AFP® Annual Conference

Association for Financial Professionals®

OCTOBER 27–30, 2013 | LAS VEGAS

ORIGINAL→ESSENTIAL→UNBIASED→INFORMATION

FSOC and What it Means to Corporate Treasurers and Executives

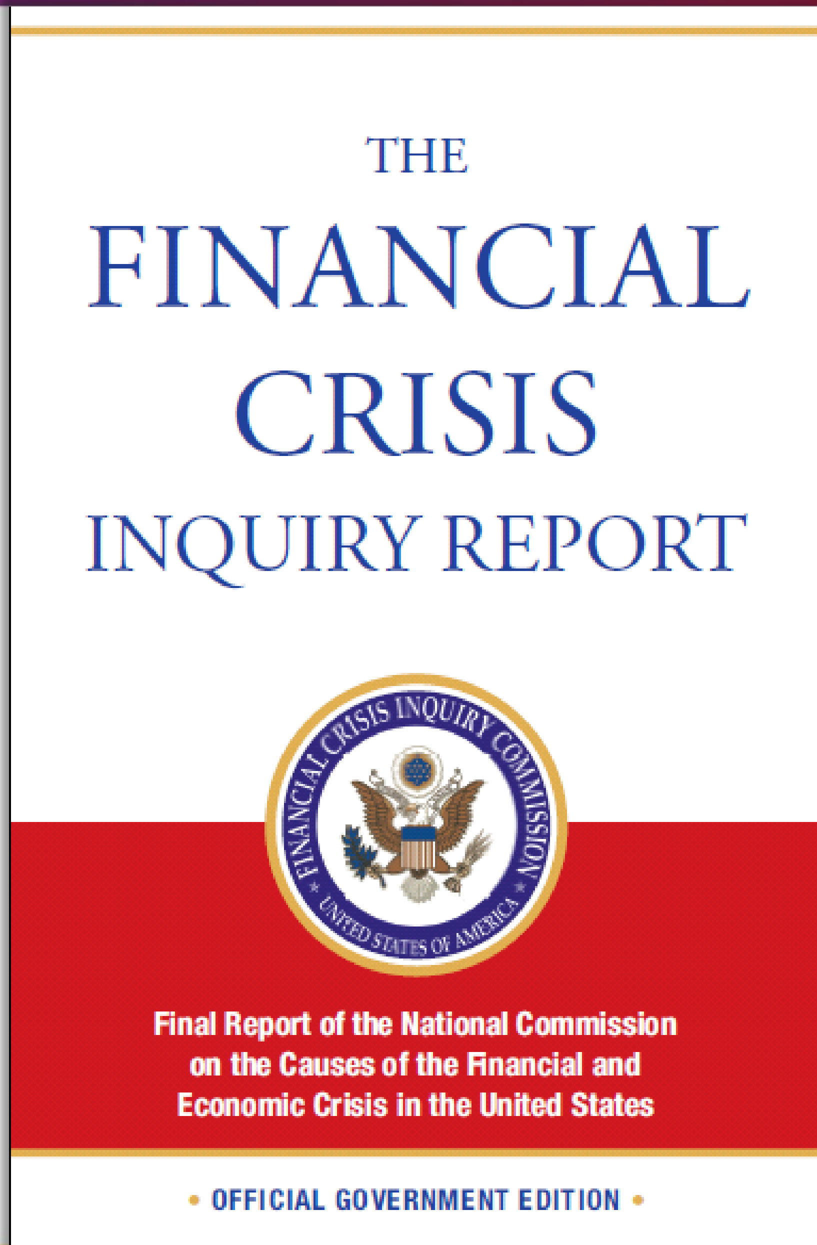
By Eugene F. Maloney
Executive Vice President and Corporate Counsel
Federated Investors, Inc.
Pittsburgh, PA

Testimony of Ben Bernanke

TESTIMONY OF BEN BERNANKE

before the Financial Crisis Inquiry Commission, transcript dated November 17, 2009 at 24.

"As a scholar of the Great Depression, I honestly believe that September and October 2008 was the worst financial crisis in global history including the Great Depression."


THE
FINANCIAL
CRISIS
INQUIRY REPORT
FINANCIAL CRISIS INQUIRY COMMISSION
UNITED STATES OF AMERICA
Final Report of the National Commission
on the Causes of the Financial and
Economic Crisis in the United States
OFFICIAL GOVERNMENT EDITION

From The Financial Crisis Inquiry Report dated January 2011, p. xvii:

- **“. . . there was pervasive permissiveness; little meaningful action was taken to quell the threats in a timely manner.**
- **The prime example is the Federal Reserve’s pivotal failure to stem the flow of toxic mortgages, which it could have done by setting prudent mortgage-lending standards. The Federal Reserve was the one entity empowered to do so and it did not.”**

Remarks by President Obama on signing Dodd-Frank Act on July 21, 2010:

- "And finally, because of this law, the American people will never again be asked to foot the bill for Wall Street's mistakes. (Applause.) There will be no more tax-funded bailouts – period. (Applause.) If a large financial institution should ever fail, this reform gives us the ability to wind it down without endangering the broader economy. And there will be new rules to make clear that no firm is somehow protected because it is "too big to fail," so we don't have another AIG."

Congressional Record, July 14, 2010, page S5828 – remarks of Senator Christopher Dodd concerning Dodd-Frank Act:

“ . . . The country reacted with great outrage over how we had ever gotten to that position and what steps we were going to take to see to it that we would never ever again subject our Nation not only to the cost of bailing out these firms but also the cost that has ensued as a result of the financial collapse to jobs and homes, retirement accounts, ability of families to educate their children, all of the effects that have been visited upon the American people and many others as a result of events that began to transpire years ago, culminating in the difficulties we saw in the fall of 2008.”

Article entitled "AG Holder Confirms Some Banks 'Too Big to Jail'" by Victoria Finkle and Rob Blackwell, *American Banker*, March 6, 2013.

Eric Holder: "I am concerned that the size of some of these institutions becomes so large that it does become difficult for us to prosecute them when we are hit with indications that if we do prosecute – if we do bring a criminal charge – it will have a negative impact on the national economy, perhaps even the world economy."

Friends of Angelo:
Countrywide's Systematic
and Successful Effort to Buy
Influence and Block Reform

Staff Report
U.S. House of Representatives
111th Congress
Committee on Oversight and Government Reform

Darrell Issa, Ranking Member
March 19, 2009

“THE MEGA SCANDAL EVERYONE HAS FORGOTTEN – Fannie, Freddie, and Congress get off scot-free” by John Fund, *National Review Online,* December 31, 2012.

“Countrywide’s most famous client was Democratic senator Chris Dodd, chair of the Financial Services Committee from 2006 to 2010.”

"The Secret 'Friends of Angelo'," *The Wall Street Journal (WSJ.com)*, June 25, 2009

* * * * * *

What we know is that Senators Chris Dodd and Kent Conrad were among the VIPs who received sweetheart mortgages under the "Friends of Angelo" program.

* * * * * *

Who Is FSOC?

- Secretary of the Treasury (serves as chairman)
- Chairman of the Federal Reserve Board
- Comptroller of the Currency
- Chairman of the Securities and Exchange Commission
- Director of the Bureau of Consumer Protection
- Chairman of the Federal Trade Commission
- Chairman of the Federal Deposit Insurance Corporation
- Chairman of the Commodity Futures Trading Commission
- Chairman of the National Credit Union Administration
- Director of the Federal Housing Agency,
- A presidentially appointed insurance industry representative

What Is FSOC's Purpose?

- **Financial Stability: To identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace;**
- **Market Discipline: To promote market discipline by eliminating expectations by shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and**
- **Emerging Threats: To respond to emerging threats to the stability of the United States financial system.**

What Are FSOC's Duties?

- To require supervision by the Federal Reserve Board of nonbank financial companies that may pose risks to the financial stability of the United States in the event of their material financial distress or failure or because of their activities;
- To make recommendations to Federal Reserve Board concerning establishment of heightened prudential standards
- To make recommendations to primary financial regulatory agencies to apply new or heightened standards

SIFI Criteria

- The extent of leverage of the company;
- The extent and nature of the company's off-balance sheet exposures;
- The extent and nature of transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;
- The importance of the company as a source of credit for households, business, and state and local governments and as a source of liquidity for the United States financial system;
- The importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities;
- The extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse;
- The nature, scope, size, scale, concentration, interconnectedness, and mix of the company's activities;
- The degree to which the company is already regulated by one or more primary financial regulatory agencies;
- The amount and nature of the financial assets of the company;
- The amount and types of liabilities of the company, including the degree of reliance on short-term funding; and
- Any other risk-related factors that the Council deems appropriate

Designation of SIFIs

- A "SIFI" is a systemically important financial institution subject to prudential supervision by the Federal Reserve Board.
- Bank holding companies with total consolidated assets of $50 billion or more are automatically SIFIs.
- A nonbank financial company may be designated as a SIFI by FSOC if it meets certain criteria.
- A company is a "nonbank financial company" if it is "predominantly engaged in financial activities," meaning that the annual gross revenues derived by the company and all of its subsidiaries from activities that are "financial in nature" represents 85 percent or more of the company's consolidated annual gross revenues, or the consolidated assets of the company and all of its subsidiaries related to activities that are financial in nature represents 85 percent or more of the company's consolidated assets.
- So far, FSOC has designated three nonbank financial companies as SIFIs: AIG, GE Capital, and Prudential.

SIFI Designation — Prudential

"The Council has voted to make a final determination that material financial distress at Prudential could pose a threat to U.S. financial stability and that Prudential will be supervised by the Board of Governors and subject to enhanced prudential standards. The Council's final determination does not constitute a conclusion that Prudential is experiencing material financial distress. Rather… the Council has determined that material financial distress at the company, if it were to occur, could pose a threat to U.S. financial stability."

"Prudential is a significant participant in financial markets and the U.S. economy and is significantly interconnected to insurance companies and other financial firms through its products and capital markets activities. Because of Prudential's interconnectedness, size, certain characteristics of its liabilities and products, the potential effects of a rapid liquidation of a significant portion of its assets, potential challenges with resolvability, and other factors described herein, material financial distress at Prudential could lead to an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy."

"Based on the Council's evaluation of all the facts of record in light of the statutory factors that it is required to consider under the Dodd-Frank Act, the Council has concluded that material financial distress at Prudential could cause an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy."

Dissent

Dissenting View of Director John Huff, the State Insurance Commissioner Representative on FSOC:

"I do not believe that there is a sufficient basis for the Council's final determination that Prudential's material financial distress could pose a threat to the financial stability of the United States. In particular, there appears to be a lack of recognition given to the nature of the insurance business and the authorities and tools available to insurance regulators. Insurance is not the same as a banking product yet the Statement of the Basis for the Council's Final Determination (the "Basis") inappropriately applies bank-like concepts to insurance products and their regulation, rendering the rationale for designation flawed, insufficient, and unsupportable."

"The designation of insurance companies that could pose a threat to the financial stability of the United States is a serious exercise, the result of which could have significant implications for 1) the stability of the financial system, 2) policyholders that may be disadvantaged to the benefit of financial counterparties, 3) the cost and availability of insurance products, and 4) the competitiveness of the insurance sector. It is critically important that these decisions are based on robust analytics and a thorough understanding of the insurance business and insurance regulation. The analysis contained in the basis for the final determination in large part relies on nothing more than speculation."

No SIFI Safe Harbor

- **Section 170 of the Dodd-Frank Act required the Federal Reserve Board, on behalf of and in consultation with FSOC, to adopt regulations setting forth the criteria for exempting certain types or classes of U.S. nonbank financial companies or foreign nonbank financial companies from supervision by the Board—the "safe harbor" provision.**
- **NO SUCH REGULATIONS HAVE BEEN ADOPTED OR PROPOSED.**

Regulation of SIFIs

- Resolution plans / living wills
- Capital plans (for bank holding companies)
- Higher capital standards under Basel III
- A higher leverage ratio than required by Basel III has been proposed in the U.S. for the top 8 banking firms.
- Stress testing
- Other requirements to be implemented: liquidity, risk management, credit exposure reporting

- ***DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT – Law, Explanation and Analysis*, by CCH Attorney-Editor Staff, Wolters Kluwer Law & Business (2010), p. 699.**
- **ACT SEC. 165. ENHANCED SUPERVISION AND PRUDENTIAL STANDARDS FOR NONBANK FINANCIAL COMPANIES SUPERVISED BY THE BOARD OF GOVERNORS AND CERTAIN BANK HOLDING COMPANIES.**

a) IN GENERAL.—

1) PURPOSE.—In order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions, the Board of Governors shall, on its own or pursuant to recommendations by the Council under section 115, establish prudential standards for nonbank financial companies supervised by the Board of Governors and bank holding companies with total consolidated assets equal to or greater than $50,000,000,000 that —

Preparing For the New Hyper-Regulatory World - I

- **New environment for Corporate Treasurers**
  - Higher cost of capital
  - Higher cost of credit
  - Higher cost of operating services
  - Higher cost of managing risk
  - Higher cost of compliance
- **Fewer financial service options**
  - Fewer (and much larger) providers
  - Fewer available instruments
  - Less relationship leverage
  - Government allocation of liquidity

Preparing For the New Hyper-Regulatory World - II

- **New Imperatives for Treasurers**
  - Monitor and speak out on regulatory proposals
  - Engage your legislators
  - Solidify availability of credit
  - Shore up balance sheet, capital structures
- **Improve global cash visibility**
- **Improve global risk visibility**
- **Upgrade treasury technology**
  - Visibility
  - Forecasting
  - Investing
  - Compliance
- **Become working capital efficient**

Are You a Bank?

- **Regulators have coined the term "shadow bank" and are actively trying to expand their mandates in that area.**
- **Shadow banks have at least one of the following characteristics:**
  - Deposit-like features
  - Maturity transformation
  - Investment-like features
- **You might be a bank or an insurance company if you:**
  - Operate a finance company
  - Receive customer advance payments/deposits

Are You a Bank?

- Issue asset backed commercial paper
- Operate an employee savings program
- Guarantee contracts or transactions
- Offer customers a "Christmas savings club"
- Issue gift cards
- Require security deposits or escrows
- Charge "late" fees
- Transact with cash

Conclusions

We are in the midst of a global regulatory arms race.

Regulations directed at Financial Intermediaries, ultimately flow through and land on YOUR desk.

You might find that some of your activities define you as a "shadow bank" and inadvertently subject you to regulation.

As a result:

- Your ability to raise capital is fundamentally changing.
- Your flexibility in employing capital is being restricted.

How will FSOC affect you?

- Those designated by FSOC as SIFIs will be comprehensively regulated and supervised by the Federal Reserve.
- Other financial firms will see their regulatory environment changed by FSOC suggestions to primary regulator, become more bank-like.
- For all Treasurers, FSOC's role in changing the regulation of financial firms will affect availability, terms and cost of financing and financial products and services to you.
- It will affect your access to short- and medium-term funding and alternatives for holding liquid assets.
- Get ready, it's going to be a wild ride.

- **Dodd-Frank Act’s burdensome rules and regulations have been imposed on the private sector.**
- **Having seen my slides and now understanding the origins of the problem and who the principal actor was among the regulatory agencies, how does FSOC designating Prudential Insurance as systemically important have anything to do with preventing the next financial calamity perpetrated by the financial services industry?**

20 Hofstra L. Rev. 1015 (2000-2001):

"A SIMPLE CODE OF ETHICS: A HISTORY OF THE MORAL PURPOSE INSPIRING FEDERAL REGULATION OF THE SECURITIES INDUSTRY"

by

John H. Walsh*

The idea that government regulation can serve a moral purpose has fallen into disrepute. Professor Henry G. Manne, an influential legal scholar,[1] has been particularly outspoken in this regard. "Morals," he wrote, "are a private luxury. Carried into the arena of serious debate on public policy, moral arguments are frequently either sham or a refuge for the intellectually bankrupt."[2]

Indeed, he suggests, to make a personal statement about the immorality of a particular type of securities transaction is to confuse oneself with God.[3]

---

*John H. Walsh, J.D., Georgetown Universityh Law Center; ph.D. (History), Boston College, is Chief Counsel in the Office of Compliance Inspections and Examinations of the United States Securities and Exchange Commission. The Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the Author and do not necessarily reflect the views of the Commission or the Author's colleagues on the Commission's staff. . . .

[1] *See generally* Symposium, *The Legacy of Henry G. Manne – Pioneer in Law & Econommics and Innovator in Legal Education,* 50 CASE W. RES. L. REV. 203 (1999) (discussing Manne's influence and contributions to corporate law and economics).
[2] Henry G. Manne, *Insider Trading and the Law Professors,* 23 VAND. L. REV. 547, 549 (1970).
[3] *See id.*

Information from The HBR Interview, "How to Restore the Fiduciary Relationship – A Conversation with Eliot Spitzer," ***Harvard Business Review,*** **May 2004: p. 4:**

<u>Question</u>: The financial services industries you've investigated are heavily regulated. How did the regulatory framework fail? Was it a failure of design or enforcement?

- ***Spitzer: It was a failure of regulatory behavior. I'm not sure the regulations as such were wrong. But the regulators who were supposed to see unethical behavior clearly didn't.*** p. 6:

<u>Question</u>: So have you found an alternative to traditional regulation that is a more effective way to use the law?

- ***Spitzer: For some kinds of cases, I think so. Sending CEOs to jail works as a deterrent.***

"WHO WILL GUARD THE GUARDS WHO ARE GUARDING US?"

Anonymous