agency or group of agencies currently has. It should also give that agency or council a sense of duty, backed up by legislative mandate, to use that information to identify weaknesses in the overall financial system and address them before they become problems that could result in the sort of panic that took place last September and October. If this proposal is successful, it should eliminate or reduce the likelihood of market meltdowns.

The proposals for enhanced prudential supervision and regulation can also play a critical role in avoiding financial panics and market meltdowns. Financial regulatory agencies need to set limitations and requirements in ways, and in compliance with international standards, that will prevent macro-risks to the system as well as micro-risks to the particular institution. It is also important to get the balance of regulation right, and not to overcompensate with standards that will stifle the economy. If we have the right prudential standards, the probability of a financial panic can be greatly reduced.

If stricter prudential regulation in the form of enhanced capital, liquidity and leverage requirements and greater activities restrictions is not coordinated with foreign and international standards, U.S. financial regulatory reform could give rise to disparate regulatory treatment, which could result in regulatory arbitrage. The Administration has called for a "global race to the top" on regulatory standards.[2] This suggests that U.S. and foreign regulators, through the G-20 and other groups, should coordinate on establishing consistent and high

[2] President Barack Obama, Remarks by the President on Financial Rescue and Reform, Federal Hall, New York, New York, September 14, 2009, *available at* http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-Financial-Rescue-and-Reform-at-Federal-Hall/.

standards for regulations. It is important to strike the right balance between setting high standards and being consistent with regard to regulating capital, leverage, liquidity and business activities. Otherwise, if a diverse group of regulators handle these issues in a piecemeal fashion, the U.S. may miss the critical opportunity to eliminate regulatory gaps. Conversely, a piecemeal approach risks over-regulation, which may create incentives to move U.S. jobs and businesses off-shore. In recent remarks, Treasury officials have identified these risks, noting that "[i]n a world of mobile capital, no single jurisdiction can achieve its regulatory objectives in isolation."[3]

Resolution authority for systemically important financial institutions is a fail-safe measure in case the "front-end" framework of systemic risk and prudential supervision and regulation does not always prevent panics or failures. Financial firms should be allowed to fail, imposing costs on their shareholders, management and creditors, regardless of whether they are large or small. If shareholders, management, creditors and other stakeholders believe that an institution will be bailed out because it is "too big or complex to fail," these stakeholders will take or allow greater risks than they would if they believed that the institution would be allowed to fail and they could lose some or all of their investments. Such excessive risk-taking as a result of this "moral hazard" can create systemic risk, as well as increasing the risk and costs of a financial crisis and the negative externalities that it produces.

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[3] Acting Assistant Secretary for International Affairs Mark Sobel, Remarks to IIB Regulatory Breakfast Dialogue in Istanbul, October 5, 2009, *available at* http://www.ustreas.gov/press/releases/tg309.htm.

Conversely, the establishment of a resolution authority mechanism by statute, if properly structured, should eliminate the perceived need to bail out certain financial institutions because it would eliminate the risk that allowing them to fail would have such a severe domino effect on their counterparties, investors and the rest of the financial system that it would be more costly to the system to allow them to fail than to bail them out. Simply put, a properly established resolution authority mechanism would obviate the need for open-ended taxpayer support and instead provide for the orderly wind down and dissolution of such institution while limiting systemic risk to the financial system.

Finally, the proposals to focus enhanced scrutiny on the risk management policies and procedures of systemically important payment, clearing and settlement systems will ensure that these systems continue to reduce risk to the overall financial system, rather than becoming systems for concentrating, hiding or spreading risk.

B. Strong Support for the Overall Goals of the Discussion Draft

SIFMA strongly supports the overall goals of the Discussion Draft's systemic risk proposals though we continue to review the recent systemic risk and resolution authority release and the specific proposals contained in that release. As described below, we believe that some of the details in these proposals need to be revised so as not to produce unintended consequences. Primarily, these include provisions in the proposed resolution authority that would reduce judicial review of the claims process and replace the rules defining creditors' rights in the Bankruptcy Code with the very different and creditor-unfriendly rules contained in the bank insolvency statute. They also include provisions in the systemic risk regulation proposal that would prohibit a systemically important financial institution, now called an identified financial holding company, from engaging in certain activities based on which side of the wall between banking and commerce the activities fall, rather than whether the activity is excessively risky or the particular institution is unable to manage the risk appropriately.

III. Resolution Authority for Systemically Important Financial Institutions

SIFMA strongly supports the Discussion Draft's proposed resolution authority for systemically important financial companies to the extent it gives a federal agency the authority to exercise core resolution powers. Core resolution powers include the authority to take control over a failing non-bank financial company as receiver or qualified receiver, to act quickly to transfer all or any part of the failing company's business to a third party or temporary bridge financial company at fair value to stabilize or wind down the company in a cost-effective and orderly fashion that minimizes systemic risk and solves the "too big to fail" problem. But SIFMA opposes replacing the transparent claims process and neutral rules governing creditors' rights in the Bankruptcy Code, which are more appropriate for non-banks, with the opaque claims process and creditor-unfriendly rules contained in the bank insolvency statute. Otherwise, the proposal will have the unintended consequence of seriously disrupting and causing permanent harm to the U.S. credit markets. Preserving a transparent and neutral claims process based on the principles of the Bankruptcy Code will not interfere with the federal agency's power to move quickly to exercise its core resolution powers.

A. Purpose of the Proposed New Resolution Authority

The central purpose of the proposed resolution authority is to give a federal agency the power to act quickly so that a systemically important financial institution can be unwound in an orderly fashion without causing a domino effect throughout the financial system or otherwise unduly disrupting the markets. Under normal market conditions, the Bankruptcy Code is effective in dealing with failed or failing companies. The market has a deep understanding of its process and substantive rules, and generally considers both to be fair and predictable. During a financial panic, market meltdown or certain other circumstances, however, leaving the authority to deal with a large and interconnected financial company in the hands of a bankruptcy court, creditors committee or trustee in bankruptcy can create a risk of serious adverse effects on financial stability or economic conditions in the United States.

These adverse effects result largely because resolution of these companies through the normal bankruptcy process occurs far too slowly given the speed with which value can disappear during a market meltdown. This is true because of the extraordinary speed with which both credit disappears for financial companies during a financial crisis and the value of certain assets (such as qualified financial contracts) dissipates upon the commencement of bankruptcy proceedings. The follow-on effects of this loss of value are distributed throughout the financial system, thereby increasing systemic risk and the cost of government intervention to stabilize the financial system.

The core resolution powers needed to achieve this purpose are the following:

- the power to allow federal regulator(s) to take control of a failed or failing company as receiver or qualified receiver if a systemic risk determination is made; and
- the power of the receiver or qualified receiver to act quickly to identify and sell the part of the business worth preserving to a third party at fair value and, when a third party buyer cannot be found at fair value, to establish a temporary entity called a "bridge financial company" to hold the part of the business worth preserving until it can be sold to a third party at fair value or wound down in an orderly fashion.

The part of the business left behind is then liquidated. The ultimate goal of the resolution authority is to wind up the affairs of a failed financial company in an orderly manner at the least cost and with the least disruption to the financial system. It is not meant to serve as a means to rescue or otherwise preserve the failing company.

These core resolution powers are designed to overcome the weaknesses in the bankruptcy process by providing a way for the systemically critical parts of a non-bank financial company's assets and liabilities to be preserved in the most cost-effective way, regardless of whether creditors within the same class are treated equally. This cherry-picking of assets and liabilities in the interest of systemic stability would normally be antithetical to established bankruptcy policies, which favor equality of treatment for similar situated creditors. It is justified, however, in the case of systemically important non-bank financial companies because of the supervening policy goals of preserving the value of these entities and minimizing public costs.

What was most needed when Lehman failed, and when AIG was rescued, was not an adequate claims process, but instead the authority of a federal regulator to take control over the failing institutions and transfer the systemically important part of its business to a temporary bridge company until it could be sold to a third party at fair value or wound up in an orderly manner. Without the authority to resolve complex financial institutions, policymakers were left with two choices: let the company fail regardless of adverse consequences to counterparties and the financial system as a whole, as in the case of Lehman, or inject taxpayer dollars to support the company, as in the case of AIG. Both decisions have had substantially negative consequences on the financial markets.

B. The Claims Process

The Discussion Draft's proposal, however, goes beyond the creation of these core resolution powers. It also replaces the Bankruptcy Code's transparent judicial claims process and neutral rules for left-behind assets and liabilities with the opaque administrative claims process and creditor-unfriendly rules defining creditors' rights contained in the bank insolvency statute. Unlike the core resolution process, there is no compelling reason for extraordinary speed in the claims process for left-behind assets and liabilities because dividing up the pie among left-behind claimants does not affect the systemically important portion of the business transferred to a third party or bridge company, but only the portion left behind to be liquidated. There is no need for the claims process for left-behind assets and liabilities to operate more quickly than a normal bankruptcy liquidation or for it to by-pass the normal procedural and substantive safeguards of bankruptcy, which were designed to comport with legitimate commercial expectations of creditors and principles of inter-creditor equity.

On the other hand, there are substantial policy reasons for allowing the due operation of the normal and expected safeguards to provide assurance that the market will have confidence that the process of left-behind assets and liabilities will be neutral, predictable and fair. The market has a deep understanding of the Bankruptcy Code, and its procedures and rules, and generally considers them to be neutral, fair and predictable. The market does not have a similar understanding or positive view of the claims process and substantive rules under the bank insolvency statute, particularly as it would apply to non-bank financial companies.

C. The Bank Insolvency Model

The Discussion Draft's proposal is modeled on the bank insolvency statute contained in Sections 11 and 13 of the Federal Deposit Insurance Act. The bank insolvency statute contains the sort of resolution framework that is essential for the proposed resolution authority to achieve its goals. The bank insolvency statute grants the FDIC power to take control over a failed or failing insured depository institution as conservator or receiver. It also authorizes the FDIC to act quickly to identify and sell any part of the business worth preserving to a third party at fair value and, when a third party buyer cannot be found at fair value, to establish a temporary “bridge bank” to hold the part of the business worth preserving until it can be sold to a third party at fair value or wound down in an orderly fashion. These are the sort of powers that a federal agency needs to have to deal with a future AIG or Lehman Brothers, instead of leaving them in the hands of a bankruptcy proceeding or bailing them out. It is therefore sensible to model the “resolution process” component of the proposed resolution authority on these provisions from the bank insolvency statute.

The bank insolvency model is not the right model for the claims process and related rules for dividing up the left-behind assets and liabilities of non-bank financial companies that would otherwise be subject to the Bankruptcy Code in the absence of a systemic determination. The uncertainty produced by such a dramatic change in the "rules of the game" based on an after-the-fact determination will substantially increase the risks and uncertainties associated with financing entities of this type.

The claims process in the bank insolvency statute was deliberately designed to favor the FDIC, as creditor, over all other creditors. Because the FDIC insures an insured bank's deposits, it is typically the largest creditor of a failed bank. Indeed, the bank insolvency statute gives the FDIC a set of "super powers" that have no counterpart in the Bankruptcy Code. These superpowers allow the FDIC to subordinate or otherwise limit the claims of other creditors in ways that are inconsistent with neutral rules governing creditors' rights.

The claims process based on this model is subject to virtually no judicial review, except for de novo judicial review after the administrative claims process has been completed. The provision that allows a company to seek judicial review of the appointment of a conservator or receiver may even be a mirage since the federal agency succeeds by operation of law to all of the company's rights and powers, without any express carve-out of the power to seek judicial review, automatically upon its appointment as conservator or receiver.

Because the FDIC does not provide insurance for the liabilities of a non-bank financial company, the super powers contained in the bank insolvency statute are inappropriate when applied to non-bank financial companies, regardless of whether a systemic risk determination has been made.

D. Unintended Consequences

If the proposed new resolution authority includes the claims process and related rules from the bank insolvency statute it will produce a number of unintended consequences that would undermine many of the proposed bill's goals, reduce the efficiency of the credit markets and impose deadweight costs on our economy.

To provide just one illustration of these unintended consequences consider the differences between the avoidable preference rules in the two statutes. Under the Bankruptcy Code, perfected security interests are respected in a bankruptcy proceeding and cannot be set aside, as long as they were taken to secure a new extension of credit. As a result, financial companies can virtually always obtain emergency liquidity in a financial crisis if they have unencumbered collateral. In contrast, the bank insolvency statute allows the FDIC to set aside any security interest taken "in contemplation of insolvency" of the failed institution. But all security interests are taken to guard against insolvency risk. As applied to non-banks, this provision could cut off a financial company's access to emergency liquidity during a financial crisis because of the uncertainty whether the security interest will be respected in the event a resolution proceeding becomes necessary.

If the proposed legislation retains the avoidable preference rule from the bank insolvency statute, financial companies that might be subject to its rules could also face higher credit costs and less credit availability during normal market conditions to account for the heightened risk that, if the entity faces financial distress or market disruption, asset-based financing will be unavailable to the entity, potentially accelerating its financial failure.

The bank insolvency statute also includes rules related to the treatment of contingent claims, fraudulent transfers, setoffs, repudiation of contracts, calculation of damages upon the rejection, and other matters that depart drastically from the bankruptcy model, ostensibly to favor federal deposit insurance claims that would not exist in the non-bank context. This departure from neutral, fair and equitable rules that would otherwise apply under the Bankruptcy Code is neither efficient nor fair.

E. Alternative Approaches to Preserve the Normal Claims Process

We believe that the proposed resolution authority should be amended to restore the claims process and rules defining creditors' rights contained in the

Bankruptcy Code. There are a number of possible ways to preserve the normal claims process, two of which are summarized below.

One approach would be to continue to allow non-bank financial companies to be removed from the bankruptcy system, but to harmonize the process and related rules for dividing up the pie among left-behind assets and liabilities of such companies in the Discussion Draft with the process and rules that would otherwise be applicable under the Bankruptcy Code. This would involve adding provisions to increase judicial involvement in the administrative claims process for left-behind assets and liabilities and to restore each of the Bankruptcy Code's substantive rules governing creditors' rights.

Another approach would be to replace all of the provisions relating to the claims process for left-behind assets and liabilities with a simple set of provisions that would cause such assets and liabilities to be resolved through the commencement of conventional proceedings under the Bankruptcy Code, subject to the federal agency's continuing to exercise its core resolution powers with respect to the assets and liabilities it determines should be sold or transferred for systemic reasons. The law could also authorize the federal agency to choose whether the left-behind assets and liabilities would be resolved under Chapter 11 or Chapter 7, and to participate in the bankruptcy proceedings in the capacity of debtor (having succeeded by operation of law to the powers of the shareholders and board of directors of the debtor) or bankruptcy trustee, as appropriate.

The benefit of either approach is to increase legal certainty as to how creditors of a systemically important financial institution will be treated under the resolution statute, which will add to stability and confidence in the financial markets both during a financial crisis and in otherwise calm market environments.

F. Minimum Recovery

SIFMA strongly agrees with the Discussion Draft's proposal, modeled on a similar provision in the bank insolvency statute, to guarantee all creditors left behind a minimum distribution equal to what they would have received in a liquidation under the Bankruptcy Code, in the absence of a systemic risk determination. The Discussion Draft's proposed financial assistance powers should ensure that left-behind creditors have an adequate remedy to assure this minimum recovery right, if the federal agency exercises its core resolution powers in a way that favors some creditors over others for the benefit of the financial system. If, for example, the simple model of administering the left-behind claims through proceedings under the Bankruptcy Code is adopted, the remedy might be to provide the bankruptcy estate with a claim for any shortfall in value which could be pursued under appropriate supervision by representatives of the left-behind creditors.

G. Solution to the "Too Big to Fail" Problem

SIFMA supports the revisions included in the Discussion Draft's proposed resolution authority that are designed to solve the "too big to fail" problem. In particular, SIFMA supports imposing time limits on qualified receiverships. But we believe that a limit of 2-5 years is too long, and should be reduced to six months or some similar shorter period. Otherwise, qualified receiverships could amount to temporary de facto nationalizations.

SIFMA also supports restrictions on providing financial assistance outside the context of a receivership or qualified receivership, but we support the flexibility provided under the emergency financial assistance provisions in the context of when an economic distress determination has been made. However, we believe that it is inappropriate to require a federal agency to ensure that all unsecured creditors bear losses since this would interfere with the federal agency's core resolution power to transfer some liabilities to a third party or bridge financial company if necessary to stabilize or wind down the company in a cost-effective and orderly fashion that minimizes systemic risk.

H. Systemic Resolution Board; Fed Membership on FDIC Board

The FDIC has only limited experience with the type of large, complex and global institution that could be subject to the proposed legislation. We therefore strongly support the provisions in the Discussion Draft's proposed resolution authority that require the FDIC to consult with the regulators of the covered financial companies. But we do not believe that these consultation requirements are sufficient to ensure that the right experience is brought to bear in resolving systemically important non-bank financial companies. Instead, we believe that a new Systemic Resolution Board should be created. The new board should be chaired by the Secretary of the Treasury, with representatives from the FDIC, the Federal Reserve, the Office of the Comptroller of the Currency and the SEC. The FDIC would be subject to the direction of the Systemic Resolution Board in exercising its powers. In addition, the appropriate functional regulator for a particular covered company should be a member of the Systemic Resolution

Board for purposes of that company and thereby directly involved in exercising the resolution authority with respect to that company.

We also strongly agree with the provision in the Discussion Draft that would give the Federal Reserve a seat on the FDIC's board, replacing the Office of Thrift Supervision if the Office of Thrift Supervision is merged with the Office of Comptroller of the Currency.

I. Increasing Legal Certainty

It is also important to include provisions in the proposed resolution authority that will increase legal certainty because of the systemic nature of the covered companies. For instance, we strongly agree with the provision in the Discussion Draft’s proposed resolution authority that would require a federal agency to promulgate regulations regarding the allowance or disallowance of claims by the FDIC. But we believe the right entity to exercise this authority is our proposed new Systemic Resolution Board of which the FDIC would be only one member. We also do not believe this mandate is sufficient unless it is coupled with an express duty to promulgate regulations in a way that increases ex-ante legal certainty for everyone potentially affected. Nor should the FDIC or the Systemic Resolution Board be allowed to rely on the FDIC's existing rules, which were developed for banks in connection with a very opaque claims process and rules governing creditors' rights that are not appropriate for non-bank financial companies. Instead, we believe that the mandate should be combined with substantially more judicial review of the claims process to make it as transparent as the bankruptcy process and with a restoration of the rules governing creditors' rights under the Bankruptcy Code.

The proposed legislation should also contain rules that increase legal certainty as to how customers and secured creditors can determine their rights, interests and priorities in securities held through a systemically important securities intermediary. Increasing legal certainty about how customers and secured creditors can protect themselves against the insolvency risk of securities intermediaries has been a U.S. national and international policy goal since at least 1987. This need is even more obvious as soon as one is made aware of the mind-boggling volumes of securities transactions, including securities collateral transactions, that are currently processed by the major clearing systems. According to data posted on the Federal Reserve's website, the average volume of U.S. government and agency securities transactions processed by the Fedwire Securities Service was $1.6 trillion per day or $419 trillion per year in 2008. Similarly, the Depository Trust Company, the principal U.S. securities settlement system for U.S. corporate securities, reported processing $455 trillion in securities transactions in 2008. A substantial, and largely immeasurable, volume of additional transactions is processed on the books of banks, brokers and other securities intermediaries, or directly between securities intermediaries, without going through Fedwire or DTC.

Clear legal rules in this area reduce systemic risk, reduce the costs and risks of securities transactions and secured credit during normal times, and help prevent seize-ups in the credit markets during times of financial stress. Any prospect of legal uncertainty as to rights and remedies will cause severe anxiety among creditors, exacerbating the very problem the legislation attempts to resolve. In the early 1990s, the Federal Reserve, the American Bar Association, the American Law Institute and the National Conference of Commissioners on Uniform State Laws launched a major project to modernize Articles 8 and 9 of the Uniform Commercial Code and the federal regulations governing U.S. government securities. While this law reform effort has been hailed as highly successful outside of insolvency law, it is important that its benefits be confirmed in insolvency law, such as the proposed resolution law. Similar provisions also should be added to the Bankruptcy Code.

IV. FDIC Proposals

A. Resolution Authority over all Bank Holding Companies

The FDIC Chairman has recently proposed extending resolution authority to all bank holding companies, not only when a systemic risk determination has been made.[4] We believe that, at a minimum, this proposal should reflect the same considerations discussed above, including a limitation of such new authority to essential resolution powers. The claims process should remain in the hands of a bankruptcy court, and the rules defining creditors' rights should be the rules contained in the Bankruptcy Code. The FDIC should not be given administrative power over the claims process, but instead should be limited to acting in the capacity of the debtor or trustee in bankruptcy in any bankruptcy proceedings. To

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[4] Chairman Sheila Bair, *Combining More Effective Bank Regulation with Market Discipline*, Transcript of Remarks to the International Institute of Finance Annual Meeting in Istanbul (Posted by Chairman Bair on the Harvard Law School Form on Corporate Governance and Financial Regulation, Oct. 21, 2009).

provide otherwise would produce all the same problems in the market discussed above with respect to systemically important non-bank financial companies.

B. Cross-Guarantee Liability

The FDIC Chairman has also proposed that cross-guarantee liability, which currently applies among commonly controlled insured depository institutions, should be extended to their holding company parents and non-bank affiliates.[5] This proposal raised serious policy issues, including fundamental questions about whether the FDIC should be able to "pierce the corporate veil" of bank holding companies and non-bank affiliates in order to use their assets to subsidize the FDIC's resolution of an affiliated insured institution.

C. Haircuts on Secured Credit

Finally, the FDIC Chairman has proposed that all claims of secured creditors be automatically reduced by 20% in any resolution proceeding in order to increase the incentive of these creditors to monitor their debtors.[6] Aside from the serious constitutional questions that this proposal may raise under the Takings Clause, as a former director of the FDIC, I can say with confidence that such a proposal is unworkable. If the various resolution proposals include the ability to abrogate the property rights of secured creditors, it would significantly impair traditional trading practices critical to our economy and distress potential and existing investors.

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[5] *Id.*

[6] *Id.*

For example, this proposal would seriously disrupt the clearance and settlement systems on which so many of the other risk-reducing proposals rely. For more than two decades, these systems have been encouraged by regulators and other public policymakers to reduce the gap between trade date and settlement in order to reduce counterparty credit risk. The standard settlement cycle for corporate securities transactions has been reduced to three days after the trade, or T+3. Transactions in U.S. government securities are settled in real time. A consequence of compressing the settlement cycle is an increased need for intraday credit or daylight overdrafts. The huge volumes of transactions processed by the world's clearance and settlement systems, which amount to more than a ***quadrillion*** dollars per year, would grind to a halt without such intraday credit. Because the amount of intraday credit needed is many times the capital and sometimes even the balance sheets of the financial institutions providing the credit, the credit must be fully or over secured by high quality collateral. If such credit providers were subject to a mandatory 20% haircut on their secured claims against U.S. insured institutions, bank holding companies, identified financial holding companies or their affiliates, they would immediately cut-off all daylight overdraft credit to such institutions. Clearance and settlement systems would grind to a halt, or the settlement cycles would have to be extended to T+7, T+10 or even T+30. Not only would this dramatically increase counterparty credit risk, it is inconsistent with the velocity of modern finance.

Similarly, in the repo market today, financial firms raise short-term cash against collateral, and lenders assume their credit exposures are fully secured by that collateral. A rule that imposed an automatic 20% haircut on secured claims would simply eliminate the willingness of anyone to lend in that market – and thus eliminate a critical source of funding that financial institutions depend on to manage their risk and fund their lending activity.

V. Activities Restrictions

The Discussion Draft would would subject a new category of financial institutions, formerly defined as Tier 1 FHCs, and now defined as identified financial holding companies, to the activities restrictions that apply to financial holding companies ("FHCs") under the Bank Holding Company Act. A financial institution may be classified as an identified financial holding company under the Discussion Draft without controlling a bank or otherwise being an "FHC" under the Bank Holding Company Act. An identified financial holding company can set up an intermediate holding company and move its financial operations to that holding company, which will then be regulated like a bank holding company, and subject to the same activities and other restrictions as a bank holding company.

The activities restrictions in the Bank Holding Company Act were designed to implement the so-called wall between banking and commerce. As a result, some permissible activities such as commercial lending can be high risk, while some impermissible activities can be low risk. We believe it would be inappropriate as a matter of public policy to extend a set of activities restrictions designed to reflect a wall between banking and commerce to identified financial holding companies that do not control a bank. To the extent the systemic risk regulator has the power to impose activities restrictions on identified financial holding companies that do not control banks, we believe those restrictions should be limited to activities deemed to involve excessive risks or risks that the particular identified financial holding company does not have the capacity to manage properly.

VI. Securitization Reform

We support initiatives to align the economic interests of asset originators and securitization sponsors with investors. We believe that the principal goal of these efforts should be to establish and reinforce commercial incentives for originators and sponsors to create and fund assets that conform to stated underwriting standards and securitization eligibility criteria, thereby making those parties economically responsible for the stated attributes and underwriting quality of securitized loans. The creation and maintenance of effective mechanisms of this type will facilitate responsible lending, as well as a more disciplined and efficient funding of consumer assets via securitization.

Many securitizations already embed this concept through various structuring mechanisms, including via the retention of subordinated or equity risk in the securitization, holding portfolio assets bearing credit exposure that is similar or identical to that of securitized assets, and representations and warranties that require originators or sponsors to repurchase assets that fail to meet stated securitization eligibility requirements, among others. However, we do not believe that mandated retention of specific portions of *credit* risk—one such form of economic interest—necessarily constitutes the sole or most effective means of achieving this alignment in all cases. Simply increasing the level of retention will not ameliorate this lack of alignment of incentives.

A 10% retention requirement will be, for many asset classes and institutions, an economically unmanageable level that is not correlated with the risk presented in those assets -- for example, prime mortgage or credit card loan transactions. Such a blunt retention requirement will also reduce the ability of lenders to finance new transactions, as valuable capital will need to be maintained against the retained positions. Hedging restrictions will create a situation where an increasing proportion of the risk on a financial institution's balance sheet will remain unhedged, and thus present heightened safety-and-soundness concerns. The crisis of the last two years has shown how significant a component of consumer finance securitization comprises; excessive credit risk retention requirements may serve to exacerbate the current scarcity of credit for consumers and small businesses.

There are numerous valid and competing policy goals that stand in opposition to requiring the retention of credit risk in both whole loan and securitization transactions. Among others, these include reduction and management of risk on financial institutions' balance sheets; balance sheet management; the redeployment of capital to enable financial institutions to originate more credit than their limited capital resources would otherwise allow; and in the case of securitization, the proper isolation of transferred assets (i.e., meeting legal criteria necessary to effect a "true sale,"). Moreover, we believe that a risk retention requirement of 10% conflicts so greatly with the achievement of these goals, that it could cause some to be unattainable.

Balancing these competing and worthwhile policy goals suggests that retention and incentive alignment mechanisms other than universal credit risk retention requirements should be considered. This viewpoint was echoed by the IMF a few weeks ago in its *Global Financial Stability Report*, which expressed strong concerns about the potential unintended negative consequences of implementing suggested credit risk retention requirements and instead indicated that regulatory authorities "should consider other mechanisms that incentivize due diligence and may be able to produce results comparable to a retention requirement, including, perhaps, representations and warranties."[7]

We therefore believe that to the extent legislation is adopted to require risk retention, regulators should have flexibility to develop and apply alternative retention mechanisms. This flexibility should include the ability for regulators to specify permissible forms and amounts of retention, how retention requirements may be calculated and measured, the duration of retention requirements, whether and to what extent hedging or risk management of retained positions is permissible, and other implementation details. Specifically, we strongly believe that the bill should grant regulators the ability to lower the risk retention requirement below 5%. As drafted, it is unclear if this ability exists, because two

[7] International Monetary Fund, "Restarting Securitization Markets: Policy Proposals and Pitfalls." *Global Financial Stability Report: Navigating the Financial Challenges Ahead* (Oct. 2009), pg. 31. <http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf>.

provisions seem to conflict.[8] If the bill intends to provide regulators with an ability to lower the risk retention requirements below 5%, we suggest clarifying the language. If the bill does not intend to grant this ability, we strongly urge the Committee to reconsider this point. The credit markets consist of originators with varied underwriting guidelines that offer many different products. Providing regulators of these market participants the ability to substantially reduce the risk retention requirement will act as an incentive to employ better origination standards for those products. A reduction of 10% to 5% does not provide enough incentive to achieve this goal.

Finally, we believe that it is imperative to achieve global harmonization and consistency of policy approaches to securitization risk retention. Different approaches are currently being considered or have been adopted in different jurisdictions, including a retention requirement adopted by the European Parliament which is roughly half of the 10% requirement set forth in the proposed bill.[9] Given the global nature of securitization activity and the mobility of global capital among jurisdictions, countries with considerably higher risk retention

[8] For example, in subsection (d)(1) the bill provides that specific regulators shall have authority to "jointly provide exemptions or adjustments to the requirements of this section, including exemptions or adjustments relating to the 10 percent risk retention threshold...." In contrast, subsection (c)(2)(A) provides that if certain standards are met, specific regulators may reduce the required percentage of risk retention to "less than 10 percent of the credit risk, but in no case less than 5 percent of credit risk...."

[9] One such approach was adopted by the European Parliament in May 2009. Article 122a to the Capital Requirements Directive prohibits EU banks from investing in securitizations unless the originator retains on an ongoing basis at least 5% of the material net economic interest of the securities securitized. The article proposes four ways the 5% retention requirement may be applied. The article's requirement is scheduled to go into effect on December 31, 2010 for new issues, and December 31, 2014 for existing securitizations where new underlying exposures are added or subtracted after that date. For more information, see: http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P6-TA-2009-0367&language=EN&ring=A6-2009-0139#BKMD-35.

requirements will be put at a significant competitive disadvantage in the global credit markets. In addition, market inefficiencies may be produced by introducing substantively different retention standards throughout the world's financial markets. We believe that is essential for policymakers to coordinate their approaches in this area.

VII. International Cooperation and Coordination

With respect to each of the Discussion Draft's systemic risk proposals, it will be critical to cooperate and coordinate with foreign and international counterparts on such proposals. We are actively monitoring developments in the U.K., the European Union and by the Basel Committee on Banking Supervision on these topics. Close cooperation among policymakers on an international basis will be essential if we are to effectively address systemic risk and other challenges affecting the financial system. We strongly support the expanded membership and role of the Financial Stability Board, and the increased cooperation and coordination among regulators in major markets in the U.S., Europe, Asia and elsewhere around the world. There are several international groups in which the U.S. participates that work to further regulatory cooperation and establish international standards, including the Financial Stability Board, the G-20, the Basel Committee on Banking Supervision, IOSCO and the Joint Forum. Congress should continue to support and encourage the efforts of these groups.

VIII. Conclusion

In conclusion, SIFMA strongly supports the overall goals of the Discussion Draft as proposed by the Administration and this Committee. We believe, however, that certain provisions require further review, comment and amendment. In particular, we believe that the proposed resolution authority should be amended to restore a transparent claims process and the rules governing creditors rights contained in the Bankruptcy Code. SIFMA has been, and is strongly committed to continuing to be, a constructive voice in this critically important public policy dialogue to restore confidence in our domestic and global financial system.