THE IMPACT OF DODD-FRANK ON CUSTOMERS, CREDIT, AND JOB CREATORS

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

JULY 10, 2012

Printed for the use of the Committee on Financial Services

Serial No. 112–143

U.S. GOVERNMENT PRINTING OFFICE

76–114 PDF WASHINGTON : 2013

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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THE IMPACT OF DODD-FRANK ON CUSTOMERS, CREDIT, AND JOB CREATORS

Tuesday, July 10, 2012

U.S. House of Representatives,
Subcommittee on Capital Markets and
Government Sponsored Enterprises,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:04 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Schweikert, Royce, Manzullo, Biggert, Hensarling, Neugebauer, Pearce, Posey, Fitzpatrick, Hayworth, Hurt, Stivers, Dold; Waters, Sherman, Hinojosa, Lynch, Maloney, Moore, Himes, and Green.

Ex officio present: Representative Bachus.

Chairman Garrett. Good morning, everyone. Today's hearing of the Subcommittee on Capital Markets and Government Sponsored Enterprises is called to order. Today's hearing is entitled, "The Impact of Dodd-Frank on Customers, Credit, and Job Creators." I thank the witnesses on the panel for being with us this morning.

But before we get to the panel, we will begin with opening statements. I yield myself 3 minutes.

It has been 2 years since the passage of the 2,300-page Dodd-Frank Act. And since that time, the economy is stagnant, the unemployment rate is above 8 percent, wages are declining, and credit, unless it is being supplied by the government, is frozen.

I not only believe that these things are interrelated, I believe that the passage of Dodd-Frank is actually one of the main reasons that there has been such a tepid economic growth over the last several years.

We have some charts that are going to be up on the screen, and here they come right now. If you look at these charts, you can see that GDP growth was at 4 percent in the three quarters preceding the passage of Dodd-Frank, and the quarter after the legislation was signed into law, GDP did what? It dropped, and it dropped continuously until it was almost negative. And it has continued to stay around 2 percent.

If you look up at the next chart, this chart examines the impact on house prices. Prior to the passage of Dodd-Frank, house prices were basically beginning to normalize and maybe even rebound, as you see. But in the 2 years after Dodd-Frank, what happened? We have unfortunately seen home values go back on their downward slide once again, all due to Dodd-Frank.

And finally, let us examine the manufacturing sector in our third chart. As the chart indicates, manufacturing production was also, just like the other two, regaining momentum in early 2010. Then, Dodd-Frank came along. It was signed into law, and average production was almost cut in half.

The reason that these impacts have been so severe is beyond the breadth and scope of this legislation. It literally makes wholesale changes in every facet of our financial markets, whether that is banking, mortgage lending, securities, trading, risk managing, or others.

Each one of the titles of Dodd-Frank taken individually could have been a multi-Congress undertaking and should have been given much more thought than it was. Unfortunately, as you all know, Dodd-Frank was rushed through the process with really extreme partisanship. And the derivatives title and Volcker pieces were literally added in the dead of night, in the back room of the Senate Dirksen Building, as many of you recall. No one knew exactly how the pieces of the bill would work, or in this case not work together cumulatively. There was absolutely no consideration given to the possible combined costs that all these cumulative changes would have.

Let me just give you an example in regards to the cost of credit. When the CFTC is finalizing its margin rules for interest rate swap, is it considering what new servicing requirements that the FTC is considering, adding to the risk retention requirements? In turn, when the FTC is considering these new servicing requirements, are they thinking about the CFPB, including a rebuttable presumption to the Qualified Mortgage (QM) definition? And likewise, when the CFPB is making their decisions, are they contemplating the possible impact of the Fed finalizing a Volcker Rule that could significantly curtail market making?

All four of these actions alone will have an impact on the cost of credit in this country for consumers. It is important that we identify these costs individually and have rules that effectively balance the costs with the benefits provided.

What is not being discussed or identified is what is the combined impact all of these rules and other rules will ultimately have on the cost of credit for borrowers in the country. When taken individually, the cost might be tolerable. But when taken all together, cumulatively, it will prove extremely onerous.

So the purpose of today's hearing is to highlight the economic impact and the cost of these rules for businesses, consumers, and the economy, not viewed through the single vacuum of each regulator writing their own rule, but viewed through a more comprehensive and holistic manner. And I am afraid that the results we will find will not be pretty.

This is one of the weakest economic recoveries that this country has ever experienced, especially given the depth of the recession. Unfortunately, Dodd-Frank and its over 400 rules are one of the main reasons that I am afraid it will be a lasting legacy of the legislation.

And with that, I yield back, and I look to the chairman of the full Financial Services Committee, who is recognized for 3 minutes.

Welcome, Chairman Bachus.

Chairman BACHUS. Thank you, Chairman Garrett. Thank you for convening this hearing, which will be the first of about seven hearings this month on Dodd-Frank and its effect on job creation and the economy and our financial institutions and consumers.

Dodd-Frank was enacted in response to the financial crisis of 2008. The law was not intended to hinder the ability of American businesses to utilize the capital markets or to unduly hamper the ability of consumers and businesses to obtain credit, create jobs, mitigate risk, and thrive.

Yet 2 years after its passage, many argue that Dodd-Frank is having precisely these negative effects. Main Street businesses are now facing a constriction of both capital and credit. The derivative rules, the Volcker Rule, and a host of other Dodd-Frank rules are putting enormous pressure on corporate balance sheets at a time when economic conditions are already putting increased demands on the time and resources of job creators and entrepreneurs.

This committee has tried to mitigate some of the potential negative impacts of Dodd-Frank by moving bipartisan legislation such as H.R. 2682, a bill that would ensure that regulators do not force derivative end-users to post margin, which would divert capital away from job creation.

Unfortunately, the Senate has failed to act on this important bill, and some regulators continue to interpret Dodd-Frank's Title VII as a grant of new authority to impose costly margin requirements on end-users.

Similarly, an overly restrictive Volcker Rule has also had a negative impact on Main Street businesses by creating borrowing costs for consumers and companies, both large and small, by increasing borrowing costs.

If businesses find it harder to borrow, it will be harder for them to make capital investments and create jobs. If consumers have less access to credit, it will be harder for them to care for their families. And if the value of the assets held by savers and investors declines, people will find it harder to save for a new home, for college or for retirement.

Our witnesses today will be able to shed more light on the cumulative effect these rules are having on our capital markets, and our economy. And I thank them for being here.

Chairman Garrett, again, thank you for holding this hearing. I look forward to the discussion.

Chairman GARRETT. Mr. Lynch is recognized for 3 minutes.

Mr. LYNCH. Thank you, Mr. Chairman.

First of all, I want to thank the witnesses for coming before this committee and helping us with our work.

Today's hearing is somewhat benignly titled, "The Impact of Dodd-Frank on Customers, Credit, and Job Creators." But the implication is that the financial reform is somehow damaging the financial system.

Normally, there is a certain lag time between an attempt at regulation and an assessment. But in this case, we haven't even gotten through the existing financial crisis and we are already planting the seeds for the next one. That is what is happening here.

My friends, and I mean "my friends" on the other side of the aisle want to do away with any reform that we put in place because of this colossal historical financial debacle that we have gone through beginning in 2008.

It appears my colleagues on the other side of the aisle have come down with a case of collective and sudden amnesia, forgetting that our financial industry is struggling because of a loss of integrity, the loss of trust because of the last financial crisis, the one we are still struggling with, because of the recklessness on Wall Street, the exact behavior that Dodd-Frank is intended to stop.

Whatever unintended effect Dodd-Frank may have on job creators, it pales in comparison to the havoc Wall Street wreaked on our economy during the financial crisis. Let me recount that according to the Treasury Department, the financial crisis that we are trying to deal with here cost Americans $19.2 trillion in household wealth—$19.2 trillion.

Better Markets, whose representative is here today to testify, believes even this staggeringly high number is too low to accurately account for the cost of the crisis. They note that we lost $2.6 trillion in unrealized potential GDP growth since the crisis. We have 12.5 million unemployed Americans not contributing to the economy and not putting away savings for their retirement.

Americans have lost an enormous amount of household wealth, including $7 trillion in home values, $11 trillion in investments in the stock market, and $3.4 trillion in retirement savings, not to mention the billions of dollars the government has spent to prop up the same banks that caused all of this damage in the first place. I want to note that I voted against TARP.

These enormous losses which are the result of the crisis, by the kind of reckless behavior on Wall Street that the Dodd-Frank law is intended to prevent, have had a much greater negative effect on customer credit and job creation than anything in Dodd-Frank itself. I am happy to join my colleagues in addressing any unintended consequences in the financial reform bill. It is not perfect. I understand that.

But let us not forget what we are trying to prevent here: another catastrophic financial crisis that has cost the American people many trillions of dollars. The potential costs of a regulatory framework riddled with loopholes are far greater than those associated with a safe, stable financial system.

I thank the gentleman for his courtesy, and his indulgence, and I yield back my time.

Chairman GARRETT. The gentleman yields back.

The gentleman from California, Mr. Royce, for 1 minute.

Mr. ROYCE. Yes, if I could point out, one can support financial reform without supporting Dodd-Frank. The problem we have with Dodd-Frank is that it did not solve too-big-to-fail; it compounded it. The banking sector is even more concentrated than it was a few years ago.

You have a smaller and smaller number of organizations holding the majority of the assets in that sector. That is partly a result of the way this was done. It didn't consolidate a fragmented regulatory structure. Other than eliminating the OTS, we still have an alphabet soup of regulatory organizations overseeing markets with a large amount of overlap.

And despite what was said at the time of its passage, it did not increase investment in entrepreneurship or foster robust growth in the economy. It did exactly the opposite.

So today's hearing will hopefully shed some light on what it has done, namely increase uncertainty throughout the economy; increase the cost of credit for consumers and businesses; and most importantly, made it easier for smaller firms to fall prey to larger ones gobbling up their competition because of the lower cost of credit now for the largest firms due to the way in which Dodd-Frank sent that message to the market that they were too-big-to-fail.

I yield back.

Chairman GARRETT. Thank you. The gentleman yields back.

The gentlelady from New York is recognized for 3 minutes.

Mrs. MALONEY. First of all, I would like to welcome my former colleague and very good friend, Ken Bentsen. It is very good to see you and all of the panelists today. I look forward to hearing your remarks.

And I would say that to even think about repealing Dodd-Frank is the height of irresponsibility. You have to remember why it was implemented in the first place. We put in financial reform because we were on the brink of another Great Depression. There was a run on the banks. There was a run on the money markets. And it was not until this Congress came in with the leadership of Nancy Pelosi and others that we stop-gapped and saved from falling off a cliff that would have been an even worse situation to respond to.

Dodd-Frank brought in huge swathes of the market that were unregulated and regulated them. I don't think anyone in America wants to go back to the subprime crisis or to a time when banks were failing, and we had a number of banks that have failed. And I know in some cases, there were forced marriages or mergers just to save the FDIC deposit insurance of American working families.

So Dodd-Frank came in and helped stabilize the markets. And I would say that markets run more on trust than on capital, and if people feel that there aren't rules of the game and transparency—I am not saying that we shouldn't make adjustments and refine it as we go forward in ways that reflect the challenges of the markets and the 21st Century, but I believe we will look back on Dodd-Frank as we did the great reforms after the Great Depression.

After the Great Depression, Congress implemented Glass-Steagall, the FDIC-insured accounts, the SEC. And it gave us 60 years of unparalleled economic prosperity in our great country. I believe that many of the reforms—granted, nothing is perfect and that is why we are here to hear from the panelists today on ways they feel they might make the regulation better, but I don't know anyone in my district who wants to go back to a totally unregulated, huge swathe, no transparency, huge areas not even on exchanges that led to really the worst economic crisis in my lifetime and one I hope I never see again.

So my time is up. I look forward to hearing the remarks of the panelists today.

Chairman GARRETT. The gentlelady yields back.

Mr. Fitzpatrick is recognized for 1 minute.

Mr. FITZPATRICK. Thank you, Mr. Chairman.

I, too, look forward to this hearing because strengthening our Nation's economy and getting Americans back to work remains our number one priority. And being able to raise capital, hedge risks, and obtain credit are necessary activities in order for businesses to grow and for businesses to create jobs and hire again.

It is important for us to continue our oversight of Dodd-Frank and to examine regulations because if businesses find it harder to borrow, it will be harder for them to make investments, to expand, and to hire workers. Moreover, if consumers find it difficult to access credit, or the value of their assets declines, it will make it harder for them to save and will put further strain on families trying to live within already strapped family budgets.

Today's hearing will shed further light on the unintended consequences that Dodd-Frank is having on America's job creators and consumers. Next week marks the 2-year anniversary since this legislation imposed some 400 new rules on our financial system. Certainly, the financial industry deserves scrutiny after the meltdown of 2008. However, we must take care to make our capital markets not only safer, but to make them stronger and ensure that those far from Wall Street do not pay the price for those who are truly responsible for the financial crisis that did occur.

So I look forward to the hearing, Mr. Chairman, and I yield back.

Chairman GARRETT. And the gentleman yields back.

Mr. Hurt is recognized for 1 minute.

Mr. HURT. Mr. Chairman, I thank you for holding today's hearing on the effects of the Dodd-Frank Act on consumers, investors, and job creators.

As we approach the 2-year anniversary of Dodd-Frank, regulators are still working through the more than 400 new rules and directives, with insufficient concern or understanding of the cumulative impact of these regulations on our economy. It is critical that this committee continue to scrutinize the effects that these regulations will have on consumers, small businesses, community banks, credit unions, and other financial institutions.

As I travel across Virginia's 5th District, I am constantly reminded by my constituents that Dodd-Frank has caused negative effects on job creation and will lead to less access to credit for consumers, higher costs for capital for small businesses, and piles of Federal regulations to work through.

As our Nation struggles through high unemployment and minimal economic growth, it is increasingly apparent that many of the regulations prescribed by Dodd-Frank will continue to act as a hindrance to our job creators and America's economic recovery.

I would like to thank the distinguished guests and witnesses for appearing before the subcommittee today, and I look forward to their testimony.

Thank you, Mr. Chairman, and I yield back the balance of my time.

Chairman GARRETT. Mr. Dold now for, I guess, the last word on this, 1 minute.

Mr. DOLD. Thank you. I thank the chairman, and I thank you for holding this hearing.

And I want to thank our witnesses for taking the time to join us today.

To promote good public policy, Congress must regularly review and revise existing laws and regulations. This process should include thorough and objective cost-benefit reviews of both intended and unintended consequences in light of historical evidence and new information.

This is particularly true with bills like Dodd-Frank, which in addition to containing over 2,000 legislative pages, requires many thousands of additional pages of implementing regulations, some of which are internally inconsistent, ineffective, unworkable or counterproductive.

I am encouraged by this committee's bipartisan work to address some of these issues. For example, with H.R. 4235, Ms. Moore and I are working together on a bipartisan basis to correct some of these problematic Dodd-Frank provisions.

But we must continue to accelerate these bipartisan efforts. We must ensure that we understand the impact of the proposed regulations as a whole. We must ensure that the proposed or existing rules do not negatively affect risk management, market liquidity, credit costs, and credit access.

Most importantly, we must ensure that unintended consequences do not ultimately limit small business expansion, job creation, and economic growth.

I look forward to the testimony, and I yield back, Mr. Chairman.

Chairman GARRETT. The gentleman yields back.

And seeing no other opening statements, I now turn to the panel, and I welcome all seven members of today's panel. I very much appreciate the testimony that you are about to present. And I know that some of you have been with us before, and others have not. For those who have not, and even for those who have been here before, just a reminder that you will be yielded 5 minutes for your remarks, and your full written statements will be made a part of the record.

And also just for your edification, in front of you of course is the timing light—red, yellow, and green—to give you an indication as to your time. When it turns red, your time is up, and since we do have a fairly large panel here—also just as a note, and I make this note not just to this panel, but to other panels who may come and other people who may be in the room, and so we are not casting dispersions on any one particular individual, association, or otherwise.

But the rule of the committee is that statements should be presented to the committee 48 hours prior to the testimony, and of course we know we are coming in through a holiday weekend and what have you coming into this, but just in general, that is what the rule is, and so we would like to try to get back to that so members and staff of the committee will have the opportunity to review it in some detail.

With that said, Mr. Bentsen, you are recognized for 5 minutes, and once again, welcome to the committee.

You are recognized for 5 minutes.

Thank you.

STATEMENT OF THE HONORABLE KENNETH E. BENTSEN, JR., EXECUTIVE VICE PRESIDENT, PUBLIC POLICY AND ADVOCACY, THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

Mr. BENTSEN. Chairman Garrett, Ranking Member Waters, and members of the subcommittee, thank you for the opportunity to share SIFMA's views.

There is much in the Dodd-Frank Act that SIFMA's members supported, such as the establishment of a systemic risk regulator, the Orderly Liquidation Authority, and a uniform standard of care for retail brokers and advisers.

Properly crafted, these provisions can appropriately increase supervision to mitigate systemic risk, improve coordination among regulators, eliminate too-big-to-fail, and improve protections in confidence for individual investors.

However, other provisions, if not properly crafted, and not in coordination with foreign regulators, could have negative consequences to the detriment to businesses, governments, individuals, and institutional investors who rely on deep and liquid U.S. capital markets.

We believe that Congress' goal in adopting the statutory Volcker Rule was to focus banking entities on providing liquidity to customers and to prohibit excessive risk-taking.

The rules as proposed defines congressionally-permitted activities far too narrowly through an artificial distinction between permitted activities and prohibited proprietary trading based on a negative presumption using hard coded metrics on a transaction by transaction basis that is unworkable, and will cause market makers to pull back, to the detriment of U.S. capital markets.

In the corporate bonds commission by SIFMA, Oliver Wyman found that liquidity losses could cost investors between $90 billion and $315 billion in mark-to-market losses, corporate issuers between $12 billion and $43 billion a year in borrowing cost, and investors between $1 billion and $4 billion per year in transaction cost that is a level and depth of liquidity decreases.

Further, Stanford University Professor Darrell Duffie noted in a paper commissioned by SIFMA that the direct and indirect effects would increase trading cost for investors, reduce the resiliency of markets, reduce the quality of information revealed through security crisis, and increase the interest expense in capital rates and costs for corporations, individuals, and others.

Buy side market participants, commercial businesses, foreign regulators, and central banks have commented that the proposal would significantly harm financial markets, pointing to the negative impacts of decreased liquidity, higher cost for issuers, and reduced returns on investments.

They further commented that other market participants are unlikely to be able to fill the critical market-making role played by banking entities, indeed the rule would apply to 17 of the 21 primary dealers in the United States.

SIFMA believes that the premium capture reserve account contained in the proposed risk retention rules will have negative consequences for the securitization markets. Both our buy side and sell side members believe that the requirements proposed will present obstacles to the structure in securitizations, including residential mortgage securitizations.

As Moody's Analytics' special report stated, as a result of the way the premium capture rule is stated, the mortgage rate impact on borrowers would be significant on the order of an increase of 1 to 4 percentage points, depending on the parameters of the mortgages being originated, and discount rates applied.

The consequences of the rule as written could significantly impede the return of private securitization markets and permanently cement the government's role in housing finance.

We are supportive of many of the goals of Title VII derivatives regulation as with all regulation concerns focus on making sure that requirements are workable, and that the benefits outweigh the cost. Those costs after all are borne by market participants who may find it more difficult and expensive to hedge risk.

We have also urged regulators to avoid unintended consequences and market impacts by carefully sequencing and phasing in implementation of rules by category, type of participant, asset class, and products within asset classes.

A particular concern is coordination. Regulators have spoken of cooperation both at home and globally, but we see very little real evidence of actual coordination.

An example of lack of coordination is the cross border application of Title VII rulemaking. The recently proposed guidance is complex, expansive in scope, and highly prescriptive. A particular concern is to propose substituted compliance, which theoretically should allow market participants operating in other well-regulated markets to rely on their home or host country regulation.

This substituted compliance process will be very different than the mutual recognition model, and will require the CFTC to individually review and approve the rules of foreign nations.

Further, we believe the CFTC's cross border application approach is flawed and that the Commission chose not to do so in the form of guidance as opposed to rule and apparently without sufficient coordination with the SEC. SIFMA supported the inclusion of single counterparty credit limits because our members had been using internal models for many years to measure and control such exposures. SIFMA, however, does not support the Federal Reserve's proposal in its current form because it exceeds congressional intent, and it would needlessly reduce liquidity in the financial system.

The new method is a crude measure that overstates exposures under any reasonable calculation methodology by a significant multiple. The effect of the new methodology for measuring credit exposure will be a reduction in market liquidity that may have a significant effect on markets more broadly.

In conclusion, the United States has taken a more comprehensive approach than any other country to address regulatory reform. Although some countries have taken steps to address components of topics covered by Dodd-Frank, no country has adopted restrictions comparable to the Volcker Rule or adopted legislation or regulators having the scope of Dodd-Frank.

There can be no question that the subsequent regulation has competitive consequences. It is essential that U.S. regulatory agencies, in proposing regulations, consider and analyze both the individual aspects and combined impact of proposed rules that may place U.S. financial markets at an unwarranted competitive disadvantage compared to those countries that have not implemented a comparable approach.

Thank you.

[The prepared statement of Mr. Bentsen can be found on page 54 of the appendix.]

Chairman GARRETT. And I thank you, very much.

Mr. Deas, welcome to the panel. You are recognized for 5 minutes.

STATEMENT OF THOMAS C. DEAS, JR., VICE PRESIDENT AND TREASURER, FMC CORPORATION, AND CHAIRMAN, THE NATIONAL ASSOCIATION OF CORPORATE TREASURERS, ON BEHALF OF THE U.S. CHAMBER OF COMMERCE

Mr. DEAS. Good morning, Chairman Garrett, Ranking Member Waters, and members of the subcommittee.

I am Tom Deas, vice president and treasurer of FMC Corporation, and the chairman of the National Association of Corporate Treasurers. Thank you for the opportunity to speak with you this morning, also on behalf of the U.S. Chamber of Commerce about the effects of Dodd-Frank on customers, credit, and job creators.

The drafters and implementors of the Act and other initiatives, such as proposed money market fund regulations, have focused mainly on the financial services industry. However, as the regulations roll out, we in Main Street businesses are concerned about our continued ability to protect day-to-day business risks with structured and cost-effective derivatives, to manage business cash flows with continued access to diversified short-term investment alternatives, and to raise capital to build new factories, conduct R&D, expand inventories, and ultimately to sustain and grow jobs.

I would like to outline our concerns about derivatives regulations, the Volcker Rule, and money market fund regulations.

On my company's use of derivatives, I can tell you that FMC Corporation is a proud American company founded almost 130 years ago. Today, our 5,000 employees work hard to keep FMC a leading manufacturer and marketer of a whole range of agricultural, specialty, and industrial chemicals. Along with many other U.S. manufacturers and agricultural producers, FMC uses over-the-counter derivatives to hedge business risks in a cost-effective way.

We use derivatives to manage the risk of foreign exchange rate movements, changes in interest rates, and global energy and commodity prices. Our banks did not require FMC to post cash margin to secure periodic fluctuations in the value of our derivatives.

This structure gives us certainty so that we never have to post a fluctuating daily cash margin while the derivatives are outstanding. However, regulators have now proposed that we will have to divert cash to a margin account where it will sit idle—unavailable for productive uses.

We still can't calculate exactly how much cash margin we would have to set aside, but FMC and other members of the Business

Roundtable estimated that on average, a 3 percent initial margin would amount to $269 million per company.

The study extrapolated the effects across the S&P 500, of which FMC is also a member, to predict the consequent loss of 100,000 to 120,000 jobs. In our world of finite limits and financial constraints, posting a fluctuating cash margin would be a direct, dollar-for-dollar subtraction from funds that we would otherwise invest in our business.

I want to assure you that FMC and other end-users employ OTC derivatives to offset risks, not create new ones.

I thank the members for your bipartisan efforts to address margining and the inter-affiliate issues through legislative action.

On the Volcker Rule, proposed regulations coordinated among five agencies have left its application confused, particularly as to the critical distinction between exempt market-making activities and prohibited proprietary trading. FMC's most recent bond issue in November, $300 million of 10-year notes was underwritten by a syndicate of our banks. As underwriters of our bonds, these firms take on the responsibility to hold or swap them if necessary to make an orderly market for our issue as it is launched. However, the Volcker Rule could significantly constrain this function through an ill-defined line in the regulation blurring what constitutes banned proprietary trading.

We estimate the added cost of this regulatory uncertainty on our bond issue would have been $15 million. We are concerned that the ambiguity could produce an opposite result from what we all hope to achieve through undue burdens on the U.S. capital markets where investors and issuers have come together with an efficiency up until now unparalleled to the world and to the benefit of American businesses.

Other impending financial regulations affect money market funds. This $2.6 trillion financial-market segment not only provides an alternative for investors who would otherwise be limited to bank deposits, but also supports Main Street companies' financing of working capital needs through purchases of our commercial paper.

In 2010, the SEC, with our support, implemented a significant strengthening of liquidity requirements. However, another round of regulations would impose redemption restrictions, float the net asset value, and impose significantly higher capital requirements on fund sponsors. If the SEC formally proposes these new rules, many treasurers would begin immediate withdrawals from money market funds. We fear the cumulative effect of the proposed changes will eliminate this investing and financing alternative for Main Street companies and make us wholly dependent on banks, concentrating risk in a sector where over the past 40 years, there have been 2,800 failures costing taxpayers $188 billion.

In summary, we are concerned about the lack of a clear end-user margin exemption and other restrictions on derivatives such as the inter-affiliate issues, and the application of an overly complex Volcker Rule, combined with regulations that could severely limit our access to money market funds. These could burden American companies, limiting growth, harming international competitiveness and ultimately hampering our ability to sustain and grow American jobs. Thank you for the opportunity to testify today on these important issues.

[The prepared statement of Mr. Deas can be found on page 70 of the appendix.]

Chairman GARRETT. Thank you, Mr. Deas.

Welcome, Mr. Deutsch.

STATEMENT OF TOM DEUTSCH, EXECUTIVE DIRECTOR, THE AMERICAN SECURITIZATION FORUM (ASF)

Mr. DEUTSCH. Chairman Garrett, Ranking Member Waters, and distinguished members of the subcommittee, my name is Tom Deutsch and I thank you for the opportunity to testify here today on behalf of the 330 member institutions of the American Securitization Forum. The securitization markets currently supply well over $1 trillion annually in Main Street credit to the economy each year for, among other things, consumers to buy houses, motorcycles, and cars, and for their own education, for farmers to buy tractors and other equipment, and for businesses to expand both their franchise as well as their physical plant.

In effect, securitization is a delivery company that delivers these trillions of dollars from long-term savers such as mutual funds, pension funds, and insurance companies into direct consumer and credit loans to America. In my oral statement today, I would like to focus on some of the key macro challenges facing the private securitization markets in the face of the current regulatory headwinds. In my written statement, you can find links to the thousands of pages of comment letters that we alone have submitted to assist U.S. and international regulators.

As an outgrowth of the financial crisis, many have focused on securitization as an ailing patient that needs heavy doses of regulatory medication to recuperate. ASF has strongly agreed that some treatment has been necessary to make appropriate and tailored reforms to the securitization market.

First, through ASF Project RESTART, we have spent considerable effort ramping up transparency for investors and better aligning incentives between issuers and investors through various standardized market practices.

Second, we have supported appropriate and tailored regulatory reform for risk retention, rating agency reform, conflicts of interest, and regulatory capital standards that would yield beneficial effects to the markets and the broader economy. But we have passed the point where heavy prescriptions of various regulatory medications have healing effects. Instead, we strongly urge policymakers to examine closely the aggregate and interactive effect of the myriad of treatments being administered, as they are becoming poisonous by being aggregated and injected in various doses, the interactive effects of which have not been thoroughly thought through. In effect, the poison to the market has become the dosage.

So in my testimony, I will briefly summarize seven manifestations of this aggregate effect on the markets. First, straightforward products like auto- and equipment-backed securitizations whose performance was strong across-the-board through the financial crisis, are now facing extraordinarily complex challenges that were not designed or intended for those markets.

Second, unintended interactions of various rules will continue to be discovered for years to come, which is causing immense cost in reworking various current structures as well as eliminating products all together.

Third, market participants are not investing and building business platforms. Rather, they are putting their skeletal platforms in the deep freeze, particularly for residential mortgages, because of the tremendous uncertainty of the outcome of proposed rules that could very well make those business lines loss centers.

This makes the Administration's and Congress' desire to bring private capital back into mortgage securitizations more difficult and more protracted. For the mortgage market, the complete absence of policy direction in Dodd-Frank for Fannie Mae and Freddie Mac, which currently lost the American taxpayer nearly $200 billion, has also kept private industry left to question when or if less than 95 percent of mortgages originated in America will actually not be guaranteed by the U.S. taxpayer.

Fourth, some rules like the Premium Capture Cash Reserve Account or PCCRA are so lethal to the RMBS and CMBS markets, that those markets are predicted to become relegated to history books for many institutions if that rule were to be put in place as proposed. The potential impact of such a rule on borrowers would be substantial with interest rates rising up to 1 percent to 4 percent, depending on the various structures. And rate locks would effectively be eliminated.

Fifth, nonbanks and banks are being subject to further disparate rules causing competitive advantages and disadvantages to develop that will inevitably cause exiting of business lines based on regulation, rather than market efficiency.

Sixth, although policy initiatives continue to evolve on a country by country basis, the global issuance and purchase of securitization is forced to comply with new and different standards in each country and each jurisdiction.

And finally, seventh, many of the rules in Dodd-Frank, such as the Volcker Rule, were not intended to affect the securitization markets. But in fact, those rules have become the biggest sources of concern for key segments of the market such as the $300 billion asset-backed commercial paper market.

When all of these rulemakings are finalized, they will inevitably result in increased costs for securitization and lending markets, which will be passed on to consumers and borrowers in the form of higher borrowing rates. Moreover, many of these markets may ultimately or finally disappear, leaving some consumers and business without access to credit at all. These are not outcomes that will help the U.S. economy or the unemployment rate decline. ASF greatly appreciates the opportunity to appear today, and I thank you for your time.

[The prepared statement of Mr. Deutsch can be found on page 82 of the appendix.]

Chairman GARRETT. Thank you.

Mr. Kelleher, you are recognized for 5 minutes.

STATEMENT OF DENNIS M. KELLEHER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BETTER MARKETS, INC.

Mr. KELLEHER. Good morning, Chairman Garrett, Ranking Member Waters, and members of the subcommittee. Thank you for the invitation to Better Markets to testify today. I am the president and CEO of Better Markets, which is a nonprofit, nonpartisan organization that promotes the public interest in the domestic and global financial markets. It advocates for transparency, oversight, and accountability with a goal of a stronger, safer financial system that is less prone to crisis and failure, thereby eliminating or minimizing the need for more taxpayer funded bailouts. I have detailed my background and what Better Markets does in my written testimony and it is also available on our Web site. I won't repeat it here.

Let me begin my summary of my testimony by stating a fact: Wall Street is not a job creator. Wall Street is a job killer of historic proportion. As we sit here today, our country and tens of millions of good, hardworking Americans are suffering through the worst economy since the Great Depression of the 1930's. That is a direct result of the Wall Street-created financial collapse of 2008, which was the worst financial crisis since the stock market crash of 1929.

As we sit here today, I am sorry, tonight, many of our neighbors will sit at their dinner table, look at their children, and worry about their future: 21 million Americans today can't find full-time work; 11 million Americans are paying mortgages higher than the value of their homes; 5 million Americans have had to move out of their homes due to foreclosures, and millions more are packing up as we speak today; and the American family's net worth has plummeted almost 40 percent in 3 years, wiping out almost 2 decades of hard work and prosperity. None of this happened because of the Dodd-Frank financial reform law passed 2 years ago. None of this happened because of the rules meant to implement the financial reform law, almost none of which have even been put in place yet. None of this happened because regulators who are the Wall Street policeman are trying to make Wall Street follow the law like everyone else in this country.

That economic disaster happened as a result of Wall Street and the financial industry being deregulated in the 1990s and virtually unregulated starting in 2000. This unleashed a recklessness that took just 7 years to cause the biggest financial collapse since 1929 and almost caused a second Great Depression. Wall Street was able to do that because it and its allies changed or eliminated the laws, rules, and regulations put in place during the Great Depression of the 1930s, which protected the American people from Wall Street and the financial industry. After that, our country did not have a financial or economic crisis on that scale for more than 70 years. And remember, even with the unprecedented degree of government regulation of Wall Street and the U.S. capital markets for 70 years, our country prospered. We built the largest, most broad-based middle class in the history of the world.

Wall Street, our financial industry, our nonfinancial businesses, and our economy all thrived for 70 years. Deregulation of the only industry in the country that threatens our financial system and entire economy changed all that. Financial predators were let loose. Doing anything and everything to make as much money as fast as possible became the Wall Street business model. And as the JPMorgan London Whale bet of April and Barclay's rate rigging scandal of today shows, little has changed.

That is why the Dodd-Frank financial reform law is more properly understood as the Wall Street re-regulation law. It is designed and intended to prevent Wall Street and the too-big-to-fail banks from causing another financial collapse and economic crisis. Nothing in that law could ever cause the damage to jobs, our economy, our financial system, and our country that Wall Street did when it caused the financial collapse and worst economy since the Great Depression.

Unfortunately, Wall Street and its allies are engaged in a campaign that attempts to deflect the public debate away from that crisis, away from Wall Street's role in that crisis, away from the cost of that crisis that they put on the American people and to the new financial reform law, to the industry's alleged burdens and to the rules being put in place to prevent another crisis.

As detailed in my written testimony, for more than 100 years the industry has complained nonstop about regulation. But history proves again and again that these complaints are without merit. The industry has always adapted and that industry and our country have prospered. In closing, the important anniversary isn't the 2 years since the passage of the financial reform law meant to protect the American people; it is the almost 4 years since Wall Street created the crisis and inflicted this economic wreckage on every corner of our country. How long before we stop worrying about Wall Street's profits and start worrying about taxpayer pockets and Main Street families?

Thank you.

[The prepared statement of Mr. Kelleher can be found on page 102 of the appendix.]

Chairman GARRETT. Thank you.

Mr. Lemke, you are recognized for 5 minutes, and welcome to the panel.

STATEMENT OF THOMAS P. LEMKE, GENERAL COUNSEL AND EXECUTIVE VICE PRESIDENT, LEGG MASON & CO., LLC, ON BEHALF OF THE INVESTMENT COMPANY INSTITUTE (ICI)

Mr. LEMKE. Good morning, Chairman Garrett, Ranking Member Waters, and members of the subcommittee. I am Thomas Lemke, general counsel of Legg Mason & Co. We are a Baltimore-based global asset management firm that manages more than $630 billion in mutual funds and other assets for our clients. I very much appreciate the opportunity today to testify on behalf of the Investment Company Institute on the impact of Dodd-Frank.

ICI is a national association of mutual funds and other SEC-registered investment companies. The members of ICI help more than 90 million investors seeking to achieve their financial goals.

It is important to note that Dodd-Frank is not directed at SEC-registered mutual funds. These funds were not a cause of the financial crisis. However, Dodd-Frank is very broad and very technical in its scope, and in a number of areas it raises important implications for mutual funds.

Our written statement addresses these matters in detail. In some cases, we believe the impact of certain provisions on mutual funds and their investors was not intended by Congress. In other cases, we believe that new regulations designed to achieve Dodd-Frank's protections should be implemented in a manner that minimizes market disruptions and strikes the right balance between cost and benefits.

I would briefly like to highlight four issues of particular concern to ICI and its members.

First, is the Volcker Rule. Congress' clear purpose in this area was to limit proprietary trading by banks and to prohibit banks from sponsoring or investing in unregistered hedge fund and private equity funds. Mutual funds and other SEC-registered funds were not the rule's target. Under the proposed rule to implement Volcker, however, some SEC-registered funds could be treated the same as hedge funds or private equity funds, thus barring banks from owning or sponsoring these funds. Virtually all non-U.S. retail funds would get similar treatment. That is not what Congress intended, and we believe the proposed rule should be amended to explicitly exclude all these funds from treatment as covered funds or banking entities.

We are also concerned that the Volcker proposal could sharply reduce market liquidity by preventing banks from exercising their historic role as market makers. For mutual funds and their investors, less liquidity means higher spreads, higher trading costs, and diminished returns.

In comments to regulators, ICI has offered recommendations designed to avoid an adverse effect on market liquidity and address other problems with the Volcker proposal. We and many other commenters believe that significant changes are necessary. As a result, we have called upon regulators to issue a new proposal for public comment before adopting any final rule.

Our second concern is the Financial Stability Oversight Council (FSOC) and its authority to designate Systemically Important Nonbank Financial Institutions (SIFIs). These provisions in Dodd-Frank did not target SEC-registered funds. Indeed, Dodd-Frank includes criteria and other language suggesting that these funds are not what Congress had in mind.

FSOC and its Office of Financial Research are conducting an analysis of asset managers to see if these companies pose any threats to financial stability. We believe this study should be subject to formal public comment. ICI also believes the FSOC will conclude at the very least that SIFI designation would not be a proper tool to address any such risks.

Third is the regulation of derivatives and asset-based securities. These instruments play an important role for many institutional investors, including registered funds.

Funds use swaps, futures, and other derivatives to manage risk, improve returns, and gain liquidity. ICI has supported reforms that would increase transparency and reduce counterparty risks in these markets, though we still have a number of specific concerns with the regulatory proposals.

Broadly speaking, we urge the SEC and the CFTC to work together, and with their global counterparts, to ensure that new regulations achieve the protections sought by Dodd-Frank in a coordinated and cost-effective manner while minimizing market disruptions.

Fourth and finally, we could not discuss the impact of Dodd-Frank without raising what we believe is a troubling example of a regulator using Dodd-Frank as a pretext to expand its authority through unjustified regulation.

In February, the CFTC vastly extended its reach over SEC-registered funds, and only SEC-registered funds, by sharply curtailing their ability to rely on a rule that has long exempted otherwise regulated entities from CFTC registration. The CFTC claims to have acted on these amendments under the "more robust mandate" it received under Dodd-Frank, but its actions were neither required nor even contemplated by Dodd-Frank.

The result of the CFTC's action is that SEC-registered funds will be subject to unnecessary and redundant regulation, the cost of which will be borne by funds and their shareholders.

ICI and the U.S. Chamber of Commerce have challenged the CFTC's Rule 4.5 amendments in Federal court. If our case does not succeed, not only will SEC-registered funds and their shareholders suffer the consequences of this ill-advised rule, but the CFTC will face a host of new registrants and further demands on its limited resources at a time when the agency itself says that its workload under Dodd-Frank "creates risks in its critical oversight roles."

We believe this prospect should be of serious concern to Congress.

Mr. Chairman and members of the subcommittee, our written statement contains additional detail on these and other matters, and I will be happy to answer any questions you may have. Thank you.

[The prepared statement of Mr. Lemke can be found on page 120 of the appendix.]

Chairman GARRETT. And we thank you.

Ms. Simpson, welcome, and you are recognized for 5 minutes.

STATEMENT OF ANNE SIMPSON, SENIOR PORTFOLIO MANAGER, INVESTMENTS, AND DIRECTOR, CORPORATE GOVERANCE, THE CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM (CALPERS)

Ms. SIMPSON. Thank you. Good morning, Chairman Garrett, Ranking Member Waters, and distinguished members of the subcommittee. My name is Anne Simpson. I am the senior portfolio manager for investments and director of corporate governance at CalPERS, the California Public Employees Retirement System.

I would like to share our views this morning on the positive impact of Dodd-Frank and to address the unfinished business. Also, to highlight the importance of completing the task of ensuring what we think of as smart regulations. This is in order to protect investors like us, but also to protect the markets upon which we and also the wider public relies.

CalPERS is the largest public pension fund in the United States, with more than $230 billion in global assets, and we are share owners in more than 9,000 companies. We pay out over $14 billion annually in retirement benefits to more than 1.6 million public employees, retirees, and their families.

This is not only an important source of daily income for our members; it also provides a positive economic multiplier to the local economy.

CalPERS fundamentally relies upon the safety and soundness of the financial markets. For every dollar that we pay in benefits to our members, 66 cents are generated by investment returns. We are a long-term investor with liabilities that are measured in decades. We need stability in the capital markets and sustainable economic growth to meet those liabilities now and in the future.

We fully understand the virtuous circle between savings, investment, financial markets, and economic growth.

The financial crisis hit us hard: $70 billion was wiped from CalPERS' portfolio. We simply cannot afford another crisis. This is why CalPERS is concerned with ensuring that financial markets are regulated in a way which: is coordinated and complete; is fully transparent; protects investors from conflicts of interest; fosters responsible behavior by market actors; and furthermore, does not prevent investors from taking advantage of new opportunities and innovation.

For us, these are the hallmarks of smart regulation. But a critical element is to ensure that regulation is proportionate. For CalPERS, we weigh the additional costs that are required and the balance with the protection that they provide to our fund.

To those who question whether we can afford to invest in smart regulation, we reply, "How can we afford not to?" The impact of the financial crisis is still around us, and we cannot be complacent about risks ahead and before us.

Those arguing that we cannot afford the cost of regulation are in danger of being penny wise and pound foolish. We see smart regulation as an investment in the safety and soundness of financial markets which generate the vast bulk of the returns to our fund. Smart regulation is an investment in the effective functioning of capital markets, which is critical not just to investors like CalPERS, but to the recovery of the wider economy.

CalPERS believes that Dodd-Frank establishes an effective framework for promoting that safety and soundness of capital markets and providing investors the protections and the rights to ensure those markets function well. However, unless effectively implemented, the promise of Dodd-Frank will remain largely unfulfilled.

Let me turn briefly to the critical elements of that unfinished business, which we regard as vital to delivering on that promise.

Derivatives: CalPERS fully supports regulation of the trading of derivatives, which we use extensively in our own portfolio. The legislation will bring oversight and transparency, and a key part is ensuring that most swaps are exchange traded or centrally cleared.

We are pleased the CFTC has adopted thoughtful rules to implement the business conduct standards, but there is more to be done. We will be glad to continue to engage with the regulators to get those rules in the right place.

The Volcker Rule: We fully support the objectives of the so-called Volcker Rule and would like to incorporate by reference the attached comment letter previously submitted by CalPERS to the relevant agencies. The principle here is simple: to ensure that banks do not rely upon the window as a backstop for proprietary trading or other risky activity. We realize there is more work to be done to ensure clarity.

Alignment of interest: We want to ensure alignment of interest between those making decisions in the financial market and the providers of the long-term capital that they are deploying. But alignment means sharing not just rewards, but risks, and over the long term.

For that reason, we support the risk retention proposals which would require those who issue asset-backed securities to retain at least a 5 percent piece of the credit risk of any asset.

As a purchaser of asset-backed securities, CalPERS wants to see that its own long-term economic interest in these securities is aligned with those originating the securitizations and underlying debt obligations.

Credit ratings: CalPERS supports reform of the industry. These entities played a troubling role in the financial crisis. They provided many securitized products with investment grade ratings, even though underlying debt instruments pose serious risks of default.

In response, Dodd-Frank included some important provisions intended to include transparency and accountability, and we have more detail in our written testimony. We are hopeful the SEC will act swiftly to issue final rules and also to withdraw the no-action letter that allows credit rating agencies to avoid liability for false ratings in securities filings.

Shareowner rights: Effective regulation also relies upon market participants playing their proper role. For that reason, shareowner rights, both to information and the ability to follow through and take action, are vital. Investor protection starts with shareholder rights. We see it as self-help.

A good example is the new rule known as "say on pay." We are pleased the SEC adopted final rules on executive compensation last year, and we have just completed our second proxy season under these rules. We see a positive impact. Dialogue with companies has improved and many companies are making sensible reforms in response to shareowner concerns. There are some additional rules to complete the set, and we look forward to their promulgation by the SEC.

Finally, regulation—

Chairman GARRETT. You are 1 minute and 40 seconds over, so—

Ms. SIMPSON. Oh, I apologize.

We would like to ensure that funding is secure and adequate. There is work to be done. We are willing to continue with our engagement with regulators. Difficult as the work is, it must be put on track.

Thank you.

[The prepared statement of Ms. Simpson can be found on page 151 of the appendix.]

Chairman GARRETT. Thank you, and I appreciate that.

And finally, Mr. Vanderslice, you are recognized for 5 minutes.

STATEMENT OF PAUL VANDERSLICE, PRESIDENT, THE COMMERCIAL REAL ESTATE FINANCE COUNCIL (CREFC)

Mr. VANDERSLICE. Chairman Garrett, Ranking Member Waters, and members of the subcommittee, my name is Paul Vanderslice. I am a managing director at Citigroup Global Markets where I have worked for the last 28 years.

I am here today in my capacity as president of the Commercial Real Estate Finance Council, also known as the CREFC. CREFC is the collective voice of the $3.5 trillion commercial real estate finance industry. Its members are portfolio lenders such as banks and insurance, commercial mortgage-backed securities lenders, issuers and investors, as well as a variety of firms that service these lenders and investors.

We appreciate the opportunity to share our views on the impact of the Dodd-Frank regulations on credit availability for commercial real estate. CREFC recognizes the importance of many aspects of Dodd-Frank, including risk retention, better disclosure, and increased transparency.

However, we are concerned that some of the proposed regulations go beyond congressional intent, and when analyzed in the aggregate have a combined effect that hinders credit and outweighs the benefits intended for investors and borrowers.

Therefore, CREFC believes it is imperative that regulators abide by Executive Order 13563 which requires that regulators take into account the overall costs of the regulations, adopt regulations where the benefits justify the costs, and ensure regulations impose the least burden on society. We appreciate the subcommittee taking the opportunity to exercise its oversight over this issue.

The U.S. commercial real estate market is funded by $3.5 trillion in commercial mortgages and has approximately $1.5 trillion in equity. Approximately $2 trillion of commercial mortgage debt is scheduled to mature in the next 5 years, almost $400 billion per year.

Traditional portfolio lenders simply lack the capacity to fulfill the aggregate CRE financing need. This is so even after you account for additional borrower equity, new valuations, and tighter loan-to-value ratios. Therefore, the refinancing gap could be in excess of $100 billion per year over the next 5 years and likely much larger. This shortfall is between what portfolio lenders can provide and what is necessary to refinance existing debt and fund those commercial real estate loans necessary for economic growth.

Over the last 2 decades, CMBS has provided this gap funding, much of it in non-CBD markets. Bloomfield, Michigan, and Paramus, New Jersey, would be examples of these non-CBD markets.

That said, the CMBS industry is in the midst of a fragile recovery. There is only $30 billion to $35 billion of projected issuance this year; 2012 will only be 18 percent of the 2006 volume of $200 billion, and 15 percent of the 2007 peak volume of $230 billion. We have not seen issuance this low since 1997.

A few lenders in 2011, because of the volatility, left the market, shuttered their entire CMBS businesses. And they did not believe in the growth of the market. There are more loan rollovers than new CMBS issues. So the market is actually losing size and may begin to lose its relevance over time. This is partially due to the headwinds facing the United States' weak economic growth forecast, as well as the intensifying European crisis.

However, the market also faces the pending implementation of the Dodd-Frank regulations and their combined effects. While the former cannot be controlled, the latter can be—as an example, the premium capture cash reserve account, also known as PCCRA, included in the proposed risk retention regulations, but not contemplated by the Dodd-Frank Act itself,

In a survey of CMBS loan originators and issuers, 92 percent of the respondents said that the imposition of PCCRA would decrease loan origination volume from current levels. Almost 62 percent of those respondents said that the volume decreases would be more than 50 percent.

Some indicated reductions would be as much as 90 percent to 100 percent. All respondents indicated that the cost of loans to borrowers would increase; 92 percent said the cost increase would be 50 basis points or more; 46 percent indicated the cost increase would be more like 100 basis points.

As an example, on a $10 million loan request, the loan would work today at a 5 percent rate. If the loan were 6 percent, the supportable debt would only be $9 million. Extrapolate this to the $100 billion refinancing gap that I had mentioned before, and that would be a $10 billion per year shortfall. Therefore, this rule would constrain credit minimum to the tune of $10 billion a year over the next 5 years.

Furthermore, in a separate survey of the CREFC board of governors, 78 percent of our board and 73 percent of our investment-grade investors that the PCCRA is purportedly designed to protect believe that PCCRA implementation would hinder CMBS. This is just one example from the 17 regulations that would affect CMBS.

We believe PCCRA: one, is outside of the congressional intent of risk retention; two, would limit CRE lending when it is needed most; and three, would materially raise the cost of debt, which would hurt the non-CBD markets the most, and that is the very market that CMBS has historically served.

This is why we are urging Congress to ensure regulators follow the congressional intent and Administration policy through Executive Order 13563. Without a strong return of CMBS, local businesses will be denied access to essential liquidity.

Thank you, and I look forward to your questions.

[The prepared statement of Mr. Vanderslice can be found on page 168 of the appendix.]

Chairman GARRETT. I very much appreciate your testimony as well.

And so, again, to the entire panel, I appreciate your coming here and your testimony. You all indicated that you welcome any questions, and so we have some. And I will recognize myself for 5 minutes.

Mr. Kelleher, I listened to Ms. Simpson, who indicated that she saw some benefits to, and she listed them, with regard to current law, Dodd-Frank, but she also saw some need for changes or reform or what have you in certain areas, and you went through some of those areas.

But in listening to your testimony, Mr. Kelleher, it seems as though you are presenting us with an either-or situation, or a false choice situation. That is to say, either we have Dodd-Frank as it is and as it is being implemented by the regulators, or we have no regulation whatsoever.

But I don't think there is anyone from either side of the aisle who has ever suggested that we have no regulation. I know it came as a surprise a week or so ago to Ranking Member Frank when we indicated that we on this side of the aisle actually put forth a proposal for regulation prior to Dodd-Frank being presented. So there are alternatives to it.

Is it your position that the bill as written and as being implemented is without flaw, does not need change, that we should not be relying upon any empirical data, as Mr. Vanderslice and others here have indicated?

Mr. KELLEHER. Thank you for your question.

Chairman GARRETT. Sure.

Mr. KELLEHER. Nothing that comes out of a democratic process, I believe, is flawless. That is the nature of a democratic process. There are compromises that have to be made.

The other important part of the democratic process that produced the Dodd-Frank law is that it was open to the public and it was considered for about 2 years before it was passed. In fairness, the industry had vast and multiple opportunities to participate and they have vast and multiple opportunities to participate in the rulemaking process.

But instead of listening to what people say when they say they are for financial reform, let us look at what they do. Who is supporting funding for the regulators? Who is burying the regulators with paper? Who is saying, "We are for financial reform," and yet criticizing it. So you are right—

Chairman GARRETT. So, reclaiming my time—

Mr. KELLEHER. —that is a theoretical possibility, but—

Chairman GARRETT. Right. Reclaiming my time, who is burying with paper, I guess, is one of the questions that we are asking here, is who is burying them with paper, in the sense that maybe there is just so much that we are asking the regulators to do that they can't find the proverbial needle in the haystack, and then what are the actual outcomes of that?

Mr. Deutsch, in your testimony, you referenced a study by Mark Zandi. And I believe you said—correct me if I am wrong—that in his study, the impact of all this, of the implementation of the regulations would raise mortgage costs for me and you, the average person, by between 100 and 400 basis points, which means one to four points, basically. Right? Is that what the Zandi report said?

Mr. DEUTSCH. The only technical clarification is that is just one aspect of Dodd-Frank, is the premium capture reserve account by itself—

Chairman GARRETT. We have asked the regulators who are inundated with all this: Is there anything that refutes the Zandi report? We haven't gotten an answer from them. Have you seen anything that refutes the Zandi report on this?

Mr. DEUTSCH. Everything we have seen and every canvassing we have done with our members supports the analysis that mortgage rates would increase substantially anywhere from one to four—

Chairman GARRETT. Okay, I appreciate that. All we go by is what we ask the regulator—not all, but what we go by. And they are not giving us anything to refute that.

Now, Mr. Vanderslice, you raised an interesting point, and I have heard this before as far as on the commercial sector as far as opposed to, I am thinking about the residential area. And I have heard this before is that the market has shrunk and that there is how many trillions of refinance rollover?

Mr. VANDERSLICE. In total debt, including CMBS, about $400 billion per year over the next 5 years.

Chairman GARRETT. And without the securitization market coming back in, we can't throw this all back on to the banks. They can't pick it up.

Mr. VANDERSLICE. Just as an example, the life insurance industry last year put out a record number of dollars, which was about $45 billion. So that was a record year for them.

Chairman GARRETT. Okay.

Mr. VANDERSLICE. So our point in this is that you need everybody. You need portfolio lenders. You need securitizers. But there is such a large number of rollovers coming that without a functioning SMBS market, the impending rollovers are adding up every day. The market today is relatively small.

Chairman GARRETT. So this is one where the issue of Ms. Simpson's comment, penny wise or pound foolish on this situation—we want to be penny wise, but the implication of it is that if we don't get it right, what you are telling us is that you could see a dramatic downturn in the commercial marketplace.

And that would do what to the economy, what to jobs, and the rest?

Mr. VANDERSLICE. Yes, commercial real estate is a very large part of the economy. Without building owners, they don't have the ability to attract tenants, they can't do tenant improvement—

Chairman GARRETT. And since my time is over, can we simply address this issue by making sure that the rule of Dodd-Frank applies to the area where it is intended to apply, and in this area it was not intended to apply—

Mr. VANDERSLICE. That is correct. PCCRA is a late addition and it is the one big impediment. CREFC again, recognizes the important of many of the aspects of Dodd-Frank, including risk retention, increased disclosure, transparency—PCCRA is a major, major bump in the road.

Chairman GARRETT. I think I understand you on that. Great. Thank you, everyone.

The gentlelady from California, Ms. Waters, is recognized for 5 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman. I would like to thank all of our presenters here today. I have listened very carefully to all of the testimony. And first, I want to say to Mr. Kelleher that I appreciate your defining what took place with the economic crisis that was created in this country basically initiated by Wall Street and all that was going on. And I appreciate your passion as you describe the crisis.

As we all know, the fallout from that crisis continues. As I travel throughout this country, with these boarded-up neighborhoods, and these foreclosures, and families who have been literally put at great risk because of all of this, what you describe is absolutely true.

And I think no one on this panel can disagree with what you described as the economic crisis that put this country at great risk. Having said that, Dodd-Frank was a tremendous effort to try and deal with this crisis that was created.

And Dodd-Frank was modified, some of the ideals in Dodd-Frank were eliminated during the conference committee. Everybody tried to do something about strengthening our regulation and oversight without destroying the markets that so many people are here to talk about have been negatively impacted.

Having said that, in the 2 years since Dodd-Frank passed, we have seen the robo-signing of foreclosure documents, the implosion of MF Global, the losses of the London Whale, the bungling of the Facebook initial public offering, the LIBOR manipulation scandal, and we learned just yesterday about another case of missing customer funds at a futures brokerage. And this is to name just a few of the many episodes.

So, this continues. Some of us have tried very hard to understand what is being said about the risk to the market that supposedly are created by Dodd-Frank. To that end, I, against my better judgment, supported the Republicans JOBS program where we made it easier for companies to raise capital, these IPOs.

I supported crowdfunding, in an effort to support the small banks. And of course, I supported rolling back some of the protections for investors in all of this in an attempt to try and send a signal that we are cooperating in whatever way we can to do modifications and innovations because we think that perhaps there is some room to compromise.

However, what we see is a continued effort to undermine Dodd-Frank, whether it is defunding the regulators, repealing the Orderly Liquidation Authority, repealing the risk retention, delaying derivatives regulations for 2 years, repealing the liability for credit rating agencies, prohibiting the SEC regulation of international swaps, and on and on and on.

We continue to get complaints about how harmful it is going to be to have transparency with the derivatives and on and on and on. Having said that, Mr. Deas, you represent the Chamber, and I guess you are also vice president and treasurer of the FMC Corporation, et cetera. Okay, so the Chamber has a lot of influences and power here. What is it you want us to do? Would you like us to get rid of Dodd-Frank? Do you have some better ideas about how to protect the investors and the customers? What is it you want this Congress to do?

Mr. DEAS. Thank you for that question, Ranking Member Waters.

As I described in my testimony, I work for a leading manufacturing company, a 130-year-old American company, and we, like you, are very concerned about the disruptions that occurred in the financial markets in 2008.

However, the regulations as they are being implemented are affecting Main Street companies, end-users, for instance of derivatives like FMC, and other members of the National Association of Corporate Treasurers, and yet we comprise less than 10 percent of the over-the-counter derivatives trading that goes on, and we were not engaged in the systemically risky activities that some of those who caused this problem were.

Main Street companies weren't writing naked credit default swaps. We were using derivatives to hedge future purchases of natural gas used in manufacturing, exposures to changes in interest rates, hedging foreign exchange rates on our exports, and other activities like that.

What we have said is that the effect of these regulations is now coming to Main Street businesses and you yourself supported the legislation to clarify the margining exemption for end-user companies from having to post that margin, which would be a direct subtraction from funds that we could otherwise invest in our business.

And I believe you, yourself, also supported the bill to correct the inter-affiliate issue where derivative transactions between companies within the same group are being regulated as though they are between two banks.

So, I thank you for those efforts, and that is what we want, an exemption for end-user companies from the broad sweep of these regulations that we believe will be to the detriment of American business and job creation.

Ms. WATERS. Thank you very much.

So, I suppose what you are saying to me is that you do recognize that there are companies that were reckless and who put this country at risk and we should have tougher regulations and Dodd-Frank does do some of that?

Is that what you agree to?

Mr. SCHWEIKERT [presiding]. You are way over time, so—

Ms. WATERS. Okay.

Mr. SCHWEIKERT. I will give you time for a quick response, and then I need to go on to my chairman, because I don't want to make my chairman mad.

Mr. DEAS. I agree there were problems in 2008, but the concern for these problems as they affect American business and Market Street companies like ours is that the cure is worse than the problem, from our perspective.

Mr. SCHWEIKERT. Okay, with that, thank you, Ranking Member Waters.

Chairman Bachus?

Chairman BACHUS. Thank you, and you didn't make me mad. Ms. Waters and Mr. Kelleher have given me a headache, but other than that, I think I am okay.

Mr. Kelleher, listening to your opening statement, and reading it last night, it kind of was deja vu, because you were in Senate leadership when we were considering Dodd-Frank and we were sort of having some of the same debates that we are having now. And I noticed that you, I think, continued to paint all of Wall Street as the cause of the greatest depression since—I think it was a depression, probably still is a recession—but Mr. Deas said that 90 percent of Dodd-Frank affects Main Street, the operation of every community bank and credit union in the country. But, let us consider—and I know this Mr. Garrett, we were kind of having the same thought when you said that the regulators were buried in paper. The three of us agree on that. They are struggling to write rules. It is just a daunting path. But I would submit to you that, that paper is a result of Dodd-Frank. That is why it is there.

And I think you have to admit that even before Dodd-Frank, they weren't enforcing the rules that they had. Now, Ms. Waters has mentioned MF Global. She mentioned, I think it is PFGBest, which failed yesterday. She mentioned LIBOR. None of that is due to Dodd-Frank. That is just pure, out and out accounting fraud. That is segregation of customer funds.

For 70 years, we have had rules against that. The most basic rule in finance is you segregate funds, you don't mix funds or do what PFGBest did, representing that they had $200 million in an account, and they only had $5 million. Now how in the world did the CFPB miss that? How in the world did that go over? It is like Madoff claiming all this money was there.

You mentioned subprime lending and securitization. In 2005, I proposed legislation on subprime lending, and I wrote the ranking member and said, "We need to move a bill." And actually, I think he agreed to 90 percent, but then litigation attorneys objected to some of what we wanted to put in as far as a safe harbor.

I know you were a litigation attorney. I think the Senate leadership said that was a nonstarter. But we did pass a subprime lending bill before Dodd-Frank, and I think at least everyone said that would stop most of that. I want to introduce on the LIBOR issue, Ms. Waters—this is an article in Reuters I think from this morning or last night. The regulators, since 2007, knew there were problems with LIBOR. In fact, Barclay's came to them in 2008 and said, "We think other institutions are misrepresenting their costs."

And it is affecting our ability to operate. The Fed actually suggested reforms in 2008. Secretary Geithner—he is now the Secretary of the Treasury, as we all know, but he was the head of the New York Fed at that time—actually scheduled a meeting in 2008 and it said the purpose was fixing LIBOR. But no one ever—they knew there was a problem. People came to them and said there was a problem. They didn't do anything about it. MF Global, now I don't know how in the world people can equate stealing $300 million worth of clients' money, customer money, with JPMorgan Chase, a hedging operation that lost their own money.

Isn't there a difference in our right to hedge our own money and lose money? And investment banking is inherently risky. All JPMorgan did was took a risk and they lost on that risk. But even if you go back the last 2 years and you take all their hedging operations, they made $40-something billion just in the last 2 years. So suddenly, they lose $2 billion, and somebody jumps up and equates that to misconduct?

Mr. LYNCH. Will the gentleman yield?

Chairman BACHUS. I will not, but let me—surely—

Mr. LYNCH. It is not $2 billion. It is not $2 billion anymore.

Chairman BACHUS. Well, $7 billion. Let us say $7 billion.

You are still 30—

Mr. LYNCH. Let us say $9 billion. We had the guy in last week.

Chairman BACHUS. The gentleman is not in order. This idea that you are going to go in and micromanage every company and say that every investment they make has to make money is a fool's errand. There are investments made every day. Loans are made every day that aren't going to be paid back. But surely, we can all agree that stealing customers' money or depositors' money, for example, MF Global—surely everybody on this committee thinks that is a worse situation than JPMorgan. And we have had three or four hearings on JPMorgan, and we had one on MF Global.

And here you have a company that misrepresents and said $200 million worth of customer money was in a bank account and there was only $5 million. Now I submit to you that we would better enforce the good old accounting rules, fraud, criminal conduct. But they hadn't even shown that they can invest when someone comes to the Fed and says we have a problem, that people are misrepresenting things, or it it takes them 4 or 5 years to even discover there is a problem, when they were told about the problem?

People went to the SEC and complained about Madoff for years. And let me close by saying that you say—and this argument we had back, I remember the same argument when we passed Dodd-Frank. You all argued against a cost-benefit analysis. And I will give you this, you are consistent. You say today that imposing our burdens on cost-benefit analysis is a tactic without merit. So asking what the cost is as opposed to the benefit, you actually believe is without merit? Do you really believe that?

Mr. KELLEHER. As stated in my testimony, it spells out how cost-benefit analysis can be done right, consistent with the statute and how it is being used by those to defeat financial reform. And that is the distinction. That is a misquote of my testimony—

Chairman BACHUS. You just think that our motive is wrong—

Mr. KELLEHER. No, it is not that. It is how you go about it and what goal one is trying to accomplish. We spell that out quite clearly. We have also spelled it out in opposition to the ICI, the Chamber, and SIFMA in the litigation. But if I might also say—

Chairman BACHUS. Well, you all voted—

Mr. KELLEHER. I did not—

Chairman BACHUS. You all opposed cost-benefit—

Mr. KELLEHER. I did not equate MF Global with JPMorgan.

Chairman BACHUS. Okay.

Mr. KELLEHER. MF Global is not systemically significant. JPMorgan is backed up by the U.S. taxpayers and the Federal safety net. And everybody who cares about taxpayers better care about JPMorgan, and—

Chairman BACHUS. No client, no customer, no depositor, no taxpayer is threatened by JPMorgan—

Mr. KELLEHER. That is not true.

Mr. SCHWEIKERT. Gentlemen?

Mr. KELLEHER. Can I just very quickly respond—

Mr. SCHWEIKERT. No. No.

Mr. KELLEHER. —to a couple of points—

Mr. SCHWEIKERT. —no—

Mr. KELLEHER. One of which is why the regulators didn't—

Mr. SCHWEIKERT. Sir?

Why don't the regulators enforce the rules they have?

Mr. KELLEHER. —defunded.

Ms. WATERS. Unanimous consent, please, Mr. Chairman, to allow the gentleman to respond?

Mr. SCHWEIKERT. Actually, no. I am going to be the one to object. Because I have been trying to be very kind to both sides here, particularly—

Chairman BACHUS. And Ms. Waters let me say this, we could go on for 2 hours—

Mr. SCHWEIKERT. No, I understand.

Chairman BACHUS. —and I don't think we are ever going to agree.

Mr. SCHWEIKERT. No.

Ms. WATERS. Regular order, Mr. Chairman, regular order.

Mr. SCHWEIKERT. Yes, Mr. Chairman, did you have a document you wanted to put into—

Chairman BACHUS. Yes, I want to introduce this report in Reuters that our regulators knew about this LIBOR—

Ms. WATERS. Regular order? Mr. Chairman, regular order?

Mr. SCHWEIKERT. Mr. Chairman, without objection, it is so ordered.

Chairman BACHUS. Yes, and that MF Global—

Ms. WATERS. Regular order, Mr. Chairman? Regular order?

Chairman BACHUS. —and that the regulators were on the scene for 5 years and never discovered it.

Mr. SCHWEIKERT. Thank you. It is so ordered.

Mr. Hinojosa?

Mr. HINOJOSA. Thank you, Chairman Schweikert, and Ranking Member Waters. As we approach the 2-year anniversary of the passing of the Dodd-Frank Act, my colleagues on the other side of the aisle are continually holding these hearings, not on proposed legislation, but to attack the Act and to make a political point. Meanwhile, new cracks in Wall Street are revealing just how important it is for Congress to fund the regulators at appropriate levels and to encourage them to propose and finalize the remaining rules under the Act.

In the last year, we have seen high-profile Wall Street players being convicted of insider trading. JPMorgan experienced an incredible loss of an amount up to $9 billion as a result of exotic credit default swaps. And most recently, we have learned of the involvement of Barclay's and other banks in the LIBOR rate-fixing scandal. Just last month, JPMorgan's CEO Mr. Dimon testified before this committee, and in a response to my question about a need to re-evaluate Wall Street's culture, he told us that there are people you can trust on Wall Street and not to paint every firm with the same brush.

I wish he would have talked about the opportunities for culture change in an organization in response to crisis. As a former businessman, I can tell you that I understand that this is management 101. In comparison, many analysts are pointing to the culture at Barclay's and other global investment banks overall as a systemic culprit in the LIBOR fixing scandal. And yet, here we are discussing how Dodd-Frank is hurting our investment banks. If anything, the recent events on Wall Street and in London should encourage us to press ahead with finalizing the rules under the Dodd-Frank Act.

Just like any large and important bill in our Nation's history, this Act too shall be fine-tuned and refined over time. And I have no problem with hearing about these tweaks and other legitimate issues. However, simply attacking Dodd-Frank as a whole without discussing new legislation comes across as overtly political and completely unproductive. That being said, I will ask my direct question to Ms. Simpson. Title VII of the Act will place reforms to bring transparency, accountability, and strong stability to the OTC derivatives marketplace. Do you agree that the changes in Title VII will bring about this transparency, accountability, and stability that I am talking about?

Ms. SIMPSON. Thank you, sir. Yes, we support the regulation of derivatives, and I should also say that CalPERS as an investor, makes extensive use of these instruments. In the letter which is attached to our testimony, we do explain that the principle of regulating derivatives is extremely important. But we accept as a player in the market, a market actor, that there will be some additional costs. For us, those costs are an investment in safety and soundness and we think that there is overall going to be systemic benefit to us as an investor. So we applaud the intent of Title VII and we also realize that we must not let the perfect be the enemy of the good, and that wrangling over the detail and delaying implementation is simply not a good strategy.

We want regulators and market participants to get around the table, roll up their sleeves, and make sure that these rules are put on the books. There are some imperfections, but that is in the nature of making legislation, as in the making of sausage, as someone once said. But we do need to get these rules on the books. We mustn't delay, it is far too important tor the beneficiaries for whom we invest. Thank you.

Mr. HINOJOSA. Mr. Kelleher, I also appreciate your passion in your testimony. You remind me of former Senator Kennedy.

Tell me, what can Congress do to get all the banks, so that we don't have things like today's New York Times—or yesterday, Monday, the July 9th New York Times which says that big banks face the fallout from the global investigation into interest rate manipulation? American and British lawmakers are scrutinizing regulators who failed to take action that might have prevented years of illegal activity.

Mr. KELLEHER. Thank you for the question, and thank you for the compliment. I appreciate it.

One of the most important things that can be done very quickly by the United States Congress is to fund the regulators adequately. Wall Street often—and it is too broad, it doesn't apply to everybody—is a high-crime area. Deregulation took all the cops off the beat. You added the responsibilities to the regulators. The regulators are the Wall Street policemen. You added massive responsibilities—

Mr. HINOJOSA. Time is running out on us, and I agree with you. Did you know that we need 1,200 people working in that Bureau, and we only have 800?

Mr. KELLEHER. Yes, and they have no IT. It is an unfair fight. And the Street is constantly overwhelming them, knowing that they don't have the personnel, the resources or the technology to compete. It is an unfair fight.

People who say they are for financial reform are not for financial reform if they do not vote for big increases for these regulators. They are voting for Wall Street profits, not taxpayer pockets.

Mr. HINOJOSA. I agree with you 100 percent.

And I yield back.

Mr. SCHWEIKERT. Thank you.

Mr. Neugebauer?

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Mr. Deutsch, I have been kind of watching the securitization markets a little bit since the 2008 period, and it appears that, for example, in the automobiles and credit cards and some of those areas, the securitization market has in many cases returned to pre-2008 levels.

The area where we are still seeing a huge amount of vacancy in private activity is obviously in the residential market area.

Just to kind of set the framework here, is there a qualified automobile loan provision anywhere?

Mr. DEUTSCH. In the risk retention proposals, there is a qualified auto loan exemption that would require at least a 20 percent downpayment to buy a car. I am not aware of anybody who puts a 20 percent downpayment on a car. It is precisely the type of concern we have of a risk retention rule designed for mortgages that is being applied to autos, but in fact, it doesn't really apply to autos.

Mr. NEUGEBAUER. But basically these markets that I am talking about don't have all the onerous provisions that have been talked about for the residential market. So would you attribute the fact there is a lack of private activity to the fact that there is just a huge amount of uncertainty about market participants coming back into that?

Mr. DEUTSCH. Yes, there are willing investors and willing issuers engaging in the auto market, $50 billion to $60 billion a year in transactions, to which Dodd-Frank rules don't currently apply. And I think the investors feel that they have appropriate protections to be able to purchase those securities and yield good returns.

Mr. NEUGEBAUER. One of the things that a lot of people talked about, and I think you brought up, or somebody brought up, is that the taxpayers have about $200 billion invested in Freddie and Fannie. And so the discussion has been, what do you replace Freddie and Fannie with? And obviously many of us think you replace it with private market activity.

If there were not all of these uncertainties out there today, dealing with risk retention and Qualified Residential Mortgages and all of the things that are out there, do you believe that there would be more private market activity in the residential market area?

Mr. DEUTSCH. I would say there would be an increase in private market activity, but without resolving Fannie and Freddie, sort of the big outstanding question, it is extremely difficult for private market participants to compete against an underpriced government guarantee.

Mr. NEUGEBAUER. It is because basically the risk premium that the private market wants versus these mortgages has been sanitized by the American taxpayers. It is hard for them to compete.

If that playing field was leveled, if Freddie and Fannie, for example, were required to charge a higher guarantee fee, where then the marketplace can say, "I think I would rather keep that return because I have looked at the integrity of those mortgages, rather than paying a 50, 70 basis point premium or giving up that much return."

Mr. DEUTSCH. Yes, I think there is no question that private market capital would return back to the mortgage sector. Rates would be higher, but that is I think the appropriate balance between risk and return in lending out money for people to take out mortgages.

Mr. NEUGEBAUER. It turns out we weren't pricing those mortgages at Freddie and Fannie appropriately anyway, because obviously the risk premium they were using turned out not to be—

Mr. DEUTSCH. I think it is approximately $200 billion underpricing of the risk premium currently to the U.S. taxpayer.

Mr. NEUGEBAUER. Right.

Mr. Bentsen, I know that your folks have looked at some of the securitization issues. What do you think is the bigger inhibitant?

Mr. BENTSEN. I agree with Mr. Deutsch in much of what he said. I think that for starters, the premium capture cash reserve is something that Congress, we believe, never intended in the original legislation. And as I said, both from our sell side and our buy side members, who don't always agree, both feel that this really takes the legs out from under the ability to really restart the securitization market, and in particular as it relates to the residential mortgage bond market.

So for starters, we think that provision really ought to be greatly amended or taken out in order to make sure that we can attract private capital back into the securitization market.

Mr. NEUGEBAUER. Yes. I think I was a little perplexed, too, that we decided to use a premium from Freddie and Fannie to finance other activities rather than trying to use that to make the American taxpayers at least get some of their—

Thank you, Mr. Chairman. I yield back.

Mr. SCHWEIKERT. Thank you, Mr. Neugebauer.

Mr. Lynch?

Mr. LYNCH. Thank you, Mr. Chairman. I appreciate it.

Mr. Kelleher, you were interrupted. You had an exchange going with the full committee chairman. There was an analysis going on, a comparison going on between yourself and the full committee chairman about the difference between MF Global, which actually stole—well, took client money to fill a hole that it had and some losses it was generating.

And the comparison was being made with Jamie Dimon and JPMorgan Chase where they simply—they were here a couple of weeks ago and we were asking them about their $2 billion loss, which was staggering at the time. And interestingly enough, my last question to Mr. Dimon was, there is word on the street that this loss could go to $5 billion.

And the full committee chairman refused me the opportunity to get an answer. He said my time had expired and he excused Mr. Dimon from answering that question.

And now we understand it could go as high as $9 billion. And you were talking about—you were trying to address the risk that the JPMorgan Chase instance presented, and I would like to give you some time to explain the danger there to the American taxpayer.

Mr. KELLEHER. Thank you, Congressman Lynch.

There is no similarity between what happened at MF Global and JPMorgan Chase. In fact, MF Global should be the model for the future, which is to say, it is a company that made wild bets, it shouldn't have done it, it failed, it is in bankruptcy, it lost its money and people lost their jobs with no systemic risk at all.

That will never happen if JPMorgan fails. If JPMorgan fails, it is going to be a systemic event that will be saved by the U.S. taxpayer. It has a balance sheet of $2.35 trillion. It has 270,000 employees across the world, thousands of legal entities, 550 subsidiaries, and on and on.

And it is backed, therefore, by the U.S. taxpayer. It gets massive subsidies, both on the FDIC side and the Fed side. So the U.S. taxpayer is underpinning JPMorgan Chase and the rest of the too-big-to-fail banks.

What JPMorgan Chase did in the so-called London Whale splash is it is reported to have bet over $100 billion in exotic, illiquid, complex derivatives, intending to make a lot of money. It didn't make a lot of money; it is losing money. And it is locked into those investments and can't get out.

It is a classic example of what banks backed up by the U.S. taxpayer should not be doing. It is also a classic example of what they did before the crisis, where they lost tons and tons of money.

And the chairman mentioned, by the way, why should we care? That operation has made $40 billion or $50 billion over time. We should care because they are claiming falsely that it is hedging. Hedging doesn't make money. Hedging should have offsetting gains and losses. That is not what they are doing. They are doing proprietary trading under the guise of hedging, which is what everybody here was worried about when the Volcker Rule was put into place to stop proprietary trading, which contributed significantly to the crisis and the need for taxpayer bailouts in 2008.

Mr. LYNCH. Very good.

I do see the comparison here. I remember I was on this committee back in 2007–2008 when this whole crisis evolved, and I remember one of the first events that we had, we had the failure of the Bear Stearns funds, but I remember distinctly the impact on Merrill Lynch. And at the time the CEO, whose name was Stanley O'Neal, and he came out and he did a press conference and he was reporting $2 billion in losses, $2.3 billion, something like that, $2.3 billion in losses of Merrill Lynch.

But he reassured people that this was well under control. But then 6 days later, he had to come out again, and he said, "Actually, our losses are $7.3 billion." And, embarrassingly, he again said, "We have things under control." And then, about 2 weeks after that, he had to come back and say, "We actually lost $11 billion." At that point, he was fired.

Now, the problem there is because these structured products are so complex he didn't know what they lost. These folks who were supposed to be the smartest, it was so opaque, and so complex that they didn't know what they lost.

And that is what Dodd-Frank is trying to get at with our transparency requirements, with the reporting requirements, to allow folks like Ms. Simpson over at CalPERS to know what those pension funds are investing in, to know what the counterparty exposure is, to have some transparency, to make sure that people have skin in the game and that there is retained capital there to address some losses if they do occur.

And so it doesn't have to be this way, where you folks defend the banks and anything they want to do, and then folks try to shackle, I guess, legitimate business practice. I think there is an opportunity here to actually protect the taxpayer.

Ms. Simpson, could you just use the last 45 seconds here to talk about the special danger to, I think, vulnerable parties, especially vulnerable parties like pension funds, if we were to go back to the way things were before Dodd-Frank?

Mr. SCHWEIKERT. Ms. Simpson, I will ask you to go quickly, and pull the microphone close.

Ms. SIMPSON. Yes, thank you.

Mr. LYNCH. Thank you, Mr. Chairman.

Ms. SIMPSON. We simply cannot afford another crisis. In the worst dark days of the most recent crisis, CalPERS was $70 billion down. Now, we have grown our way back to close to where we were, but it is simply not achievable to earn rates of return that would plug that gap. So these reforms for us are absolutely system critical to long-term sustainability.

Mr. LYNCH. Thank you very much. I yield back.

And I thank the gentleman for his indulgence.

Mr. SCHWEIKERT. Thank you, Mr. Lynch.

Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman.

I know that the study by Mark Zandi of Moody Analytics has already been brought up and discussed, but I would like to dig a little deeper into this matter. I, myself, have not seen the study. I do know Mr. Zandi is a frequently cited economist, particularly by my colleagues on the other side of the aisle.

Mr. Bentsen and Mr. Deutsch, I think you both alluded to this study, so I assume perhaps you have looked into it more deeply. But as I understand it, and I guess, Mr. Deutsch, I am reading from your testimony, that the premium capture cash reserve account that the rules promulgated under Dodd-Frank, that according to Mark Zandi, this could increase mortgage interest rates 1 to 4 percentage points; 100 to 400 basis points.

The last time I looked, I believe 30-year fixed-rate mortgages are going for roughly 3.75 percent. So is it a fair assessment to say that Dodd-Frank has the potential to double mortgage interest rates by the premium capture cash reserve account alone?

Mr. Deutsch?

Mr. DEUTSCH. I guess my response is that just one provision of Dodd-Frank could double the interest rate. If you add all the provisions relative to Dodd-Frank, it would be well more than that.

Mr. HENSARLING. Staggering. Have you seen any other studies? And so, again, this is just one provision of Dodd-Frank, cumulative impact.

I believe also you mentioned in your testimony about the Qualified Mortgage; that due to a subjective standard that will be promulgated by the CBPB, which frankly puts the capital "S" in subjectivity, as we all know. But you cite, I believe, another study that says that the lawsuits arising from that could cost anywhere from $70,000 to $100,000.

Have you calculated what that provision alone could do to interest rates? Do you know the answer to that?

Mr. DEUTSCH. I think a lot of our members have tried to calculate just how much the costs would be. And they have all come to the conclusion that it just will be too prohibitively high to be able to engage in any mortgage lending even close to the line of what a nonqualified mortgage is. So they simply will not be able to originate mortgages even close to that line of what a Qualified Mortgage would be.

Mr. HENSARLING. Mr. Bentsen, again, you cited the Zandi study as well. Could you elaborate on its findings for your organization?

Mr. BENTSEN. I agree with Mr. Deutsch that just the premium recapture provision alone changes the economics so significantly that it could have an impact like Zandi and his colleague found in the Moody's study. And so to his point, that is just one provision.

And I think it comes down the points that I made earlier, it is important how these rules are written and how they are implemented. It is important to consider the costs associated with how the rules are proposed. It may seem like mountains of paper, but that is known as the Administrative Procedures Act, and that is the whole process which Congress established long ago to comment as rules are written.

That is why, like the Zandi study; like the Oliver Wyman study as it relates to corporate bond issuance and the impact that the Volcker Rule as proposed could have; like the Federal Reserve's proposal for single counterparty credit limits and the impact that could have—we have to look at then in the totality and what the costs will be to the cost of capital and the cost of credit. And beyond any reasonable doubt, that will have an impact on economic activity.

Mr. HENSARLING. Mr. Deutsch, on page six of your testimony, you state that the ABS market briefly ground to a halt in December of 2010 because of investor concerns over the Orderly Liquidation Authority, and only resumed due to a near-term patch in the form of an FDIC General Counsel's letter. These types of risk will be priced into the asset-backed security market, resulting in higher costs for consumers and businesses.

Could you elaborate, please?

Mr. DEUTSCH. Yes, the Orderly Liquidation Authority created a provision that allows the FDIC effectively to step in for nonbank financial companies. When asset-backed securities are issued, the auto companies create and hold title effectively to the car loan and they will sell off the asset-backed securities.

Investors began to realize, and it took them 6 months to actually figure out the complex weave of the Dodd-Frank regulation, that in fact under the Orderly Liquidation Authority, the FDIC may be able to come in and take the underlying notes to the auto securitization, in effect, eliminating the securitization part of the securitization, which would leave an investor unprotected.

Ultimately, the FDIC had to step in and patch that, to say, "No, no, we won't take that in." But Dodd-Frank, on its very face, did allow that, and ultimately the ABS markets, much like under the 436(g) scenario in July of 2010, had to shut down for a brief period of time until the FDIC resolved that.

Mr. HENSARLING. I see my time has expired.

Mr. Chairman, 2,000 pages and so little time. Thank you.

Mr. SCHWEIKERT. Thank you.

Mr. Sherman?

Mr. SHERMAN. Thank you.

I don't know who to address this question to, but perhaps the worst day in Congress I have had, and for many others, is when the big banks came to us and said, "If you don't bail us out, we are going to take the whole economy down with us."

One argument there is, is maybe no one bank should be big enough to take the whole economy down. Another argument is maybe we should have higher capital requirements. The third approach is maybe we should just ignore the problem until it comes up again.

Assuming we want to create a circumstance where, at least as long as I serve in Congress, which some would argue will only be a few months, but others might think longer, that we are not going to have a situation where a bank is able to call the Treasury and claim they are going to take the whole economy down with them, unless we bail them out.

Mr. Bentsen, you have handled tougher questions before in our time together. I don't know if you have a comment or whether anybody else does.

Mr. BENTSEN. Mr. Sherman, I guess I would make a couple of comments. Dodd-Frank did establish in Title I and Title II provisions that really address the first two points that you make, and in terms of establishing a systemic risk regulator statutorily over large and even not-so-large bank holding companies, and then establishing the authority to impose bank-like prudential standards on designated nonbank entities.

In addition—

Mr. SHERMAN. So if those powers are actually used, you think that insulates us?

Mr. BENTSEN. They are used by law for bank holding companies with more than $50 billion in assets. But if I may, Mr. Sherman, it is a very important point. The law also established the Orderly Liquidation Authority to wind down failing systemic entities. We supported that. We think that is a good thing to mitigate systemic risk.

And importantly, the Act precludes—it repealed a provision under the Federal Reserve Act that precludes the Federal Reserve, the government, from stepping in to bail out any failing institution.

And the last thing I would make very clear is that we can't ignore Basel 2.5 and Basel III, the international capital accords of which the United States is a party to and which firms both in the United States and non-U.S. firms operating in the United States have raised tremendous amounts of capital, high-quality capital, far greater than where they were before in meeting the Basel III requirements which haven't even taken effect yet.

Mr. SHERMAN. I am sure the shareholders of JPMorgan are happy that the institution was well-capitalized, and I thank you for that answer. Dodd-Frank has certainly done a lot to insulate us, but the amount of that insulation will depend in large part on how assertive the regulators are in using the enormous power that we have given them.

Mr. Vanderslice, I have heard from banks in my district that the regulators get anxious about local and regional bank exposure to any kind of commercial property. Do you have a perspective on this?

Mr. VANDERSLICE. I do. And again, I am here speaking on behalf of CREFC, not my employer. But as far as the bank exposure to commercial real estate, I think Basel III, which is another topic that has not been brought up, basically now applies to the smaller community banks as well. So the increased capital, considerations that those banks will have to have in place again kind of constrains the amount of money that would at least go into commercial real estate.

You really have two issues. You have a legacy issue on the balance sheets of a lot of banks and regional banks, small lenders. And also, you have the wave of maturities coming up. So you take those two things into account.

And, we think any type of regulation should be supportive of, kind of see that picture of loans coming due, as well as increased capital considerations, and kind of take the whole picture into account.

Mr. SHERMAN. Do you find that banks are under pressure not to simply renew loans—you know these are mostly 5-year loans when they come due when of course foreclosing on the property exposes the bank to perhaps even more risk?

Mr. VANDERSLICE. Most of what I am involved in is CMBS, which is effectively where the loans are sold into a trust, there is a third party servicer that is brought in. So those servicers, when a loan reaches its maturity, they go through a series of scenarios whether it is in the best interest of the trust that they service to extend or to foreclose or a lot of times, it is a middle ground where there is a partial discounted pay off as it is called, and then a restructured loan.

So there are a variety of different exits, as it is called. So there is no one solution that fits all.

Mr. SHERMAN. Thank you.

Mr. SCHWEIKERT. Thank you.

Mr. Fitzpatrick?

Mr. FITZPATRICK. Thank you, Mr. Chairman.

I have a question for Mr. Lemke regarding money market funds, and of course, any member of the panel is welcome to respond, as well.

It has been widely reported that the SEC is contemplating new regulations for money market funds, and there are several members who have expressed concerns about new regulations when only recently new reforms were implemented.

So I was wondering if you could comment on those reforms, and specifically how you think reforms are working out?

Mr. LEMKE. Absolutely, and the industry agrees very much that these reforms that were adopted in 2010 need to be given an opportunity to work.

During last year when we had difficulties in Europe, the reforms actually worked very well. We had no major issues with money market funds, and we believe those reforms were more than adequate to deal with the issues that came up with money market funds during the crisis.

In particular, the proposals that the SEC is reportedly talking about while we always support solid regulation in our industry, these regulation can't destroy the fundamental structure of a money market fund. And what we have been hearing from our clients, both in the institutional world and in the retail world, is they are not in favor of floating NAV funds, which is one of the options that is being proposed.

And the second option being talked about is redemption fees and capital hold backs, both of which will be unwieldy and make the product unworkable. So we are hoping the SEC comes out with proposals that maintain the integrity of the product that is so popular with many investors and also is a great source of funding for so many sources within the country.

Mr. KELLEHER. If I may add, we should remember though that during the fall of 2008, one of the biggest outlays of the U.S. taxpayers and the government to stop the financial crisis from actually leading to a collapse of the financial system and a second great depression, was the guarantee that the U.S. Government did to put the full faith and credit of the U.S. Government behind the $3.8 trillion money market fund at the time.

It was, I believe, the single largest U.S. Government guarantee of a private activity in the history of the country. So I am not disagreeing with Mr. Lemke; I am just saying that it is overwhelmingly important that we get the rules right. Because contagion and the domino effect run right through the money market funds.

It is fast money, and it moves fast. If we don't build the protections around that right, the U.S. taxpayer is going to be on the hook again.

Mr. LEMKE. But it is also important, Dennis, to note that there were no claims made under that protection, and in fact the government made $1.2 million of premiums from the industry.

Mr. KELLEHER. The government actually did not make $1.2 million on a risk-adjusted basis.

Mr. LEMKE. —the question for—

Mr. KELLEHER. There were no claims because the guarantee wasn't there.

Mr. FITZPATRICK. Reclaimining my time, Ms. Simpson, do you think that banks will impose Volcker Rule compliance costs? Will that ultimately be borne by customers? Who is going to bear the brunt and the cost of compliance of the Volcker Rule?

Ms. SIMPSON. Thank you.

The cost will ultimately be borne by shareholders. The important calculation here is about risk adjusted returns. And I think that the industry is going to be restructured by these rules, but it is going to be restructured for the safety and soundness of the market, which is why we support this.

It is no good to any of this if we can run up high returns, running very high risks. So it is quite true and we have set this out in our accompanying letter on the Volcker Rule, that we anticipate that there will be an impact on liquidity, there will be an impact on profitability, but actually these are false returns if they are not underpinned by proper risk management and Volcker is actually going to help with that.

There is no return without risk, but we need to have risks properly managed.

Mr. FITZPATRICK. Ms. Simpson, are you familiar with Senator Franken's credit rating agency reform proposal, in the Senate?

Ms. SIMPSON. Is this regarding the issue of pays model being rethought?

Mr. FITZPATRICK. It is the Rolodex—the next credit rating agency that comes up would be assigned to do credit reviews of structured products.

Ms. SIMPSON. Yes.

Mr. FITZPATRICK. Does CalPERS support the Franken Amendment?

Ms. SIMPSON. No, we do think the issue of pays model needs to be revisited because there is an inherent conflict of interest there, but we do think to have the Rolodex model isn't actually going to solve the problem.

We want the reforms that have been promised to be put on the books. We think that is going to be very helpful, but there is something more flawed in the business model that needs to be addressed. So we would like an opportunity to get around the table with the industry and the regulators and try to solve that problem.

Mr. FITZPATRICK. Okay. I yield back, Mr. Chairman, thank you.

Mr. SCHWEIKERT. Thank you, Mr. Fitzpatrick.

Ms. Moore?

Ms. MOORE. Thank you so much, Mr. Chairman.

I would like to start out with Mr. Lemke and sort of follow up on what Representative Fitzpatrick was discussing to say I am very concerned about the floating NAV and so I want to start out by asking you sir, if the SEC and the FDIC and the Fed were concerned—if they were to promulgate rules that included the floating net asset values, and of course I think that would mean this money would flow out of those particular investments.

Where do you think those funds would go? Do you think that they would go into less regulated or overseas instruments or vehicles?

And if the industry is so opposed to the floating NAV, how do we address the concerns of the SEC and the Fed—I believe that Mr.

Kelleher mentioned that we had full backing of the FDIC, and that is what stabilized the market at that time.

So, how do we address the concerns of the SEC and the Fed?

Mr. LEMKE. We continue to believe that the 2010 amendments that the SEC put in place have already addressed the concerns with money market funds. Again, we had a highly extraordinary market crisis, a temporary fix was put in place—and we should point out that money market funds were one of the first financial institutions that suffered during the crisis because they invest in such short-term paper.

They are much like a canary in a coal mine, the signal to the general market that problems were coming. We think that those issues have been addressed and—bring back the other issue with the SEC is that perhaps they are talking to different people, but what we are hearing from retail and institutional investors is they do not favor a floating NAV.

It is highly complicated, it is going to make their lives far more difficult, and as we already know, money will leave money market funds and that is going to reduce opportunities for investors to get returns, but it is also going to reduce the market for corporations and State and local governments that need funding on a short-term basis to be able to operate their activities.

Ms. MOORE. So, what is your suggestion?

Mr. LEMKE. For?

Ms. MOORE. You believe it has already been done?

Mr. LEMKE. Yes, we do.

Ms. MOORE. And we just need more time to demonstrate that?

Mr. LEMKE. Yes, and the experience so far has been very positive that these reforms have worked.

Ms. MOORE. Mr. Kelleher, I see you are dying to respond to this question as well.

Mr. KELLEHER. One can't fairly say that the reforms since 2010 have worked. We haven't had a crisis. We haven't had a run. And frankly, even today, what used to be the implicit guarantee behind the too-big-to-fail banks is now explicit.

The U.S. Government is not going to allow a too-big-to-fail bank to fail today. It is why they get a funding advantage, a credit rating boost, and why they can compete unfairly against all the other banks and all the other institutions in the country.

So, saying that the rules have worked well is to say nothing. The only time that we will know if the rules work is if we have another crisis, and believe me, we don't want one.

But we need rules that work in a crisis when there is a real run. Mr. Lemke is exactly right, and spells out the problem well. Let me quote him, "investing the money market funds in short-term paper, it is like the canary in the coal mine." He is right. It is the first money to run. And that is why we have to get that right, because that is almost like the light on the fuse, the end of which is the explosion and the collapse of the financial system.

Ms. MOORE. Thank you, Mr. Kelleher. I reclaim my time.

You mentioned earlier in your testimony that you didn't think that Dodd-Frank was perfect, although we definitely need some kind of re-regulation.

What unintended consequences if any do you see in Dodd-Frank that we need to address? What areas of our work do we need to revisit?

Mr. KELLEHER. I think the regulators would disagree with you that Better Markets thinks Dodd-Frank was perfect, because we filed 100 comment letters and had dozens of meetings about how to change Dodd-Frank and implement the rules in a way that is faithful to the law.

It is not perfect. It is not the law I would have written. So we haven't taken that position and no one would take that position. It is a product of democracy and it has pluses and minuses, but overall, it can work if people of good faith implement it.

The Volcker Rule needs to be changed in some way so that it is clear and more faithful to the statute. The statute got it right, better in some ways than the Rule, but the Volcker Rule has to focus on compensation and focus on making sure the permitted activities of market making and hedging actually do those activities and don't become a vehicle for disguised prop-trading. There are a whole variety of things in the derivatives area and in the too-big-to-fail area including putting in place the prudential standards under Section 165 at the Fed, including the Orderly Liquidation Authority and living wills.

All of which we have recommended changes that be made in the rulemaking process. Because while there has been discussion earlier about the Orderly Liquidation Authority of the FDIC, that is at the end. It is as important to get the front-end regulation from the Fed and the Treasury to make sure that the living wills are in place and that these too-big-to-fail institutions can be taken down in an orderly fashion, which they cannot be today because we don't even have international agreements yet.

So if you look at Lehman, Lehman would happen today just like it did in 2008. And if the government doesn't step in, then JPMorgan Chase, Goldman Sachs, Morgan Stanley and all the other too-big-to-fail banks would be bankrupt, as they would have been in 2008 but for the trillions of dollars the U.S. Government and U.S. taxpayers put behind them.

So I think there are a lot of things that can be improved, and we have been arguing to improve them.

Ms. MOORE. Thank you. I yield back, Mr. Chairman.

Mr. SCHWEIKERT. Thank you, Ms. Moore.

Mr. Royce?

Mr. ROYCE. Thank you.

Mr. Kelleher, just going through some of the observations you made earlier about the side effects of Dodd-Frank in terms of the impact it does have on the larger institutions crowding out their smaller competitors, I think that this is one of the reasons why some of us have a problem with a strategy that ended with now several years after the crisis we now have 5 of the largest banks holding 52 percent of all U.S. banking industry assets, right?

That is up sizably over the last couple of years, and that means exactly what you implied there, that the FDIC is right when they say that there is this huge basis point advantage, lower cost of lending, that goes to these large institutions. Why? Because, you are right, it is explicit now.

And there are those economists who said all along that the problem in the system was that we were not requiring enough capital, and when we hit a storm or when the Fed got the interest rates wrong and created a bubble because we ran negative real interest rates for 4 years running, or all of the other errors that were made, arguably, in this whole scheme, that we would hit the skids and if these institutions weren't well-capitalized enough they wouldn't survive.

The GSEs—and I know we have talked about this—were leveraged 100–1. The investment banks were allowed to leverage 30–1. It should have been 10–1.

So the question I really have for you is, to think that those regulators who so blatantly failed the last time around are going to be so prescient that they are going to be able to see this thing coming, that is not the way things work in financial calamity. That is why we require adequate capital, or should have. That is why, going forward, we should be requiring adequate capital.

Because you presume that you can do something that I am not sure human beings can really do. Right?

Mr. KELLEHER. No.

Mr. ROYCE. And I just throw that question out for you.

Mr. KELLEHER. Thank you. There is much that we agree on, but the one thing that is very important is that we learned, history teaches us after the Great Depression that there is no silver bullet for policing the financial industry. What you have to have is layers of protection.

And history also teaches us that while capital is a convenient mechanism, it almost always fails, because it is risk-adjusted capital, it is easy to be gamed based on the assets and things, but it is a key, key—

Mr. ROYCE. No, no, no, but if you do the leverage ratio, and if regulators can do one thing—and let us hope we can do that—manage to keep abreast of where that ratio is. That is where we were so far off the mark, right, 100–1 at the GSEs, 30–1 for the investment banks, and that is with knowledge, that is with the regulators knowing that was the situation.

If we are going to assume that you have special powers—

Mr. KELLEHER. No—

Mr. ROYCE. —shouldn't we at least assume that you would be able to get to the bottom of a leverage ratio and enforce it? How do we do that? Because my concern is that all the other folderol that we have enacted has allowed the larger institutions now going forward because of that lower cost of borrowing to gobble up their smaller competitors and thereby to overleverage again.

In other words, I am not sure we are out of the thicket. And I think to get back to the solution at hand, I would like to have you sort of just revisit this. I remember I was involved in the markup and I remember your engagement, too, on the Senate side. I just think we should rethink some of these premises. Do you know what I mean?

Mr. KELLEHER. Look, everything can be rethought and looked at again to make sure it works by people in good faith who believe fundamentally in financial reform, but I would say that there are too-big-to-fail banks which compete unfairly because of public subsidies and support that preexisted Dodd-Frank. And Dodd-Frank didn't create it and Dodd-Frank didn't even make it worse. The financial crisis did.

But what is most important—

Mr. ROYCE. No, but making it explicit did. I think you would concur—

Mr. KELLEHER. The U.S. Government did that, not Dodd-Frank.

But more importantly, the point is, you are right. I don't presume anybody is prescient or fully capable. We need layers of protection—capital is one part of it, but multiple other layers are absolutely essential to protect the American taxpayer, our financial system and our economy from this ever happening to them again.

Mr. ROYCE. Right. But remember one other thing: The largest institutions are now best positioned to absorb those regulatory costs, which—and my worry is with their competition, right? I am worried about the other financial institutions, the banks, the community banks.

Mr. KELLEHER. We want fair competition, too.

Mr. ROYCE. See? And so, we have now layered on all of those costs that have so disadvantaged the competition, thus in some ways compounding the problem. That is why I would like to get us to see this from a different paradigm.

Mr. KELLEHER. 90 percent of Dodd-Frank is focused on systemically significant institutions, maybe even more—

Mr. ROYCE. But not in terms of regulatory cost.

Mr. KELLEHER. Ultimately, it is really focused on systemically significant firms. So I think nobody has a bigger interest in reining in Wall Street than the other 99 percent of the banks. There are 7,500 banks in the United States. Only 20 have assets more than $20 billion—$50 billion. Those 7,500 banks have a huge interest in reining in Wall Street to eliminate that unfair competition and subsidy. I agree with that.

Mr. ROYCE. Thank you, Mr. Chairman.

Chairman GARRETT. Thank you, Mr. Royce.

Mr. Green?

Mr. GREEN. Thank you, Mr. Chairman. I thank the witnesses for appearing. And if I may, Mr. Chairman, we have a witness who is from Houston who represented us in Congress, and I want to thank him for being here and thank you for the rich history that your family has in making Texas a better State and the country a better place. That, of course, is Mr. Bentsen.

And I also thank you for your balanced approach. You have indicated that there are some things in Dodd-Frank that you have supported, but you do have some concerns with the Volcker Rule, and I share some of your concerns and look forward to working with you to see if we can come to some bipartisan solutions.

Mr. Deutsch, how are you today?

Mr. DEUTSCH. Doing great. Thank you, sir.

Mr. GREEN. How many times have you appeared before the committee? This is just a matter of curiosity.

Mr. DEUTSCH. I think we are in the range of 12 or 13 times.

Mr. GREEN. You and I know each other fairly well. Welcome back.

Mr. DEUTSCH. It is always great to answer questions from you.

Mr. GREEN. Thank you very much.

Mr. Deas, I think that you have, with your candor—and I appreciate candor—brought us to what I see as a crucial question. You have indicated that the cure is worse than the problem that we had. That was your comments as it relates to Dodd-Frank. I will give you a chance to amend. Do you agree with that statement, that the cure is worse than the problem?

Mr. DEAS. No, sir, I said that—what I meant to say—

Mr. GREEN. All right.

Mr. DEAS. —what I believe I said was that the cure as it was applied to end-users and Main Street companies is worse than the disease.

Mr. GREEN. So is it fair to say—thank you for the clarification—that you do not support the repeal of Dodd-Frank?

Mr. DEAS. We have been working within the—

Mr. GREEN. I am going to have to do something now. I hate to do this to you, but let me just ask you this, and I will extend this to everyone on the panel. Because I think that there is some confusion as to where people stand on this question of Dodd-Frank, and let us just go on the record, and let us understand that we have made prior statements and this is a time to be consistent with our prior statements.

So if you are of the opinion that we should repeal Dodd-Frank, kindly extend a hand into the air. If you are of the opinion we should repeal it. All right, I take it from the absence of hands, and I would like the record to reflect, that there is no one on the panel who desires to repeal Dodd-Frank.

And that is a good thing, because, quite candidly, I think that it can be amended, it can be tweaked.

Is there anyone who believes that any legislation of this magnitude has ever been developed that didn't have to be amended? If so, raise your hand. So we are in agreement, Dodd-Frank is very much like any major legislation, you have it and then you have to work with it to tweak it and make it better.

But I do want to go to Mr. Kelleher, and I hope I pronounced it correctly. If I did not, you will have the opportunity to correct me. But you were talking about what I am going to call the baby in the bathwater test. There are people who will say that there is a baby in the bathwater, but then they throw out everything, the baby and the bathwater.

Recognizing that there is a baby in the bathwater, and then throwing out the baby, I am not sure that your actions are comporting with what you say. And this is what you brought up, sir.

So I would like for you to continue your comments about people saying one thing and doing another as it relates to Dodd-Frank.

Mr. KELLEHER. I think the most important marker of whether or not people who claim they are for financial reform, people who claim that they want to protect the American taxpayer, the economy and the financial system, the marker is, are they voting for funding for the regulators or not?

The regulators are so grossly underfunded, they don't have the manpower, personnel or IT capability, just technology, to keep up with the industry.

So if people believe in financial reform, we need to put the cops back on the Wall Street beat, we need to make it a fair fight so that they have the ability to pass intelligent, robust, capable, proper rules that implement financial reform and regulate Wall Street in a smart way.

That is what has to be done. Right now, they are just being pummeled. They are being criticized. They are being abused nonstop.

And so anybody who says they are for financial reform but does not loudly, publicly, and often demand increased funding for the regulators, the CFTC and the SEC, then don't believe them when they say they are for financial reform. You cannot be for financial reform and not be for funding the regulators and putting the cops back on the beat. That is all there is to it. It is an either-or. Either you are going to protect Wall Street's profits or you are going to protect taxpayer pockets. That is the choice.

Mr. GREEN. Thank you.

And, Mr. Chairman, I yield back.

Mr. SCHWEIKERT. Thank you, Mr. Green. Mr. Stivers?

Mr. STIVERS. Thank you, Mr. Chairman. Welcome to the committee everybody. And I am going to focus on probably the Volcker Rule. Maybe a little bit about money markets. A couple of my colleagues have talked about that. And then if I have time, I will ask some questions about risk retention. But I would like to start with the Volcker Rule and I would like to start with Mr. Bentsen. Can you tell me, you talked about the Wyman Study earlier and how it will affect capital markets. Can you talk about how the Volcker Rule might impact U.S. jobs and job creation?

Mr. BENTSEN. The Wyman Study found that in the case of corporate bond issuance—as I mentioned, the cost associated with that would have a net negative effect on corporate earnings. And so one could extrapolate from that obviously if you have a net negative effect on corporate earnings, that is going to impact capital investment or investment in plant and equipment and ultimately jobs by corporations. I think that the bigger question, or the bigger issue with Volcker is that it doesn't have to be that way. Now very clearly SIFMA was not supportive of Volcker when it was being considered. We were very upfront about that.

It is the law of the land. But we believe the regulators have misinterpreted what Congress wrote in the statute and have actually come up with a proposed rule that is contrary to the statute, will impede traditional market-making activity and raise the cost of capital for—as virtually every commentator or certainly 90 percent of the commentators from buy side to sell side, to issuers, to foreign central banks, will raise the cost of capital which will have a negative economic impact.

Mr. STIVERS. And obviously, there will be some cost associated with that which could affect American jobs. Do you think anything in the Volcker Rule could encourage American companies to relocate jobs overseas? Or incentivize investors or firms to move operations to foreign jurisdictions?

Mr. BENTSEN. I think the best way I could answer that, Congressman, would be that if it has, as we believe—if the Rule proceeded as proposed, we believe it would have a very negative impact on U.S. financial markets. U.S. financial markets have been losing share of business in equities and the corporate bond market over time. Some of that is just a natural progression as other markets grow and develop. But I don't think we want to hasten that decline that would have an impact on U.S. corporations, small businesses and the like to access our capital markets.

Mr. STIVERS. Thanks. And other than this transaction-based approach, you actually suggested in your testimony that there is a better approach as opposed to looking at every individual transaction, maybe looking at the entire picture of what a firm is going as opposed to getting them concerned about every transaction. Do you want to talk any more about that?

Mr. BENTSEN. Absolutely. We think that there are a number of things that the regulators—and we suggested a number of things that the regulators could do and again we are not alone in this. The buy side has weighed in on this in addition to the sell side. We think first of all you need to reverse the negative presumption. Second of all, you need to move away from hard coated metrics and instead have supervisors work with the firms that they examine and allowing those firms to develop their own set of metrics and come up with their own compliance programs, similar to what is done in the anti money laundering program.

And most of all, that the Rule recognized what Congress recognized in saying that customer focused business fits within the market making exemption and allows that to move forward. And so we think that nothing we have proposed takes away the authority of the examiner or the regulators to step in and tell a firm, we don't like what you are doing. But it does it in a way that we think doesn't impede the ability of firms to meet their market making commitment, provide liquidity to the markets as Congress explicitly provided for in the statute.

Mr. STIVERS. Thank you. And Mr. Deas, can you talk about the impact of the Volcker Rule on Main Street? Your testimony talked about what it would do and what it would cost companies on Main Street in additional cost of credit. But what does that mean to jobs? And what does that mean to American competitiveness?

Mr. DEAS. The example I used, that on our most recent bond issue of $300 million, we estimate the cost over the life of the issue would be an additional $15 million of financing costs. And that is $15 million that my company wouldn't have to invest in expanding plant and ultimately growing jobs. That effect would be replicated across the entire productive economy.

Mr. STIVERS. And to Mr. Green's point, do you think that the— to Mr. Bentsen's point, do you believe the Volcker Rule could be fixed as well?

Mr. DEAS. I believe that inherently the Volcker Rule requires intent be proven or disproved. And in other words, from the eyes of one regulator, and there are five regulators who are charged with implementing this, a transaction may be proprietary trading, whereas from the financial market participant it might be market making, which they thought was exempt. And if that cannot be cleared up, then they will stay away from it at a higher cost to American business.

Chairman GARRETT. Thank you, Mr. Stivers.

Mr. STIVERS. I yield back the balance of my nonexistent time.

[laughter].

Mr. SCHWEIKERT. Mr. Manzullo?

Mr. MANZULLO. Thank you. The problem I still have with Dodd-Frank is at the time of the collapse, there were Federal regulations and laws in effect that if had been properly implemented, could have avoided the entire crash. Let me just give you an example. The Fed has had the authority since 1994 to govern bank holding companies, documentation and underwriting standards for mortgages that they issue. If the Fed had been properly doing its job, it would not have allowed the 1As and the subprimes and the so-called cheater loans to take place.

It wasn't until October 1, 2009, that the Fed required written proof of a mortgage applicant's earnings. Come on. That was so basic. And Ken, you were here in 2000 when we had the first GSE reform bill. It didn't go anywhere. In 2005, we had the second one, along with the Royce Amendment which would have really tightened up the underwriting standards. Of course everybody was fighting. Oh you can't stop the building boom, et cetera, et cetera. But we can talk all we want about the Volcker Rule, about this and about that and we need to get back to, at least in my opinion the reason for the collapse of the economy was in the residential home market.

But no one seems to talk about the fact that we are looking at new rules and new regulations and yet there were laws in effect at the time that could have stopped this. Now granted, 75 percent of the mortgages were private label. In fact during the height of all of this, 25 percent were GSEs. Does anybody agree with me on this statement? Want to comment on it? Which I find interesting. Because people very seldom want to talk about what really caused the economic collapse. And I have gone through the testimony here.

Unfortunately, I didn't have the opportunity to sit in on all the testimony going on. But maybe it is because I have been on this committee since 1994, that I have had the opportunity to sort of take a historical view as what could have happened. It was hell around here. When people like myself and Ed Royce were taking a look at something come down in the future, we couldn't put our finger on it, but we could smell that something was going wrong and something dramatically would happen when people who could not even make the first monthly payment on their homes were allowed to purchase homes.

The Federal Government had the authority to intervene and stop that practice. Why didn't the Federal Government intervene at that time? Anybody who is in favor of Dodd-Frank and more legislation should be able to answer that question. Or at least comment on it. Do I have no takers on it?

Mr. KELLEHER. It depends on what you are saying. I think it is certainly the case, sir that there were plenty of rules on the books that were not enforced, or were poorly enforced. But I think you will agree, because you were here, that in 1999 Gramm-Leach-Bliley took many laws off the books. In 2000, the Commodity Futures Modernization Act prohibited regulation of the derivatives markets. In 2001, there was a famous picture that reflected the attitude at the time where the two top banking regulators and the two top banking lobbyists had a chainsaw cutting through regulations saying they weren't going to be enforced.

And in 2004, I think it was the OCC that sued to stop States from enforcing predatory lending, the point that you just made. So one of the problem is—and I may be wrong, it may not have been the OCC, maybe one of the other Federal regulators, I don't remember. But there were States like North Carolina and others who saw what was happening on the street level as you often do when you go home to your districts. You are actually close to the street and you know what is happening, particularly in the neighborhoods, residential markets. And what they saw was unleashed predatory behavior in the mortgage markets. Exactly what you just said.

No money down, and get 110 percent of your loan. So the State attorneys general started to enforce their predatory lending laws. A Federal regulator went to court to preempt them from doing that saying that it was Federal power and then they didn't do it. So you are absolutely right that there were some laws in place that could have stopped this, including, importantly, State laws that the Fed stopped from being enforced. But it is also the case that many laws were repealed, overtaken, and changed both statutorily from here—

Mr. MANZULLO. I understand, but the reason I brought that up—I am not being critical of anybody here on the panel because everybody has made some really good statements—is the fact that maybe I am wrong and maybe I look at it through a different lens, but there had to be a trigger cause.

There had to be a trigger. And to me, it was the residential market. And even with the repeal, in Gramm-Leach-Bliley, of different regulations, et cetera, there never was a repeal of the authority that the Fed had all along in order to regulate the documents and the underwriting standards.

And I make that statement based upon the fact that you could have the best drafted bill in the world that Congressman Bentsen would agree that doesn't—the Volcker Rule, for example, doesn't go transaction by transaction, but it is just a broad generic view. And still, if the people in charge of the agencies are not with it and are not monitoring Wall Street, it still won't do any good.

Mr. SCHWEIKERT. Mr. Manzullo, I can't imagine you ever being wrong.

[laughter].

And now to one of those moments that I am going to yield myself 5 minutes here. And almost every potential question has, sort of, been randomly thrown out, but there is something that I have, sort of, a fixation on that I would love to solicit the panel. I am going to start with you, Mr. Deutsch.

Presently, if you look at our mortgage markets, our residential mortgage markets, it is a government market now. I see numbers 97, 96, 98 percent of all home loans now are Fannie, Freddie, Ginnie, FHA. And we have worked very hard both in my office and on this committee in the discussions on the mechanics, what do we have to do to start to rebuild a private-label market again, something that will be stable, good visibility—the appropriate visibility so we never have the problems in the future?

And we meet with different players up and down the food chain, from the folks in the TBA side all the way down to the securitization, to the servicing. And we get this pushback constantly, saying, "Well, there is this one piece of Dodd-Frank we are worried about." And often that worry is it is a rule that hasn't actually been promulgated yet, but we are worried about it.

Mr. Deutsch, you and I have had this conversation at least a couple dozen times as we have been, sort of, systematically trying to figure out how you rebuild a private securitization market.

What do you see in Dodd-Frank right now that are the biggest barriers to move from functionally a socialized mortgage market we have today to something that would have some competition in it?

Mr. DEUTSCH. First, I would start with what is not in Dodd-Frank, which is there is no reform of Fannie and Freddie. That is a big outstanding question, and if you are a market participant, you want to know what that is. And right now, they are issuing $1.2 trillion of mortgage-backed securities a year. That is a huge part of the market that you just don't know where it is going to go; how is that reform going to fall?

Second, the Premium Capture Cash Reserve Account. I think if we could beat that horse any harder, we would. Unfortunately, we can't beat it any harder. It is a regulatory abomination, in terms of being able to create CMBS and RMBS in the future.

Third, the Qualified Mortgage definition: If it comes out that is very vague, as to what is or is not a Qualified Mortgage, any originator and then ultimately any investor who would buy into a mortgage-backed security is going to say, if there is anything even close, I don't want that loan, which means credit is going to get cut off more and more to the borrowers who most need it.

So those are a couple of the quick areas. I think within Dodd-Frank there are substantial questions outstanding for the RMBS market. And until many of those are answered, if you are running a business, if you are running a firm, why would you want to put money to create a platform when, a year from now or 2 years from now or 3 years from now, the regulators may say, sorry, that is not going to be a platform that can work?

Mr. SCHWEIKERT. Mr. Vanderslice, almost the same question, maybe more on the CMBS: What is out there in Dodd-Frank that is scaring the expansion, the growth and the reforms within the private-label markets?

Mr. VANDERSLICE. I think it was said best before; I think the term was "regulatory abomination," with respect to PCCRA. There are plenty of things in Dodd-Frank that work for the commercial real estate market. I think we have been very clear about that at CREFC—risk retention, better disclosure, increased transparency.

And, there are a lot of things that are very positive. PCCRA is the stumbling block that we are wrestling with right now.

Mr. SCHWEIKERT. Okay. And, sort of, the open-ended side of the question is if you are like I am where you believe, whether it be perception or rules that are to come that we are creating more and more of a concentration of trillion-plus dollars a year of a government-insured mortgage market, in many ways we are creating massive risk at that level.

Congressman, from what you pick up out there, what would you be doing right now to start reviving the private-label market? And what Dodd-Frank obstacles do I have within that?

Mr. BENTSEN. I think Mr. Deutsch hit a lot of the important points. I think there is a lot of uncertainty because we don't know what the final rules are going to be with respect to QM and QRM, what the final risk retention will look like, whether or not there will be a premium recapture.

So in order to make an investment and—on a business model, you don't know what the rules of the road are going to be.

And then on top of that, we have now Basel 2.5 and Basel III coming in, so if you are subject to those rules, then, in addition, you are going to have to—you are still trying to figure out what your capital requirements are going to be, in addition to risk retention.

So I think all of that uncertainty, not to mention, as well, as Mr. Deutsch mentioned, what exactly is going to happen with respect to the GSEs going forward, is that has to be resolved.

Mr. SCHWEIKERT. And we have had the conversation with probably half of this panel that also fear that running parallel what happens to the GSEs, what is within Dodd-Frank that is an impairment in creating a private-label market.

And I am already over my time. I recognize my friend from New Mexico, Mr. Pearce, for 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman.

Since I was feeling the, as you are talking through your statement and as I am reading it, the desire for predictability, and I understand that the points have been well-made, though, that I am not sure that the path forward is to more regulations. MF Global had the CFTC and the SEC both sitting in the room there, right at the time they are making the decision to use the customer's segregate funds in an illegal way and nobody said a word, and now they can't find, whatever, or they couldn't find the money for a couple of months afterwards.

JPMorgan had 57 regulators sitting in the rooms with them as they were going through their—and so with I understand the desire for predictability, but as you talked about the sustainable economic growth, I don't know any country or any company even in the world that has that. Those sustainable economic growth models of the really regulated utilities of the past led to markets that—well, you see what happened in the telecommunications market when it deregulated.

I grew up with the old black phone, it was just one, and then you didn't even have an extension cord. And that product market just exploded once the regulations were pulled away, and that is what regulations do—they give certainty, but they also take away the innovations and the future. And so, I don't know.

What actuarial assumptions does your plan have to keep it, sort of, in balance?

Ms. SIMPSON. Thank you. It is a very good point about regulation. This is not a question of quantity; it is about quality. In our remarks, we really put an emphasis that regulation is one piece and it must be smart regulation. It must ensure that the market players play their role. And among the market players are of course share-earners like CalPERS. We want the information and we also want the rights so that we can act as responsible earners.

Mr. PEARCE. Sure, I understand that.

Ms. SIMPSON. That is important. The—

Mr. PEARCE. What actuarial assumptions—

Ms. SIMPSON. The actuarial assumption that we have the discount rate is 7.5 percent.

Mr. PEARCE. 7.5 percent.

Ms. SIMPSON. That is—

Mr. PEARCE. What if you fall 0.25 percent short? How much does that affect your payout?

Let us say you get 7.5 percent. Do you have that figure?

Ms. SIMPSON. I am sorry, I don't, and we would be glad to come back to you, but the impact—

Mr. PEARCE. I am guessing that it is going to penalize your funds something in the neighborhood of $15 billion per 0.25 percent. And that is what we are all facing is that we are in a highly competitive world.

What kind of a payout do your beneficiaries receive?

In other words, they get blank percent of their active-duty pay? What—

Ms. SIMPSON. That is correct. The average pension paid to our members is $2,000 a month.

Mr. PEARCE. No, what percent?

Ms. SIMPSON. It is 0.5 percent per year, per year of service. But the formula varies among the 1,000 employers that we invest for. CalPERS is a complex structure, but we would be glad to come back to you with the details.

I worked in the investment office, not the actuarial or the benefits office, so I apologize.

Mr. PEARCE. Going back to your testimony, on page five, you really, kind of, log in on the CDS things, and you talk about the collateralized debt obligations and those market failures. And you, sort of, lead to the concept that more regualtions would be better.

And I would tell you that there are a couple of guys sitting in a garage apartment in Berkeley, written up in the big short here. They had $110,000 and they figured out that these things can't be real, and they bet against it, and with $110,000, they made $80 million because they were betting against the CDOs and CDSs and whatever.

Your retirement fund had $232 billion. This is what your risk managers are supposed to do. And for you to come to us and you want us to give more regulations, then I am thinking about the 57 regulators sitting in there watching while JPMorgan does what they do, and now they are saying, well, if we just had more, it would be okay.

And I am sorry. I just don't think that predictability is going to be out there.

Do your beneficiaries vote on the pay levels of high executives?

Ms. SIMPSON. At CalPERS?

Mr. PEARCE. Yes.

Ms. SIMPSON. Our staff? No, the—

Mr. PEARCE. See, you are asking on page 10 for you to be able to vote on corporate compensation, but you don't offer it inside.

That is very problematic. If it weren't such a big problem, you would be doing it yourself anyway, but there is just—I understand, I really—we all wish there was more predictability and more certainty, but life is going to be very uncertain, you can see the world-wide chaos that is developing in the financial markets. Thank you Mr. Chairman, I appreciate your indulgence.

Mr. SCHWEIKERT. Thank you, Mr. Pearce, and we only have about 3 minutes.

Ms. SIMPSON. Our request is the transparency for information that enables us to price risk. Risk is where return has been in the balance in a proper way. Our salaries are extremely modest. They are set by State government and they are all on our Web site. So I do invite you to—

Mr. SCHWEIKERT. All right. Thank you, Ms. Simpson, but we only have about 3 minutes left on the Floor vote so let me, without objection, ask for unanimous consent to put 2 items into the record: a statement from the Mortgage Bankers Association; and a statement from the Bond Dealers of America

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the record will remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

Thank you for your participation today. This hearing is adjourned.

[Whereupon, at 12:50 p.m., the hearing was adjourned.]

A P P E N D I X

July 10, 2012

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Testimony of Kenneth E. Bentsen, Jr.
Executive Vice President for Public Policy and Advocacy
Securities Industry and Financial Markets Association

Before the Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services, U.S. House of Representatives

July 10, 2012

Chairman Garrett, Ranking Member Waters, members of the Subcommittee, my name is Ken Bentsen and I am the executive vice president for public policy and advocacy at the Securities Industry and Financial Markets Association (Sifma)[1]. Thank you for the opportunity to share our views regarding the Dodd-Frank Act today.

The Dodd-Frank Act is the most expansive financial regulatory law in more than seventy years. In addition to amending the multitude of prior statutes, the Act contains a tremendous amount of new law, resulting in at least 150 rulemakings affecting every aspect of financial services. There is much in the Act that SIFMA's members supported such as the establishment of a systemic risk regulator, the Financial Stability Oversight Counsel (FSOC), the new Orderly Liquidation Authority designed to resolve failing systemically identified firms, and the authorization of a uniform standard of care for brokers and advisors providing personalized investment advice. We believe that properly crafted through the rule making process, these provisions as well as others can appropriately increase supervision to mitigate systemic risk, improve coordination among regulators, eliminate too big to fail, and improve protections and confidence for individual investors. However, other provisions, if not properly crafted both domestically and in coordination with regulators around the world, could have far reaching negative consequences to the detriment of the businesses, governments, non-profits, and individual and institutional investors who rely upon deep and liquid U.S. capital markets.

In response to the Committee's request I will limit my written remarks to implementation of the Volcker Rule, Credit Risk Retention, Title VII, and Section 165(e) Single Counterparty Credit Limits.

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org

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1. The Volcker Rule

We believe that Congress' goal in adopting the statutory Volcker Rule was to focus banking entities on providing liquidity to customers and to prohibit excessive risk taking beyond that required for customer activity. The rule (the "Proposal"), as proposed by the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) (the "Agencies") however, defines Congressionally permitted activities far too narrowly and subjects banking entities to a conceptually difficult and operationally expensive set of requirements, the costs of which cannot be justified based on their benefits. Specifically, these requirements may paralyze effective market making, which is far from the statute's intent. In addition, as an unintended and deleterious side effect, the Proposal will severely limit banking entities' abilities to hedge their own risk, thereby increasing rather than decreasing the risk to banking entities and the financial system.

Our Key Conceptual Concerns with the Proposal's Approach:

Artificial Distinction Between Permitted Activities and Proprietary Trading. The Proposal attempts to draw a bright dividing line between the permitted activities and prohibited short-term proprietary trading. We believe that drawing such a line is not only unnecessary and impractical, but also is inconsistent with the structure of the statutory Volcker Rule. Congress allowed the permitted activities ***regardless*** of the fact that they are short-term proprietary trading. Therefore, the Agencies' attempt to define the permitted activities as distinct from proprietary activities is inconsistent with congressional intent and doomed to failure. It results in an overly narrow interpretation of the permitted activities that constrains the beneficial effects those activities have for corporate issuers and investors that rely on the capital markets.

Negative Presumptions and Reliance on Hard-Coded Criteria. The Agencies' focus on prohibited behavior, at the cost of overly restricting permitted activities, is expressed in the negative presumptions that permeate the Proposal. Throughout the Proposal, the Agencies assume that activities are prohibited unless proven otherwise. We believe that this negative presumption is inconsistent with explicit congressional intent to allow useful principal activity. We believe it is also inconsistent with the historical approach that the Agencies have taken in supervising banking entities, which would have formed Congress' expectation of how the Volcker Rule would be implemented. We believe that the numerous letters to the Agencies from members of Congress and from the Financial Services Committee hearing on the Proposal both indicate Congress' surprise and concern at the path the Agencies have taken.

The negative presumption manifests itself most clearly in the Agencies' reliance on hard-coded criteria to define the permitted activities, under which the failure to meet any single criterion

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disqualifies the trading unit from engaging in the permitted activity. Such an approach shoehorns all permitted activity into one or a few archetypes, rather than reflecting the numerous ways market participants engage in beneficial activities that Congress meant to protect. Even more unfortunately, the archetype chosen by the regulators does not represent the majority of the markets, but rather is reflective of a small portion of transactions in one type of liquid market.

For example, the heavy reliance on bid-ask spreads, and the presumption that revenues that deviate from bid-ask spreads are indicative of prohibited proprietary trading, are at odds with the fact that few markets have a readily determinable bid-ask spread that is quantifiable or that could sustain a market-making business. As a result, in order to rebalance the proprietary trading proscription with the permitted activities, we believe that the hard-coded criteria should be removed from the rule and, subject to our specific recommendations and, to the extent relevant, incorporated into the final Volcker Rule regulations as guidance.

In addition, revenue sources differ significantly by asset class. In markets where trades are large and less frequent, such as the market for customized securitized products, appreciation of the price of a covered financial position may be a major (or the predominant) contributor to revenues, since one position moving up or down significantly may have a marked impact on the profit and loss of the trading unit. Requiring that the activity generate revenues primarily from fees, commission, bid-ask spread, etc. places a limit on the extent to which the sources of income can differ by asset class.

Transaction-by-Transaction Approach. We believe that the Proposal's transaction-by-transaction approach to principal trading is symptomatic of the focus on proscribing proprietary trading and is inconsistent with the intent of a statute that broadly speaks of permitted "activities." We believe that an analysis that seeks to characterize specific transactions as either market making, hedging, underwriting or another type of permitted or prohibited activity does not accord with the way in which modern trading units operate, which generally view individual positions as a bundle of characteristics that contribute to their complete portfolio. We believe that analyzing permitted activities on a transaction-by-transaction basis will not only be unsuccessful but will also, in the process, harm legitimate activity in financial markets.

Overly Specific and Prescriptive Compliance Regime. Finally, we believe that the Proposal's compliance regime is overly specific, prescriptive and impractical. We believe this arises from trying to develop a scheme that identifies each and every possible instance of prohibited proprietary trading in an otherwise permitted activity. We believe the effect, instead, will be to make some activities so impractical for banking entities that they can no longer be cost-justified. For example, the strict dichotomy in the Proposal between customer trades and non-customer trades would seem to require banking entities to tag each and every trade as to whether the counterparty qualifies as a customer at that particular time for that particular trade. We believe

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that, instead, the Agencies should institute a principles-based framework that provides banking entities the discretion and flexibility to customize compliance programs tailored to the actual structure and activities of their organizations. The Agencies should permit banking entities to leverage existing compliance regimes, including the use of existing board-level governance protocols.

Potential Costs of the Proposal. The potential costs to the financial markets, investors and corporate issuers from incorrectly implementing the Volcker Rule, in a manner consistent with the Proposal, are enormous. For example, in a study commissioned by SIFMA, the Oliver Wyman financial consulting firm estimated the impact on issuers and investors of a loss of liquidity possibly resulting from the Proposal.

Oliver Wyman found that liquidity losses could cost investors between $90 billion and $315 billion in mark-to-market losses on the value of their existing holdings; cost corporate issuers between $12 billion and $43 billion per year in borrowing costs; and cost investors between $1 billion and $4 billion per year in transaction costs as the level and depth of liquidity decreases.[2] Further, Stanford University professor Darrell Duffie noted in a paper commissioned by SIFMA that the "direct and indirect effects" of the Proposal "would increase trading costs for investors, reduce the resiliency of markets, reduce the quality of information revealed through security prices, and increase the interest expense and capital raising costs of corporations, individuals, and others," explaining that "[t]hese outcomes would lead to somewhat lower expected economic growth" that would have "potential adverse consequences for systemic risk"[3]

Many commenters, including customers, buy-side market participants, industrial and manufacturing businesses, treasurers of public companies and foreign regulators, central banks and sovereign issuers—constituencies with different goals and interests—have agreed that the Proposal would significantly harm financial markets. They point to the negative impacts of decreased liquidity, higher costs for issuers, reduced returns on investments, and increased risk to corporations wishing to hedge their commercial activities. Commenters from each of these groups have made the case that other market participants are unlikely to be able to fill the critical role played by the customer-oriented principal activities of banking entities.

We agree with AllianceBernstein that "the inability to confidently engage in market making activities on a principal basis under the Proposal, along with the onerous recordkeeping and compliance burdens required will have a material and detrimental impact on the ability of covered banking entities to engage in market making activity [and] will dramatically reduce

[2] Oliver Wyman, *The Volcker Rule Restrictions on Proprietary Trading: Implications for Market Liquidity* (Feb. 2012) ("Oliver Wyman 2012 Study").
[3] Darrell Duffie, Stanford University, *Market Making Under the Proposed Volcker Rule* (Jan. 16, 2012) ("Duffie Analysis")

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market liquidity, increase costs and in some cases impact the ability of market participants to meet their legally required obligations to investors and other stakeholders."[4]

We do not think these consequences were the Agencies' intention. We believe that the Agencies, like Congress, wish to allow banking entities to provide corporations and investors liquidity in financial instruments by intermediating between market participants over time and in size—the essential function of market makers.

Our Suggestion for Reorienting the Proposal

We believe that the Proposal can be reoriented to avoid much of this negative impact and bring it closer to congressional intent regarding the statutory Volcker Rule. Rather than seeking to scrutinize every transaction in search of possible prohibited proprietary trading, the Proposal should protect the ability of banking entities to engage in the critical financial intermediation explicitly permitted by Congress. We agree that Congress intended, and the Agencies should require, banking entities to eliminate pure proprietary trading businesses. However, banking entities should be allowed to engage in customer-focused principal trading under the statutorily permitted activities.

To foster customer-oriented business, the Agencies' hard-coded criteria should be recast as guidance that helps banking entities to differentiate client-focused business from other business. We believe a business should be viewed as customer-focused, and therefore engaged in market making, if it is oriented to meeting customer demand throughout market cycles. The Agencies' guidance should explicitly recognize that maintaining a customer focus not only requires a commitment to buy from and sell to customers, but also requires obtaining positions in anticipation of customer flow and trading in the interdealer market in order to validate liquidity, volatility, pricing, and other market trends.

This guidance would be incorporated in policies and procedures by the banking entities with risk limits and controls monitored by the Agencies through examinations. Certain quantitative metrics, measured at a level within the organization that permits activities to be viewed as a whole, may help highlight certain activities that could be discussed with examiners and in the context of horizontal reviews. As suggested in the Proposal, however, metrics should not be used as a bright-line trigger for remedial action. Some metrics may be more relevant than others, depending upon the particular asset class, activity, particular market, and unique characteristics of each banking entity. Over time, based on discussions with examiners, the banking entities and

[4] Letter from AllianceBernstein L.P. to the Agencies (Nov. 16, 2011). *See also* Duffie Analysis at 3 (noting that "the Agencies' proposed implementation of the Volcker Rule would reduce the quality and capacity of market making services that banks provide to U.S. investors" and that "investors and issuers of securities would find it more costly to borrow, raise capital, invest, hedge risks, and obtain liquidity for their existing positions"); Oliver Wyman 2012 Study at 2 (concluding that the Proposal "could significantly impair liquidity provided by market makers").

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examiners would determine the usefulness and relevance of individual metrics. We believe this reorientation would ensure that covered banking entities avoid prohibited speculative activity while preserving deep and liquid financial markets.

2. Credit Risk Retention – Premium Capture Provisions

In the securitization markets, SIFMA has long held a view that any one proposal should not be viewed on its own. Mortgage lending, for example, is a sequence of many connected and interdependent events – from appraisals and loan origination, to secondary market funding, to servicing, securitization, and trading. Many parties are involved, from consumers to lenders, lawyers to rating agencies, appraisers and accountants, and in many ways most importantly, mortgage investors. It all must work together, and it all exists in a world where multiple regulations impact various aspects of each step. Retention is but one issue; one must also consider how retention interacts with accounting standards (consolidation standards), capital rules (e.g., Basel 2.5 and Basel III) and lending laws (e.g., the definition of the "Qualified Mortgage," which is intimately connected to the Qualified Residential Mortgage (QRM)), among others. Our testimony will focus on retention, and in particular, one aspect of the Agencies' Proposing Release.

On April 29, 2011, the Department of the Treasury, OCC, Federal Reserve, FDIC, SEC, Federal Housing Finance Agency (FHFA), and the Department of Housing and Urban Development (HUD) jointly proposed rules ("the "Proposing Release") to implement the requirements of section 941(b) of the Dodd-Frank Act regarding credit risk retention.[5] SIFMA has been on the record in support of the general principles that underlie risk retention since before the rule became the law. The proposed rules would implement a risk retention regime, define the contours of a so-called Qualified Residential Mortgage, and implement other qualified asset tests. My comments here will focus on one aspect of the proposal that we believe must be amended due to its destructive nature – the so-called Premium Capture Cash Reserve Account provisions (PCCRA).

This premium capture requirement likely will deter sponsors from structuring securitizations with premium or interest-only tranches, or other structures that monetize excess spread up-front. Both our buy- and sell-side members are strongly concerned that the requirement for a premium capture cash reserve account as presently configured presents a serious obstacle to structuring securitizations, including residential mortgage securitizations, by taking away a legitimate source

[5] SIFMA has submitted four comment letters on the Proposing Release. See: April 21, 2011 letter on Par Value (http://www.sifma.org/issues/item.aspx?id=24954), June 10, 2011 letter on behalf of sponsor and issuer members (http://www.sifma.org/issues/item.aspx?id=25925), June 10, 2011 letter on behalf of investor members (http://www.sifma.org/issues/item.aspx?id=25926), and a January 20, 2012 letter on PCCRA (http://www.sifma.org/issues/item.aspx?id=8589937126).

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of funds to enable sponsors to recoup costs and generate a reasonable return. We believe that the reserve account as proposed will undermine any hopes of reviving the private market for those securities.

Moreover, this premium capture cash reserve account is not required by the Act. This concern was expressed in an August 1, 2011 letter from House Financial Services Chairman Spencer Bachus and Representative Scott Garrett to the heads of the federal regulatory agencies implementing the PCCRA that stated: "Specifically, the proposal contains a requirement never discussed during the deliberations on what became the Dodd-Frank Act that securitizers set aside the premium from sales of securities in so-called premium capture cash reserve accounts (PCCRAs)....Cutting off or greatly reducing this vital source of capital through the operation of a provision that Congress never considered (or even contemplated) is bad policy and an inappropriate exercise of regulatory authority."

Operation of the PCCRA Provision

The PCCRA provisions are likely to significantly impair the ability of private capital to assist in reducing the role of the government sponsored enterprises (GSEs) in mortgage finance. The effect of these provisions could negatively impact the economics of many securitizations to the extent that they would not be possible. As it is structured, PCCRA would eliminate or materially eliminate all profitability from a transaction. It would also drive the amount of risk retained by the sponsor to levels well beyond those envisioned by the law. This is bad for lenders and issuers, as it removes securitization as a funding option. This is bad for investors, who need new mortgage products to invest in. And most importantly, it is bad for consumers, as the PCCRA provisions stand to reduce the ability of private funds to finance mortgage lending and will likely reduce the features that customers are able to obtain with their mortgages, such as rolling closing costs into the loan amount.

Here is how PCCRA is defined: The proposed rules provide that *in addition to the amount of credit risk that a sponsor is already required to retain under the other provisions of the proposed rules (e.g., 5 percent)*, a sponsor must establish and fund a premium capture cash reserve account in an amount equal to any amount by which (1) the gross proceeds, net of closing costs paid by the sponsor(s) or issuing entity to unaffiliated parties, received from the sale of asset-backed securities (ABS) interests in the issuing entity to persons other than the retaining sponsor exceed; (2) 95 percent of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction or 100 percent of the par value of all ABS interests in the issuing entity issued as part of the securitization transaction (depending on the specific form of retention chosen).

In a simplified example[6]: A pool of loans has a par value of $100 and the proceeds from the securitization of those loans is $104. Under premium capture, the $4 above the par value of the loans is held back. This is *in addition to* the $5 of required risk retention, meaning that the overall level of risk retained is 8.7 percent (9/104) rather than the prescribed 5 percent (5/100). If the profit motive is taken off the table, what is the incentive to issue securitizations?

This requirement is so onerous that, as stated in the Proposing Release, "few, if any, securitizations would be structured to monetize excess spread at closing and, thus, require the establishment of a premium capture cash reserve account."[7] We agree. Left unstated in the Proposing Release, however, is what a securitization sponsor that holds premium assets is to do, other than to "structure their securitization transactions in a manner that does not monetize excess spread at closing"[8] – or find an alternative to securitization.

Based upon communications with certain of the Agencies and our review of the Proposing Release, we believe that the Agencies intend that in a securitization of a premium pool, the sponsor would artificially increase the par value of the residual interest by the amount of the premium - thus avoiding the funding of a cash reserve account equal to the amount of the premium, but forcing the sponsor to retain (or try to find a buyer for) a residual interest having a par value representing the premium. It is also possible that in some cases the sponsor could increase the value of other ABS interests in addition to the residual, although it is not clear how this would work in practice. We fail to see why the credit risk retention rules should force a sponsor to artificially adjust the values of securitization interest, or compel sponsors to structure transactions in certain ways. The law requires the retention of 5 percent of the risk of a transaction, and that is what the implementation rules should use as a target. Regulations should not add completely new and unconsidered structures to the law when all market participants have expressed concern over the viability of the market under such a structure. Once again, the sponsor would be economically disadvantaged for purposes that appear to be outside the scope of congressional intent.

The economic result of this approach would be so severe that, if it were implemented through the risk retention rules, many sponsors would avoid securitization. The premium capture provisions appear to be based on a view that all excess spread belongs in the residual interest, and that to allocate any excess interest cash flows in another way inappropriately devalues the residual interest. We believe that this is a misconception.

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[6] Please note that the exact meaning of the term "par value", as used in the Proposing Release is unclear. This complicates the analysis of PCCRA and many other provisions of the rulemaking. See SIFMA June 10, 2011 letter on behalf of sponsor and issuer members at 15, and SIFMA April 21, 2011 letter on this specific issue of the definition of par value.
[7] Proposing Release, 76 Fed. Reg. 24090 at 24113.
[8] *Id.*

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Accounting and Capital Implications of PCCRA will Further Weaken the Ability of Private Capital to Fund Mortgage Lending

We also note, as mentioned in the first paragraph of this section, that the PCCRA provisions will interact with other regulations and rules – most importantly accounting rules. We believe that the requirement for a fully subordinated premium capture cash reserve account in addition to the amount of credit risk required to be retained under the proposed rules could prevent sponsors from achieving sale treatment for assets transferred to securitization vehicles in transactions that otherwise would qualify for sale treatment under U.S. accounting rules. This would drive increases in capital requirements and would further weaken the incentive to securitize as well as further weaken the ability of securitization to fund mortgage credit origination.

A securitizer's determination of the financial accounting and reporting to accord a securitization transaction can be a complex exercise, requiring an analysis of the application of both consolidation and sales accounting standards, in that order. A securitizer must determine whether it is required to consolidate the special purpose (securitization) entity to which the assets were transferred, by applying the relevant guidance in the FASB's Accounting Standards Codification ("ASC") Topic 810, *Consolidation*. If the securitizer must consolidate the securitization entity, the transferred assets will continue to be reported in the securitizer's financial statements and continue to attract capital requirements for that institution.

In those cases in which a sponsor retains 5 percent of the ABS interests and is obligated to fund a subordinated cash reserve account in the amount of any premium capture, the effect of the premium reserve account is akin to imposing an incremental, *de facto* horizontal risk retention on the securitizer. Thus, the securitizer's obligation to fund losses under the premium capture arrangement, alone or in combination with other retained interests, would likely require the securitizer to consolidate the securitization entity.

An extended discussion of the potential consequences stemming from a securitizer's consolidation of a securitization entity – in contrast to the transaction achieving off-balance sheet/sales accounting treatment with respect to the transferred assets – is beyond the scope of this testimony. However, suffice it to say that ongoing "on-balance sheet" reporting of securitized assets may, importantly for a regulated financial institution, require the entity to maintain more regulatory capital to support the on-balance sheet assets. This will further limit the ability of private capital to fund mortgage lending and reduce the availability of credit to consumers.

Consequences of PCCRA for Consumers

Unless withdrawn, the premium capture provisions would likely discourage many securitization transactions, unnecessarily change some lenders' origination practices, and increase the cost of some consumer loans.

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The premium capture provisions would have the harshest impact on residential and commercial mortgage securitization markets. The commercial market has recently begun to recover, but the residential mortgage securitization market, outside of the GSEs, has yet to show much life. The premium capture provisions could severely damage the recovery of commercial markets and inhibit any recovery in residential securitization markets.

The premium capture rules do not appear to consider the costs of origination or otherwise account for a securitizer's cost basis in the pool assets. All that matters under the premium capture provisions as proposed is whether gross proceeds, or deemed gross proceeds, exceed the requisite percentage of par value. The fact that a securitizer may have paid a premium for the pool assets does not appear to excuse the securitizer from being obligated to subordinate the premium, either in a cash reserve account or in the residual interest. In such circumstances, there may be very little market for premium loans.

Lenders could react to the premium capture provisions by changing origination practices to avoid above-market rates and instead charge borrowers higher points and fees. Mortgage lenders could be reluctant to grant rate locks to prospective borrowers due to the risk that market rates move lower and the lender is left with a premium loan that is expensive to securitize.

It is not clear to us whether the premium capture provisions are intended, in whole or in part, to indirectly limit certain lending practices. If such is the case, we suggest that these matters are more appropriately handled directly in regulation of consumer lending.

The Agencies should Withdraw PCCRA and Re-propose the Risk Retention Rules
We note that our PCCRA concerns were echoed in a Special Report[9] authored by Mark Zandi and Christian deRitis of Moody's Analytics that stated: "As a result of the way the premium capture rule is stated, the mortgage rate impact to borrowers would be significant— on the order of an increase of 1 to 4 percentage points depending on the parameters of the mortgages being originated and the discount rates applied...Yet the consequences of the rule as written could significantly impede the return of private securitization markets and permanently cement the government's role in housing finance."

We urge the Agencies to take the time needed to carefully reevaluate the proposed rules, perform a risk/benefit analysis of the rules and their potential effects, and republish the rules in proposed form in order to provide a fair and reasonable opportunity for public comment. In doing so, the premium capture provisions should be withdrawn; they appear to be related more to limiting profitability and indirectly regulating lending practices than to risk retention. The provisions

[9] Moody's Analytics, Special Report – A Clarification on Risk Retention, September 22, 2010, pages 2-3.

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would also impose an undue economic burden on securitizations, potentially further limiting access to credit for many borrowers.

3. Title VII – Derivatives Regulation

We are supportive of the goals of Title VII derivatives regulation, namely improving oversight of over-the-counter (OTC) derivatives markets and reducing systemic risk. In fact many aspects of swap market regulation, such as greater transaction reporting and central clearing were well underway before the Dodd-Frank Act was passed into law. As with all regulation, our concerns focus on making sure that requirements are workable, and that the benefits – as measured by how well such rules accomplish their stated purposes – outweigh the costs. Those costs, after all, are borne by market participants (financial and commercial entities) who may find it more difficult and expensive to access credit or other financial resources, such as hedging, that are vital to risk management functions.

We have outlined our concerns through written comments on rules pertaining to many aspects of Title VII rulemaking.[10] In particular, we believe rigorous cost benefit analysis is not only necessary in determining whether a particular rule is on balance beneficial; it is also crucial in evaluating alternative approaches to accomplishing regulatory goals. We have also urged regulators to take care to avoid unintended costs and market impacts by carefully sequencing and phasing in the implementation of rules by category, type of participant, asset class and products within asset classes. The idea that such fundamental building blocks of a new market structure, such as, but not limited to: the establishment of, and reporting to, swap data repositories; the establishment of central counterparties and determinations of mandatory clearing requirements; the establishment of swap execution facilities (SEFs) and mandatory trading requirements; the registration of swap dealers and major swap participants; real time reporting; internal and external business conduct requirements; and capital and margin requirements can all be implemented at virtually the same time, and without benefit of gaining crucial insights as each block is put into place, is highly unrealistic at best and reckless at worst.

But that is not the end of the story; regulators have spoken of cooperation both at home and globally in OTC derivatives rulemaking, but we see very little real evidence of actual coordination. Except for the two definition rule sets, where there exists a statutory requirement to conduct joint rulemaking, there is scant evidence that there will be harmonized rules for swaps and securities-based swaps, even though there are business lines in which the line between the two products is an arbitrary distinction such as "narrow-based" vs. "broad-based" indexes. These products only differ because one is based on nine or fewer underlying reference assets and the other ten or more; they are traded by the same person or group whose counterparties are also the

[10] http://www.sifma.org/issues/regulatory-reform/otc-derivatives/activity/

same, and yet they will likely have to comply with different business conduct requirements and execute on different types of SEFs. For example, the SEC states in its proposed rules for SEF core principles that the regulatory approaches taken by the SEC and CFTC may differ due to "differences between the markets and products that the [SEC] and CFTC currently regulate." As noted above, many market participants will engage in both swaps and security-based swaps and thereby will be subject to both regulatory regimes. Requiring such market participants to execute similar types of transactions in dissimilar ways on separate trading platforms will add significant administrative and compliance costs and risks, generating unnecessary confusion to no one's benefit.[11] Both agencies should be particularly careful in their approach towards SEF rules, and rules related to central trading and clearing, such as block trade size thresholds, as a robust and flexible environment is crucial to developing liquid swap markets.

The CFTC and SEC should also continue to evaluate the impact of amendments to Rules 4.5/4.13 and how Registered Investment Companies that must now register as Commodity Pools will be subject to redundant, and in some areas conflicting, SEC and CFTC requirements. The lack of consistency between the two regimes will have a number of adverse consequences, including increased costs for investors and unnecessary, and potentially confusing, forms of disclosure and reporting to investors.

Another area where lack of coordination is likely to have costly consequences is the cross border application of Title VII rulemaking. If improperly drawn, as the initial reading of the recently proposed CFTC guidance appears to be, extraterritorial application of U.S. regulations could create two sets of rules for swap regulation and could isolate the U.S. swap market from the global market, of which it is currently a major part. If transacting with a U.S. entity (financial intermediary, financial end user and commercial end user alike) puts non-U.S. entities at risk of becoming subject to U.S. regulation globally, it is clear that such non-U.S. entities will not transact with U.S. entities, denying U.S. firms access to those global markets. This will raise the cost of hedging, for example, and if the cost is prohibitive, will lead U.S. firms to decide not to hedge.

The recently proposed CFTC cross border guidance is complex, expansive in scope, and highly prescriptive. At this time we are not at all sure that the terms of so-called substituted compliance –which theoretically should allow market participants in other well regulated markets to rely on their home market regulation – actually would work in practice.

This "substituted compliance" process will be different than the "mutual recognition" model and would require the CFTC individually review the rules of foreign nations. We are concerned generally by determinations of cross border equivalence that are not outcomes based, and are

[11] SIFMA AMG letter to SEC on registration and regulation of security-based swap execution facilities, April 4, 2011.

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used instead as a tool to export regulations from one jurisdiction to another. As we have noted in previous comment letters, if a host country regulator were to extend certain regulations to the global entity, the entity would be subject to overlapping and potentially inconsistent regulation. In such an event, the non-U.S. entity may decide that the easiest way to comply with each jurisdiction's requirements is to register separate entities in many more jurisdictions than it otherwise would. This fragmentation of global firms could lead to inefficient results. With respect to capital, for example, it would remove the benefits of netting, collateral management and centralized risk management, which are key components of systemic risk mitigation.[12]

Further, we believe the CFTC's cross border application approach is flawed in that the Commission chose to do so in the form of guidance as opposed to a rule, and apparently, without sufficient coordination with the SEC. By failing to put forth a rule, the CFTC avoided conducting any cost benefit analysis and formal comment by affected parties. We believe a more holistic, rules-based approach, as we understand the SEC is likely to do after all of the Title VII rules have been proposed, is a more prudent approach.

We have long supported a more genuinely cooperative and harmonized approach to cross border rulemaking, such as mutual recognition or global standard setting. We believe these are more appropriate tools for developing a coherent regulatory structure, providing regulators and the regulated with substantial efficiencies while avoiding placing unnecessary burdens on markets, creating barriers to market entry, distorting competition or encouraging regulatory arbitrage.

4. Section 165(e) Single Counterparty Credit Limits

SIFMA supported the inclusion of a single counterparty credit limit in Section 165 of the Dodd-Frank Act because our members have been using internal models for many years to measure and control such exposures. SIFMA, however, does not support the Federal Reserve Board's proposal (the "FRB proposal") in its current form because the proposal would needlessly reduce liquidity in the financial system and dampen economic activity. The FRB proposal would result in the need for extraordinary adjustments of relationships among market participants that are unnecessary, unwise, potentially destabilizing and, in certain instances, unsupported by the statute or congressional intent.

Dodd-Frank instructed the Federal Reserve to promulgate regulations prohibiting covered companies from having a credit exposure to any unaffiliated company in excess of 25 percent of the covered company's capital stock and surplus. "Capital stock and surplus" is calculated by adding the covered company's total regulatory capital to its excess loan loss reserves. The Act defines credit exposure to an unaffiliated company as:

12 SIFMA letter to the Agencies on the extraterritorial application of Title VII regulations, February 3, 2011.

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- All repos, reverse repos, securities borrowing, and lending transactions with the company;
- All guarantees, acceptances, or letters of credit issued on behalf of the company;
- All purchases of or investments in securities issued by the company;
- Counterparty credit exposure to the company in connection with a derivative transaction; and
- Other similar transactions that the Federal Reserve designates by regulation.

The Federal Reserve has proposed a two tiered rule to implement Section 165(e):

- **Tier 1:** No covered company may have an aggregate net credit exposure to any single unaffiliated counterparty in excess of 25 percent of the covered company's capital stock and surplus.
- **Tier 2:** No covered company with $500 billion or more in assets (major covered company) may have an aggregate net credit exposure in excess of 10 percent to any other major covered company or to any foreign banking organization with $500 billion or more in assets. SIFMA believes the Federal Reserve did not make a case for this part of the FRB proposal.

This proposal requires large banking organizations to use new methodologies for measuring credit exposures that ignore their current approved internal methodologies. The new method is a crude measure that overstates exposures under any reasonable calculation methodology by a significant multiple. *The effect of the new methodology for measuring credit exposure will be a reduction in market liquidity that may have a significant effect on markets more broadly.*

In particular, it would:

- force banking organizations away from CCPs;
- discriminate against foreign government debt;
- deny the benefits of double default protection;
- limit the use of collateral posted against certain credit transactions; and
- not allow firms to fully net some exposures.

Central Counter-Parties (CCPs)
The Dodd-Frank Act contains numerous provisions that encourage firms to use CCPs, to improve transparency and increase the oversight of the swaps market. The FRB proposal, however, requires firms to limit their exposures to CCPs like all other counterparties to the same

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25 percent cap. Because of the limited number of CCPs and the high barriers to establishing a CCP that would meet regulatory requirements, a firm might hit the cap with respect to all available CCPs. This may lead firms to create more customized swaps that may be cleared bilaterally, avoiding CCPs altogether. This creates a perverse incentive for banking organizations not to use CCPs for their derivative transactions. This runs against the policy in Title VII to improve transparency and the use of CCPs.

Non-US Government Bonds
When a firm holds foreign sovereign debt, including as collateral, the firm must count it as an exposure to the foreign government. This discriminates against other government debt in favor of US Treasury bonds as collateral. This will certainly impact the liquidity of foreign debt markets. Additionally, these limits will most affect US firms doing business overseas, where they must frequently use the local non-US government debt as collateral for transactions.

Double Default (Substitution)
If a firm purchases credit protection from a third-party with a direct counterparty, the firm must count these as credit exposures to the third-party protection provider, and not the direct counterparty. This ignores the double default protection that such protection provides. "Double default protection" simply means that's it is less likely that both the third-party and the covered firm or the direct counterparty would default at the same time. The FRB proposal ignores the widely recognized benefits of double default protection and results in a significant overstatement of exposure that is concentrated in the protection providers. Because there are relatively few providers with the infrastructure and capital that market participants expect, the effect of this requirement may be to limit the availability of these important credit risk management products. *The rule should give banks credit for the double default protections that third-party credit protection provides.*

Collateral
The rule does not give a firm credit for the full value of all collateral posted against a derivative transaction. This is an inaccurate measurement of a firm's real credit exposure, and *the rule should give greater credit for the vital risk-managing function that collateral provides.*

Netting
The FRB proposal does not allow firms to fully net, or off-set, their derivative positions with counterparties. This results in an inaccurate measurement of a firm's real credit exposure, and *the rule should provide for a fuller recognition of netting.*

Alternatives
SIFMA, along with The Clearing House, the American Bankers Association, The Financial Services Roundtable and the Financial Services Forum suggested several alternative ways the

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Federal Reserve could implement the single counterparty credit limit required in the Dodd-Frank Act. First, the Federal Reserve could amend its proposal to fix the problems as noted above: exempting high quality non-U.S. sovereigns, individuals, CCPs, and allowing netting, the use of the full value of collateral and double default protection. A second alternative would be to allow firms to use a "stressed" version of the internal models they currently use to measure such risk. Thirdly, the Federal Reserve could use a supervisory stress approach which would require a covered company to use a replacement cost, calculate in accordance with regulatory capital rules for derivative transactions under specific stress scenarios specified by the Federal Reserve.

The full potential combined impact of financial services regulatory reforms, including the FRB proposal, Basel III (both capital and liquidity), Title II of Dodd-Frank, proposed margin requirements for swaps (Section 731 of Dodd-Frank) and the Volcker Rule (and related regulations currently under consideration by U.S. regulators has not yet been comprehensively analyzed and, to our knowledge, no one in the regulatory or academic communities has asserted that it has. The reality is that the cumulative effects of the FRB proposal and other rulemakings and reforms, which are often individually complex and when considered together amount to an incredibly complex mosaic, are almost certain to have unintended consequences and potential economic costs, and are likely in some cases to create the potential for actually increasing instead of decreasing systemic risks.

Conclusion

The United States has taken a more comprehensive approach than any other country to address regulatory reform. Although some countries have taken steps to address components of topics covered by Dodd-Frank, no country has adopted restrictions comparable to the Volcker Rule or adopted legislation or regulations having the scope of Dodd-Frank. There can be no question but that substantive regulation has competitive consequences. It is essential that U.S. regulatory agencies, in proposing regulations, consider and analyze both the individual aspects and combined impact of proposed rules that may place U.S. financial markets at an unwarranted competitive disadvantage compared to those countries that have not implemented a comparable approach. We urge U.S. regulators to consider and address the interplay among reforms in the context of considering individual reforms. Further, regulators should undertake substantial cost-benefit analysis to determine what affect such rules may have on the competitiveness of U.S. financial markets and the impact on the users of those markets.

100 Years Standing Up for American Enterprise

U.S. CHAMBER OF COMMERCE

Statement of the U.S. Chamber of Commerce

ON: "The Impact of Dodd-Frank on Customers, Credit, and Job Creators"

TO: House Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services

DATE: July 10, 2012

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

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Good morning Chairman Garrett, Ranking Member Waters, and members of the subcommittee. I am Thomas C. Deas, Jr., Vice President and Treasurer of FMC Corporation and Chairman of the National Association of Corporate Treasurers, an organization of treasury professionals from several hundred of the largest public and private companies in the country.

Thank you for the opportunity to testify on behalf of the U.S. Chamber of Commerce at today's hearing: "The Impact of Dodd-Frank on Customers, Credit, and Job Creators." This is a timely hearing and a unique opportunity to discuss the impact of the Dodd-Frank Act on the ability of companies like mine to access the financial markets to fuel business expansion, job creation, and economic growth.

We very much appreciate the opportunity to address some of the issues arising from the unintended consequences of the Dodd-Frank Act. While we have sought to inform the regulators of our concerns, and believe they continue to seek ways to address our issues, we appreciate that as with any complicated piece of legislation continued Congressional oversight is necessary if we are to avoid economic consequences no one could foresee. This is particularly the case for end-users like FMC that were not the subject of the Act, but now find ourselves significantly affected by its implementation.

While the drafters and implementers of the Dodd-Frank Act and other initiatives such as proposed money market fund regulations have focused on the financial services industry, the impacts are being felt by Main Street businesses as well. Uncertainties about aspects of the law we thought were clear, like the derivatives end-user exemption from margining and central clearing, harm the ability of companies to manage and mitigate risk. The implementation of the Volcker Rule can imperil our ability to raise funds from the debt and equity markets. Also, potential money market regulations could harm our ability to manage business cash flow and fund short-term borrowings in the commercial paper market.

The effect of all these new rules would be to increase the demands on the capital of American businesses, such as to fund derivatives margin accounts or money market fund hold-backs, while at the same time making it more difficult and expensive to raise that capital. Regulatory uncertainty and complexity can be as concerning for the economy as the underlying risks the regulations are meant to address.

We are concerned that as we enter a period of increasing financial stress as evidenced by the continuing European sovereign debt crisis and what seem to be slowing global economic indicators, the tools and markets on which we have relied will no longer be as

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accessible to us. The prudent reaction to these uncertainties is to hold back in reserve financial resources that would otherwise be used to grow our businesses.

Let me take a few minutes to give a more in-depth focus of the effects of the Dodd-Frank Act and money market fund regulations on Main Street companies.

Derivatives

Along with many other U.S. manufacturers and agricultural producers, FMC also uses over-the-counter ("OTC") derivatives to hedge business risks in a cost-effective way. We are very concerned that several of the proposed derivatives regulations could hamper our use of this important tool and adversely affect our global competitiveness. I had the valuable experience of negotiating and executing some of the very first OTC derivatives – currency swaps – back in 1984. The OTC derivatives market has grown from its inception at that time to its current size by offering end-users a degree of customization not available in exchange-traded derivatives. FMC and other end-users enter into OTC derivatives customized to match the amount, timing, and where necessary, the currency, of their underlying business exposures. By matching derivatives to our business exposures, we create an effective economic hedge. The value of the derivative moves in an equal, but opposite, way in relation to the value of the underlying risk we are hedging. Let me give you a specific example of how proposed derivatives regulation could hamper my company's ability to compete against foreign producers.

FMC competes very effectively against foreign companies in several markets for our crop protection chemicals. For example in Brazil, we have leading positions in sugar cane and cotton, developed with significant product and technical support from our U.S. operations. To enhance FMC's product offering to Brazilian soybean farmers and profitably grow our business there, we offer to sell our agricultural chemicals for use at planting time in exchange for an agreed quantity of soybeans at harvest time. We can do this because we simultaneously enter into a custom OTC derivative that offsets the amount and timing of the future delivery of soybeans by our customers. In a developing economy like Brazil, farmers do not have FMC's degree of access to the worldwide financial markets. We provide our products to Brazilian farmers on terms that insulate them from the risk of changes in future commodity prices and foreign exchange movements in the price of the Brazilian real against the U.S. dollar. In the Brazilian soybean market, we compete against international producers based in Germany, Switzerland, and Australia, as well as local Brazilian companies. Because of significant differences in the way derivatives regulations are being implemented in Europe and elsewhere outside the United States, FMC and other U.S. companies could be put at a

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competitive disadvantage. On July 7th, the G-20 international committees coordinating derivatives regulation published their recommendation that non-financial end-users that are not systemically important be exempted from mandatory margining and central clearing. If the U.S. regulations remain out of step with those of our international trading partners, American businesses will be hurt.

Competitive Consequences of End-User Margining
At the time of passage of the Dodd-Frank Act, we understood from the legislative language as well as from letters and colloquies by the principal drafters, that end-users would be exempted from any requirement to post cash margin. However, rules proposed last year would give the prudential regulators the authority to impose a framework with many complicated parameters, each of which is subject to future adjustment, which could result in many end-users – regardless of their size – having to post cash margin for their derivatives transactions. This proposal and the uncertainties it creates represent real challenges to making business decisions about the future. The European Union regulators have generally exempted non-financial end-users from mandatory margining. They have accepted the argument that end-users, whose derivatives activity comprises less than 10 percent of the total OTC derivatives market, are not significantly contributing to systemic risk and should be exempt from regulations designed for swap dealers.

At this point, U.S. end-users still do not know with certainty what their future cash margin requirements will be. The U.S. regulators have taken a pair of offsetting transactions that match completely, and settle with offsetting cash payments at maturity, as does FMC's soybean sale and hedge, and created a new and unwelcome uncertainty – that of funding a daily fluctuating cash margin call. While this may be appropriate for swap dealers making a market in derivatives or those using derivatives for speculative purposes, its application to end-users hedging underlying business exposures creates an imbalance that is economically burdensome to end-users.

Cost of End-User Margining
FMC's derivatives are executed with several banks, all of which are also supporting our company through their provision of credit lines. None of these banks require FMC to post any form of collateral to secure their credit support. Our banks also do not require FMC to post cash margin as collateral to secure mark-to-market fluctuations in the value of derivatives. Instead they price the overall transactions to take this risk into account. This structure gives us certainty so that we never have to post cash margin while the derivative is outstanding. However, if we are required by the regulators to post margin, we will have to hold aside cash and readily available credit to meet those margin calls.

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Depending on the extent of price movements, margin might have to be posted within the trading day as well as at the close of trading. Because failure to meet a margin call would be like bouncing a check, and would constitute a default, our corporate treasury would act very conservatively in holding cash or immediately available funds under our bank lines of credit to assure we could meet any future margin call in a timely fashion and with a comfortable cushion.

Adopting more conservative cash management practices might sound like an appropriate response in the wake of the financial crisis. However, end-users did not cause the financial crisis. End-users do not contribute meaningfully to systemic risk because our use of derivatives constitutes prudent, risk mitigating hedging of underlying business transactions. Forcing end-users to put up cash for fluctuating derivatives valuations means less funding is available to grow our businesses and expand employment. The reality treasurers face is that the money to margin derivatives has to come from somewhere and inevitably less funding will be available to operate and grow our businesses.

FMC and other members of the Business Roundtable estimated that BRT-member companies would have to hold aside on average $269 million of cash or immediately available bank credit to meet a 3 percent initial margin requirement. Though the rule proposed by regulators is not specific as to the precise amount of collateral, in our world of finite limits and financial constraints, any cash margin requirements represent a direct dollar-for-dollar subtraction from funds that we would otherwise use to expand our plants, build inventory to support higher sales, undertake research and development activities, and ultimately sustain and grow jobs. In fact, the study extrapolated the effects across the S&P 500, of which FMC is also a member, to predict the consequent loss of 100,000 to 120,000 jobs. The effect on the many thousands of end-users beyond the S&P 500 would be proportionately greater. We would also have to make a considerable investment in information systems that would replicate much of the technology in a bank's trading room for marking to market and settling derivatives transactions.

We have heard that the regulators may propose that purely internal trades, for example between a parent company and a wholly owned subsidiary, should be subject to the whole range of real-time reporting, margining, clearing, and other requirements applicable to swap dealers. Since these inter-affiliate trades, entered into in many cases for internal accounting and cost-allocation purposes, do not present any systemic risk, they should be exempt. FMC and many other Main Street companies would have to transfer risk management activities using derivatives, currently conducted efficiently at

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corporate headquarters, into each subsidiary, once the required information systems are developed, tested and made operational. This could make derivatives-based risk management more difficult and prohibitively more expensive.

Summary of Derivatives End-Users' Concerns

Let me take a moment to summarize some of our principal concerns with the implementation of derivatives regulation:

- First, we are concerned that the regulations have imposed an uncertain framework for cash margin on end-user trades, potentially diverting billions of dollars from productive investment and employment into an idle regulatory levy.
- Second, even if the final regulations clearly exempt end-users from margin requirements, we still have the risk that the regulators will require swap dealers to hold excessive capital in reserve against uncleared over-the-counter derivatives – with the cost passed on to end-users as they manage their business risks. We believe that swap dealers' capital requirements should be appropriate to the actual loss experience of the specific type of derivative. The unintended consequence of excessive capital requirements could be for some end-users to cease hedging risks and for others to use foreign markets.
- Finally, we are concerned that regulators will make customized derivatives prohibitively expensive through margin and increased capital requirements, with the effect of forcing us into standardized derivatives from common trading facilities that will not provide the exact match we seek with our underlying business exposures. It is the customization available with OTC derivatives that is so valuable to us and makes the derivatives effective in hedging our exposures.

I know many people who suffered through the financial turmoil of 2008 are tempted to label all derivatives as risky bets that should be curtailed. However, I hope these examples of prudent use of derivatives by my company and other end-users who form the backbone of our country's economy have demonstrated the wisdom of the end-user exemptions that we believe to have been the legislative intent.

I will note that in general those charged with the responsibility of drafting derivatives regulations have been very forthcoming and open in soliciting input from end-users; however, the end-user exemption we thought was clear is now uncertain and several important rules have not been finalized. We support legislation to create a true exemption from margin requirements that would apply to all end-users. The consequences of getting derivatives regulation wrong will be borne by American business and ultimately our fellow citizens.

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Volcker Rule

The broadness and ambiguity surrounding provisions of the Volcker Rule—a regulation spread out over five agencies dealing with practices the regulators have stated that they themselves don't fully understand is likely to have a chilling effect on those activities that are at the heart of capital-raising activities for American companies. A misapplication of the Volcker Rule can harm U.S. competitiveness, capital efficiency, and financial stability.

Main Street companies like FMC rely on financial institutions for access to the capital markets and to mitigate financial risks. U.S. businesses use the debt and equity markets to fund their long-term capital needs. While the market-making and underwriting exceptions to the Volcker Rule attempt to recognize this fact, the inability to define these practices gives us concern about the ability of regulators to enforce the Volcker Rule. Additionally, a potential regulatory scrutiny on a trade-by-trade basis could make financial institutions reluctant to engage in permissible activities, harming the ability of companies to raise capital.

Impaired market liquidity and reduced access to credit

We are concerned the Volcker Rule could impair the ability of banks to function as market makers. FMC's most recent bond issue, $300 million of senior notes due in 2022, was underwritten by a syndicate made up of banks that also support us through their commitment of $1.5 billion of credit lines. As underwriters of our bond issue, these firms take on the responsibility to hold our bonds in inventory if necessary to make an orderly market for the issue as it is launched. However, the Volcker Rule could significantly constrain this function by dictating how financial institutions should manage their holdings of our bonds. The Volcker Rule also could constrain underwriting activities if the retention of bonds in a bank's portfolio is determined to constitute proprietary trading.

A conservative application of the Volcker Rule could force financial institutions either to raise their fees for these activities, or to become risk adverse and not engage in them at all. This could reduce the flow of capital to Main Street companies, while diminishing liquidity in our capital markets. If financial institutions can no longer hold inventory or are unwilling to do so it will be more difficult for FMC to raise capital.

With reduced market liquidity, transaction spreads widen, risks increase, and price changes become more volatile. To compensate for these new risks, investors will demand higher rates. We have estimated that on FMC's most recent bond issue, the

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additional cost over its ten-year life could amount to $15 million – a direct subtraction from funds we would otherwise be able to invest for growth.

Restricted trading in proper and allowable businesses
The originally proposed Volcker Rule is inherently complicated and forces regulators to define the intent of a trade. At the worst extreme, financial institutions could be required to prove the intent of each trade. This cannot be done in any reliable or consistent way. One entity's proprietary trade is another entity's market-making activity. Proprietary trading defies a symmetrical definition.

The complexity of the Volcker Rule will force financial institutions to adopt the most conservative interpretation of the rule and the least favorable intent of any trade. With the burden of proof on the banks, the compliance costs could become prohibitive. The net result will likely be the elimination of otherwise acceptable market-making activities. This could result in banks exiting or scaling back such routine activities as selling our commercial paper, providing cash management sweep accounts and multi-currency trade finance. These are services treasurers view as critical tools to execute sound financial management.

Competitive disadvantage for U.S. businesses and financial institutions
The United States' major trading partners have rejected U.S. requests that they adopt analogs to the Volcker rule. This puts American businesses, like FMC, and U.S. financial institutions at a disadvantage. By eliminating a core revenue stream from U.S. banks, the Volcker Rule would effectively reduce the ability for U.S. banks to compete and grow. Additionally, in order to avoid the territorial jurisdiction of the Volcker Rule, foreign financial firms may retreat from the U.S., further depriving American businesses of capital and degrading the ability of U.S. regulators to oversee and regulate financial activity.

Finally, most companies will still have financial risks that need to be managed. U.S. business could be forced to turn increasingly to foreign banks in overseas markets. This could have the unintended consequence of simultaneously weakening U.S. banks while strengthening foreign banks.

Increased compliance costs for Main Street businesses
The reach of the Volcker Rule can extend to non-financial businesses, although they present no meaningful systemic risk. For example, many manufacturing companies offer financing services to their customers. They may own a commercial or consumer finance subsidiary or have a credit card company. These businesses will incur increased

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costs and higher compliance burdens. Some will pass these costs on to their customers. Others will simply discontinue the financial or card services. In any event, the result is higher-cost credit for those willing to pay and less credit for most small businesses and consumers.

Many U.S. companies also engage in activity overseas through joint-ventures. These joint-ventures provide unique trading opportunities for American companies to create jobs at home and generate positive returns for their investors. Any member of a joint-venture that has a Volcker compliance program will force the entire joint venture to have a Volcker compliance program. Therefore, American companies could be viewed as a less reliable partner for these types of business activities.

We at FMC are celebrating our eighty-first year of listing on the New York Stock Exchange. When we came to the exchange in 1931 it was to access the largest and most liquid source of equity capital in the world. We have benefited from over a thousand-fold increase in our equity market capitalization since then. We have also utilized the U.S. public debt markets where investors and borrowers have come together with an efficiency unparalleled in the world. We ask your help in assuring these markets remain viable to support continued growth of Main Street companies like ours.

Money Market Funds

Other critical financial regulations being proposed in parallel with the Dodd-Frank Act affect money market funds, which are under scrutiny for designation as being systemically risky by the Financial Stability Oversight Council. These funds play a critical role in the U.S. economy because they work well to serve the investment and short-term funding needs of businesses across America. Corporate treasurers rely on money market funds to manage cash efficiently and affordably. Cash balances for companies fluctuate on a daily, weekly, monthly or other periodic basis, and depending on the nature of the business, some companies' cash levels can swing widely - from hundreds of dollars to hundreds of millions of dollars. A corporate treasurer's job is to ensure that there is sufficient liquidity to meet working capital needs, and money market funds are the most liquid, flexible and efficient way to manage short-term investments. They are also an important source of short-term funding through their purchases of companies' commercial paper.

Money Market Funds as an Investment

There are many reasons why money market funds are an attractive investment choice for businesses. For companies with cash surpluses, money market funds offer a stable

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$1.00 price per share that allows for ease of accounting for frequent investments and redemptions. They also offer market rates of return for cash that may sit idle, earning no interest in a commercial bank account. Moreover, investments in money market funds can be made and redeemed on a daily basis without fees or penalties, providing the liquidity needed to manage fluctuating working capital needs.

These funds also offer a diversified and expertly managed short-term investment vehicle. This allows companies to invest in one fund while diversifying exposure to a number of underlying investments. Additionally, money market funds perform a credit analysis of their underlying assets and report this in a transparent way that facilitates our own credit analysis of the fund. Corporate treasurers are professional stewards of our companies' cash and we take our responsibility seriously. Money market funds allow significant cash inflows and outflows to be managed efficiently and effectively with the risk spread across a diversified portfolio.

Money Market Funds as a Financing Source

Money market funds also represent a major source of funding to the corporate commercial paper market in the U.S., purchasing approximately 40% of all outstanding commercial paper. In April 2012, we estimate that U.S. money market funds held approximately $380 billion in commercial paper. This source of financing is vital to companies across America as commercial paper is an easy, affordable way to obtain short-term financing. Without money market funds, the commercial paper market would be substantially less liquid, forcing companies to turn to more expensive means of financing. Higher financing costs will create a drag on business expansion and job creation.

For example, a typical commercial paper issuer can fund its day-to-day working capital needs through flexible borrowings of maturities matched to the exact number of days they require. The least expensive bank borrowings are less flexible by being limited to maturities of one, two, three, six or twelve months. Bank borrowings with flexibility to be repaid daily, like commercial paper, are only available at significantly higher prime-based interest rates.

2010 Changes to Rule 2a-7

Before discussing possible further changes in the regulation of money market funds, it is important to emphasize that significant changes have already been implemented. Just two years ago, the U.S. Securities and Exchange Commission made enhancements to money market fund regulation through major revisions to its Rule 2a-7. These changes strengthened money market funds through more stringent liquidity requirements.

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Funds are now required to meet a daily liquidity requirement such that 10 percent of the assets turn into cash in one day and 30 percent within one week. This large liquidity buffer makes it unlikely that large redemption requests—even at the rate seen in the 2008 financial crisis—would force a fund to sell assets at a loss prior to their maturity.

Despite the fact that the 2010 reforms have just been implemented, advocates of further regulation have focused much attention on three significant structural changes to money market funds—redemption restrictions, a floating NAV, and a mandatory capital buffer. As discussed below, we believe each of these would have a significant negative impact on the ongoing viability of these funds, and also adversely affect the corporate commercial paper market.

Redemption Restrictions

We are concerned about the SEC's potential implementation of redemption hold-backs or other restrictions on our ability to access cash invested in money market funds. Some of our NACT member treasurers are already making plans to withdraw funds from money market accounts to have full access to their funds and avoid the complexities of monitoring simultaneous hold-back positions on multiple transfers into and out of money market funds. The more diversification we seek through spreading investments across multiple money market funds, the more we proliferate pockets of cash in multiple hold-back accounts. The counter to this would be to concentrate investments, producing the opposite result the regulators are trying to achieve.

If corporate treasurers have less efficient access to their cash investments, they would be forced to fund working capital needs through higher drawings on their credit facilities or issuing additional commercial paper, incurring additional costs.

Floating Net Asset Value

Treasurers are also concerned by the proposal to establish floating net asset values (NAVs) for money market funds. Most treasury workstations built for managing corporate cash do not have accounting systems in place to track NAVs on each transfer into and out of money market funds. They would also have to be modified to track short-term capital gains and losses for income tax purposes. Treasury workstations would need to be upgraded to accommodate these changes, and that investment would significantly lag behind the timing of implementing floating NAVs. As a result, corporate treasurers would likely withdraw money market fund investments until the systems issue is solved. We fear that these and other withdrawals will cause many money market funds to wind down significantly limiting this $2.6 trillion investment alternative.

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In addition, many companies have investment policies precluding them from investing in variable-rate instruments. We believe the cost-benefit trade-offs for the proposed change to a floating NAV are not justified.

Capital Buffer

One other proposal that the Securities and Exchange Commission has publicly discussed is the implementation of some type of capital buffer in an attempt to protect against losses. A capital buffer would have to be funded by contributions from the fund's sponsor. With the Federal Reserve continuing to target very low interest rates, many funds would be forced to cease operations, leaving fewer choices for investors. Additionally, some costs may be passed on to investors. If the capital buffer is built up over time by allocating some of the fund's yield to the buffer, it would take too long to build the necessary buffer to protect against losses. Similarly, the creation of a subordinated class of shares to provide the buffer would require additional returns to be paid to those shareholders, and in our near-zero interest rate environment, this could eliminate any remaining returns for investors. We fear increasing fees or reducing yields would be likely to deter many investors, including corporate treasurers, from investing in money market funds.

The cumulative effect of the proposed changes will drive money market fund investors to bank deposits, concentrating risk in a sector where over the past 40 years there have been 2,800 failures costing taxpayers $188 billion.

Conclusion

Thank you again for the opportunity to testify today on these important issues. We are very concerned that the lack of a clear end-user exemption from posting cash margin for derivatives, the application of an overly complex Volcker Rule, combined with regulations that could destroy money market funds will result in burdens on Main Street companies that will limit their growth and harm their international competitiveness.

We can and should take the time to get this right, because if we don't, American businesses, economic growth and job creation will suffer as a result.

I would be happy to respond to any questions you may have.

FMC

American SECURITIZATION FORUM.

Statement of:

Tom Deutsch
Executive Director
American Securitization Forum

Testimony before the:

House Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises

Public Hearing on:

The Impact of Dodd-Frank on Customers, Credit, and Job Creators

July 10, 2012

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I. Introduction and Executive Summary

Chairman Garrett, Ranking Member Waters, and distinguished Members of the Subcommittee, I thank you for this opportunity to testify here before you today on behalf of the 330 member institutions of the American Securitization Forum.[1]

In the testimony that follows, we address in detail the key regulatory initiatives arising out of Dodd-Frank and other legislative and regulatory initiatives that the entire scope of ASF's membership has been focused on, while simultaneously operating to extend credit to consumers and businesses. For each of these initiatives, we provide Internet hyperlinks to the thousands of pages of comment letters that we have submitted to help U.S. and international regulators avoid negative impacts to the credit markets resulting from unintended consequences of the myriad of rulemaking proposals.

But before we address the detailed issues, we focus first on some of the key macro challenges facing the private securitization markets. These markets currently supply hundreds of billions of dollars in Main Street credit to the economy each year for, among other things: consumers to buy houses, cars, motorcycles and college educations; farmers to buy tractors and equipment; and businesses to expand their franchises and physical plants. These securitization markets effectively ship mass quantities of long-term saved capital from pension funds, mutual funds, insurance companies and banks into individually tailored loans to Main Street consumers and businesses. Given the historical shift worldwide of savings patterns, the banking sector simply cannot supply enough capital directly to credit seekers. Instead, securitization in its simplest form links up savers with everyday Americans looking to borrow.

As an outgrowth of the financial crisis though, many have focused on securitization as an ailing patient that needs heavy doses of regulatory medication to recuperate. ASF has strongly agreed that some treatment has been necessary to make appropriate and tailored reforms. First, through ASF's Project RESTART[2], we have spent considerable effort ramping up transparency for investors by developing model templates for loan and grouped-level standardized disclosure for various asset classes and also to better aligning incentives between issuers and investors by developing model repurchase provisions and representations and warranties. Second, we have supported appropriate regulations for risk retention, rating agency reform, conflicts of interest and regulatory capital standards that would yield beneficial effects on the markets and the broader economy.

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[1] The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory and market practice issues. ASF members include over 330 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. For more information about ASF, its members and activities, please go to www.americansecuritization.com.

[2] Additional details and the key deliverables of ASF Project RESTART may be found on our website at www.americansecuritization.com/restart.

But we have passed the point where heavy prescriptions of various regulatory medications have healing effects. Instead, we strongly urge policy makers to examine closely the aggregate and interactive effect of the myriad of 'treatments' being administered,[3] as they are becoming poisonous by being injected in aggregated doses, the interactive effects of which have not been thought through. In effect, the poison to the market is in the dosage. While Dodd-Frank may have endeavored to improve the asset-backed securitization process, the layers upon layers of regulation promulgated thereunder will, in the aggregate, result in substantial cost that will ultimately impede securitization and increase the cost of credit for consumers and businesses alike.

The manifestations of these aggregate and interactive effects are as follows:

1. Straight-forward products like auto and equipment-backed securitizations, whose performance was strong across the board through the entirety of the financial crisis, are now facing extraordinary compliance challenges with a complex web of expansive policy initiatives;
2. Unintended interactions of various rules will continue to be discovered for years, which is causing immense costs in reworking various structures or eliminating products all together. The markets would accept these changes if they were constructive and thought-through, but this is occurring without coordination among the rules or analysis of potential interplay;
3. Market participants aren't investing in building platforms. Rather, they're putting their skeletal platforms in the deep freeze, particularly for RMBS, because of the tremendous uncertainty of the outcome of proposed rules that could very well make those business lines loss centers. As a result, significant brain drain out of private-label RMBS specialists continues to occur, making the Administration's[4] and Congress'[5] desire to bring private capital back into mortgage securitizations more difficult and more protracted. For the mortgage market, the complete absence of direction for Fannie Mae and Freddie Mac has also kept private industry left to question when or if less than 95%[6] of mortgages will be securitized without effectively a 100% taxpayer guarantee behind it;
4. Some rules like the premium capture cash reserve account are so lethal to the RMBS and CMBS markets that those markets are predicted to become relegated to history books for all of those other than a few niche players serving extremely limited segments of the market, if that rule were to be put into place as proposed. The potential impact of such a rule on borrowers would be substantial, with interest rates having to rise multiple percentage points and rate locks effectively being prevented.
5. Non-banks and banks are being subjected to further disparate rules causing competitive advantages and disadvantages to develop that will inevitably cause exiting of business lines based on regulation, rather than on market efficiency or capability;

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[3] Please see Exhibit A for a macro overview of the myriad of key initiatives with which the securitization markets are grappling.
[4] *See* http://portal.hud.gov/hudportal/documents/huddoc?id=housingfinmarketreform.pdf, February 2011.
[5] *See* http://www.gpo.gov/fdsys/pkg/BILLS-112hr3644ih/pdf/BILLS-112hr3644ih.pdf and http://www.corker.senate.gov/public/?a=Files.Serve&File_id=3207ad19-86b6-4444-b436-e016483b67fb.
[6] *See* http://www.standardandpoors.com/spf/ratings/Positive_Housing_Newsn3_6_12.pdf at p. 4.

6. Although policy initiatives continue to evolve on a country by country basis, the global issuance and purchase of securitizations are forced to comply with new and different standards in each jurisdiction. For example, risk retention standards in Europe require the investor in ABS to police compliance, whereas in the U.S. the issuer is expected to be the compliance monitor with the forthcoming rules; and
7. Many of the rules in Dodd-Frank, such as the Volcker Rule, were not intended to alter the securitization markets, but, in fact, have become the biggest sources of concerns for key segments of the market such as ABCP because of overbroad rules and an absence of appropriate exemptions.

a. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank)

The reforms set forth in Dodd-Frank are vast, impacting all corners of the financial markets, including retail banking, derivatives, hedge funds, mortgage origination, insurance, capital requirements and securitization, among others. Additionally, there were numerous provisions targeted specifically at securitization, including risk retention requirements, conflicts of interest prohibitions, due diligence standards, and disclosure and reporting requirements. As it turns out, however, there are numerous other provisions throughout Dodd-Frank that, whether intended or not, will have a substantial impact on securitization.

Various regulatory agencies have been tasked with implementing the required rulemakings, but very few of them have actually been completed. A recent report indicates that, as of July 2, 2012, 78.9% of rulemakings with a specified deadline had missed their deadline, and only 29.9% of rulemakings are complete with final rules.[7]

When the rulemakings are ultimately finalized, they will inevitably result in increased cost for the securitization and lending markets, which will be passed on to consumers and businesses in the form of higher borrowing rates. Alternatively, certain parts of the market may disappear entirely, leaving some consumers and businesses without effective access to affordable credit. The rulemakings targeting the mortgage market are a great example of how costs will be aggregated through layers of regulation on both origination and secondary market activities. We review each in turn below.

Dodd-Frank sought to regulate the origination of mortgage loans by requiring lenders to make a determination that borrowers have a reasonable ability to repay the loans and imposing substantial liability on lenders and investors for loans that do not comply. It is this risk of liability that threatens the functioning of the secondary market, which provides the capital necessary to fund mortgages nationwide. Congress recognized this risk, and included the concept of a "qualified mortgage" to promote certainty in the secondary market. A qualified mortgage would be deemed to meet the ability-to-repay requirement, provide a safe harbor from liability for both lenders and investors, and generally promote sound lending. Unfortunately, the CFPB appears to be seriously considering employing a subjective standard for determining what constitutes a qualified mortgage and a rebuttable presumption of compliance that will result in

[7] *See* http://www.davispolk.com/files/Publication/8bc2b1c4-c800-45b1-8324-0381454f6ceb/Presentation/PublicationAttachment/b9462d4e-0be9-4eee-9829-0455bca61e9a/July2012_Dodd.Frank.Progress.Report.pdf.

frivolous lawsuits, costing anywhere from $70,000 to $100,000 to defend.[8] The very real cost associated with this liability risk will cause investors and other secondary market participants to require a premium in order to invest in mortgages, resulting in higher borrowing rates. In addition, many low and moderate income borrowers, indeed the very segment the law intend to protect, will likely be denied access to credit altogether because the resulting risk premium will make mortgages prohibitively expensive for this segment of borrowers.

Dodd-Frank also sought to regulate the capital markets for mortgages, requiring that securitizers hold 5% of the credit risk of each loan securitized. The risk retention rules enacted by Congress will prove to be costly for consumers, but the concept will not be prohibitive if implemented properly. However, the regulators implementing the rules went beyond the mandate in Dodd-Frank and proposed a "premium capture cash reserve account" (PCCRA) that would effectively eliminate incentives to securitize by (i) locking up returns and origination expenses in an account for the life of the securitization, (ii) assuring the accounting consolidation of the securitization onto the balance sheet of the securitizer, and (iii) interfering with an originator's ability to offer borrowers rate locks. In the aggregate, these effects would have a substantial impact on borrowers. In fact, Mark Zandi of Moody's Analytics has estimated that mortgage rates would increase by *1 to 4 percentage points* if the rule is implemented as proposed.[9] Combine that amount with costs associated with the ability-to-repay requirement and onerous capital charges nearing 100% of a horizontal risk retention, and the rate originators would have to charge borrowers again becomes prohibitively high.

Congress provided relief from the risk retention requirements for high quality assets called "qualified residential mortgages" (QRMs). However, the QRM definition proposed by the regulators is very tight, and most mortgage loans originated would not meet the definition. In fact, only 19.8% of conventional GSE loans originated from 1997 thought 2009 would have met the QRM standards.[10] Even in 2009, during which time credit was very tight, only 30.5% of loans would have been QRMs.[11] Note further that the size of the QRM market will be limited by regulation to, at most, the size of the "qualified mortgage" market, which may itself be narrow depending on final rules put out by the CFPB. What this means is that the bulk of the mortgage market may not meet QRM requirements and that most borrowers would be subject to higher rates due to the premium capture rule. Furthermore, we are concerned that the very conservative terms of the proposed QRM definition, taken together with the risk retention requirements, will provide a significant and undue competitive advantage to the GSEs, which are exempt from the risk retention requirements. This will have the effect of further entrenching the GSEs in the market when many in Congress, as well as the Administration, are calling for more private capital and less government subsidy.

But this discussion focuses on only two of the mortgage rules arising exclusively out of Dodd-Frank. Each day it seems a new policy maker has a new rule or government program that can 'fix' the housing market. But these proposals give rise to thoroughly misguided ideas like using eminent domain to unconstitutionally seize current, underwater mortgages without

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[8] "The Coming Crisis in Credit Availability," Amherst Mortgage Insight, June 4, 2012, at p. 9.
[9] *See* http://www.economy.com/mark-zandi/documents/2011-09-21-Zandi-A-Clarification-on-Risk.pdf at p. 2.
[10] *See* http://www.fhfa.gov/webfiles/20686/QRM_FINAL_ALL.pdf at p. 5.
[11] Id. at p. 6.

providing just compensation that securitization trust owners would be entitled to. Why would new private capital want to invest in products that ultimately can be seized by government fiat all in the name of a purported public purpose?

Consumer and business lending is also impacted by all of the impending regulation, most of which was intended for the RMBS market. Unlike private RMBS, the securitization market for consumer and business assets, such as auto and equipment loans, is currently well-functioning, with some asset classes enjoying issuance at almost pre-crisis levels. Keep in mind, many of these asset classes had absolutely nothing to do with creating the crisis, and performed exactly as intended during the crisis. However, we are concerned that many of the pending rulemakings could eventually derail the recent success by imposing unnecessary costs that will be passed on to consumers and businesses. What follows is a laundry list of other proposed regulations that we believe could have an impact on the securitization market:

- The regulators indicated that the proposed risk retention rules for credit card ABS and asset-backed commercial paper (ABCP) were intended to track current market practices. However, the proposed rules failed to achieve that result and would cause billions of dollars to flee this critical short-term funding market.
- The regulators proposed qualifying auto and commercial loan exemptions from risk retention that fail to embrace traditional loan underwriting practices, and will not be employed by market participants.
- The Volcker Rule is aimed at preventing proprietary trading, but the regulators have proposed rules that would prevent many traditional securitization activities even though Dodd-Frank specifically required that the Volcker Rule not "restrict the ability of a [bank] to sell or securitize loans."
- The SEC has proposed public style disclosures for asset classes that traditionally issue ABS in the private placement market. Such a requirement could put a stranglehold on many non-traditional asset sectors that employ securitization as an efficient funding mechanism, such as franchise businesses like Domino's Pizza and Sonic restaurants, and small to medium-sized companies funding timeshares, railcars, containers, cell towers and film receivables.
- Some regulations have yet to be proposed, but are potentially so impactful that they have already caused significant concern in the market. For example, Dodd-Frank granted the FDIC authority to orderly liquidate certain nonbank financial companies, some of which use securitization to fund auto and equipment loans, among other assets. The orderly liquidation authority (OLA) may be used to change or add to the insolvency laws that currently apply to these types of securitizations, potentially exposing investors to insolvency risks that have not existed before. The ABS market briefly grounded to a halt in December 2010 because of investor concerns around OLA, and only resumed due to a near term patch in the form of an FDIC general counsel's letter. These types of risks will be priced into the ABS, resulting in higher costs for consumers and businesses.
- Finally, special attention should be given to the risk-based and liquidity capital rules that are being enacted in the United States over the next several years. Each of these rulemakings will have a very real impact on the consumer economy, as they will determine the amount of capital a bank needs to hold against specific

> investments, including investments in securities that are backed by consumer and business assets such as auto loans, credit cards and equipment loans. If these rules are not appropriately calibrated, consumers and businesses alike will be impacted by the resulting costs.

While each of the rulemakings mentioned in this testimony is significant in its own right, the aggregate effect of all will have profound impacts on the consumer economy. We ask that regulators and Congress work alongside the industry to produce workable and effective rules that do not inhibit securitization or make it prohibitively more expensive, as either result will inevitably be felt by main street consumers and businesses. As demonstrated from the statistics below, our sputtering economy can ill-afford to keep the securitization market on the sidelines.

II. The State of the Securitization Market

Different segments of the asset-backed securities ("ABS") markets have recovered at varying levels since the end of the recent recession, as noted by the Board of Governors of the Federal Reserve System ("FRB") in its October 2010 report on risk retention.[12] Although auto loan and lease ABS rebounded to $59.4 billion in issuance in 2011, this level remains down from the $79.7 billion in issuance in 2006.[13] Another area of strong performance has been in equipment ABS, where issuance in 2011 moved up to $8.6 billion, surpassing the $8.4 billion of 2006 issuance.[14] These asset classes, however, remain exceptions. Between 2006 and 2011, credit card ABS issuance dropped 77.1% from $72.5 billion to $16.4 billion,[15] in large part due to banking regulators linking capital requirements directly to accounting consolidation standards under FAS 166 and 167. During those same four years, student loan issuance has fallen nearly 73.4% from $65.7 billion to $17.5 billion.[16] By comparison, on the residential mortgage-backed security ("RMBS") side, only $22.2 billion of private-label RMBS were issued in 2011, down **96.9%** from the $723.3 billion issued in 2006.[17] In addition to the overall reduction of issuance in the RMBS market, we further note that 98% of RMBS were federally-backed in 2011, as compared with only 56% in 2006 when private credit accounted for a much larger share of RMBS issuance.[18]

Simply put, the absence of a properly functioning securitization market, and the funding and liquidity this market has historically provided, adversely impacts consumers, businesses, financial markets and the broader economy. The recovery and restoration of confidence in securitization is therefore a necessary ingredient for economic growth to resume, and for that growth to continue on a sustained basis into the future.

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[12] Board of Governors of the Federal Reserve System, "Report to the Congress on Risk Retention" (Oct. 2010), p. 2, *available at* http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf.

[13] Data are from *Asset Backed Alert*; *see* also the ASF presentation to the Financial Stability Board of April 10, 2012, *available at* http://www.americansecuritization.com/uploadedFiles/ASF_FSB_Presentation_4-10-12.pdf.

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] *Id.*

[18] *Id.*

III. Risk Retention

ASF continues to support better alignment of incentives of issuers and originators with investors of ABS and we believe these incentives should encourage the application of sound underwriting standards. Despite the appreciable efforts of the FRB, Department of Housing and Urban Development, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Office of the Comptroller of the Currency, and Securities and Exchange Commission (collectively, the "Risk Retention Regulators"), significant work still needs to be done to evolve the proposed risk retention regulations into workable solutions. Outlined below are a few key issues with respect to risk retention.[19]

a. Premium Capture

ASF strongly opposes the proposed premium capture rule, as it exceeds the mandate and legislative intent of Dodd-Frank by adding on to the 5% risk retention requirement the entire value of ABS issued in a securitization over par—effectively nullifying the securitizer's entire return on the transaction. The premium capture rule also does not take into account the cost of origination of loans, including out-of-pocket costs such as appraisals, title insurance, and overhead, and interferes with an originator's ability to use interest rate hedges and thus offer rate locks to borrowers. The rule as drafted will have pervasive effects on securitization and borrowers, including virtually assuring the accounting consolidation of the securitization onto the balance sheet of the securitizer regardless of the risk retention form employed. For financial institutions with regulatory capital requirements, consolidation effectively takes securitization off of the table as a viable funding mechanism.

Most disturbing, however, is that the premium capture rule as currently proposed eliminates virtually all incentives to securitize for institutions other than those that securitize purely for financing. Institutions with other sources of funding will move away from securitization altogether, resulting in a constriction of credit and an increased cost of capital. We view the premium capture rule as the most dangerous proposed rule in that it would effectively sideline banks from engaging in RMBS and CMBS in the future.

b. Failure to Incorporate Market Practices

The commentary in the risk retention proposing release specifically indicates that the proposed risk retention regulations for asset-backed commercial paper ("ABCP") and credit card ABS are meant to track current market practices. However, there are numerous parts of the proposed regulations that are, in fact, not at all consistent and would cause detrimental effects on those markets. Through our comment letter process, ASF has identified these inconsistencies and recommended specific regulatory changes to resolve them.[20]

[19] For more exhaustive coverage of our views on the proposed risk retention regulations, *see* our Risk Retention Comment Letter, *available at* http://www.americansecuritization.com/uploadedFiles/ASF_Risk_Retention_Comment_Letter.pdf.

[20] *See, e.g.*, http://www.americansecuritization.com/uploadedFiles/ASF_ABCP_Risk_Retention_Follow_Up_2_23_12.pdf.

c. Competing Regimes

It is important to highlight that securitization transactions in Europe are subject to their own risk retention requirements set forth in the European Union's CRD Article 122a.[21] The structure of the European risk retention regime is fundamentally different than the U.S. rules. While the U.S. rules apply to issuers of ABS, the European rules apply to European Economic Area credit institutions that invest in ABS. Ultimately, this could have the peculiar result of application of both risk retention regimes, which is further confused by the regulations' differing requirements. Harmonization among the two sets of rules will be critical to a functioning and efficient securitization market that is not weighed down by duplicative requirements and unnecessary costs.

d. The QRM Definition and Leveling the Playing Field

An exemption is provided from the risk retention requirement for high quality assets called "qualified residential mortgages" ("QRMs"). As currently contemplated, only the highest quality mortgage loans will qualify as QRMs and therefore QRMs will comprise only a small percentage of the mortgage market. The Risk Retention Regulators' proposing release indicates that approximately 19.79% of all loans purchased or securitized by the government sponsored enterprises ("GSEs") during the period of 1997-2009, and approximately 30.52% of loans in 2009 alone, would have met the QRM criteria.

We note again that the proposed risk retention regulations provide a complete exemption from the risk retention requirements (including an exemption from the requirement to establish a premium capture cash reserve account) for RMBS guaranteed by the GSEs for so long as the GSEs operate under the conservatorship or receivership of the Federal Housing Finance Agency ("FHFA"). We are concerned that the very conservative terms of the proposed QRM definition, taken together with the risk retention requirements, will provide a significant and undue competitive advantage to the GSEs over private market participants. In our view, the best way to level the playing field and avoid increasing the role of the GSEs in the residential mortgage market is to reduce the impact of the risk retention requirements on private market participants. This could be accomplished in a variety of ways. We urge the Risk Retention Regulators to consider adjusting the criteria for QRMs, such that the vast majority of loans to prime borrowers will qualify as QRMs. Furthermore, reconciling the QRM criteria with the GSE requirements would enable private market participants to compete on equal terms with the GSEs for most of the prime mortgage market. If the QRM definition ultimately is a narrower definition than what qualifies as a conforming loan for the GSEs, because of the GSE exemption from risk retention, the private markets will be so price disadvantaged that every non-QRM loan that is GSE eligible will continue to flow to the GSEs, unless or until they are radically restructured.

IV. QM and Ability-to-Repay

The "qualified mortgage" ("QM"), to be defined by the Bureau of Consumer Financial Protection ("CFPB"), is related to the QRM, in that the QRM's standards can be no broader than

[21] *See* CRD Directive 2006/48/EC, p. 78, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0048:20100330:EN:PDF.

the QM's standards. This means that the size of the QRM market will be limited to, at most, the size of the QM market. The QM comes by statute from Sections 1411 and 1412 of the Dodd-Frank Act, which establish a new ability-to-repay requirement for certain residential mortgage loans and establish that a QM shall be deemed to meet this requirement.

Under the ability-to-repay requirement, a lender may not make a covered mortgage loan unless the lender makes a reasonable and good faith determination, based on verified and documented information, that the borrower will have a reasonable ability to repay the loan. While the proposed ability-to-repay requirement applies to lenders, the legal consequences of noncompliance essentially rest with the secondary market, as Section 1413 of Dodd-Frank imputes liability on investors and other assignees of mortgage loans that do not meet the requirement. Because the requirement is subjective, investors will not be able to make bright-line judgments as to whether a loan complies, making it difficult to invest in loans that are measured solely by that standard.[22]

Dodd-Frank provides that with respect to any residential mortgage loan, a lender, and any investor assignee of that loan, may presume that the loan has met the ability-to-repay requirement if the loan is a QM. However, there are aspects of the QM definition proposed by the FRB that will make it difficult or even impossible to determine whether the loan qualifies, especially in the case of investor assignees, which are far removed from the origination process. The final regulation must be clear and objective. Additionally, the CFPB is determining whether the protection afforded by a QM should be a "safe harbor" or a "rebuttable presumption." These two options would provide starkly different levels of protection for investors in QMs. If investors are not appropriately insulated from liability through a true safe harbor, they will need a significant risk premium to offset the potential liability. Such a premium will undoubtedly be passed on to borrowers in the form of higher interest rates. Our comment letter to the CFPB provides additional detail on the subject.[23]

V. Role of the GSEs Going Forward

Dodd-Frank did not address the question of what to do with Fannie Mae and Freddie Mac (the "GSEs") on a going forward basis, and that debate lingers on. Ultimately, Congress and the Administration must address this issue head-on, but until that time comes, which many commentators believe may be years or even a decade away, there is potential for meaningful change in the near term to fix certain inefficiencies that exist in the agency market.

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[22] The regulation of "high cost" loans under the Home Ownership Equity Protection Act ("HOEPA"), including the availability of significant enhanced damages for HOEPA violations and assignee liability, led to the ultimate demise of the market for HOEPA loans, with many investors, including both Fannie Mae and Freddie Mac, refusing to purchase them. If non-QM loans suffer the same fate as HOEPA loans, credit availability would ultimately be constrained for many borrowers (with the amount of impacted borrowers being dependent upon the size of the QM market).

[23] *See* http://www.americansecuritization.com/uploadedFiles/ASF_Comments_on_QM_NPR_7_22_11.pdf.

a. Current GSE Market Inefficiencies and a Potential Single Security

On February 21, 2012, FHFA released its Strategic Plan[24] that proposes to build a new infrastructure for Fannie Mae and Freddie Mac, including the development of a single securitization platform that would "allow for a single mortgage-backed security." ASF believes that secondary mortgage market participants must play an integral role in the implementation of any such security and began holding member meetings to discuss its implications. On July 2, 2012, in response to the Strategic Plan, ASF produced a White Paper outlining the various views of our members on the creation of a single agency security.[25] The White Paper does not address broader legislative GSE reform, but instead, the deficiencies in the plumbing of the current GSE finance system that can be acted upon in the near-term.

Despite unlimited support by the U.S. government for both GSEs, securities issued by Freddie Mac trade at a substantial discount to comparable securities issued by Fannie Mae. Freddie Mac traditionally has made up for this discount by providing loan sellers a lower guarantee fee or other concessions. For example, Freddie Mac often will offer a "market adjustment payment" to lenders to normalize the pricing differential. Because these incentives decrease revenue to Freddie Mac relative to Fannie Mae, they effectively act as a further government subsidy under the conservatorship. Moving to a single security should minimize, and potentially even eliminate, this differential and save the U.S. taxpayers the very real losses associated with this discount. A single security, whether originally issued by Fannie or Freddie, must be fungible, or of equal value in the market. In order to accomplish this, perceptions about and differences between operations at Fannie and Freddie must be eliminated as described in the White Paper. Implemented correctly, a single agency security could benefit all participants in the mortgage market, including borrowers, originators, investors and the taxpayer. It is critical, however, that policymakers take into account industry perspectives on the development of this security.

VI. Orderly Liquidation Authority

In enacting the orderly liquidation authority of Title II of Dodd-Frank ("OLA"), Congress intended to create a new statutory regime for the orderly liquidation of "Covered Financial Companies", as designated by the Financial Stability Oversight Council ("FSOC"). However, several sources, including the Dodd-Frank Act itself, suggest that Congress also intended for the resulting statutory regime to operate in such a way as to minimize the likelihood of different results to creditors of such potential Covered Financial Companies from those results arising under the Bankruptcy Code. If a creditor faces the possibility of two different insolvency regimes, it will have to structure transactions to comply with both. Doing so will raise transaction costs and ultimately raise the costs and lower the availability of credit. Additionally, two specific issues have emerged since Dodd-Frank was enacted.

The first issue relates to an interpretation of OLA that would give the Federal Deposit Insurance Corporation ("FDIC"), as receiver for a Covered Financial Company, broader powers

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[24] *See* "A Strategic Plan for Enterprise Conservatorships," February 21, 2012 (the "Strategic Plan"), at http://www.fhfa.gov/webfiles/23344/StrategicPlanConservatorshipsFINAL.pdf, which was incorporated into FHFA's broader "Strategic Plan: Fiscal Years 2013-2017" on May 14, 2012.

[25] *See* http://www.americansecuritization.com/uploadedFiles/ASF_Single_Agency_Security_White_Paper_2012.pdf

to avoid certain previously perfected security interests than a trustee (a "Bankruptcy Trustee") under the Bankruptcy Code would have upon a Chapter 7 liquidation of the same Covered Financial Company. To eliminate the ambiguity in a manner consistent with the legislative intent, ASF suggested in a December 13, 2010 letter to the FDIC that these "preference provisions" would benefit from additional rulemaking by the FDIC.[26] The FDIC has since issued a General Counsel's Letter to ASF,[27] a Notice of Proposed Rulemaking,[28] to which ASF responded with further comments,[29] and, in July of last year, a Final Rule[30] to rectify the ambiguity around the priorities and claims process under OLA.

The second issue relates to various "repudiation" concerns, including (i) whether a transfer of property by the Covered Financial Company or a covered subsidiary thereof would constitute an absolute sale or a secured borrowing and (ii) whether the separate existence of another person or entity would be respected and its assets and liabilities not substantively consolidated with the assets and liabilities of the Covered Financial Company or of any covered subsidiary thereof.

The resolution of this concern, as elaborated in a separate ASF letter to the FDIC,[31] is to harmonize FDIC rules implementing OLA "with the insolvency laws that would otherwise apply to a covered financial company."[32] In response to ASF's letter, the FDIC issued a General Counsel's Letter[33] in January 2011 clarifying that its repudiation power under OLA would be exercised consistent with the Bankruptcy Code or other applicable insolvency laws, including bankruptcy- and State-law principles governing legal isolation, on an interim basis until 90 days after the FDIC Board of Directors adopts a regulation to formally address the matter, an action that the FDIC Board has not yet taken. We anticipate significant market attention to any future rulemaking in this area.

[26] *See* "ASF FDIC Request re OLA," American Securitization Forum (December 13, 2010), *available at* http://asf.informz.net/ASF/data/images/emailattachments/advocacy/asf_orderly_liquidation_letter_to_the_fdic_12_13_10.pdf.

[27] *See* http://www.americansecuritization.com/uploadedFiles/FDICGeneralCounselLetterreOLA-12-29-10.pdf.

[28] *See* NPR at http://edocket.access.gpo.gov/2011/pdf/2011-6705.pdf.

[29] *See* http://www.americansecuritization.com/uploadedFiles/ASF_OLA_Transfers_Letter_FINAL_5_23_11.pdf.

[30] *See* http://www.gpo.gov/fdsys/pkg/FR-2011-07-15/pdf/2011-17397.pdf.

[31] ASF's letter requested that (a) the FDIC as receiver for a covered financial company shall not, in the exercise of its statutory authority to disaffirm or repudiate contracts, reclaim, recover, or re-characterize as property of the covered financial company or the receivership financial assets transferred by the covered financial company, provided that such transfer satisfies the conditions for a legal true sale as applied in the law defining property of the estate under the Bankruptcy Code, and (b) the Act does not itself contain any provision which would mandate a different approach or analysis regarding the factors or circumstances under which the separate existence of one or more legal entities would properly be disregarded than the existing approach or analysis under the Bankruptcy Code. *See* http://www.americansecuritization.com/uploadedFiles/ASF_Orderly_Liquidation_Letter_1_14_11.pdf.

[32] *See* Section 209 of Dodd-Frank.

[33] *See* http://www.americansecuritization.com/uploadedFiles/GC_Letter_to_ASF_1_14_2011.pdf.

VII. Rating Agency Reform

a. Franken Amendment Study & Rule 17g-5

On May 10, 2011, the Securities and Exchange Commission ("SEC") published a request for comment relating to the study the SEC is required to undertake pursuant to Dodd-Frank Section 939F (the "Franken Amendment") addressing, among other things, the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns nationally recognized statistical rating organizations ("NRSROs") to determine credit ratings of structured finance products. Because of the structure of Section 939F, the SEC is required to implement the assignment system unless the SEC "determines an alternative system would better serve the public interest and the protection of investors."

As we elaborated in our comments to the SEC in September 2011,[34] we believe that any proposal to establish such a system would be detrimental to the securitization market in a number of ways. Such a system is premised on the assumption that all "qualified" NRSROs are created equal with respect to rating a particular asset class. However, internal investor guidelines restrict the securities in which they can invest based on the NRSRO that provides the rating and issuers may struggle to market securities that have a rating from a non-approved NRSRO. The Franken Amendment would also cause potential conflicts of interest and moral hazard given that the government would create the initial assignment board. Furthermore, the alleged purpose of Section 939F is to examine and eliminate the perceived conflicts associated with the "issuer-pay" ratings model. The SEC has already attempted to address this conflict with its amended Rule 17g-5, which requires issuers to post information provided to hired NRSROs so that non-hired NRSROs can produce unsolicited ratings. While modifications to Rule 17g-5 are necessary to adequately alleviate any perceived conflicts in rating structured finance products, we believe it is a far better alternative to the counterproductive approach suggested by the Franken Amendment.

b. The Repeal of Rule 436(g)

Upon the effective date of Dodd-Frank in the summer of 2010, Rule 436(g) under the Securities Act was repealed, which caused the complete shutdown of the U.S. public securitization market. Rule 436(g) had excluded NRSROs from being treated as "experts" when their ratings were included in a registration statement under the Securities Act. Repealing Rule 436(g) required NRSROs to consent to the inclusion of their rating in a prospectus, which attached liability to the institution. ASF immediately began discussions with SEC staff to help alleviate the problem. The market paralysis was partially mitigated through the grant of temporary no-action relief by the staff of the SEC on July 22, 2010.[35] The no-action letter relief was then extended indefinitely on November 23, 2010.[36] ASF applauds the SEC's decision to issue the no-action letters but believes a permanent, comprehensive solution is needed to ensure the long-term viability of the U.S. public securitization markets. Given the implications of Rule

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[34] *See* our comment letter for more information on assigned credit ratings and a modified Rule 17g-5, *available at* http://www.americansecuritization.com/uploadedFiles/ASF_Letter_to_SEC_regarding_Franken_Amendment_(9-12-11).pdf.

[35] *See* http://www.americansecuritization.com/uploadedFiles/SEC_NAL_July2010.pdf.

[36] *See* http://sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm.

436(g) outlined above, ASF believes that proposed solutions may include amending Regulation AB to permanently eliminate the requirement to include ratings in the prospectus or enacting legislation to repeal the repeal of Rule 436(g).[37]

VIII. Volcker, Conflicts of Interest, Derivatives

a. Volcker Rule

The Volcker Rule, despite its breadth as written, is intended to address concerns that have nothing to do with the securitization markets: specifically, the concern that banking entities may be exposed to undue risks through proprietary trading and the sponsorship and ownership of hedge funds and private equity funds. However, many securitization vehicles potentially are brought within scope of the proposed regulations simply because they share the same exemptions from the Investment Company Act as traditional hedge funds and private equity funds. In fact, Section 13(g)(2) of the Volcker Rule specifically required that the Volcker Rule not "restrict the ability of a [bank] to sell or securitize loans."

Anything short of an exclusion for securitization entities from the definition of covered fund will limit the securitization market in a manner prohibited by Section 13(g)(2) of the Volcker Rule. Accordingly, we believe it is appropriate for the regulators charged with finalizing the Volcker Rule to provide for a broad carve out for entities that act as depositors and issuers in securitization transactions in the final Volcker Rule regulations.

b. Conflicts of Interest in Securitization

Section 621 of Dodd-Frank seeks to address conflicts of interest in securitization and generally provides that an underwriter or sponsor (or any affiliate or subsidiary) of an ABS shall not, for one year after closing, engage in any transaction that would result in any material conflict of interest with respect to any investor. While this general statutory mandate is included in Dodd-Frank and in the proposed rules issued by the SEC, there is significant legislative intent that makes clear this provision was meant to eliminate incentives for market participants to intentionally design ABS to fail. While ASF has expressed its full support of the intent behind the legislation, we remain deeply concerned that overly broad rules could have serious unintended consequences on the secondary market. Any rules implemented by the SEC must be crafted so as to prohibit the situations that result in such material conflicts of interest without causing unnecessary adverse impacts on traditional securitization activities.

c. Regulation of Derivatives

On April 12, 2011, two long-awaited proposed rules on margin and capital requirements for non-cleared swaps were issued, the first jointly by five federal agencies and the second by the Commodity Futures Trading Commission ("CFTC"). In addition, there are numerous other related proposals that may affect securitization, including (i) the SEC's end-user exception to the mandatory clearing of security-based swaps and swap participant definitions, (ii) the CFTC's swap participant definitions and the end-user exception and (iii) business conduct standards for

[37] *See* our support for the "Asset-Backed Market Stabilization Act" which seeks to reinstate Rule 436(g), *available at* http://www.americansecuritization.com/uploadedFiles/ASF_Letter_Supporting_HR_1539_and_HR_940.pdf.

"swap dealers" and "major swap participants" relating to ERISA plans. ASF has submitted comment letters on all of these proposals.[38] ASF believes that structured finance participants should not, standing alone, be considered to be included in any of these new rulemakings and that, in particular, the mandatory clearing, margin and capital requirements should not apply to swaps entered into by structured finance participants.

Applying any of these requirements may render many structured financings uneconomic as the special purpose vehicle ("SPV") would be required to post cash and liquid securities which it does not have. The source of repayment for structured financings is generally the cash flow from the assets or receivables which is generated over time. Applying clearing, margin and capital requirements would affect the cash flow analysis for a structured financing and cause adverse effects on the functioning of this market, including ultimately resulting in a reduction in the available amount of loans or other financing for the assets underlying the structured financing.

IX. Capital

a. Section 939A

Section 939A of Dodd-Frank requires that the federal regulators remove any reference to or reliance on credit ratings from federal regulations and substitute appropriate standards of creditworthiness in their place. Therefore, it has been necessary in light of Section 939A for the bank regulators to propose and adopt changes to the capital rules that use alternatives to ratings as the methods for determining such capital charges. As a result, our advocacy in this area has been devoted to ensuring that the resulting capital requirements (i) assess capital charges that are appropriate for the risks of securitization positions held by banks, and (ii) can be reasonably determined by banks based on the information available to banks that invest in ABS.

Since the adoption of Dodd-Frank, the uncertainty associated with complying with new and different capital requirements has made many U.S. banks more reluctant to invest in potential securitizations. This has substantially decreased the liquidity of the securitization market, impacting both the availability and cost of the sources of consumer and business credit that would otherwise have been financed through securitizations. More clarity now exists with respect to these issues since last month the bank regulators adopted final rules for determining the capital required for asset-backed securities held in a bank's trading book and proposed regulations for determining the capital of ABS held in a bank's banking book. These regulations rely on the use of supervisory formulas for determining the capital of securitization positions in

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[38] *See* "ASF Margin and Capital Requirements for Covered Swap Entities Letter" (July 11, 2011) *at* http://www.americansecuritization.com/uploadedfiles/asfswapmarginletter20110711.pdf; "ASF Derivatives End-User Exception Comment Letter to SEC," (February 4, 2011), *at* http://asf.informz.net/ASF/data/images/emailattachments/advocacy/asf_letter_to_sec_re_end-user_exception.pdf; *see* "ASF Derivatives Comment Letter to SEC," (February 14, 2011), *at* http://asf.informz.net/ASF/data/images/emailattachments/advocacy/asf_letter_to_sec_re_derivatives-2-14-11.pdf; *see* "ASF Derivatives Comment Letter to CFTC," (February 22, 2011), *at* http://www.americansecuritization.com/uploadedFiles/2_22_11_ASF_CFTC_letter_re_Derivatives.pdf; and *see* "ASF Title VII Business Conduct Standards Letter," (February 22, 2011), *at* http://www.americansecuritization.com/uploadedFiles/2_22_11_ASF_cftc_comment_letter_re_business_conduct_standards.pdf.

lieu of ratings. We have appreciated the willingness of the bank regulators to work with our members to address some of the most significant issues associated with these formulas and their inputs and we believe that the regulators have attempted to address many of these issues in the final market risk regulations and in the proposed banking book regulations. Without these changes, required capital would have been severely overstated for many senior securitization positions and understated for certain riskier, junior securitization positions, improperly providing incentives to banks to invest in the latter.

While ASF members have been very supportive of removing the "government seal of approval" of ratings from regulations, the replacement should at minimum be better than ratings. Even with these changes, however, two things have become clear with respect to the implementation of section 939A. First, the complexity within the system for determining capital has drastically increased the cost and manpower necessary to calculate that capital. Second, it remains very unclear whether this dramatic increase in cost and complexity will actually lead to stronger capital levels throughout the financial system.

b. Basel 2.5, III

The global response to recent financial crises has targeted regulatory capital and liquidity standards as well. We support initiatives both here and abroad to ensure that all banking institutions maintain robust capital and liquidity buffers to guard against systemic and idiosyncratic shocks. We also applaud regulatory authorities who have been thoughtfully wrestling with the extraordinarily challenging policy and implementation issues that these initiatives have presented.

Here again, however, businesses and consumers alike are experiencing more costly and less available credit because policymakers opted for a hasty shotgun approach over more targeted and coherent measures. For example, the Basel III liquidity framework published in December 2010 would require banking institutions to prefund all or part of their short-term obligations (including unfunded commitments) with unencumbered, high-quality liquid assets. This means that, if the highest-quality bank in the United States were to provide a $500 million committed liquidity facility to the highest-quality corporation, the bank would need to acquire and set aside in advance at least $500 million of unencumbered cash or government securities to guard against even the most improbable risk of that facility being drawn within the next 30 days. Another example is Section 171 of the Dodd-Frank Act, which establishes "generally applicable risk-based capital requirements" as a floor for all U.S. banking institutions. Because the United States and the rest of the G20 have long endorsed a regulatory capital framework that imposes a separate set of standards on internationally active institutions, the second-order effect of Section 171 is that larger U.S. institutions will be forced to adhere to and monitor compliance with two different regulatory capital regimes in parallel. Yet another example is the incongruity between accounting standards that were fundamentally revised in 2009 to discount exposure to risk and U.S. risk-based capital standards that continue to rely on them. This has not only resulted in duplicative capital being held against the same loan to a business or consumer, with associated adverse effects on the cost and availability of that loan, but the door has also been opened to increased regulatory arbitrage and misdirected economic incentives.

X. Conclusion

In this testimony, we have endeavored to give a brief snapshot of key initiatives under Dodd-Frank that will create significant challenges for securitization to deliver low-cost credit availability to consumers and businesses nationwide. But Dodd-Frank is not being implemented in a vacuum. That is, these businesses have to continue to operate and function while also attempting to implement these massive regulatory changes. Additionally, other policy initiatives not mentioned in this testimony (due to length concerns) are also being undertaken and create substantial compliance challenges. These other initiatives should also be considered in this context. They include:

- The SEC's Regulation AB II Proposals;
- The SEC's ANPR and Concept Release on the Investment Company Act;
- The FDIC's NPR on Assessments and Large Bank Pricing;
- The FDIC's Securitization Safe Harbor;
- The FRB's NPR on Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies (Reg YY);
- The CFPB's RFI on Private Education Loans;
- The FHFA's Alternative Servicing Compensation Proposals; and[39]
- Numerous International Proposals.

ASF greatly appreciates the invitation to appear before this Subcommittee to share our views related to these current issues. I look forward to answering any questions the Subcommittee may have.

Thank you.

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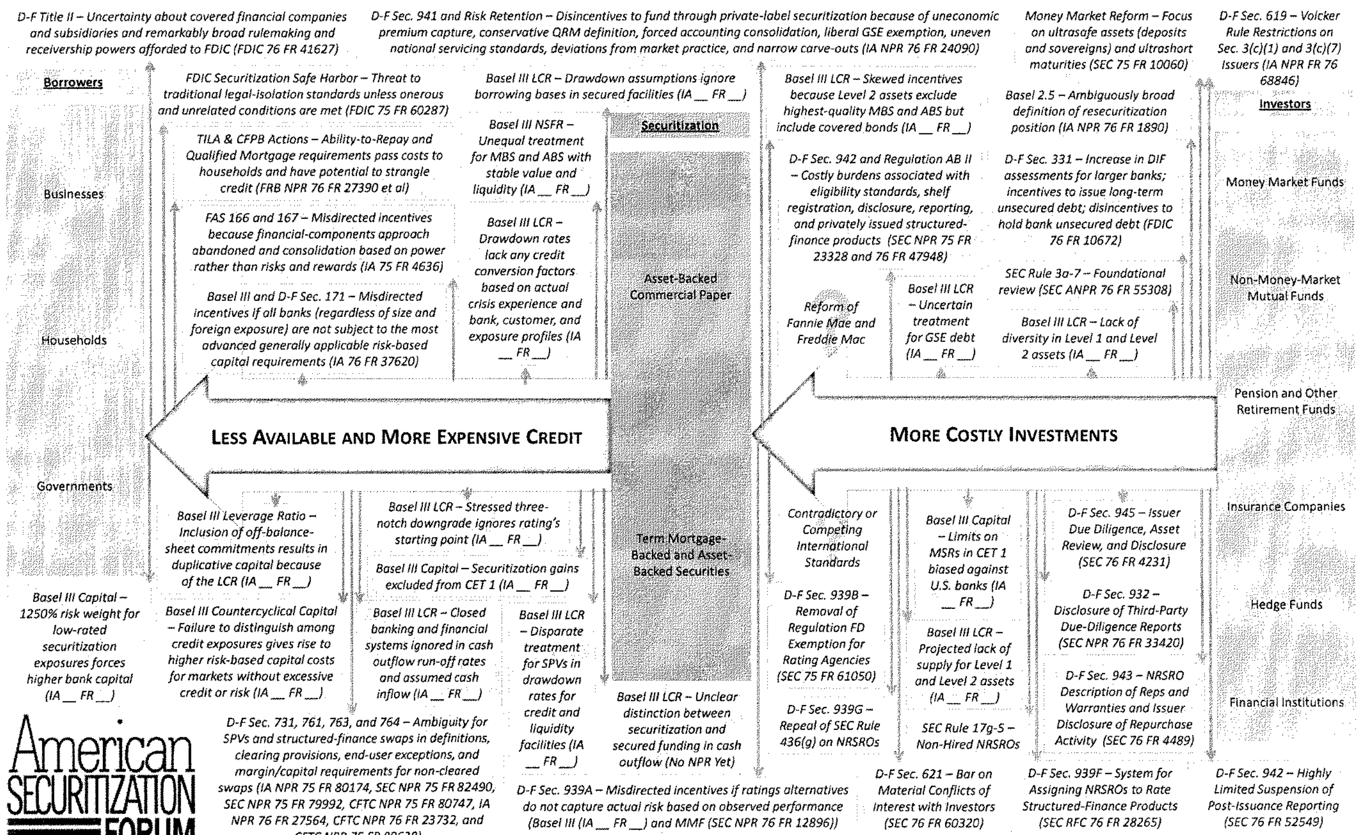
[39] *See* ASF's comment letters in response to these rulemakings, *at* http://www.americansecuritization.com/uploadedFiles/ASFRegABIICommentLetter8.2.10.pdf, http://www.americansecuritization.com/uploadedFiles/ASFRegABIIABCPCommentLetter8.2.10.pdf, http://www.americansecuritization.com/uploadedFiles/ASF_Reg_AB_II_Waterfall_Comment_Letter_8.31.10.pdf, http://asf.informz.net/ASF/data/images/emailattachments/advocacy/asf_reg_ab_ii_auto_abs_comment_letter_8.31.10.pdf, http://www.americansecuritization.com/uploadedFiles/ASF_Comment_Letter_on_SEC_Reg_AB_II_Re-Proposal_10-4-11.pdf, http://www.americansecuritization.com/uploadedFiles/ASF_Equipment_ABS_Letter_(11-2-11).pdf, http://www.americansecuritization.com/uploadedFiles/ASF_Rule_3a-7_Comment_Letter_11_7_11.pdf, http://www.americansecuritization.com/uploadedFiles/ASF_3(c)(5)(C)_Comment_Letter_11_7_11.pdf, http://www.americansecuritization.com/uploadedFiles/Associations_Response_to_Revised_Higher-Risk_Asset_Definitions_120529.pdf, http://www.americansecuritization.com/uploadedFiles/ASF-FDIC-NPR-Response-Letter-7.1.10.pdf, http://www.americansecuritization.com/uploadedFiles/ASF_Comment_Letter_on_Reg_YY_NPR_4_29_12.pdf, http://www.americansecuritization.com/uploadedFiles/ASF_Letter_to_CFPB_re_Private_Education_Lending_1_17_12.pdf, and http://www.americansecuritization.com/uploadedFiles/ASF_Alternative_Servicing_Comp_Letter_(12-21-11).pdf.

Exhibit A



D-F Title II – Uncertainty about covered financial companies and subsidiaries and remarkably broad rulemaking and receivership powers afforded to FDIC (FDIC 76 FR 41627)
D-F Sec. 941 and Risk Retention – Disincentives to fund through private-label securitization because of uneconomic premium capture, conservative QRM definition, forced accounting consolidation, liberal GSE exemption, uneven national servicing standards, deviations from market practice, and narrow carve-outs (IA NPR 76 FR 24090)
Money Market Reform – Focus on ultrasafe assets (deposits and sovereigns) and ultrashort maturities (SEC 75 FR 10060)
D-F Sec. 619 – Volcker Rule Restrictions on Sec. 3(c)(1) and 3(c)(7) Issuers (IA NPR FR 76 68846)
Borrowers
Businesses
Households
Governments
FDIC Securitization Safe Harbor – Threat to traditional legal-isolation standards unless onerous and unrelated conditions are met (FDIC 75 FR 60287)
TILA & CFPB Actions – Ability-to-Repay and Qualified Mortgage requirements pass costs to households and have potential to strangle credit (FRB NPR 76 FR 27390 et al)
FAS 166 and 167 – Misdirected incentives because financial-components approach abandoned and consolidation based on power rather than risks and rewards (IA 75 FR 4636)
Basel III and D-F Sec. 171 – Misdirected incentives if all banks (regardless of size and foreign exposure) are not subject to the most advanced generally applicable risk-based capital requirements (IA 76 FR 37620)
Basel III LCR – Drawdown assumptions ignore borrowing bases in secured facilities (IA __ FR __)
Basel III NSFR – Unequal treatment for MBS and ABS with stable value and liquidity (IA __ FR __)
Basel III LCR – Drawdown rates lack any credit conversion factors based on actual crisis experience and bank, customer, and exposure profiles (IA __ FR __)
Securitization
Asset-Backed Commercial Paper
Term Mortgage-Backed and Asset-Backed Securities
Basel III LCR – Skewed incentives because Level 2 assets exclude highest-quality MBS and ABS but include covered bonds (IA __ FR __)
D-F Sec. 942 and Regulation AB II – Costly burdens associated with eligibility standards, shelf registration, disclosure, reporting, and privately issued structured-finance products (SEC NPR 75 FR 23328 and 76 FR 47948)
Reform of Fannie Mae and Freddie Mac
Basel III LCR – Uncertain treatment for GSE debt (IA __ FR __)
Basel 2.5 – Ambiguously broad definition of resecuritization position (IA NPR 76 FR 1890)
D-F Sec. 331 – Increase in DIF assessments for larger banks; incentives to issue long-term unsecured debt; disincentives to hold bank unsecured debt (FDIC 76 FR 10672)
SEC Rule 3a-7 – Foundational review (SEC ANPR 76 FR 55308)
Basel III LCR – Lack of diversity in Level 1 and Level 2 assets (IA __ FR __)
Investors
Money Market Funds
Non-Money-Market Mutual Funds
Pension and Other Retirement Funds
Insurance Companies
Hedge Funds
Financial Institutions
LESS AVAILABLE AND MORE EXPENSIVE CREDIT
MORE COSTLY INVESTMENTS
Basel III Leverage Ratio – Inclusion of off-balance-sheet commitments results in duplicative capital because of the LCR (IA __ FR __)
Basel III Capital – 1250% risk weight for low-rated securitization exposures forces higher bank capital (IA __ FR __)
Basel III Countercyclical Capital – Failure to distinguish among credit exposures gives rise to higher risk-based capital costs for markets without excessive credit or risk (IA __ FR __)
Basel III LCR – Stressed three-notch downgrade ignores rating's starting point (IA __ FR __)
Basel III Capital – Securitization gains excluded from CET 1 (IA __ FR __)
Basel III LCR – Closed banking and financial systems ignored in cash outflow run-off rates and assumed cash inflow (IA __ FR __)
Basel III LCR – Disparate treatment for SPVs in drawdown rates for credit and liquidity facilities (IA __ FR __)
D-F Sec. 731, 761, 763, and 764 – Ambiguity for SPVs and structured-finance swaps in definitions, clearing provisions, end-user exceptions, and margin/capital requirements for non-cleared swaps (IA NPR 75 FR 80174, SEC NPR 75 FR 82490, SEC NPR 75 FR 79992, CFTC NPR 75 FR 80747, IA NPR 76 FR 27564, CFTC NPR 76 FR 23732, and CFTC NPR 75 FR 80638)
Basel III LCR – Unclear distinction between securitization and secured funding in cash outflow (No NPR Yet)
D-F Sec. 939A – Misdirected incentives if ratings alternatives do not capture actual risk based on observed performance (Basel III (IA __ FR __) and MMF (SEC NPR 76 FR 12896))
Contradictory or Competing International Standards
D-F Sec. 939B – Removal of Regulation FD Exemption for Rating Agencies (SEC 75 FR 61050)
D-F Sec. 939G – Repeal of SEC Rule 436(g) on NRSROs
Basel III Capital – Limits on MSRs in CET 1 biased against U.S. banks (IA __ FR __)
Basel III LCR – Projected lack of supply for Level 1 and Level 2 assets (IA __ FR __)
SEC Rule 17g-5 – Non-Hired NRSROs
D-F Sec. 621 – Bar on Material Conflicts of Interest with Investors (SEC 76 FR 60320)
D-F Sec. 945 – Issuer Due Diligence, Asset Review, and Disclosure (SEC 76 FR 4231)
D-F Sec. 932 – Disclosure of Third-Party Due-Diligence Reports (SEC NPR 76 FR 33420)
D-F Sec. 943 – NRSRO Description of Reps and Warranties and Issuer Disclosure of Repurchase Activity (SEC 76 FR 4489)
D-F Sec. 939F – System for Assigning NRSROs to Rate Structured-Finance Products (SEC RFC 76 FR 28265)
D-F Sec. 942 – Highly Limited Suspension of Post-Issuance Reporting (SEC 76 FR 52549)
American SECURITIZATION FORUM®

Dennis M. Kelleher
President and CEO
Better Markets, Inc.
Testimony on "The Impact of Dodd-Frank on Customers, Credit, and Job Creators"
The Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises
July 10, 2012

Good morning Mr. Chairman Garrett, Ranking Member Waters and members of the subcommittee. Thank you for the invitation to Better Markets to testify today.

Better Markets is a nonprofit, nonpartisan organization that promotes the public interest in the domestic and global capital and commodity markets. It advocates for transparency, oversight and accountability with the goal of a stronger, safer financial system that is less prone to crisis and failure, thereby, eliminating or minimizing the need for more taxpayer funded bailouts. Better Markets has filed almost 100 comment letters in the U.S. rulemaking process related to implementing the financial reform law and has had dozens of meetings with regulators. Our website, www.bettermarkets.com, includes information on these and the many other activities of Better Markets.

My name is Dennis Kelleher and I am the President and CEO of Better Markets. Prior to that, I was a senior staffer in the Senate. Prior to the Senate, I was a litigation partner at Skadden, Arps, Slate, Meagher & Flom, where I specialized in securities and financial markets in the U.S. and Europe. Prior to obtaining degrees at Brandeis University and Harvard Law School, I enlisted in the U.S. Air Force while in high school and served four years active duty as a crash-rescue firefighter. I grew up in central Massachusetts.

INTRODUCTION

Customers, credit and credit markets, job creators, businesses, investors and consumers – all of Main Street and much of America, for that matter – have been devastated by a terrible economy that is a direct the result of the financial collapse and economic crisis that began in 2007, reached a peak in 2008-2009 and continues to this day. Indeed, it was the worst financial collapse since the Stock Market Crash of 1929 and it is the worst economy since the Great Depression of the 1930s.

While many played a role in the recent collapse and crisis, Wall Street is at the top of the list of those responsible because it caused that collapse and crisis by the reckless and irresponsible creation and distribution of toxic and often worthless securities, among their many other actions.

Unfortunately, Wall Street, many of the major financial industry participants, and their trade groups and other allies deny or minimize their role in the financial collapse and the economic crisis. Moreover, they are trying to obscure and conceal the cost of the collapse and crisis. Perhaps most importantly, they are also engaged in a comprehensive misinformation campaign that attempts to refocus the public debate **away from the crisis** and Wall Street's role in creating it **to the new financial reform law** and the rules being put in place to prevent another crisis and protect the American people, taxpayers, Treasury and economy.

Thus, before the "impact" of the Dodd-Frank financial reform law–more properly understood as **the Wall Street re-regulation law** – on customers, credit and job creators can be properly considered, a thorough discussion of the Wall Street-created financial collapse and economic crisis that gave rise to that law must come first. After all, it would be impossible to evaluate the impact of a law without the context and an understanding of why the law exists, what the law was intended to do and how it was designed to do it.

Wall Street was able to cause the collapse and crisis largely because it used its economic power to gain political, academic, media and other power that enabled it to tear down the many laws, rules and regulations put in place during the Great Depression of the 1930s to protect the American people from Wall Street's recklessness and greed. It must be remembered that, after those laws, rules and regulations were put in place, our country did not have a financial or economic crisis on that scale for more than 70 years.

It must also be remembered that, even with all those many laws, rules and regulations – a truly unprecedented degree of government regulation of Wall Street and the U.S. capital markets – our country prospered; we built the largest and most broad-based middle class in the history of the world; and Wall Street, our financial industry, our nonfinancial businesses and our economy all thrived.

By 2000, virtually all of those protections were torn down and Wall Street was not just de-regulated, but almost entirely un-regulated. The results are clear: after 70 years of regulation that protected the American people, our financial system and our economy, it took just 7 years for Wall Street's unregulated investment, trading and other activities to cause what almost became a second Great Depression.

Those actions by Wall Street required the U.S. government to spend, lend, guarantee, pledge, assume, or otherwise use trillions of dollars to save Wall Street from itself and to prevent the crisis from becoming even worse. While they may deny it, every single major bank and all of the other too big to fail financial institutions would have collapsed into bankruptcy but for the actions of the U.S. government and the taxpayer dollars used to bail them out and put them back on the road to profitability. Thus, JPMorgan Chase, Goldman Sachs, Morgan Stanley, Merrill Lynch, Bank of America, AIG, Citigroup and the others are only in business today because they were all bailed out by the U.S. government and the American taxpayer.

But, those bailouts were only part of the costs of that crisis. The economic wreckage caused by Wall Street's actions has touched every corner of our country: high and persistent unemployment and under-employment, historically high foreclosures and underwater homeowners, slow-to-no economic growth, business failures, untold wealth destruction, widespread and growing poverty, and so many other costs continue to mount, including, increasingly, a loss of belief in the American Dream.

Just one measure of these costs reveals how deep and overwhelming the crisis has been and continues to be on our country: the Federal Reserve Board recently released a study that shows that **the net worth of the median family declined 38.8% in just three years, from 2007-2010, wiping out more than $7 trillion in wealth** – **almost two decades of prosperity** – **that was due entirely to the financial crisis.**

This financial and economic calamity has proved yet again that, other than war, nothing devastates a country more than the economic ruin that follows a financial crisis such as the one that began in 2007. (Better Markets tracks the cost of the crisis on its website: www.bettermarkets.com.)

The Dodd-Frank financial reform law was passed to prevent that from ever happening again. It was necessary to protect the American people, taxpayers and Treasury from Wall Street and to eliminate or minimize the need for any future bailouts. The law is designed to do that largely by re-regulating Wall Street and systemically significant institutions and activities. After all, the financial crisis and the costs it created arose due to the de-regulation and non-regulation of Wall Street. In stark contrast, the country prospered after Wall Street was comprehensively regulated for the 70 or so years after the Great Depression.

Any attempted genuine evaluation of the impact of the Dodd-Frank financial reform and Wall Street re-regulation law, or parts of it, must take these facts into account.

And, of course, any attempt to really understand the financial reform law and its impact would require considering the law as a whole and not just picking a couple of discrete parts, taken out of context, and discussing them as if they were either representative of the entire law or somehow could be properly understood as isolated standalone provisions. Thus, while this hearing seeks specific comment only on derivatives regulation, the Volcker rule, risk retention, and single counterparty credit limits, understanding how these provisions relate to the entirely of financial reform and how they relate to preventing another financial collapse and economic crisis are essential to evaluating them or their impact.

My testimony will, therefore, first review the financial collapse and economic crisis, the deregulation of the financial industry and what it has cost and continues to cost the American people. Then I will discuss the re-regulation of the financial industry and the need to shift costs from society back to the industry so that incentives and costs are properly aligned to reduce reckless behavior and the need for bailouts. Unsurprisingly, this re-regulation has caused industry to complain about its costs, but history proves that such complaints have little merit and that the industry and the country can thrive when Wall Street is properly regulated. Industry's latest attack on financial reform is an attempt to impose a burdensome cost benefit analysis on every rule, but that tactic is also without merit. Lastly, I will discuss the specific rules the hearing will focus on.

Financial reform was necessitated by the largest financial and economic collapse since the Stock Market Crash of 1929 and the Great Depression of the 1930s, and it was enacted to prevent a second Great Depression

As the aftershocks of the Lehman Brothers bankruptcy shook the world in September of 2008, the U.S. and global financial system seized up and nearly collapsed. Only massive, multi-trillion dollar interventions by the U.S. government and international institutions prevented that calamity in the fall of 2008 and the spring of 2009. Making matters worse, as the **financial system** was unraveling, the U.S. and global **economies** were also grinding to a halt. That too required multi-trillion dollar governmental actions to prevent a second Great Depression.

The wave of bailouts, buyouts, and other rescue efforts that were undertaken to support the nation's leading financial institutions revealed the depth of the unfolding crisis. In the days and weeks after the Lehman bankruptcy, the U.S. government nationalized Fannie Mae and Freddie Mac, and then effectively nationalized AIG and Citigroup through bailouts totaling hundreds of billions of dollars. To prevent their inevitable bankruptcies, investment banks Goldman Sachs and Morgan Stanley were allowed to quickly convert into bank holding companies, thereby receiving full access to the federal safety net. Bank of America acquired investment bank Merrill Lynch, and Wells Fargo acquired Wachovia (derailing Citigroup's attempt to buy Wachovia only days before). The nation's largest savings and loan association, Washington Mutual, failed, was seized by regulators, and was ultimately sold to JPMorgan Chase at a bargain basement price (similar to the bargain price JPMorgan paid for Bear Stearns in March 2008).

Throughout this time, the U.S. government was creating innumerable rescue programs to prevent any financial institution or sector of the financial industry (including the $3.8 trillion money market fund industry) from collapsing. The much ballyhooed $700 billion TARP program was but one of the countless emergency measures adopted during this time.[1] And, it must be remembered that the U.S. government also assisted foreign banks and financial institutions throughout the world, not just those in the U.S. The pace and scale of deteriorating events was unprecedented, as the contagion from the liquidity and solvency crises spread rapidly to every corner of the financial system and the globe.

But even those unprecedented actions, programs, and interventions -- representing trillions of dollars -- were not sufficient to stop the multiple crises from spiraling out of control, as almost every financial indicator continued to deteriorate and to do so at an accelerating pace into 2009. Indeed, as late as February 2009, **more than five months after the Lehman bankruptcy**, the financial systems and economies of the U.S. and the global community were still declining rapidly, with no bottom in sight. Policymakers were facing a very dark and dangerous abyss and **the possibility of a second Great Depression was a very real and increasingly likely prospect**.

In response, the U.S. government took additional unprecedented actions. For example, on February 23, 2009, it announced that the full faith and credit of the United States would stand behind **the entire financial system, which was thus effectively nationalized**, as set forth in this dramatic policy statement:

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[1] It what appears to be yet another attempt to minimize and understate the depth and cost of the crisis, some talk misleadingly as if TARP was the only government rescue program and some even claim that TARP will make money. That is not accurate. TARP is currently projected to cost at least $60 billion. However, even if all the money TARP lent was paid back, that doesn't mean it would have "made" money. The silly claim that has been made by people who know better is that if TARP (or any one of the other bailout programs) take in one penny more than it lent (or the other programs spent, pledged, guaranteed or otherwise used), then it made money. That is simply misleading propaganda. The only proper way to evaluate any of these programs is what any return was or should have been on a **risk adjusted basis**. By that measure, not only have none of the government bailouts "made" money; they have all cost taxpayers and the government hundreds of billions if not trillions of dollars (above and beyond all the other costs).

> A strong, resilient financial system is necessary to facilitate a broad and sustainable economic recovery. The U.S. government stands firmly behind the banking system during this period of financial strain to ensure it will be able to perform its key function of providing credit to households and businesses. The government will ensure that banks have the capital and liquidity they need to provide the credit necessary to restore economic growth. Moreover, we reiterate our determination to preserve the viability of systemically important financial institutions so that they are able to meet their commitments.

Joint Statement by the Treasury, FDIC, OCC, OTS, and the Federal Reserve (Feb. 23, 2009) (full statement available at http://www.federalreserve.gov/newsevents/press/bcreg/20090223a.htm).

That historic step was followed by others, and trillions of additional government dollars were spent, lent, pledged, guaranteed, or otherwise used in an all-out effort to prevent a second Great Depression. We now know that those actions somehow worked, that the financial system did not entirely collapse, and that a second Great Depression was avoided. Having lost 54 percent of its value since its October 9, 2007 high, we also now know -- with the benefit of hindsight -- that the stock market hit its lowest point on March 9, 2009 and that the precipitous and uncontrolled decline of the financial markets and the economy stopped sometime in the March-April 2009 period.

However, and most important, **even to this day no one knows** exactly why or how complete disaster was averted. No one knows which policy, program, intervention, action, or expenditure -- or what combination or order of those measures -- arrested the downward spiral.

Nevertheless, the need to prevent such a calamity from ever happening again is overwhelmingly and indisputably clear: Not only did the financial collapse and economic crisis cost many trillions of dollars, it also caused vast, unquantifiable, and still-ongoing human suffering, from skyrocketing unemployment, millions of home foreclosures, widespread poverty, and enormous wealth destruction, to foregone retirements, obliterated college funds, and, for many, the lost American Dream. This proved yet again that, other than war, nothing devastates a country more than the economic ruin that follows a financial crisis such as the one that began in 2008.

That is why comprehensive financial reform and the re-regulation of Wall Street was essential. The Dodd-Frank law is intended to protect the American people, taxpayers, and the U.S. Treasury from ever again having to suffer through and pay for another financial collapse and economic crisis. Above all, it is intended to prevent a second Great Depression from afflicting the United States. That dire outcome was avoided, but just barely and through a measure of good luck. The American people may not be so fortunate next time and, most importantly, they should not have to depend on luck. They should have the benefit of laws, reforms, rules, and regulations to protect them, and they should be able to count on their elected representatives and regulators to fulfill their duties and ensure that those safeguards are put in place.

That is what Dodd-Frank financial reform law is all about and how its impact should be evaluated.

The benefits of avoiding another financial crisis are enormous, totaling trillions of dollars, measured not just in terms of the current crisis but also in light of a potentially worse financial disaster that may befall our country if reform is not fully implemented

It cannot be legitimately denied that the value of a stronger and more comprehensive regulatory system is huge. It includes the benefits of sparing our economy and our society the devastating consequences that another financial collapse and economic crisis would bring in the form of both monetary losses and human suffering.

A reasonable starting point for determining the cost of a future crisis is the cost of the recent financial collapse and ongoing economic crisis. The impact of that crisis is staggering. Better Markets has a detailed analysis of the costs of the crisis on its website (www.bettermarkets.com), but here are some snapshots of the financial devastation it caused:

- Gross domestic product ("GDP") has fallen dramatically and it is not expected to return to normal levels until at least 2018. At that time, the cumulative shortfall in GDP relative to potential GDP is expected to reach **$5.7 trillion**.

- The unemployment rate skyrocketed to 10.1 percent in October of 2009, representing **15.4 million workers**, many of whom have become members of the permanently unemployed.

- Government expenditures, including corporate bailouts, special lending facilities, unemployment benefits, and the economic stimulus package are well in excess of a trillion dollars. The value of the government's total commitment of support, provided through some 50 separate programs, is estimated at **$23.7 trillion**.

- The national debt will increase by **$8 trillion** as of 2018 as a result of the crisis, due to the combined effects of government expenditures and reduced revenues.

- The stock market fell by more than 50 percent in just 18 months, from October 2007 until March of 2009, representing **$11 trillion** in evaporated wealth.

- From 2007 to 2010 median family income fell 7.7 percent, from $49,600 to $45,800, and median family net worth fell 38.8 percent, which totals more than $7 trillion, "**erasing almost two decades of accumulated prosperity**."

- Home values have declined 33 percent since the crisis began, representing **$7 trillion** in lost value.

- Over **11 million** homeowners own homes worth less than their mortgages, or about 22.8 percent of all residential properties with a mortgage.

- A total of **at least 3.6 million** homes—and by some accounts **5 million**—have been lost to foreclosure since the crisis began, with millions of additional foreclosures to come.

- The number of families falling below the poverty line has climbed steadily since 2007, rising from 12.5 to 15.1 percent, representing over **46 million** individuals deemed poor.

- The human anguish caused by the crisis has been enormous and incalculable, encompassing all of the psychological and physical health effects that come with unemployment, poverty, homelessness, delayed retirements, abandoned college educations, increased crime rates, and lost healthcare.

- Maybe worst of all, the faith of the American people in The American Dream, where the U.S. is the land of opportunity, everyone gets a fair shot, and the next generation will have it better than the last, is dropping at an alarming rate, which could undermine the spirit of our country.

It is impossible at this point to quantify all of the consequences of the still-unfolding economic crisis. Moreover, the actual costs of another crisis are almost certain to be far greater than what we have witnessed since 2007. This is attributable to the fact that our fiscal and monetary capacities to institute remedial measures and to absorb the costs of a future crisis have now become so depleted. With the annual budget deficit now exceeding 1.2 trillion dollars, the Treasury will have far fewer fiscal tools at its disposal with which to manage another financial crisis. This vulnerability will persist for years to come, until something approximating a full recovery has been achieved, and no one is expecting that for a very long time.

From 2007 to 2010, the U.S. government responded to the financial and economic crisis by implementing trillions of dollars in emergency measures to prevent a precipitous slide into a second Great Depression. To create a more lasting safeguard against another financial crisis, the comprehensive reforms in the Dodd-Frank law were passed. Those reforms promise an enormous **collective benefit** -- avoiding the costs of what would likely be a second Great Depression -- but only if they are implemented on a **collective basis**. Therefore, as legislators evaluate the law, as regulators promulgate rules under the law, and as courts review those rules, they must consider the entire set of reforms enacted and the benefits that those reforms can provide as a single, coherent collection. If the cohesive framework envisioned in the financial reform and Wall Street re-regulation law is not understood and evaluated this way, then the public, the markets, and the economy as a whole will once again be vulnerable to another financial catastrophe.

Effective financial reform that protects the American people requires the re-regulation of the financial industry and that will result in shifting costs back to the industry from society where it was shifted when the industry was de-regulated

Over a three-year period beginning in 2007 and culminating in the passage of the financial reform and Wall Street re-regulation law on July 21, 2010, the U.S. government witnessed the financial and economic destruction caused by the crisis, implemented emergency measures to contain it, and then made the judgment that comprehensive reforms were essential to protect investors, taxpayers, the Treasury, the financial system, and the economy from another financial crisis. That will necessarily result in the industry assuming their proper regulatory costs and burdens, which are necessary to prevent those costs from being shifted to taxpayers and society. Those burdens include initial and ongoing compliance costs as well as the elimination of extremely profitable lines of business.

Those consequences were well known, but nevertheless intentionally imposed to **re-regulate the recently de-regulated financial industry**, thus closing regulatory gaps and strengthening existing requirements for the benefit of investors, the public, and the entire economy.

The financial industry was very significantly regulated after the Stock Market Crash of 1929 and during the Great Depression. Those regulations protected the public, investors, taxpayers, the financial system, and the economy for seven decades. It was no accident that they prevented a repeat of the Crash of 1929 and the Great Depression for more than 70 years. However, those regulatory protections were removed, primarily during the 1990s, reaching a peak in 1999 with the passage of the Gramm-Leach-Bliley Act of 1999 and in 2000 with the passage of the Commodities Futures Modernization Act.

Thus after seventy years of regulation, it took just seven years of de-regulation for the financial industry to engage in the high risk trading and reckless investments that nearly collapsed the financial system and almost ushered in a second Great Depression. While the costs are still being counted and incurred, the U.S. government had to spend, lend, pledge, guarantee, insure, or otherwise use trillions of dollars to prevent the full collapse of the financial system and halt the economic crisis.

The primary motivations in passing the Dodd-Frank financial reform and Wall Street re-regulation law were to prevent such a financial collapse and economic crisis from ever happening again, and to avoid a second Great Depression. In many respects, the reforms in the Dodd-Frank law re-regulate the financial industry as it had been regulated beginning in the 1930s. **This re-imposition of regulation also means shifting the substantial costs of risky behavior and predatory practices from the public back onto the industry**—or, as economists would say, forcing the industry to assume the costs of the externalities that they imposed on society when they were deregulated.

Thus, the Dodd-Frank financial reform law and the regulations promulgated thereunder must necessarily (1) prohibit some activities, including fraudulent transactions and those based upon conflicts of interest; (2) curtail other behaviors, including excessive speculation; (3) force the reallocation of funds to other uses, such as capital and margin; and (4) increase transparency and competition through pre- and post-trade reporting, thus reducing profit margins.

Further illustrating this approach, the Dodd-Frank law imposes a broad set of regulatory reforms on bank holding companies and nonbank financial institutions, with the focus on systemically important institutions. They will pay necessary compliance costs from new requirements relating to registration, reporting, recordkeeping, public disclosures, risk committees, examinations, fees, and capital and leverage requirements, among other enhanced supervisory prudential standards. Key provisions of the statute will also eliminate some immensely profitable trading activities. Most notable is the "Volcker Rule," which prohibits insured depository institutions, bank holding companies, and certain nonbank companies from almost all proprietary trading and all but de minimis investment in hedge funds. These bans on highly profitable activities will effectively eliminate billions of dollars in annual revenue for the largest banks. But, they are necessary to protect the American people, taxpayers and Treasury from Wall Street.

Given that the ongoing costs of the last financial collapse and economic crisis have exceeded trillions of dollars, the enormous collective benefits of the financial reform and Wall Street re-regulation law far exceed the costs and lost profits that industry will have to absorb as the price for protecting the American people, taxpayers, Treasury and economy.

Industry always complains about the alleged costs and disruption of regulation, but history proves that they are without merit

Critics argue that the costs of the Dodd-Frank financial reform and Wall Street re-regulation law are or will be excessive and that they will cripple the financial industry and even stifle economic recovery from the financial crisis. However, using the past 100 years as a guide, there is no basis for the claim that the essential reforms, even on the scale required by the Dodd-Frank financial reform law, will produce these consequences.

Since the emergence of financial market regulation, the financial services industry has argued that new regulatory requirements will have a devastating impact by imposing unbearable compliance costs. Yet Wall Street has always absorbed the cost of those new regulations and has consistently remained one of the most profitable sectors in our economy. For example, a century ago, when securities regulation first emerged at the state level, Wall Street railed against it as an "unwarranted" and "revolutionary" attack upon legitimate business that would cause nothing but harm. However, in the years following this early appearance of financial regulation, banks and their profits grew handsomely.

Subsequently, when the federal securities laws were adopted in the midst of the Great Depression, Wall Street staunchly opposed them, claiming that they would slow economic recovery by impeding the capital formation process and discouraging the issuance of new securities – virtually identical arguments that industry is making today. However, in the years after the enactment of the federal securities laws, the nation's securities markets flourished and became what has often been described as the envy of the world. The same pattern has been repeated with each new effort to strengthen financial regulation, including deposit insurance, the Glass-Steagall Act, mutual fund reform, and the national market initiatives of the mid-1970s.

The lesson to be learned from this history is that when faced with new regulations, members of the regulated industry routinely argue that the costs and burdens are too heavy—but then they invariably adapt and thrive. Opponents of reform under the Dodd-Frank law are following this familiar pattern, and their attempts to minimize regulation by invoking the costs and burdens must be similarly discounted.

Equally unfounded is the claim heard from opponents of regulatory reform that regulation is stifling overall economic growth and preventing a robust recovery from the financial crisis. This claim is unsupported, often just repeated as a self-evident proposition. In fact, the slow pace of economic recovery is not attributable to regulation but instead to rampant unemployment and lack of consumer demand following the worst financial crisis since the Great Depression. We need more financial regulation, not less, to ensure that the economy recovers and that we never again experience such a profound and long lasting financial disaster.

"Economists who have studied the matter say that there is little evidence that regulations cause massive job loss in the economy, and that rolling them back would not lead to a boom in job creation." In fact, the Bureau of Labor Statistics continuously surveys the private sector to understand the reasons for layoffs. Data for 2010 shows that only 0.2 percent of the people who lost their jobs in layoffs were let go because of government regulation. By comparison, 30 percent were let go because of a drop in business demand.

In survey after survey, business owners consistently say that their reluctance to hire employees and expand production arises from uncertainty about consumer demand for products and services, not concern over regulation. One policy analyst recently canvassed numerous sources on the impact of financial regulation, ranging from the Bureau of Labor Statistics, the Wall Street Journal, the McClatchy Newspapers, and business trade data. The surveys and data collected from these organizations debunk the myth that either existing regulation or uncertainty about future regulation over financial services is responsible for the current economic stagnation. For example, a Wall Street Journal survey of business economists found that "[t]he main reason U.S. companies are reluctant to step up hiring is scant demand, rather than uncertainty over government policies."

Even as additional and essential regulations are being adopted, corporate America is actually faring well. Regulation is clearly not interfering with corporate profits, cash reserves, or executive compensation. Corporate profits are at record levels, representing over 10 percent of Gross Domestic Product ("GDP") after tax, and executive compensation has nearly regained its pre-recession levels, with a reported remarkable 27 percent increase in median pay in 2010. That level of compensation remained steady and even increased somewhat in 2011, with the top 100 CEOs receiving a total of $2.1 billion in compensation.

The stagnant consumer demand holding back economic growth was a direct result of the financial collapse and economic crisis, which were a direct result of **too little** regulation. In the years leading up to the crisis, huge sectors of our financial markets (such as swaps) were completely unregulated, and other sectors (such as mortgage-backed securities) were poorly regulated.

The resulting costs of the crisis are enormous and lasting. As set forth in summary fashion above and in detail on our website (www.bettermarkets.com), they include unemployment totaling 12.5 million Americans, a massive drop in GDP, a huge decline in home values, and decimated retirement accounts. These costs, inflicted by the financial collapse caused by Wall Street, are what brought our economy to a standstill, not excessive regulation. Regulated, transparent markets with less fraud and reckless conduct will restore confidence in our markets and banks. That will in turn help economic growth and confidence.

Moreover, industry's claims that financial reform will reduce market liquidity, capital formation and credit availability, and thereby hamper economic growth and job creation, simply disregard the fact that the financial crisis did more damage to those concerns than any rule or reform possibly could. In September 2008, there was no market liquidity, capital formation or credit availability and, since then, there has been little economic growth and even less job creation. That is due to the Wall Street created financial collapse and economic crisis. The financial reform and Wall Street re-regulation law was passed and is designed to prevent that from ever happening again.

The latest attack on financial reform and re-regulating Wall Street is the claim that no rule passed to implement the law protecting the American people can cost industry too much, which ignores how much Wall Street has cost America

Having failed to prevent the passage of a comprehensive financial reform law, the financial industry is redoubling its efforts to make sure the law is never implemented as intended. What that means is that they are trying to prevent the protection of the American people, taxpayer, Treasury and economy from suffering **again** as a result of their unregulated conduct.

Their latest weapon to kill or weaken financial reform is to claim that every rule and regulation passed to implement the Dodd-Frank financial reform and Wall Street re-regulation law must be subjected to exhaustive "cost-benefit analysis," which is a seductively innocent sounding phrase. Indeed, it is an activity that on its face seems sensible and appealing. After all, assessing and weighing the costs and benefits of taking an action appears on the surface to be reasonable. However, in the context of regulation generally and financial regulation in particular, that thinking is simply wrong and it will likely kill financial reform, as Wall Street has intended all along.

Moreover, it is a ridiculous argument: the very industry that caused the financial collapse, economic crisis and trillions of dollars in costs -- many that continue to this day -- now claims that it cannot be re-regulated to prevent it from causing yet another crisis **if** the costs it must bear are too great. That would be irrational. The American people, taxpayer, Treasury and economy have to be protected from Wall Street; Wall Street doesn't have to be protected from regulation. In fact, Wall Street must be re-regulated because when it is deregulated and unregulated it causes financial collapse, economic crisis and trillions of dollars in costs – all of which the American taxpayers have to pay.

Nonetheless, the industry is making this argument in the regulatory process and in lawsuits filed to prevent Wall Street from being re-regulated. For example, the Securities

Industry and Financial Markets Association (SIFMA) and the International Swaps and Derivatives Association (ISDA) have sued the CFTC over what is referred to as its "position limits" rule claiming, among other things, that the CFTC did not conduct the proper cost benefit analysis. Better Markets filed a brief opposing that argument and detailing why it is without merit.

More recently, the Chamber of Commerce and the Investment Company Institute (ICI) have sued the CFTC over re-establishing a registration requirement for investment companies acting as commodity pool operators. Better Markets also filed a brief in this case detailing why industry's claims are without merit.[2]

In addition, Better Markets has just completed a report that it will be issuing next week entitled "Setting the Record Straight on Cost Benefit Analysis and Financial Reform at the SEC." The Report comprehensively reviews these cost benefit claims and demonstrates that these arguments are without merit and must be rejected.

As part of the comprehensive financial reform and Wall Street re-regulation law, derivatives regulation, the Volcker rule, risk retention, and single counterparty credit limits are essential to protecting the American taxpayer from again having to bail out the financial industry

The hearing seeks to focus on only four parts of the comprehensive financial reform and Wall Street re-regulation law: derivatives regulation, the Volcker rule, risk retention, and single counterparty credit limits. Each is an integral part of re-regulating Wall Street and protecting Main Street. Each needs to be strong and clear if the American people are to be protected.

Derivatives Regulation

First, no one can deny that the unregulated and nontransparent derivatives markets, conducted almost entirely over the counter, were a central cause of the financial collapse and economic crisis that begin in the U.S. in 2007. As the ongoing Eurozone crisis shows, allowing major financial institutions to engage in derivatives activities of unknown amounts -- with unseen risks, often even to the institutions themselves as well as the regulators and the public -- can cause the entire financial system to collapse. As Warren Buffett has aptly noted, derivatives are "financial weapons of mass destruction."

They must be regulated and transparent. They must be moved from the dark over the counter markets to exchanges, ideally, or to clearing houses and execution facilities, at a minimum. Collateral and margin must be required and counterparty concentration must be

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[2] *See* Brief of Better Markets, Inc. as Amicus Curiae in Support of Defendant Commodity Futures Trading Commission, Inv. Co. Institute v. CFTC, No. 1:12-cv-00612 (BAH) (D.D.C. 2012) (filed June 29, 2012), *available at* http://bettermarkets.com/sites/default/files/ICI%20v.%20CFTC%20-%20Amicus%20Brief%20of%20Better%20Markets%20June%2025,%202012.pdf; Corrected Brief of Better Markets, Inc. as *Amicus Curiae* in Support of Defendant Commodity Futures Trading Commission, Int'l Swaps and Derivatives Ass'n v. CFTC, No. 11-cv-2146 (RLW) (D.D.C. 2011) (filed May 1, 2012), *available at* http://bettermarkets.com/sites/default/files/Amicus%20Brief%20CFTC%204-30-12.pdf.

limited, and trade reporting must convey meaningful information in real time. In addition, the product and entity definitions for "swaps" and "dealers" that trigger these new regulatory requirements must be broad and without loopholes. Further, rules implementing business conduct standards must be strong so that conflicts of interest and other abuses that destroy the integrity of the marketplace – and kill investor confidence in the markets -- are limited to the maximum possible extent. Better Markets has commented on all facets of this new regulatory structure in an effort to balance the onslaught of industry pressure aimed at weakening these protections.

These reforms are going to cost money, but, contrary to self-interested claims, they will not cost **more** money than the current system. Currently, these costs are hidden, embedded or shifted to society. The costs of risky, unregulated derivatives trading became apparent to everyone in the Fall of 2008, but those costs were shifted to society rather than born by financial market participants. The financial reform and Wall Street re-regulation law shifts those costs back to the market participants, which is where they belong and which will reduce risky conduct and, thereby, reduce the risk of crises and bailouts.

The new requirements relating to margin in swap transactions perfectly illustrate the need to reallocate the costs of regulation -- and the ability to do so without stifling the market. Many financial firms fought against this new approach. They claimed forcing derivatives to trade in the light of day on open exchanges would increase costs for commercial end users who rely on derivatives to manage their risks. What they didn't mention is that the supposedly "new" costs that end users would face from margin requirements (a transparent risk-management tool that Congress rightly determined should become the new norm) had really existed all along, but had simply always been embedded in the spreads they paid in the dark markets where end users had no way to determine what they were being charged or the ability to comparison shop regarding price or features.

For example, a business that uses an interest rate swap to trade a fixed rate for a floating rate might now have to put up initial margin of, say, 5% of the total value of the swap. This is to ensure that there is at least some cash on hand to cover losses in case interest rates move sharply against them. Previously, they may not have had to pay this 5% margin charge. But you can guarantee they would have paid it elsewhere, embedded in the overall price of the swap, or in the spreads that the market offered them. In the past, the derivatives desk at a large dealer would simply have guesstimated the credit risk posed by a firm, and calculated a buffer that they would then add to the price of the swap.[3] This would be invisible to the end user, and also to regulators, but it was there nevertheless. Indeed, any trader who tried to avoid this step would have been fired on the spot. The problem was, this cost was entirely opaque, and there was no obligation on the part of the dealer to actually set the extra cash

[3] *See* Better Markets Comment Letter "End User Exception to Mandatory Clearing of Swaps", February 22, 2011, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27992&SearchText=better%20markets

aside as a risk management buffer. Instead, it would just be treated as regular income and either used for other trading, or to pay bonuses.[4]

The new regime requires this hidden cost to be made explicit, and for the cash to be set aside as a genuine buffer against losses. This has been confusing to some end-users, largely because some in the financial industry have misleadingly characterized this as a completely new cost. The analyses presented to end-users by self-interested derivatives dealers not only ignored the previously embedded costs, but also assumed that all derivatives would now be subject to a uniformly high level of initial margin, with no netting. Thus, from a set of false assertions, they arrived at the entirely misleading conclusion that mandatory clearing would be costly to end users, when in fact it is quite the opposite. By bringing trading out into the open and requiring proper risk management, mandatory clearing greatly reduces the risk of another financial crisis.[5] The benefit of that reduced risk is, of course, enormous.

Moreover, transparency will enable end users to determine what they are being charged and for what. This will enable comparison shopping and, almost certainly, engender competition among providers. Of course, the big dealer banks that currently control the opaque over the counter markets do not want such transparency or competition.

Dodd-Frank did recognize that there are some situations in which it might be advantageous for a commercial firm, such as a manufacturer, to trade a derivative off-exchange. Consequently, the law carved out a very narrow exemption from the clearing mandate. The exemption applies only to purely non-financial firms, and only when they are hedging purely non-financial risk. It tasked the CFTC with implementing this with an appropriately narrow scope.

Thus, in the vast majority of cases, derivatives will now have to be traded on exchange-like venues, with proper risk-management systems.[6] The risk of a future financial crisis will be greatly lessened and transparency will be increased.

The Volcker Rule

Second, the Volcker Rule prohibiting most proprietary trading and all but de minimis investments in hedge funds by banks that benefit from the federal financial safety net or are otherwise systemically significant is an essential reform. It effectively applies to only the biggest too big to fail banks because they are really the only ones that engage in any substantial proprietary trading or hedge fund investments. Moreover, while some continue to

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[4] *See* Better Markets Comment Letter General Regulations and Derivatives Clearing Organizations, February 11, 2011, available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27682&SearchText=, see also Mello, A. and Parsons, J., "Margins, Liquidity and the Cost of Hedging", May 2012, available at www.web.mit.edu/ceepr/www/publications/workingpapers/2012-005.pdf.
[5] *See* Better Markets Comment Letter "Trading Documentation and Margining Requirements under Section 4s of the CEA", November 4, 2011, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=49931&SearchText=better%20markets.
[6] *See* Better Markets Comment Letter "Core Principles and Other Requirements for Swap Execution Facilities," March 8, 2011, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=31238&SearchText=better%20markets.

deny it, proprietary trading by those systemically significant financial institutions played a key role in the financial collapse and economic crisis.[7]

Proprietary trading is fundamentally no more than wild speculating by making huge leveraged bets with the banks' money for the purpose of hitting the jackpot and getting an enormous bonus windfall. Thus, this type of very high risk trading offers vast and fast wealth to those working for these too big to fail institutions. However, if those bets go wrong, as they did in 2007 and 2008, they can lose massive amounts of money very quickly and drag down an entire bank, which then has to be bailed out so it doesn't take down the entire financial system.

However, the law also carefully carves out certain permitted, socially desirable activities such as market making and risk-mitigating hedging. To avoid the big banks from disguising improper proprietary trading as a permitted activity (which they are highly incentivized to do given the gigantic bonus potential), the permitted activities are carefully defined. For example, permissible market making must be "designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties." The permitted activity of "risk-mitigating hedging" is also very carefully defined in the statute. Most of the industry's so-called concerns and objections to these definitions appear to be no more than attempts to create loopholes in the definitions of permitted activities so that they can continue their high-risk, but lucrative proprietary trading.

Reinforcing the ban on proprietary trading and ensuring that the permitted activities don't become such loopholes, the Volcker Rule also prohibits, among other things, any "transaction, class of transactions or activity ... if the transaction, class of transactions or activity ... would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies ...."

Thus, the recently reported trading by JP Morgan Chase's Chief Investment Office (CIO) in London (the so-called "London whale") almost certainly would have violated the letter and not just the spirit of the law and proposed Volcker Rule. First, given enormous net gains (reportedly 25% of the bank's net income for 2010) and losses (now reported to be approaching $9 billion) reported, this trading activity cannot properly be described as "hedging." And, given the swings in net profits and losses, it cannot properly be characterized as "**risk-mitigating** hedging," which is the definition of the permitted activity. Moreover, it has been widely reported that JP Morgan's CEO personally transformed the CIO from a low-risk hedging operation into a "profit seeking" operation; real "risk-mitigating hedging" does not generate net profits, which is what the CEO reportedly structured and staffed the CIO operations to create. (While losses and profits may be generated, they should be largely offsetting, resulting in little net profit or loss.)

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[7] All these issues and more are addressed in four comment letters filed by Better Markets in response to the proposed Volcker Rule: November 5, 2010, *available at* http://www.regulations.gov/#!documentDetail;D=FSOC-2010-0002-1363; February 13, 2012, *available at* http://www.federalreserve.gov/SECRS/2012/March/20120309/R-1432/R-1432_021312_105537_519233431691_1.pdf; *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=57403&SearchText=; and June 19, 2012, *available at* http://www.sec.gov/comments/s7-41-11/s74111-594.pdf. They are referred to in the text by date.)

Moreover, the JP Morgan CIO's trading certainly involved "high-risk assets" and "high-risk trading strategies," which are also expressly prohibited by the law. This is proved not only by the net profits and losses generated, but also by the fact that the CIO had to wager vast amounts of money to create those profits and losses, reportedly involving hundreds of billions of dollars. The CIO had, by the CEO's admissions, more than $350 billion under its control and much of that was apparently bet by the "London Whale" seeking to make a big splash and get a huge bonus, if not other rewards. Proving the high-risk nature of these assets and trading strategies, they apparently involved relatively illiquid securities because the bank couldn't exit the investments in any reasonable period of time to minimize its losses.

As if all that wasn't enough to demonstrate beyond a doubt that JP Morgan's trading violated the law and rule, it is also the case – as the CEO himself has admitted – that those very high risks were unknown to the bank, the bank's CEO, CFO and other executive, risk and operational management.[8] The narrow permitted activity of "risk-mitigating hedging" cannot, by definition, occur by accident, which is why the proposed rule has detailed procedures to establish that such hedging is in fact risk mitigating and in fact bone fide (although, as set forth in Better Markets February 13, 2012 comment letter, those procedures need to be strengthened).

Thus, the incentives to engage in this high risk behavior are enormous and must be addressed directly, which Better Markets did in its comment letters by focusing on compensation. Moreover, we addressed with specificity the industry's complaints regarding their claim that the rule will reduce their ability to act as market makers for corporate bonds, i.e., the alleged liquidity concerns. In this regard, it is noteworthy that the industry did not provide information or data on their own purported inventories to show (rather than merely claim) how the proposed rule would impact liquidity.

They do rely on a paper by the consulting firm of Oliver Wyman. Given that the paper was purchased by SIFMA on behalf of the industry, it is no surprise that it agrees with SIFMA's and the industry's position on the Volcker Rule. Like their arguments, however, the paper is deeply flawed. Better Markets addressed these flaws in its comment letters (specifically in the April 16, 2012 and June 19, 2012 comment letters), but I will briefly address the primary flaw here: Oliver Wyman, without explanations or basis (and contrary to basic economics), assumed that there would be no new entrants into the business of market making if the biggest too big to fail banks stopped making markets as a result of the Volcker Rule (which itself is a highly dubious assumption because market making is an expressly permitted activity).

Specifically, the Oliver Wyman paper stated that "[w]e do not directly analyze a wide range of potential knock-on effects, including... [t]he potential replacement of some proportion of intermediation currently provided by Volcker-affected dealers by dealers not so affected." As set forth in our comments letters of February 13, 2012, April 30, 2012 and June

[8] Moreover, JP Morgan's CEO also, without detail or explanation, claimed that the London Whale trade "morphed" into something he "couldn't defend." Hard to conclude that statement is anything other than an attempt to mislead because a trade or trades – as he well knows -- do not "morph." They are not living organisms. People structure trades, put trades on, take them off, change them and are supposed to authorize, supervise and monitor them. Someone or group of people did all of that, even if it wasn't with the knowledge or consent of the CEO, CFO or others.

19, 2012 (referenced and cited above), there is, however, a great deal of historical and contemporary evidence that entry is the normal market response to profit opportunities like this, including recently in the corporate bond markets.

This should come as no surprise to anyone. After all, the big dealer banks are not nonprofit organizations and do not make markets for free. They do it to make money and because there is money to be made. If they don't make that money, other market participants will move into the business to reap the profits.

Frankly, most of the industry's other objections simply don't stand up under the most minimal scrutiny either. For example, they claim that it is almost impossible to distinguish between proprietary trading and market making or hedging. This is simply silly. Such activities have been going on for decades if not centuries or more and there has not been any evidence of widespread confusion over those activities...........until the Volcker rule banned proprietary trading.

Wall Street has some of the highest paid people in the world and many claim that they are the smartest people in the world, but all of a sudden they can't tell the difference between different activities? These are self-interested complaints that seek to get the law and the rules re-written in a way that would allow the biggest banks to continue their wildly lucrative proprietary trading by a different name. While that would increase Wall Street's profits, it would yet again risk a raid on taxpayer's pockets and must not be allowed.

Risk Retention

Third, dealing with risk and risk retention are some of the most important aspects of the new financial reform law.

Poor regulation of asset securitization played an important role in the financial crisis. Sophisticated financial institutions created hundreds of billions in high-risk assets which they sold to others, who ultimately took the losses on them. They sold subprime residential mortgage-backed securities and collateralized debt obligations – often highly rated – that were in fact toxic financial time bombs that waiting to explode.

Wall Street firms created and sold these dubious assets in such great quantity largely because they were able to offload the losses to the buyers. For example, there was no requirement that sponsors of asset-backed securitization vehicles retain significant ownership interests. The economic incentives were perverse, and the results were disastrous.

Section 941 of the Dodd-Frank Act addresses this problem. It requires that sponsors of asset-backed securities retain a 5 percent ownership interest in the securities it creates and sells. This more closely aligns the interests of the sponsors and investors, much as mortgage down payments align the interests of home buyers and mortgage lenders.

To make sure that sponsors cannot use financial engineering (often misleadingly referred to as "innovation") to escape the risk retention requirement, the rules implementing Section 941 place an operational restriction on asset securitizers. If they issue "interest-only" or "premium" bonds as part of the securitization, the proceeds from these bonds must be placed into a "premium capture cash reserve account" for the life of the securitization. The premium capture account would be used to cover losses on the underlying assets before any other interest or account in the issuing entity.

The reason for this is simple. Interest-only and premium bonds are used by sponsors to realize expected future profits from the securitization vehicle -- the so-called "excess-spread" between the coupon payments on securities issued and the interest payments on the underlying collateral -- up front. These bonds can therefore be used to reduce or eliminate the risk retention requirement. But putting revenues from these bonds into an account that would be in a first loss position would negate that possibility.

Those who object to the premium capture account are in essence objecting to the risk retention requirement. And if securitized assets can only be issued if sponsors retain none of the risk, then there is good reason to believe that many of the worst practices that brought on the last crisis will continue and likely create another crisis and require yet more taxpayer bailouts.

Interconnectedness

Fourth, the interconnectedness of systemically significant institutions and activities enabled and facilitated the rapid spread of the financial collapse in 2007 to 2009 (so called "contagion" or "domino effect"). This risk has to be eliminated or minimized if there is any chance of containing future financial crises and taxpayer bailouts. Section 165(e) of the Dodd-Frank financial reform law -- which limits the credit exposure among the biggest banks -- is one of the ways that the contagion risk of interconnectedness is addressed.

The proposed Fed rule limits net exposures to a single counterparty to 10% of the bank's capital and surplus for holding companies with more than $500 billion in assets. This is an essential attempt to limit direct interconnectedness between the biggest, systemically significant banks where the risks of contagion are greatest. Higher levels of exposure – which would increase the systemic harm of single Lehman or Bear Stearns-like failure – are inconsistent with a stable financial system.

While the proposed rule is a good start, it needs to be strengthened, as we set forth in our comment letter of April 30 to the Fed, accessible here: http://www.federalreserve.gov/SECRS/2012/May/20120501/R-1438/R-1438_043012_107250_511116121698_1.pdf. Better Markets advocated that single counterparty exposure limits be made more effective by limiting permissible netting for collateral, guarantees and hedges, and by looking through legal form to determine actual exposures to counterparties. In no event should the proposed rule be weakened as some in the industry are advocating.

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STATEMENT OF

THOMAS P. LEMKE
GENERAL COUNSEL AND EXECUTIVE VICE PRESIDENT
LEGG MASON & CO., LLC

ON BEHALF OF THE

INVESTMENT COMPANY INSTITUTE

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ON

"THE IMPACT OF DODD-FRANK ON CUSTOMERS, CREDIT, AND JOB CREATORS"

JULY 10, 2012

EXECUTIVE SUMMARY

- Operating under a remarkably comprehensive regulatory framework, mutual funds and other registered investment companies ("registered funds") help over 90 million shareholders to achieve their financial goals. Congress did not direct the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") at these funds, because they were not a cause of the financial crisis. Nonetheless, the statute and rules implementing it will have important implications for all market participants, including registered funds and their advisers.

- Certain provisions of the Dodd-Frank Act are intended to promote bank safety and soundness and financial stability, but care must be taken to ensure that their implementation does not have unintended adverse consequences—for registered funds and their shareholders, the financial markets, or the broader economy.

    - **Volcker Rule.** The regulatory proposal to implement the Volcker Rule reaches much farther than Congress intended, inappropriately capturing some U.S. registered funds and virtually all non-U.S. retail funds. Any final rule should expressly exclude these funds from the definitions of "covered fund" and "banking entity." The proposal also could impair the financial markets and limit investment opportunities for registered funds and their shareholders. ICI has provided recommendations for addressing these concerns in its comments to regulators.

    - **Designation of Systemically Important Nonbank Financial Companies ("SIFIs").** It is important that the Financial Stability Oversight Council ("FSOC") act deliberatively in exercising its authority to designate nonbank SIFIs for heightened regulation and consolidated supervision by the Federal Reserve Board. SIFI designation is neither warranted nor appropriate for registered funds or their advisers because, among other things, they do not present the risks such designation is intended to address. While ICI welcomes the study of asset management companies the Office of Financial Research is undertaking on behalf of the FSOC, we feel strongly that: (1) it would be premature to evaluate such companies under the existing SIFI designation framework before completion of this analysis; and (2) the FSOC should publish the study (and any future material changes to its SIFI designation guidance) for public comment.

    - **Enhanced Prudential Standards for Nonbank SIFIs and Large Bank Holding Companies.** The Federal Reserve Board's proposal to implement enhanced prudential standards under Section 165 of the Dodd-Frank Act is premature as applied to nonbank SIFIs, because the FSOC has not yet designated any such SIFIs. Without knowing which entities will be designated, the Federal Reserve Board cannot comply with its statutory obligations regarding nonbank SIFIs. The Federal Reserve Board therefore should exclude nonbank SIFIs and separately propose a process for prescribing the enhanced standards that will be applied to them.

- **Unlimited Insurance for Noninterest-Bearing Transaction Accounts.** In the Dodd-Frank Act, Congress granted circumscribed authority for the FDIC to provide unlimited deposit insurance only to specified accounts and only for a two-year period. Congress should reject calls to extend this program beyond its statutory expiration date, because the program has the potential to dislocate markets and increase systemic risk in times of market stress by creating an unlimited taxpayer-supported backstop for noninterest-bearing transaction accounts.

- In addition to the Volcker Rule, Dodd-Frank Act provisions on asset-backed securities ("ABS") and derivatives have implications for registered funds as investors in the financial markets.

    - **Asset-Backed Securities.** As investors in ABS, registered funds have a strong interest in ABS markets that function fairly and in the interests of investors.

        - **Risk Retention.** ICI generally supports the goal of the joint regulatory proposal to implement the credit risk retention requirements imposed by the Dodd-Frank Act. We believe that the proposed standards for risk retention may not be appropriate or necessary for certain classes of ABS in which registered funds invest—in particular, notes issued by asset-backed commercial paper programs and securities issued by municipal tender option bond programs.

        - **Prohibition Against ABS Conflict of Interests.** ICI also supports the rule the Securities and Exchange Commission ("SEC") has proposed to implement the prohibition under the Dodd-Frank Act against material conflicts of interest in connection with certain securitizations. The SEC should clarify, however, that the proposed rule excludes actions taken in connection with investing in an ABS by a registered fund that is an affiliate of an entity that structures or distributes an ABS. In addition, the proposed rule's exception for liquidity commitments should not be viewed as inconsistent with the restrictions under the regulatory proposal to implement the Volcker Rule.

    - **Derivatives.** Registered funds are participants in the derivatives markets and use these instruments in a variety of ways. Accordingly, ICI and its members have encouraged reform efforts in the derivatives markets.

        - **Implementation of Title VII.** It is crucial for implementation of the new regulatory framework for derivatives to follow a sequential, deliberative and coordinated process to minimize unforeseen and unintended consequences for market participants, customers and the derivatives markets, including disruptions to the markets and risk mitigation strategies. Specifically, the implementation periods should: (1) afford adequate time for the SEC and the Commodity Futures Trading Commission ("CFTC") to gather additional market data to inform future rulemaking; (2) allow market participants to build market infrastructures, modify business operations, complete testing, and perform outreach and education of customers; and (3) phase in rule requirements by type of market participant and asset class.

- **The Status of Non-Deliverable Foreign Exchange Forwards.** Under the Dodd-Frank Act, foreign exchange ("FX") swaps and forwards are considered swaps unless the Secretary of the Treasury makes a written determination that either or both should not be regulated as swaps. The Treasury has issued a proposed determination that would exempt FX swaps and forwards from the definition of swap, but would not include non-deliverable FX forwards ("NDFs") within the exemption. ICI has consistently supported Treasury's proposed exemption of FX swaps and forwards, and strongly believes that the exemption should extend to NDFs, which are functionally and economically identical to FX forwards. Treasury, in coordination with the CFTC or, if necessary, Congress, should clarify that FX forwards include both deliverable FX forwards and NDFs.

- **The Process for Making a Swap "Available to Trade."** Late last year, the CFTC, pursuant to the Dodd-Frank Act, proposed a process to establish which swaps will be subject to mandatory trading, or will be made "available to trade" on a designated contract market ("DCM") or swap execution facility ("SEF") for purposes of the Commodity Exchange Act. The CFTC's proposed process would grant the DCMs and SEFs a significant role in making these determinations. To address the incentives a DCM or SEF may have to require that a swap be subject to mandatory trading, even in the absence of a liquid trading market for the swap, the CFTC should require DCMs and SEFs to consider objective standards or thresholds as part of the make "available to trade" determination process, and should make consideration of each standard/threshold mandatory.

- **The Determination of Block Trades.** Pursuant to the Dodd-Frank Act, both the SEC and CFTC have issued proposals relating to block trades. Market transparency is a key element to ensuring the integrity and quality of the swaps markets, but that must be balanced against adequately protecting information regarding a registered fund's block trades. It is critical that the SEC and CFTC adopt block thresholds that account for the liquidity in each unique category of swaps, calculate the thresholds regularly, and establish thresholds that are low enough to encourage the use of block trades.

- We wish to make the Subcommittee aware of an agency's troubling use of the Dodd-Frank Act as a pretext for expanding its authority through unjustified regulation.

  - For almost thirty years, the CFTC has provided a uniform exclusion through its Rule 4.5 from regulations applicable to commodity pool operators for entities already subject to another regulatory scheme. Invoking its supposed "more robust mandate" to "manage systemic risk" under Dodd-Frank, the CFTC has sharply curtailed this exclusion, but only for registered funds and not for other entities covered by the rule.

- In actuality, the CFTC's amendments to Rule 4.5 were neither required nor even contemplated by the Dodd-Frank Act. The additional regulation that amended Rule 4.5 will impose on registered funds is redundant of the comprehensive regulation to which registered funds and their advisers are already subject by the SEC. The CFTC has not justified the need for these additional regulatory burdens, nor the significant costs they will impose on registered funds and their shareholders. Nor has the agency adequately explained how registered fund shareholders, which already enjoy comprehensive protections under the federal securities laws, will benefit from this additional, redundant layer of regulation.

I. INTRODUCTION

My name is Thomas Lemke. I am General Counsel and Executive Vice President of Legg Mason & Co., LLC. We are a Baltimore-based global asset management firm that manages more than $630 billion in mutual funds and other assets for our clients.

I am pleased to appear before the Subcommittee today on behalf of the Investment Company Institute ("ICI") to discuss the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") on customers, credit, and job creators. ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs").[1] ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of registered funds, their shareholders, directors, and advisers. As of July 2012, members of ICI manage total assets of $12.9 trillion.

Over 90 million shareholders depend on registered funds in seeking to achieve their most important financial goals, such as saving for college, purchasing a home, or providing for a secure retirement. Registered funds and their advisers operate under a remarkably comprehensive framework of regulation, including the Investment Company Act of 1940 ("Investment Company Act"). That framework has been enhanced over the years by Congress and the Securities and Exchange Commission ("SEC"), the primary mutual fund regulator. Its major features—strict limits on leverage, daily mark-to-market valuation, exceptional transparency, and strong governance, among others—again proved their worth to investors through the financial turmoil of recent years.

Enacted in response to that turmoil, the Dodd-Frank Act is very broad and complex and touches nearly every part of the financial services industry. It is not directed at registered funds, because they were not a cause of the financial crisis. Nonetheless, in a number of areas the statute and rules implementing it will have important implications for all participants in the financial markets, including registered funds and their advisers.

As we approach the second anniversary of the Dodd-Frank Act, regulators have made significant progress with implementation efforts. But there is still much to do and important questions remain unanswered. During the implementation process, ICI and its members have been closely following regulatory developments and providing extensive comments. The registered fund industry has a unique perspective on our regulatory system, because our funds are both issuers of securities and investors in domestic and international financial markets. Our efforts are focused on, among other things, ensuring that the regulations implementing the Dodd-Frank Act do not have harmful or unintended consequences for registered funds and their shareholders—or for the financial markets or the broader economy—and that any regulations strike the right balance between costs and benefits.

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[1] For ease of reference, this testimony refers to all types of U.S. registered investment companies—including mutual funds, closed-end funds, ETFs, and UITs—as "registered funds," unless the context requires otherwise.

Below, we highlight areas of continuing focus for ICI and its members. First, we discuss certain provisions of the Dodd-Frank Act intended to promote bank safety and soundness and financial stability, but whose implementation may have adverse consequences for registered funds, their advisers, and fund investors (Section II). Second, we discuss implementation of the Dodd-Frank Act provisions on asset-backed securities and derivatives, which will affect registered funds as investors in the markets (Section III). Finally, we discuss a clear example of regulatory overreach in which the Dodd-Frank Act is used as a pretext for the agency's rulemaking (Section IV).

II. UNINTENDED EFFECTS FROM RULES DESIGNED TO PROMOTE FINANCIAL STABILITY

The Dodd-Frank Act contains various provisions aimed at enhancing the safety and soundness of banks and identifying and mitigating potential risks to financial stability. ICI concurs with these broad goals, as a more resilient financial system will benefit all market participants. But building this more resilient system is challenging and complex, and care must be taken to avoid unintended negative consequences. That is why ICI, like other market participants, believes that *how* these Dodd-Frank provisions are implemented is of utmost significance.

Below, we discuss our specific concerns regarding regulatory efforts to implement the "Volcker Rule," and to designate and regulate systemically important nonbank financial institutions. We also explain our strongly held view that Congress should not extend further Dodd-Frank's grant of temporary unlimited deposit insurance for noninterest-bearing transaction accounts.

A. Concerns with the Proposal to Implement the Volcker Rule

1. U.S. Registered Funds

Congress enacted the "Volcker Rule" provision of the Dodd-Frank Act (Section 619) in order to restrict banks from using their own resources to trade for purposes unrelated to serving clients and to address perceived conflicts of interest in certain bank transactions. The Volcker Rule was not directed at registered funds. Unfortunately, the proposal to implement the Volcker Rule ("Proposed Rule")[2] nonetheless raises a number of concerns for the U.S. registered fund industry.

If adopted in its original form, the Proposed Rule would reach much farther than it seems Congress intended. For example, the Proposed Rule could treat many registered funds as hedge

[2] *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846 (November 7, 2011), issued by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System ("Federal Reserve"), Federal Deposit Insurance Corporation ("FDIC"), and SEC. The Commodity Futures Trading Commission ("CFTC") was not a party to the Proposed Rule; instead, it issued a separate yet substantively similar proposal to implement the Volcker Rule. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds, 77 Fed. Reg. 8332 (February 14, 2012). Below, we refer to the foregoing regulators collectively as the "Agencies."

funds—a result that contradicts the plain language that Congress passed. The Proposed Rule also could restrict banks from playing their historic role as market makers buying and selling securities—despite the fact that Congress specifically designated "market making-related activity" as a "permitted activity" for banks under the Volcker Rule. If banks cannot provide these services, particularly in the less liquid fixed income and derivatives markets and the less liquid portions of the equity markets, registered funds and other investors likely would face wider bid-ask spreads, higher transaction costs, and diminished returns. The Proposed Rule also could greatly impair the U.S. financial markets by imposing stringent restrictions that go well beyond what is necessary to effectuate Congress' intent in enacting the Volcker Rule, potentially hurting our broader economy and impacting job creation and investments in U.S. businesses overall. Finally, the Proposed Rule, as issued, could limit investment opportunities for registered funds and their shareholders.

ICI's comment letter on the Proposed Rule described these concerns in detail.[3] Below, we highlight our main concerns and provide recommendations for addressing them. Given the significant changes we believe are necessary to address our concerns and those of other commenters, ICI recommended in its comment letter, and still strongly urges, that the Agencies issue a revised proposal for comment before adopting any final rule.

a. *Organization, Sponsorship and Normal Activities of Registered Funds*

- *The Rule Expressly Should Exclude All Registered Funds from the Definition of "Covered Fund".* Under the Dodd-Frank Act, a banking entity is prohibited from having an ownership interest in, or acting as sponsor to, a hedge fund, private equity fund, or "similar fund" as the Agencies determine by rule—collectively defined in the Proposed Rule as "covered funds." However, the Proposed Rule would include within "covered fund" any investment vehicle that is considered a "commodity pool" under Section 1a(10) of the Commodity Exchange Act, thereby greatly expanding the reach of the Volcker Rule, even to the extent of sweeping in a number of registered funds. ICI believes that treating *any* registered fund as "similar" to a hedge fund or private equity fund for purposes of the Volcker Rule is contrary to Congressional intent and, frankly, common sense. Providing an express exclusion for registered funds from the definition of "covered fund" would avoid this unintended result.

- *The Rule Expressly Should Exclude All Registered Funds from the Definition of "Banking Entity".* The Proposed Rule suggests that a registered fund generally would not be considered a subsidiary or affiliate of the banking entity that sponsors or advises it.

[3] *See* Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Ms. Elizabeth M. Murphy, Secretary, SEC, *et al.*, dated February 13, 2012 ("ICI Volcker Comment Letter"), available at http://www.ici.org/pdf/25909.pdf. *See also* Statement of the Investment Company Institute for Hearing on "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation," Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives (January 18, 2012), available at http://financialservices.house.gov/UploadedFiles/HHRG-112-BA-WState-ICI-20120118.pdf.

Without an express exclusion in the rule text, however, it is possible that some registered funds could nevertheless inadvertently become subject to all of the prohibitions and restrictions in the Volcker Rule—a result not intended by Congress. For example, during the period following the launch of a new registered fund by a bank-affiliated sponsor, when all or nearly all of the fund's shares are owned by that sponsor (the "seeding process" for a new fund), the registered fund could be considered an affiliate of the banking entity and, thus, subject to the Volcker Rule in its own right. Providing an express exclusion for registered funds from the definition of "banking entity" would avoid this unintended result without thwarting in any way the policy goals of the Volcker Rule.

- *The Rule Should Not Limit the Ability of Banking Entities to Serve as Authorized Participants for Registered Exchange-Traded Funds and Conduct Related Activities.* The proprietary trading provisions of the Proposed Rule call into question whether banking entities could continue to serve as Authorized Participants ("APs") for ETFs registered under the Investment Company Act and conduct related activities. ETFs are similar to mutual funds (the most common type of registered fund) except that they list their shares on a securities exchange, thereby allowing retail and institutional investors to buy and sell shares throughout the trading day at market prices. Increasingly popular with investors, ETFs use a different process for offering their shares. APs alone transact in shares directly with ETFs, in large amounts (typically involving 50,000 to 100,000 ETF shares) based not on market prices but on the ETF's daily net asset value. AP transactions with an ETF are a unique and controlled form of arbitrage trading that, in the view of the SEC, is a critical component of maintaining efficient pricing in the ETF marketplace and protecting ETF investors. Some APs also may engage in traditional market making activities in the ETFs with which they participate. The Agencies should revise the Proposed Rule to ensure that APs can continue to fulfill these important roles.

b. *Impact on the Financial Markets*

- *Liquid and Efficient Markets are Important for Registered Funds.* Banking entities are key participants in providing liquidity in the financial markets, promoting the orderly functioning of the markets as well as the commitment of capital when needed by investors to facilitate trading. The Proposed Rule has the potential to decrease market liquidity, particularly for the fixed-income and derivatives markets, and the less liquid portions of the equities markets. A reduction of liquidity would have serious implications for registered funds, leading to wider bid-ask spreads, increased market fragmentation, and ultimately the potential for higher costs for fund shareholders.

- *The Complexity of, and Difficulties of Complying with, the Proposed Rule Threaten Market Liquidity and May Adversely Impact Registered Funds.* Much of the concern surrounding the effect of the Proposed Rule on market liquidity arises from the complexity of the Proposed Rule and its exemptions from the proprietary trading prohibition. ICI supports suggestions to recast what appear to be rigid criteria defining permitted activities under the Proposed Rule as guidance that could be incorporated into banking entities' policies and procedures.

- *The Presumption of Prohibited Activity is Unwarranted*. The Proposed Rule generally presumes that a banking entity's short-term principal trading activity is prohibited proprietary trading. This presumption of prohibited activity prejudices the analysis of a banking entity's trading activity from the outset. Moreover, the process to rebut the Proposed Rule's presumption would be extremely complex and onerous.

- *The Conditions of the Proposed Exemptions Do Not Reflect the Operation of the Financial Markets*. The Proposed Rule appears tailored primarily for the traditional trading of equities on an agency-based "last sale" model, which differs substantially from how fixed income and other markets operate. It does not reflect that, in the majority of the financial markets, market makers provide liquidity by acting as principal. It does not take into account the need to provide flexibility and discretion to market makers to enter into transactions to build inventory.

- *The Conditions of the Proposed Exemption for Market Making-Related Activities are Impractical*. The conditions under the market making-related activities exemption are extremely complex and we believe will be so difficult to comply with as to be effectively unworkable in a number of financial markets and for a significant number of financial instruments.

- *The Risk-Mitigating Hedging Exemption Must be Flexible*. The conditions provided under the proposed risk-mitigating hedging exemption create uncertainty as to whether a specific hedge would fulfill the requirements of the exemption. The exemption should be made flexible enough to allow banking entities appropriately to manage all possible risks and to facilitate hedging against overall portfolio risk; it should not be a transaction-by-transaction analysis.

- *The Proposed Government Obligations Exemption Should be Expanded to Cover All Municipal Securities and Foreign Sovereign Obligations*. The proposed exemption for trading in certain government obligations does not extend to transactions in obligations of an *agency or instrumentality* of any State or political subdivision. ICI recommends that the exemption be expanded to include *all* municipal securities, which would be consistent with the current definition of municipal securities under the Securities Exchange Act of 1934 ("Exchange Act"). The Proposed Rule also should be expanded to provide an exemption for foreign sovereign obligations; such an exemption is consistent with Congressional intent to limit the extraterritorial reach of the Volcker Rule and with the purposes of the Volcker Rule.

- *The Agencies' Proposed Implementation of the Proprietary Trading Prohibition Would Impact the Structure of the Financial Markets and the U.S. Economy Overall.* The Agencies' proposed implementation of the proprietary trading prohibition could have negative implications for capital formation. Banking entities also may find it difficult to remain in the market making business, which could lead to less regulated and less transparent financial institutions performing these activities. The over-broad restrictions of the Proposed Rule, which go well beyond what is necessary to effectuate Congress' intent in enacting the Volcker Rule, could hurt our broader economy, impacting job creation and investments in U.S. businesses overall.

c. *Limiting Investment Opportunities for Registered Funds and Their Shareholders*

- *The Foreign Trading Exemption Should Be Revised to Avoid Adverse Effects on U.S. Registered Funds' Investments in Certain Foreign Securities.* Although Congress intended that trading outside of the United States be a "permitted activity" under the Volcker Rule, the Proposed Rule narrowly defines which transactions would be considered to take place outside of the United States—and, in so doing, departs from an existing and well-understood U.S. securities regulation (Regulation S under the Securities Act of 1933) that governs whether an offering takes place outside of the United States. Many registered funds invest in securities, such as sovereign debt securities denominated in foreign currency, for which the primary and most liquid market is outside of the United States. These transactions often involve non-U.S. banking entities as counterparties. The narrow exemption in the Proposed Rule for trading outside of the United States may well cause some non-U.S. banking entities to avoid engaging in transactions with persons acting on behalf of U.S. registered funds, even when those transactions would comport fully with Regulation S. As a result, U.S. registered funds' access to non-U.S. counterparties could decrease significantly, and liquidity in some markets could be reduced. Revising the Proposed Rule to conform to the existing approach under Regulation S would avoid these highly undesirable results.

- *The Rule Should Exempt Asset-Backed Commercial Paper and Municipal Tender Option Bond Programs.* The Proposed Rule would impair two particular types of securitization activities that are part of traditional banking activities—notes issued by asset-backed commercial paper ("ABCP") programs and securities issued pursuant to municipal tender option bond ("TOB") programs.[4] This would have significant negative implications for issuers of these financing vehicles and their investors, many of which are registered funds. There is no indication, however, that Congress intended to include ABCP or municipal

[4] ABCP programs and municipal TOB programs are discussed further in Section III.A, *infra*.

TOB programs within the scope of the Volcker Rule; rather, Congress specifically sought to avoid interfering with longstanding, traditional banking activities. The provision of credit to companies to finance receivables through ABCP, as well as to issuers of municipal securities to finance their activities through TOBs, are both areas of traditional banking activity that should be distinguished from the types of financial activities that Congress sought to restrict under the Volcker Rule. Without liquid ABCP and TOB markets, credit funding for corporations and municipalities would be unduly and unnecessarily constrained. It is therefore important that the Proposed Rule be revised to exempt ABCP and municipal TOB programs.

2. Non-U.S. Retail Funds

The Proposed Rule raises similar and additional concerns for funds that are publicly offered and substantively regulated outside of the United States ("non-U.S. retail funds").[5] Without substantial changes, the Proposed Rule would unduly impede the ability of both U.S. and non-U.S. entities to organize and sponsor, and operate non-U.S. retail funds and harm certain financial markets, market participants, and financial instruments.

a. *Organization, Sponsorship and Normal Activities of Non-U.S. Retail Funds*

- *The Rule Expressly Should Exclude All Non-U.S. Retail Funds from the Definitions of "Covered Fund" and "Banking Entity".* It seems clear that Congress did not intend for the Volcker Rule to target non-U.S. counterparts to U.S. registered funds. Yet, under the Proposed Rule as drafted, non-U.S. retail funds are inappropriately encompassed by the definitions of "covered fund" and, in some circumstances, "banking entity," and could face serious and dramatically disruptive effects on their organization and operation. In fact, if the Proposed Rule is not revised, the Volcker Rule will be applied more restrictively outside of the United States than within it—an odd result in itself, and surely not one Congress intended. Overall, many of the difficulties and problems posed for non-U.S. retail funds could be addressed by excluding non-U.S. retail funds from the definitions of "covered fund" and "banking entity." Such an approach would not compromise Congress' intent with respect to hedge funds and private equity funds and is in keeping with Congress' intent to limit the extraterritorial impact of the Volcker Rule.[6]

[5] *See* Letter from Dan Waters, Managing Director, ICI Global ("ICIG"), to Ms. Elizabeth M. Murphy, Secretary, SEC, *et al.*, dated February 13, 2012. ICIG, our global affiliate, is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICIG seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. Members of ICIG manage total assets in excess of US $1 trillion.

[6] In its comment letter, ICIG recommended several other changes to limit the disruption caused by the Proposed Rule should the Agencies choose not to exclude non-U.S. retail funds from "covered fund" and "banking entity."

b. *Impact on the Financial Markets*

- *The Proposed Rule Should Utilize Regulation S to Delineate Offshore Securities Transactions.* Without revision, the Proposed Rule will result in less liquidity and smaller and/or more fragmented markets for many securities. Certain transactions may be incredibly complex and difficult to accomplish in a sensible and cost-efficient manner. Because the foreign trading exemption is focused on offshore securities transactions, we believe that the Proposed Rule should be revised to follow the approach of Regulation S, which has been the global standard for defining the line between the U.S. and non-U.S. securities markets for more than 20 years.

- *The Rule Should Not Limit the Ability of Banking Entities to Serve as Authorized Participants for Non-U.S. Retail Exchange-Traded Funds and Conduct Related Activities.* The Proposed Rule should be amended to assure that the ability of banking entities to serve as APs for non-U.S. retail funds is not prohibited or constrained. This could be achieved by explicitly designating non-U.S. retail ETF trading activity by banking entity APs as a permitted "market making" activity and excluding non-U.S. retail ETFs from the definition of a covered fund. In addition, if non-U.S. retail funds are not excluded from the definition of "covered fund," the Proposed Rule would need to be revised to accommodate the purchase of non-U.S. retail ETFs by APs that are banking entities. Many of the most active APs in the non-U.S. ETF market are banking entities.

- *Liquid and Efficient Markets Are Important for Non-U.S. Retail Funds.* Similar to the concerns expressed above, non-U.S. retail funds are apprehensive about the effects the Proposed Rule will have on the liquidity of the markets, both in the United States, where many of these funds trade, and abroad (particularly with respect to obligations of foreign governments and international and multinational development banks). We believe that failure to amend the Proposed Rule to address these concerns would severely harm funds and their investors.

B. Designation of Systemically Important Nonbank Financial Companies

In testimony for the Subcommittee's June 2011 hearing on oversight of the mutual fund industry, ICI discussed its views on systemic risk regulation.[7] We emphasized why it is important that the Financial Stability Oversight Council ("FSOC") act deliberatively in exercising its authority under the Dodd-Frank Act to designate systemically important nonbank financial companies ("SIFIs") for

[7] *See* Testimony of Paul Schott Stevens, President and CEO, Investment Company Institute, before the Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives, on "Oversight of the Mutual Fund Industry: Ensuring Market Stability and Investor Confidence" (June 24, 2011) ("ICI June 2011 Testimony"), available at http://financialservices.house.gov/UploadedFiles/062411stevens.pdf, at 40.

heightened prudential regulation and consolidated supervision by the Federal Reserve. We also expressed our strongly held view that SIFI designation is neither warranted nor appropriate for registered funds or their advisers because, among other things, they do not present the risks that such designation is intended to address.

We conveyed these same views to the FSOC as it worked to develop a rule to govern the SIFI designation process.[8] When it adopted a final rule and associated guidance earlier this year, the FSOC indicated that it and the Office of Financial Research ("OFR") are continuing to analyze what threats to financial stability—*if any*—arise from asset management companies and whether such threats can be mitigated by SIFI regulation or are better addressed through other regulatory measures.[9] ICI welcomes this further analysis. It suggests the FSOC recognizes that the risk profile of asset management companies differs from that of banks and of other nonbank financial companies and, moreover, that it is committed to exercising its SIFI designation authority in a careful and thoughtful manner to achieve its intended goals. ICI believes this review will lead the FSOC to conclude, at the very least, that SIFI designation would not be an appropriate regulatory tool for addressing risks, if any, that registered funds or their advisers might raise regarding financial stability.

ICI feels strongly that it would be premature for the FSOC to evaluate asset management companies under its existing SIFI designation framework before its further analysis has been completed. We also believe that, to further inform its views, the FSOC should publish for comment the study the OFR is undertaking. Openness and transparency are critical throughout this process, especially for new governmental bodies such as the OFR. Finally, if the FSOC determines to issue additional guidance regarding asset management companies (or to make other material changes to the guidance already issued), it should provide the public with notice and the opportunity to comment before finalizing any such guidance.[10] We support similar recommendations recently made by a bipartisan group of members of Congress, including Representatives John Carney and Nan Hayworth, in a letter to Treasury Secretary (and FSOC Chairman) Timothy Geithner.[11] All of these recommended procedural

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[8] *See* Letters from Paul Schott Stevens, President & CEO, Investment Company Institute, to the Financial Stability Oversight Council, dated Nov. 5, 2010, Feb. 25, 2011, and December 20, 2011, available at http://www.ici.org/pdf/24696.pdf, http://www.ici.org/pdf/24994.pdf, and http://www.ici.org/pdf/25729.pdf, respectively.

[9] FSOC, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 77 Fed. Reg. 21637 (April 11, 2012) ("SIFI Designation Adopting Release"), at 21644.

[10] *See* Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to the Financial Stability Oversight Council, dated December 20, 2011, *supra* n. 8. The FSOC has only indicated that it *may* provide an opportunity for public comment, as it deems appropriate. SIFI Designation Adopting Release, *supra* note 9, 77 Fed. Reg. at 21647.

[11] *See* Letter from Members of Congress John Carney, Nan Hayworth, Gary Peters, Gary Miller, Gwen Moore, John Campbell, Michael Capuano, David Schweikert, Brad Sherman, Donald Manzullo, and Gregory Meeks, to The Honorable Timothy Geither, Chairman, FSOC, dated June 15, 2012.

steps are consistent with and would help demonstrate the FSOC's stated "commit[ment] to fostering transparency with respect to the Designation Process."[12]

C. Enhanced Prudential Standards for Nonbank SIFIs and Large Bank Holding Companies

To date, FSOC has designated no nonbank organization as a SIFI. In January of this year, however, the Federal Reserve issued a proposal under Sections 165 and 166 of the Dodd-Frank Act outlining the enhanced prudential standards that would apply both to any entity so designated and to bank holding companies with at least $50 billion in total consolidated assets ("large BHCs").[13] ICI's comment letter on the proposal discussed the following two areas of concern with the Federal Reserve's approach.[14]

1. <u>The Section 165/166 Proposal Ignores Statutory Obligations</u>

First, it is premature for the Federal Reserve to apply this proposal to nonbank SIFIs. Without knowing which entities will be subject to enhanced prudential standards, the Federal Reserve cannot comply with its statutory obligation to take into account differences among nonbank SIFIs and large BHCs based on specified considerations.[15] It is therefore not surprising that the overall approach of the proposal is to apply the "same set" of enhanced prudential standards to all nonbank SIFIs and large BHCs. This approach is inconsistent, however, with what the statute requires. Moreover, applying a bank-oriented regulatory framework to *all* covered companies, as the proposal does, disregards Congressional recognition that for purposes of prescribing enhanced prudential standards under Section 165, one size *does not* fit all.[16]

The danger in this approach is illustrated by the proposed risk-based capital and leverage requirements. Section 165(b)(1)(A)(i) provides that the Federal Reserve, in consultation with the FSOC, may determine that risk-based capital requirements and leverage limits are inappropriate for a particular company because of the company's activities or structure. In such a case, Congress has

[12] FSOC, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies,* 76 Fed. Reg. 64264, 64267 (October 18, 2011.)

[13] Board of Governors of the Federal Reserve System, *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies,* 77 Fed. Reg. 594 (Jan. 5, 2012) ("Section 165/166 Proposal").

[14] *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, dated April 30, 2012, available at http://www.ici.org/pdf/26118.pdf.

[15] The considerations are: (1) the factors described in subsections (a) and (b) of Section 113 of the Dodd-Frank Act; (2) whether the company owns an insured depository institution; (3) nonfinancial activities and affiliations of the company; and (4) any other risk-related factors that the Federal Reserve determines appropriate.

[16] *See, e.g.*, Section 165(b)(3) of the Dodd-Frank Act (requiring, among other things, that the Federal Reserve adapt the prudential standards in light of a company's predominant line of business, including assets under management or other activities for which particular standards may not be appropriate).

directed that the Federal Reserve *must* apply "other standards that result in similarly stringent risk controls." But the proposal makes no mention of the possibility that for some companies, risk-based capital requirements and leverage limits may not apply in the same way or even at all. To the contrary, the proposal would apply the specified requirements to any nonbank covered company "as if it were a bank holding company."[17]

It goes without saying that applying enhanced prudential standards that are inappropriate or unworkable will not further the policy goals underlying Section 165. Capital requirements are a good example because, while they are a tool of proven value for banks and broker-dealers, they simply do not make sense in all contexts, including in the case of registered funds and their advisers.[18]

For these reasons, ICI recommends that the Federal Reserve exclude nonbank SIFIs from its rulemaking at this time. Instead, the Federal Reserve should propose, in a separate rulemaking, a process for prescribing the enhanced standards that will be applied to nonbank SIFIs, taking into account the characteristics and risks of those entities so designated.

2. <u>Proposed Single Counterparty Credit Limits Should Not Treat Registered Funds as "Subsidiaries" of Covered Company Sponsors/Advisers</u>

Second, ICI is concerned about the possible application of the single counterparty credit limits proposed by the Federal Reserve. Section 165(e) of the Dodd-Frank Act directs the Federal Reserve to establish single-counterparty credit limits for large BHCs and nonbank SIFIs (referred to collectively in the proposal as "covered companies") to limit the risks that the failure of any individual firm could pose to a covered company. Under the proposal, the aggregate net credit exposure of a covered company and all of its "subsidiaries" to any unaffiliated counterparty and its subsidiaries may not exceed 25 percent of the covered company's capital stock and surplus (reduced to 10 percent if a covered company and its counterparty are both either a bank holding company with $500 billion or more of total consolidated assets or a nonbank SIFI of any size).

The term "subsidiary," as defined in the proposal, generally would not include a registered fund that is sponsored or advised by a covered company, and thus the credit exposure of a registered fund to a counterparty would not be aggregated with the credit exposure of the fund's sponsor or adviser to the same counterparty. ICI believes this is the appropriate outcome because it is well settled under Federal and State law that registered funds are independent legal entities from their sponsors/advisers.

In its release discussing the proposal, however, the Federal Reserve asked whether this outcome may be at odds with the support that some money market funds received from their sponsors during the financial crisis. The Federal Reserve requested comment on whether a money market fund or other

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[17] *See* proposed § 252.13(b)(1) and (b)(3).

[18] *See, e.g.,* Letter from Scott C. Goebel, Senior Vice President and General Counsel, FMR Co., to Financial Stability Oversight Council, dated Dec. 19, 2011.

registered fund or investment vehicle should be included as part of its sponsoring covered company for purposes of this rule.[19]

ICI strongly disagrees with any suggestion that the proposed single counterparty credit limits be applied to a registered fund sponsored or advised by a covered company. As our comment letter to the Federal Reserve explained, treating registered funds in this manner would not further the purpose of the proposed credit limits, and would unnecessarily disrupt the operations of the registered funds while creating potential conflicts of interest between those funds and their covered company sponsor/adviser. Moreover, such treatment could create the inaccurate perception that support from a registered fund's adviser or sponsor is likely—a result directly contrary to the Federal Reserve's objective.

D. Unlimited Insurance for Noninterest-Bearing Transaction Accounts

Section 343 of the Dodd-Frank Act requires the FDIC to provide unlimited insurance for "noninterest-bearing transaction accounts" for two years starting December 31, 2010.[20] This provision is intended to give depositors of insured depository institutions, most notably corporations and other institutional investors, additional assurance that their balances in noninterest-bearing transaction accounts will be safe as the financial crisis wanes.[21] As with any program that insures customer funds, however, the insurance coverage authorized by Section 343 poses potential costs to taxpayers and raises the risk of dislocations elsewhere in the financial system. Presumably in recognition of these potential costs and risks, Congress granted circumscribed authority, requiring the FDIC to provide unlimited insurance for only specified accounts, and for only a two-year period.

We understand that some are calling for Congress to extend this unlimited insurance program beyond its statutory expiration date.[22] ICI strongly opposes any such extension. We view the program as having the potential to dislocate markets and increase systemic risk in times of market stress by creating an unlimited taxpayer-supported backstop for these transaction accounts.[23]

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[19] *See* Section 165/166 Proposal, *supra* note 13, 77 Fed Reg. at 614-15 (Question 24).

[20] Section 343 provides for the "prospective repeal" of the unlimited insurance requirement effective January 1, 2013.

[21] Section 343 is similar to, but also differs in certain key respects from, the Transaction Account Guarantee Program ("TAGP") the FDIC first adopted in October 2008. Originally set to expire on December 31, 2009, the TAGP was extended through June 30, 2010 and subsequently through December 31, 2010. *See* FDIC, *Deposit Insurance Regulations; Unlimited Coverage for Noninterest-bearing Transaction Accounts*, 75 Fed. Reg. 60341 (Sept. 30, 2010), at 60342.

[22] *See, e.g.*, Joe Adler, *Banker's Banks Add to Calls for Extending TAG*, American Banker, June 26, 2012, available at http://www.americanbanker.com/issues/177_123/bankers-banks-transaction-account-guarantee-extension-1050448-1.html.

[23] *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation (October 10, 2010), available at http://www.fdic.gov/regulations/laws/federal/2010/10c48AD37p.PDF (commenting on FDIC proposal to implement Section 343).

To understand ICI's concerns, it is helpful first to understand the economic role of deposit insurance and how deposit insurance can influence the actions of banks and depositors, as well as investors in the broader markets. Banks have limited ability to liquidate assets quickly to meet large, unexpected withdrawals. Deposit insurance reduces the probability of bank runs by eliminating the potential advantage enjoyed by those depositors who are first to withdraw their money from a bank. Greater stability of bank deposits provides greater stability in the credit creation process and the overall economy.

Despite its demonstrated benefits, however, deposit insurance also entails risks for the financial system. For example, insurance reduces the incentives for insured depositors to monitor the creditworthiness of banks, which in turn creates a moral hazard that can encourage banks to take additional risks, knowing that depositors will not withdraw their deposits if the bank's financial condition deteriorates.[24] In addition, deposit insurance can cause other systemic risks for financial markets by increasing the propensity for investors to sell off assets—such as stocks, bonds, mutual fund shares, and other securities—and move the proceeds into insured deposits. As the FDIC has previously observed, this behavior can produce or exacerbate broader market dislocations during periods of financial stress.[25]

Indeed, recent experience suggests that such activity would worsen any future financial crisis and reduce credit available to businesses, state and local governments, and other borrowers. Depository institutions would be unlikely, and in many cases unable, to buy the assets investors were selling. Instead of risking a recurrence, every effort should be made to avoid such a series of events.

Historically, the risks posed by deposit insurance programs have been mitigated by capping the amount of a depositor's account that is insured (currently $250,000).[26] In the case of the insurance

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[24] *See, e.g.,* FDIC, The Deposit Insurance Funds: Options Paper (Aug. 2000), available at http://www.fdic.gov/deposit/insurance/initiative/optionpaper.html ("2000 Options Paper") (recognizing that "deposit insurance can create moral hazard and increase the risk and cost of failure if deposit insurance premiums do not fully compensate the FDIC for increases in risk posed by particular banks and thrifts. By assuming the risk of loss that would otherwise be borne by depositors, deposit insurance eliminates any incentive for depositors who are fully insured to monitor bank or thrift risk, thus reducing what is known as 'depositor discipline.' Management can therefore take greater risks without increasing the depository institution's cost of funds.").

[25] *See id.* ("There is also the possibility of a large shift of household assets into insured deposit accounts in the event of financial market volatility. There is currently more than $11 trillion outstanding in U.S. equity holdings (including mutual fund shares) alone. In a protracted bear market, some of these funds could be transferred to insured deposits."). *See also* Alan S. Blinder and R. Glenn Hubbard, *Blanket Deposit Insurance is a Bad Idea*, WSJ Asia, Oct. 16, 2008 (arguing that 100% federal deposit insurance would pull funds out of other assets, including money market funds and other money market instruments, as well as out of other countries, as occurred when deposits flowed from Britain to Ireland after Ireland instituted a deposit guarantee).

[26] *See* 2000 Options Paper, *supra* note 24 ("The coverage limit represents a balance between the goals of deposit insurance, on the one hand, and the need to limit moral hazard and the risk to taxpayers and the insurance funds, on the other.").

authorized by Section 343 of the Dodd-Frank Act, the statutory limits on the types of accounts covered and the December 31, 2012 termination date should serve to reduce the possible negative effects of the program. With the stability of the U.S. financial system at stake, the importance of these limits cannot be overemphasized.[27] Congress therefore should resist any efforts to vitiate them.

III. OTHER ISSUES AFFECTING REGISTERED FUNDS AS INVESTORS IN THE MARKETS

As discussed above, the regulatory proposal to implement the Volcker Rule raises significant concerns for registered funds and their shareholders, including concerns for funds as investors in the financial markets. As institutional investors that invest nearly $13 trillion on behalf of over 90 million shareholders, registered funds have a strong interest in regulations that affect the functioning of the financial markets. ICI regularly provides input on behalf of its members on a variety of matters relevant to registered funds' participation in the financial markets.[28] The discussion below focuses on certain implications of the Dodd-Frank Act for registered funds' investments in the asset-backed securities ("ABS") market and the derivatives markets.

A. Asset-Backed Securities

The Dodd-Frank Act includes numerous provisions relating to ABS disclosure, reporting, risk retention, and conflicts of interest that were intended to address issues that arose during the financial crisis.[29] As investors in ABS, registered funds have a strong interest in ABS markets that function fairly and in the interests of investors.[30]

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[27] ICI pointed to similar concerns and risks associated with any potential unlimited federal guarantee of assets invested in money market mutual funds, notably the risk of exacerbating the financial crisis by drawing large sums of deposits away from banks. See Investment Company Institute, *Report of the Money Market Working Group*, March 17, 2009 ("MMWG Report"), at 64-65. As noted in the MMWG Report, these risks are not theoretical. As a result, during the development in September 2008 of the Treasury Department's Money Market Fund Guarantee Program, ICI was a strong proponent of limiting the coverage and duration of that program.

[28] *See, e.g.,* Appendix to Testimony of Kevin Cronin, Global Head of Equity Trading, Invesco, on Behalf of the Investment Company Institute, before the Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, on "Market Structure: Ensuring Orderly, Efficient, Innovative and Competitive Markets for Issuers and Investors" (June 20, 2012) (listing key ICI comments and statements on market structure issues), available at http://financialservices.house.gov/UploadedFiles/HHRG-112-BA16-WState-KCronin-20120620.pdf.

[29] *See, e.g.,* Subtitle D of the Dodd-Frank Act, "Improvements to the Asset-Backed Securitization Process" (Sections 941-946).

[30] Registered funds also have an interest in strong disclosure and reporting standards for ABS, and we have, in the past, supported the SEC's efforts to improve disclosure and reporting for ABS. *See, e.g.,* Letter from Karrie McMillan, General Counsel, ICI, to Elizabeth M. Murphy, Secretary, SEC, dated October 4, 2011, available at http://www.ici.org/pdf/25532.pdf; Letter from Karrie McMillan, General Counsel, ICI, to Elizabeth M. Murphy, Secretary, SEC, dated November 15, 2010, available at http://www.ici.org/pdf/24712.pdf; Letter from Karrie McMillan,

1. Risk Retention

In March 2011, six federal regulators (the "Regulators") jointly issued a proposal to implement the credit risk retention requirements imposed by the Dodd-Frank Act.[31] The proposal generally requires an ABS sponsor to retain not less than five percent of the credit risk of any asset that the sponsor, through the issuance of the ABS, transfers, sells, or conveys to a third party. ICI supports the goal of the proposal, as registered funds have a strong interest in ensuring that securitizers of ABS act consistently with the interests of investors. We are concerned, however, that the proposed standards for risk retention may not be appropriate or necessary for certain classes of ABS in which registered funds invest.[32] Specifically, we do not believe that the proposed requirements sufficiently reflect differences among certain classes of ABS or market practice for those particular securities.[33] This is particularly so with respect to notes issued by ABCP programs and securities issued by municipal TOB programs.

The proposal includes a risk retention option specifically designed for ABCP programs that meet certain conditions. ABCP programs are short-term, senior-secured investment vehicles that issue instruments in the money markets. They are used by a wide variety of corporations—such as banks, finance companies, and broker-dealers—to obtain low-cost financing for a diverse range of financial receivables. ABCP programs are referred to as "asset-backed" because the entities that issue the ABCP own, or have security interests in, multiple pools of various types of financial assets. Most existing ABCP programs could not meet the proposed rule's conditions, however. ICI recommends, in lieu of the ABCP risk retention option, that the Regulators exclude or exempt from the proposal's risk retention requirements those bank-sponsored ABCP programs that meet strict criteria ICI suggested in its comment letter to the Regulators.[34] These criteria reflect an alignment of interests between the ABS

General Counsel, ICI, to Elizabeth M. Murphy, Secretary, SEC, dated August 2, 2010, available at http://www.ici.org/pdf/24465.pdf.

[31] *Credit Risk Retention,* 76 Fed. Reg. 24090 (April 29, 2011). Section 941 of the Dodd-Frank Act, which mandates risk retention requirements, added Section 15G to the Exchange Act.

[32] Letter from Karrie McMillan, General Counsel, ICI, to Elizabeth M. Murphy, Secretary, SEC; Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System; Mr. Alfred M. Pollard, General Counsel, Federal Housing Finance Agency; Office of the Comptroller of the Currency; Mr. Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation; Regulations Division, Office of General Counsel, Department of Housing and Urban Development, dated July 29, 2011 ("Risk Retention Comment Letter"), available at http://www.ici.org/pdf/25368.pdf.

[33] The legislative history for Section 15G of the Exchange Act states that "a 'one size fits all' approach to risk retention may adversely affect certain securitization markets .... Accordingly, the bill requires that the initial joint rulemaking include separate components addressing individual asset classes -- home mortgages, commercial mortgages, commercial loans, auto loans, and any other asset class that the regulators deem appropriate. The Committee expects that these regulations will recognize differences in the assets securitized, in existing risk management practices, and in the structure of asset-backed securities, and that regulators will make appropriate adjustments to the amount of risk retention required." S. Rep. No. 111-176, at 130 (2010).

[34] Risk Retention Comment Letter, *supra* note 32.

sponsor and investor, making it unnecessary to impose further risk retention requirements on such bank-sponsored ABCP programs.

The proposal is silent regarding municipal TOB programs. A municipal TOB program is created by a sponsor bank that deposits one or more high-quality municipal bonds into a trust which issues two classes of tax-exempt securities: a short-term security that is supported by a liquidity facility and an inverse floating rate security. Tax-exempt money market funds are the principal holders of the short-term securities. ICI has requested clarification from the Regulators that TOBs are not within the scope of the proposal or, alternatively, that they be exempted from its requirements.[35] TOBs are distinguishable from traditional ABS and do not raise the concerns the risk retention requirements were intended to address. Applying the proposed risk retention requirements to TOBs would not be in the public interest. Furthermore, the structural characteristics of TOB programs would make it difficult for their sponsors to satisfy the proposed risk retention requirements. If TOB sponsors were forced to restructure their programs significantly to comply with the proposed rules' requirements, the increase in the cost of TOB program sponsorship could adversely affect the state and local governments that indirectly receive funding through these programs.

2. Prohibition Against ABS Conflicts of Interest

Last September, the SEC proposed a rule that would implement the prohibition under the Dodd-Frank Act against material conflicts of interest in connection with certain securitizations.[36] ICI generally supports the proposed rule, as it would serve to protect investors in ABS against certain conflicts of interest that may be raised by the activities of securitization participants.[37] At the same time, we are concerned that registered funds could fall within the proposed rule's scope because they may be affiliates of entities that structure or distribute ABS. Actions taken by a registered fund in connection with investing in ABS, through its investment adviser acting in a fiduciary capacity, do not raise the conflicts of interest the proposed rule seeks to address. The SEC should clarify that the proposed rule excludes such activities.

The proposed rule includes an exception for commitments to provide liquidity for an ABS, including those liquidity commitments provided by securitization participants in connection with notes issued by ABCP programs, which we support.[38] Certain restrictions under the regulatory proposal to implement the Volcker Rule (discussed in Section II above) could be interpreted, however,

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[35] *Id.*

[36] *Prohibition against Conflicts of Interest in Certain Securitizations*, 76 Fed. Reg. 60320 (September 28, 2011). Proposed Rule 127B under the Securities Act of 1933 would implement the prohibition under Section 621 of the Dodd-Frank Act.

[37] *See* Letter from Karrie McMillan, General Counsel, ICI, to Elizabeth M. Murphy, Secretary, SEC, dated February 13, 2012, available at http://www.ici.org/pdf/25907.pdf.

[38] ABCP has unique characteristics that distinguish it from typical ABS, including liquidity facilities for the benefit of investors that often are provided by the sponsoring bank or one of its affiliates.

to prohibit such liquidity arrangements for bank-sponsored or advised programs, which would threaten the viability of such programs.[39] Such a result would be inconsistent with Congressional intent in enacting the exception for liquidity commitments, an exception set forth in the Dodd-Frank Act itself. Morever, such a prohibition is not necessary to address the conflict of interest concerns against which the Volcker Rule was designed to protect.

B. Derivatives and Title VII of the Dodd-Frank Act

The implementation of the Dodd-Frank Act will dramatically change the derivatives markets, establishing a new regulatory framework for the swaps markets and their participants.[40] Registered funds are participants in these markets, and they use swaps and other derivatives in a variety of ways to manage their portfolios. For example, registered funds use derivatives to hedge positions; equitize cash that a fund cannot immediately invest in direct equity holdings; manage the fund's cash positions more generally; adjust the duration of the fund's portfolio; manage bond positions in general; or manage the fund's portfolio in accordance with the investment objectives stated in its prospectus. Relative to comparable cash securities, derivatives' potential benefits include the ability to:

- Hedge exposure to a market, sector, security, or other target exposure;
- Gain or reduce exposure to a market, sector, security, or other target exposure more quickly, more precisely, and/or with lower transaction costs and portfolio disruption;
- In some cases, utilize a more liquid alternative to traditional cash securities; and
- Gain access to markets in which transacting in cash securities is difficult, costly, or not possible.

Accordingly, ICI and its members have encouraged reform efforts in the derivatives markets.[41] During the hearings that led to the Dodd-Frank Act, for example, ICI specifically supported measures that would increase transparency and reduce counterparty risk of certain over-the-counter derivatives.[42] We, therefore, have urged the CFTC and the SEC to promulgate regulations in a manner that provides the protections sought by the Dodd-Frank Act while minimizing disruptions to the markets, market participants, and customers. In this regard, four issues are of particular concern to us: the

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[39] ICI Volcker Comment Letter, *supra* note 3, at 39.

[40] Throughout this section of the testimony, we will use the term "swaps" to refer to both swaps and security-based swaps, unless the context requires otherwise.

[41] *See, e.g.,* ICI June 2011 Testimony, *supra* note 7. Testimony of Karrie McMillan, General Counsel, Investment Company Institute, before the Subcommittee on General Farm Commodities and Risk Management Committee on Agriculture, United States House of Representatives, on "Implementing Dodd-Frank: A Review of the CFTC's Rulemaking Process" (April 13, 2011) ("ICI April 2011 Testimony"), available at http://www.ici.org/pdf/11_cftc_rule4.5_exclude.pdf.

[42] Testimony of Paul Schott Stevens, President and CEO, Investment Company Institute, Before the U.S. House of Representatives Committee on Financial Services on "Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals" (July 17, 2009), available at http://www.ici.org/govaffairs/testimony/09_reg_reform_jul_tmny.

implementation process for the final swaps rules; the status of non-deliverable foreign exchange forwards; the process for making a swap "available to trade;" and the determination of block trades.

1. Implementation of Title VII

The process of finalizing and implementing the rulemakings under Title VII of the Dodd-Frank Act must ensure that the new rules are tailored appropriately, work in tandem with one another, and strike the right balance between costs and benefits. ICI appreciates the extraordinary efforts the SEC and CFTC (together, the "Commissions") have made in the very difficult task of developing rules to address the complexities of the swaps markets while avoiding unintended adverse consequences. To ensure that the final regulatory framework "gets it right," however, it is crucial that the Commissions sustain a transparent and open rulemaking process, phase in the effective and compliance dates of the final rules in a logical manner, provide adequate time for market participants to transition to the new rules, and harmonize and coordinate with domestic and international regulators, as appropriate.

Implementation of the new regulatory framework must follow a sequential, deliberative and coordinated process to minimize unforeseen and unintended consequences for market participants, customers and the derivatives markets, including disruptions to the markets and risk mitigation strategies.[43] Specifically, the implementation periods should:

- Afford adequate time for the Commissions to gather additional market data to inform future rulemaking;
- Allow market participants to build market infrastructures, modify business operations, complete testing, and perform outreach and education of customers; and
- Phase in rule requirements by type of market participants and asset class.

Market participants are struggling with the implications of the new rules on their activities in these markets, and are hampered in developing compliance strategies by the need to wait for action from other market participants. Phasing in the rules will provide market participants with essential time to identify the cumulative impact of the rule changes, build upon the actions of other market participants, and manage the cumulative costs of the rule changes.

[43] *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, CFTC, dated November 4, 2011 ("November 2011 Implementation Letter"), available at http://www.ici.org/pdf/25619.pdf; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, and David A. Stawick, Secretary, CFTC, dated June 10, 2011("June 2011 Implementation Letter"), available at http://www.ici.org/pdf/25276.pdf; and Letter from American Bankers Ass'n, ABA Securities Ass'n, The Clearing House Ass'n, L.L.C., Financial Services Forum, Financial Services Roundtable, Institute of International Bankers, International Swaps and Derivatives Ass'n, Investment Company Institute, Managed Funds Ass'n and Securities Industry and Financial Markets Ass'n to Elizabeth M. Murphy, Secretary, SEC, and David A. Stawick, Secretary, CFTC, dated December 6, 2010, available at http://www.ici.org/pdf/24780.pdf.

ICI commends the Commissions for recognizing the importance of phasing in the rules in each of their proposals that address the sequencing of the compliance dates of the final swaps rules adopted under Title VII.[44] We are concerned, however, that the CFTC's proposed schedules for phasing in compliance with the swaps rules significantly underestimate the time needed for the swap market to transition to the new framework. They also underestimate the time needed for the transition to take place in an orderly manner that does not disadvantage certain market participants and minimizes disruption to the marketplace.[45] In order to ensure a smooth, efficient, and effective transformation of the swaps markets, we believe the Commissions should provide a transition period of 18 to 24 months following adoption of final rules. The SEC's recent statement on the anticipated sequencing of the compliance dates for the Title VII rules on security-based ("SB") swaps explains the general order in which SB swap market participants might prepare for compliance with the final rules and discusses the sequencing of the rules in relation to one another.[46] ICI is in the process of evaluating this proposal, and expects to comment on it shortly. In addition to the comments we will have on the proposal itself, we believe it will be essential for the Commissions to harmonize and coordinate their approaches with one another. Similarly, to address the global nature of the derivatives markets, the Commissions' rules should be finalized only after harmonizing requirements and principles with those rules being adopted by foreign regulators.[47] Where harmonization is not possible, coordination should be undertaken.

2. The Status of Non-Deliverable Foreign Exchange Forwards

Under the Dodd-Frank Act, foreign exchange ("FX") swaps and forwards are considered swaps unless the Secretary of the Treasury makes a written determination that either or both should not be regulated as swaps.[48] In May 2011, the Treasury issued a proposed determination, which to date has

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[44] *See Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 77 Fed. Reg. 35625 (June 14, 2012) ("Proposed SEC Implementation Statement"); *Swap Transaction Compliance and Implementation Schedule: Trading Documentation and Margining Requirements under Section 4s of the CEA*, 75 Fed. Reg. 78176 (September 20, 2011); and *Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(h) of the CEA*, 75 Fed. Reg. 58186 (September 20, 2011).

[45] *See* November 2011 Implementation Letter, *supra* note 43.

[46] Proposed SEC Implementation Statement, *supra* note 44.

[47] We note that the CFTC recently proposed interpretive guidance on the cross-border application of Title VII. *See Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act*, available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister062912.pdf. The SEC has indicated that it will issue similar guidance in connection with SB swap transactions. Proposed SEC Implementation Statement, *supra* note 44, at 35631.

[48] Section 1a(47)(E) of the Commodity Exchange Act, as amended by the Dodd-Frank Act. These products, however, would remain subject to certain reporting requirements, and anti-fraud and business conduct standards under the Commodity Exchange Act.

not been finalized, that would exempt FX swaps and forwards from the definition of swap.[49] The Treasury's proposed determination would not include non-deliverable FX forwards ("NDFs") within the exemption. ICI has consistently supported Treasury's proposed exemption of FX swaps and forwards, and strongly believes that it should extend to NDFs.[50]

An FX forward is a transaction to exchange two currencies at a future date at an exchange rate that is agreed upon at the time of entering into the transaction.[51] An NDF is cash settled in just one currency and does not involve the exchange of underlying currencies. NDFs are used by market participants instead of FX forwards when a particular currency cannot be physically delivered because of currency controls or local law restrictions. NDFs are functionally and economically identical to deliverable FX forwards. They do not pose greater risk to market participants or the financial system.[52] Whether the FX forward is deliverable or non-deliverable is not relevant to the market participant's investment decision. For these reasons, we recommend that Treasury, in coordination with the CFTC, or, if necessary, Congress, clarify that FX forwards include both deliverable FX forwards and NDFs. Failure to do so would result in operational difficulties for market participants when assessing their swaps activity for purposes of certain CFTC rules, could allow for potential arbitrage between the two types of FX forwards, and would increase fragmentation in the currency markets because NDFs would be subject to clearing and trading requirements, while FX forwards would not.

3. <u>The Process for Making a Swap "Available to Trade"</u>

Late last year, the CFTC, pursuant to the Dodd-Frank Act, proposed a process to establish which swaps will be subject to mandatory trading, or will be made "available to trade" on a designated contract market ("DCM") or swap execution facility ("SEF"), for purposes of the Commodity Exchange Act.[53] The CFTC's proposed process would grant the DCMs and SEFs themselves a significant role in making these determinations. In ICIs' view, the proposed process clearly would not

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[49] *See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act*, 76 Fed. Reg. 25774 (May 5, 2011).

[50] *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, and Cecelia Calaby, Executive Director and General Counsel, ABA Securities Association, to Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, and Mr. David A. Stawick, Secretary, Commodity Futures Trading Commission, dated July 22, 2011, available at http://www.ici.org/pdf/25354.pdf; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Mary J. Miller, Assistant Secretary for Financial Markets, United States Department of the Treasury, dated June 6, 2011, available at http://www.ici.org/pdf/25254.pdf; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Mary J. Miller, Assistant Secretary for Financial Markets, United States Department of the Treasury, dated November 29, 2010, available at http://www.ici.org/pdf/24751.pdf.

[51] *See* Section 1a(24) of the Commodity Exchange Act, as amended by the Dodd-Frank Act.

[52] See letters cited in note 50, *supra*.

[53] *Process for a Designated Contract Market or Swap Execution Facility To Make a Swap Available To Trade*, 76 Fed. Reg. 77728, (December 14, 2011).

provide the CFTC with a role sufficient to curb the financial incentives DCMs and SEFs will have to mandate prematurely the trading of swaps on their platforms.[54] If swaps are made "available to trade" prematurely, market participants would be required to trade that those swaps over a DCM or SEF, even in the absence of a liquid trading market for the swap. ICI believes strongly that only those swaps that are the most liquid should be subject to mandatory execution.

To address the incentives a DCM or SEF may have to make a swap "available to trade" prematurely, ICI recommends that the CFTC require DCMs and SEFs to consider objective standards or thresholds as part of the make "available to trade" ("MAT") determination process, and that consideration of each standard/threshold be mandatory. We note that the SEC, which is subject to a similar requirement with respect to SB swaps, also has recognized that SEFs face a conflict of interest with respect to such determinations.[55] Accordingly, the SEC has stated that the MAT determination should be made "pursuant to objective measures established by the [SEC], rather than by one or a group of [security-based SEFs]."[56] We support the SEC's approach to MAT determinations and recommend that the CFTC make its approach more consistent with that of the SEC.

4. <u>The Determination of Block Trades</u>

Pursuant to the Dodd-Frank Act, both the SEC and CFTC have issued proposals, and the CFTC has adopted rules, that would require, upon execution, reporting of swap transaction data to a registered swap data repository ("SDR"). The SDR would make certain of the swap data publicly available in real time. Market transparency is a key element to ensuring the integrity and quality of these markets,[57] but that must be balanced against the need to adequately protect information regarding a registered fund's block trades.

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[54] *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, Commodity Futures Trading Commission, dated February 13, 2012, available at http://www.ici.org/pdf/25910.pdf.

[55] The Dodd-Frank Act added an analogous provision to the Exchange Act applicable to transactions in SB swaps executed on an exchange or on an SB SEF. *See* Section 3C(h)(2) of the Exchange Act.

[56] *Registration and Regulation of Security-Based Swap Execution Facilities*, 76 Fed. Reg. 10948, 10970 (February 28, 2011); *see also* Proposed SEC Implementation Statement, *supra* note 44, at 35641.

[57] As part of its recommendations to the Commissions regarding the sequence for implementation of the new swaps regulatory framework, ICI has recommended that the Commissions begin by finalizing and implementing rules requiring reporting of swap transaction data to the regulators. Initially, reporting should be limited to non-public, regulatory reporting to gather data to inform, for example, block trading rules without significantly disrupting the swaps market and market participants' trading strategies by impacting liquidity. ICI believes that the information gathered through this process will assist the Commissions in better understanding the structure and operations of the swaps markets and adopting appropriately tailored and effective rules. Further, only after such analysis can the Commissions accurately determine the effect of public dissemination of certain of the swap transaction data. See June 2011 Implementation Letter and November 2011 Implementation Letter, *supra* note 43.

Block trades are large transactions that are negotiated off an exchange's trading facility, and then posted on the trading facility. In the swaps markets, they enable registered funds, on behalf of their shareholders, to transact in large amounts with minimal disruption to the swaps market. Block trades also reduce the possibility that registered funds would be subject to the higher trading costs associated with large (non-block) transactions, costs that would be borne by funds and their shareholders. As explained below, flexible and anonymous block trading is essential given the swaps market's comparative lack of depth and liquidity.

After a block trade has been executed, one or more of the counterparties will seek to reduce risk by hedging its exposure, usually by transacting on an exchange. Knowledge of a block trade therefore signals to other market participants that there is the potential for subsequent trading activity.[58] This signaling can negatively affect the market and registered fund shareholders by significantly skewing pricing if the market does not have sufficient time to digest the block order. In addition, opportunistic market participants may piece together information about a registered fund's holdings or trading strategy, leading to front running of the fund's trades, which adversely impacts the price of the swap and the underlying security to the detriment of fund shareholders.

Failure adequately to protect registered funds' block trading strategies could compromise funds' sensitive trading data, enabling market participants to identify funds and their trading strategy to the detriment of funds, their shareholders and the liquidity of the market in which those trades occur. In response to a significant number of comments (including those of ICI), the CFTC recently reproposed rules specifying the procedures for determining block trade sizes.[59] While ICI appreciates that the CFTC intended the reproposal to provide a more tailored approach than its original proposal, ICI remains deeply concerned that the proposed swap categories are too broad, grouping together swaps with vastly different liquidity profiles, and that the CFTC has proposed a calculation for determining minimum block trade size that would result in too high a threshold for block trades.[60] The SEC has yet to propose specific block trade thresholds, and has requested comment on various methods of establishing block trade thresholds, as well as other issues related to block trades.[61] We recommend that the Commissions coordinate their proposals to the extent possible.

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[58] In post-transaction analysis of block trades, our members report being able to see that the market tracked their movements.

[59] *Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades*, 77 Fed. Reg. 15460 (Mar. 15, 2012).

[60] *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, CFTC, dated May 14, 2012, available at http://www.ici.org/pdf/26158.pdf. The 67-percent notional amount calculation proposed by the CFTC for determining minimum block trade size would result in approximately 94 percent of trades being reported in real-time. We believe this calculation would set the minimum block thresholds too high, given the lack of depth and liquidity in the swaps markets, which could cause disruptions in these markets.

[61] Proposed SEC Implementation Statement, *supra* note 44.

The best way to identify the appropriate thresholds for block trades in the swaps market is to account for the liquidity in each unique category of swaps.[62] The risks, trading and liquidity associated with a particular swap differ for each individual swap category within an asset class based on type, term and underlying security. The Commissions should reflect these granular but significant differences by creating narrow buckets to which the threshold formulas would apply.[63] These thresholds should be calculated regularly (*e.g.*, quarterly or, at a minimum, semi-annually) to ensure that they are appropriately tracking liquidity in the swap categories.[64]

In addition, the thresholds must be low enough to encourage the use of block trades. Setting the thresholds too high could cause significant market disruption and harm to registered fund shareholders by eliminating the use of block trades in these markets and the associated benefits provided by such trades.[65] Therefore, the Commissions should err on the side of caution by setting the thresholds low initially to collect data to enable them to evaluate the thresholds and the appropriate delays for data dissemination.

IV. CFTC RULE 4.5

While all of the issues discussed above are mandated by, or otherwise stem directly from, the Dodd-Frank Act, the CFTC's Rule 4.5 is an example of an agency using the Dodd-Frank Act as a pretext for an expansion of its authority through unjustified regulations.

Since its initial adoption almost thirty years ago, CFTC Rule 4.5 under the Commodity Exchange Act rule had provided a uniform exclusion from CFTC regulation as a commodity pool operator ("CPO") for entities that are already subject to another regulatory scheme. Among these entities are registered funds, which are comprehensively regulated by the SEC under all four of the major federal securities laws. On February 8, 2012, the CFTC adopted amendments to Rule 4.5.[66] The

[62] Under the proposed CFTC thresholds, many transactions that should be treated as block trades would not qualify as such.

[63] We acknowledge that the CFTC has attempted to do this to a greater extent in its reproposal; however, the proposed categories appear to continue to group together swaps of a wide range of liquidities. We recommend that the CFTC analyze the data it will receive from SDRs to provide more granular categories within the interest rate and credit default swap asset classes to more accurately reflect liquidity and to determine whether further refinements are necessary for the FX and other commodity asset classes. We also disagree with the CFTC's proposal not to treat any trades in equity swaps as block trades, and believe the CFTC should propose an appropriate minimum block size for such equity swaps.

[64] We therefore believe the CFTC's proposal to set minimum block sizes annually would be too infrequent and that the thresholds must be calculated more regularly to reflect changes in the market.

[65] As noted above, we are concerned that the CFTC's proposed 67-percent notional amount calculation would result in too high a threshold for block trades. We instead recommend that the CFTC adopt the 50-percent notional amount calculation that was suggested by the CFTC as an alternative approach and to phase-in this standard over a period of time for very illiquid categories of swaps. *See supra* note 60 and accompanying text.

[66] *See Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations*, 77 Fed. Reg. 11252, 11253 (Feb. 24, 2012); *correction notice published at* 77 Fed. Reg. 17328 (Mar. 26, 2012) ("Rule 4.5 Adopting Release").

CFTC's amendments sharply curtail the Rule 4.5 exclusion, but *only* for registered funds and not for other entities covered by the rule.

Under amended Rule 4.5, any registered fund that engages in more than a *de minimis* level of investment in commodity futures, commodity options or swaps or that does not satisfy the rule's restrictions on marketing will not qualify for the exclusion. In that case, the registered fund's investment adviser will have to become registered with the CFTC as a CPO, in addition to being registered with the SEC. And the registered fund and its adviser will become subject to the CFTC's separate regime of disclosure, reporting, and recordkeeping, as well as to regulation and oversight by the National Futures Association ("NFA").

This additional regulation is altogether unnecessary and redundant of the comprehensive regulation to which registered funds and their advisers are already subject by the SEC. The CFTC has neither justified the need for these additional regulatory burdens, nor the significant costs the rule will impose on registered funds—costs that ultimately will be borne by their shareholders. Nor has the agency adequately explained how registered fund shareholders, which already enjoy comprehensive protections under the federal securities laws, will benefit from this additional, redundant layer of regulation.

The CFTC attempts to justify its action by pointing to the 2008 financial crisis and passage of the Dodd-Frank Act, saying that the statute gives it a "more robust mandate" to "manage systemic risk" in the derivatives markets.[67] In fact, the amendments to Rule 4.5 were neither required nor even contemplated by the Dodd-Frank Act.[68] We agree with the observations made by CFTC Commissioner Jill Sommers, whose dissent in this rulemaking criticized the agency's rationalization as unpersuasive:

> . . . Congress was aware of the existing exclusions and exemptions for CPOs when it passed Dodd-Frank and did *not* direct the Commission to narrow their scope or require reporting for systemic risk purposes. The Commission justifies the new rules as a response to the financial crisis of 2007 and 2008 and the passage of Dodd-Frank, yet there is *no evidence* to suggest that inadequate regulation of commodity pools was a contributing cause of the crisis, or that subjecting entities to a dual registration scheme will somehow prevent a similar crisis in the future."[69]

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[67] Commodity Futures Trading Commission, Cross-Motion for Summary Judgment, Opposition to Plaintiffs' Motion for Summary Judgment, and Motion to Dismiss in Part at 12, *Investment Company Institute, et al. v. CFTC*, Case No. 1:12-cv-00612 (D.D.C. June 18, 2012) (quoting Rule 4.5 Adopting Release, *supra* note 66, at 11275).

[68] The CFTC also has described the amendments as being "consistent with the tenor of the provisions of the Dodd-Frank Act," despite *nothing* in the statute even remotely alluding to the need for CFTC oversight of registered funds. Rule 4.5 Adopting Release, *supra* note 66.

[69] *See* Commissioner Jill E. Sommers, *Dissenting Statement, Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations* (February 9, 2012), available at

Similar cautions were raised *prior* to the CFTC's adoption of the amendments. In particular, Chairman Jack Kingston repeatedly expressed his concern to CFTC Chairman Gensler that the then-proposed Rule 4.5 amendments were not mandated by the Dodd-Frank Act, and urged that the rulemaking be delayed until major rulemakings required by Dodd-Frank were completed.[70] Indeed, the CFTC in this rulemaking disregarded the plain recommendations of members of this Congress that it focus on its actual Dodd-Frank mandate.[71]

Also troubling is the fact that the CFTC failed to perform even the most rudimentary cost-benefit analysis. Last year, Chairmen Kingston and Conaway alerted the CFTC to their concerns that costs associated with the proposed changes to Rule 4.5 "will likely result in higher costs for many of our constituents that have invested their savings in investment plans that have exposure to the futures markets."[72] And as recently as January of this year—one month before the CFTC's vote to approve the amendments—the two Chairmen stated that they "remain opposed to the promulgation of this rule without a thorough cost-benefit analysis because the proposed rule has the potential to create duplicative, unnecessary regulations."[73] These concerns were not heeded, and the CFTC adopted the amendments to the rule with only a cursory analysis that failed to meaningfully assess the rule's impact. Commissioner Sommers observed in her dissent that the CFTC's cost-benefit analysis of the rule was "sorely lacking."[74]

Perhaps most regrettable, in ICI's view, is the fact that the CFTC failed to address the significant concerns raised, and specific recommendations offered, by the public through consideration of this rulemaking. ICI and our members made every effort to advocate for a more sensible outcome.

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http://www.cftc.gov/PressRoom/SpeechesTestimony/sommersstatement020912a ("Sommers Dissenting Statement") (emphasis added).

[70] *See* Letter from Chairman Jack Kingston, Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies, Committee on Appropriations, U.S. House of Representatives, and Chairman K. Michael Conaway, Subcommittee on General Farm Commodities and Risk Management, U.S. House of Representatives, to the Honorable Gary Gensler, Chairman, CFTC, dated January 30, 2012 ("2012 Kingston and Conaway Letter"); Letter from Chairman Jack Kingston, Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies, Committee on Appropriations, U.S. House of Representatives, Chairman K. Michael Conaway, Subcommittee on General Farm Commodities and Risk Management, U.S. House of Representatives, and Congressman Bill Owens, U.S. House of Representatives, to the Honorable Gary Gensler, Chairman, CFTC, dated October 3, 2011 ("2011 Kingston, Conaway, and Owens Letter").

[71] *See* Letter from Frank D. Lucas, Chairman, Committee on Agriculture, and K. Michael Conaway, Chairman, Subcommittee on General Farm Commodities and Risk Management, to the Honorable Gary Gensler, Chairman, U.S. Commodity Futures Trading Commission, dated July 14, 2011 ("In light of the volume of rules that are required by Title VII, it is prudent to prioritize the time and resources of your staff. We recommend that you promulgate rules that are required before moving to rules that are not explicitly required by Dodd-Frank." (going on to describe Rule 4.5)).

[72] 2011 Kinston, Conaway, and Owens Letter, *supra* note 70.

[73] 2012 Kingston and Conaway Letter, *supra* note 70.

[74] Sommers Dissenting Statement, *supra* note 69.

ICI filed three detailed comment letters; met with CFTC commissioners and staff; participated in the CFTC staff's public roundtable; and testified on Capitol Hill about this rulemaking.[75] Twelve of our member firms also filed comments.

ICI strives to work cooperatively within the administrative process to help regulators craft rules that are effective, efficient, and equitable. Unfortunately, we could not reach that outcome in this instance, and our mission—to advance the interests of registered funds, their shareholders, directors, and advisers—led us to conclude that our only recourse was to challenge the CFTC's action in court. Accordingly, we joined with the U.S. Chamber of Commerce in April to file a legal challenge to the adoption of the Rule 4.5 amendments.[76] The briefing in the litigation is almost complete, and we are hopeful that a decision will be issued by the court sometime this fall.

If our challenge is unsuccessful and the amendments to Rule 4.5 are upheld in court, it is important for this Subcommittee to be aware of the considerable long-term implications this rulemaking will have, not only for registered funds and their shareholders, but for the CFTC. A host of new registrants will increase the agency's workload, and regulatory oversight of these new registrants will place further demands on the CFTC's limited resources, at a time when the agency acknowledges that it cannot meet new responsibilities under the Dodd-Frank Act.[77] In fact, the CFTC's recent performance plan states that the redeployment of resources necessary to address "the surge of Dodd-Frank registrations and reviews . . . *creates risks in its critical oversight roles.*"[78] The Rule 4.5 amendments likewise will strain the resources of the NFA, which serves as the frontline regulator for CPOs.

V. CONCLUSION

I appreciate the opportunity to share these views with the Subcommittee. ICI looks forward to working with Congress and regulators on these and other issues as implementation of the Dodd-Frank Act continues.

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[75] *See* Letters from Karrie McMillan, General Counsel, ICI, to David A. Stawick, Secretary, CFTC, dated October 18, 2010, April 12, 2011 and July 28, 2011, available at http://www.ici.org/pdf/24625.pdf, http://www.ici.org/pdf/11_cftc_rule4.5_exclude.pdf, and http://www.ici.org/pdf/12_com_ltr_cftc_rdtble.pdf, respectively; ICI April 2011 Testimony, *supra* note 41.

[76] *See* Complaint, *Investment Company Institute, et al. v. CFTC,* Case No. 1:12-cv-00612 (D.D.C. Apr. 17, 2012).

[77] *See* Testimony of the Honorable Gary Gensler, Chairman, Commodity Futures Trading Commission, Before the U.S. Senate Appropriations Subcommittee on Financial Services and General Government (March 21, 2012) (stating that "effectively overseeing these markets depends on adequate funding for the agency's expanded mission.").

[78] Commodity Futures Trading Commission, *President's Budget and Performance Plan, Fiscal Year 2013,* Prepared for the Committee on Appropriations (February 2012) (emphasis added).

Testimony of

Anne Simpson

Senior Portfolio Manager, Investments
Director of Corporate Governance

California Public Employees' Retirement System

before the

United States House of Representatives

Committee on Financial Services

Subcommittee on Capital Markets and Government Sponsored Enterprises

July 10, 2012

The Impact of Dodd-Frank on Customers, Credit, and Job Creators

Chairman Garrett, Ranking Member Waters, and Members of the Committee:

Good morning. I am Anne Simpson, Senior Portfolio Manager, Investments and Director of Corporate Governance at the California Public Employees' Retirement System (CalPERS). I am pleased to appear before you today on behalf of CalPERS and share our views on the positive impact Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is having on US capital markets.[1] I also want to address the "unfinished business" of Dodd-Frank, to highlight the importance of completing the task of ensuring smart regulation to protect investors and protect the markets upon which we and the wider public rely.

My testimony includes a brief overview of CalPERS, including how we benefit from effective financial markets regulation and the role that shareowner rights and corporate governance play in building investor confidence. My testimony also includes a discussion of our views on those key provisions of the Dodd-Frank we believe will significantly enhance investor protections, improve corporate governance and strengthen the U.S. financial system to the benefit of long-term investors like CalPERS and the thousands of retirees and employees that are the beneficiaries of our fund.

Some Background on CalPERS

CalPERS is the largest public pension fund in the United States with approximately $232 billion in global assets and equity holdings in over 9,000 companies. CalPERS pays out over $14 billion annually in retirement benefits to more than 1.6 million public employees, retirees, their families and beneficiaries. This is not only an important source of daily income for those

[1] Unless otherwise noted, all section citations refer to Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203 [hereinafter Dodd-Frank]

individuals; it also provides a positive economic multiplier to the local economy.[2] We fully understand the virtuous circle between savings, investment and economic growth. That is at the heart of the CalPERS agenda.

As a significant institutional investor with a long-term investment time horizon, CalPERS fundamentally relies upon the integrity and efficiency of the capital markets. For every dollar that we pay in benefits to our members, 66 cents are generated by investment returns. The financial crisis hit us hard. $70 billion were wiped from CalPERS assets. We simply cannot afford another assault on our fund. We rely upon the safety and soundness of capital markets, and more broadly, sustainable economic growth, to provide the long term returns that allow us to meet our liabilities. However, there is still much to be done to bring about smart regulation, which is why we support the efforts of the Systemic Risk Council. The SRC is a joint project by the CFA Institute and the Pew Charitable Trusts established to urge regulators to effectively monitor and regulate risk to our financial system and chaired by former FDIC chair Sheila Bair.

"As evidenced by the 2008 crisis and even recent headlines, we need a more effective and efficient early-warning system to detect issues that jeopardize the functioning of US financial markets before they disrupt credit flows to the real economy," Bair said in announcing the creation of the SRC. "And two of the most critical tasks are how to impose greater market discipline on excess risk taking and effectively end the doctrine of 'too big to fail'."

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[2] *See* "The Economic Impacts of CalPERS Pension Payments in 2010", Dr. Robert Fountain, Regional Economic Consultants, (July 2011). ("Every California County benefits from CalPERS retirement payments. In larger urban counties impact is greatest on the total dollar amount of gross regional product. In smaller, rural counties the percentage increase in the gross regional product is greatest. CalPERS payments have a positive impact on jobs throughout the state and in 17 counties they supported more than one percent of the total jobs in their communities.")

In our view, smart regulation should be structured as follows:

First, regulation needs to be complete and coordinated. Innovation in financial markets has led to the development of new financial instruments and pools. Regulation needs to keep pace with financial innovation and the attendant risks in order to be relevant. (Derivatives are an example of that innovation, but it is innovation outside the reach of regulation.)

Second, regulation needs to allow market players to exercise their proper role and responsibilities. Capitalism was designed to allow the providers of finance a market role in allocating investment, and then holding boards accountable for their stewardship of those funds. This is why shareowner rights are vital to the functioning of markets, including the ability of investors to propose candidates to boards of directors (known in short as 'proxy access') and to remove directors who fail.

Third, regulation needs to ensure transparency, so that markets can play their vital role in pricing risk. Timely, relevant and reliable information is the currency of risk management. Those agencies which have a role in channeling that information need to be fit for that purpose. (Credit ratings agencies were found wanting in this regard.)

Fourth, regulation needs to address conflicts of interest and perverse incentives which can undermine the market's ability to allocate capital effectively. (Short term, risk-free compensation for executives has fuelled poor decision taking, as one of example of this).

Fifth, regulation needs to ensure it does not prevent institutional investors from financing legitimate strategies, and taking advantage of new opportunities. Regulation is not there to prevent risk taking, it is there to ensure that risks are disclosed, and can be managed.

Finally, regulation needs to be proportionate. For CalPERS, we balance the additional costs that are required with the potential for financial ruin. To those who question whether we can afford to invest in smart regulation, we reply, how can we afford not to? The financial crisis dealt a crippling blow to many investors, and the underlying sub-prime mortgage scandal has triggered widespread loss for ordinary people throughout the country. The devastating impact on the real economy is still with us, and recovery is still frail. The costs of regulation need to be weighed against this loss.

We see smart regulation as an investment in safety and soundness of financial markets which generate the vast bulk of the returns to our fund. Smart regulation is an investment in the effective functioning of capital markets, which is critical not just to our fund, but to the recovery of the wider economy.

CalPERS' Investment Strategy – The Impact of Dodd-Frank

CalPERS believes that Dodd-Frank, as enacted, will establish an effective framework for promoting the safety and soundness of capital markets and providing institutional investors the protections and rights to ensure markets function. However, unless effectively implemented, the promise of Dodd-Frank will remain largely unfulfilled. Below we highlight the critical elements of "unfinished business" which we regard as vital to delivering on that promise.

Derivatives Regulation

CalPERS strongly supports the goal of regulating the trading of derivatives to ensure risks are disclosed, and conflicts of interest are addressed. CalPERS believes that pension plans and their beneficiaries will benefit greatly from the oversight and transparency the legislation would bring to the derivatives market. The Investors' Working Group[3] succinctly explained the problems with unregulated swaps markets. The blue-ribbon panel lead by former SEC Chairmen Bill Donaldson and Arthur Levitt was direct:

> It is widely acknowledged that OTC derivatives contracts, and particularly CDS, played a significant role in the current financial crisis. For December 2008, the Bank for International Settlements reported a notional amount outstanding of $592 trillion and a gross market value outstanding of $34 trillion for global OTC derivatives. This enormous financial market was exempted from virtually all federal oversight and regulation by the Commodity Futures Modernization Act of 2000 (CFMA).
>
> Although OTC derivatives have been justified as vehicles for managing financial risk, they have also spread and multiplied risk throughout the economy in the current crisis, causing great financial harm. Warren Buffett has dubbed them "financial weapons of mass destruction." Problems plaguing the market include lack of transparency and price discovery, excessive leverage, rampant speculation and lack of adequate prudential controls.[4]

Dodd-Frank sought to address many of these issues by helping ensure that most swaps are exchange-traded and/or centrally cleared.[5] It also raised by the bar for swaps dealers transacting with special entities such as CalPERS by establishing business conduct standards. We are pleased that the CFTC has adopted thoughtful rules to implement the business conduct standards, but worry that many other implementing regulations remain incomplete. These include key definitions, from which many other requirements stem, rules on position limits, clearing, reporting and extraterritoriality. With regard to the latter, the CFTC recently proposed a rule relating to extraterritorial applications of swaps regulation. While we are still reviewing the

[3] Established in 2008, the Investors' Working Group was an independent, nonpartisan commission sponsored by the Council of Institutional Investors and the CFA Institute Centre for Financial Market Integrity to recommend ways to improve the regulation of U.S. financial markets.

[4] Investors' Working Group, *U.S. Financial Regulatory Reform, The Investors' Perspective* pp 10-11 (July 2009), http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf [hereinafter IWG Report]

[5] *See* Dodd-Frank, Section 701 et seq.

proposal, as a global investor, we hope the agency's final rule closes any and all offshore loopholes.

The Volcker Rule

We strongly support the objectives of Section 619, the so-called Volcker Rule, and would like to incorporate by reference the attached comment letter previously submitted to the Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation and Securities and Exchange Commission.

The recent trading losses by JP Morgan Chase illustrate the importance of ensuring that regulators impose careful constraints on proprietary trading by federally insured financial institutions. Although the firm's CEO has asserted that "no client, customer or taxpayer money was impacted by this incident," there is no doubt that clients, customers and taxpayers were exposed to excessive risks due to speculative proprietary trading. That the losses were borne by shareowners does not detract this crucial point, nor does it diminish the need to effectively implement the Volcker Rule.

We are hopeful the federal agencies will act swiftly to issue final rules in these areas and expect the rules to positively impact investor protections and capital formation.

Alignment of Interest

Rational individuals tend to act in their own economic interest. . For that reason, it is vital that incentives are aligned when those individuals taking risks as taking them with other peoples' money. We regard it as a vital part of fiduciary oversight to ensure that interests are aligned between executives in companies, and the providers of long term capital, such as CalPERS.

That alignment needs to reflect potential rewards, but also the downside risk. We observed the impact of misaligned incentives in painful detail during the recent financial crisis when lenders re-packaged risky debt obligations such as accounts receivable or subprime mortgages as high quality asset-backed securities. In essence, these companies would make bad loans, resell them (as securitized products) and shift the risk of default to someone else. By separating the debt origination and default risk, orginators had little economic incentive to scrutinize anyone's credit worthiness.

Section 941 changed this by imposing new "risk retention" obligations upon those who issue asset-back securities and require them to retain at least a five percent of the credit risk of any asset. However, these provisions have not yet been implemented. Federal financial regulators issued a proposed rule in March 2011, but have failed to finalize the risk retention rules. As a purchaser of asset-back securities, CalPERS has a compelling interest to see that it's long-term economic interest in the securities are aligned with those originating the securitizations and underlying debt obligations.

We are hopeful that financial regulators will act swiftly to issue final rules in these areas and expect the rules to positively impact investor protections and capital formation.

Credit Rating Agencies

Credit rating agencies played a major role in the recent financial crisis. They provided many securitized products with investment-grade ratings, even though underlying debt instruments posed serious risks of default. The agencies used outdated modeling to help assign a rating and were highly motivated (by the issuer-pays model) to provide their clients the ratings they sought. Moreover, the regulatory exemption from Section 11 liability (found in Securities Act Rule 436(g)) effectively exempted the firms from third-party liability. In sum, problems with the asset-backed securities markets would not have been as glaring had credit rating agencies properly scrutinized the securities they were rating and not provided these products with ratings that suggested they were of high quality and low risk.

In response, Dodd-Frank included some important provisions intended to improve transparency and accountability of credit rating agencies. These include:

- Strengthening regulatory oversight through creation of a new Office of Credit Ratings within the SEC responsible for both inspections and rulemaking (§932).
- Strengthening internal control requirements to ensure rating agency compliance with their own ratings policies, procedures, and methodologies (§932);
- Adopting new rules to reduce the influence of conflicts of interest on ratings decisions (§932, §939H);
- Enhancing transparency for ratings, including the assumptions underlying those ratings and the methodologies on which they are based, in order to better enable investors to determine whether and how to use those ratings (§932);
- Adopting of universal ratings symbols (§938);
- Increasing accountability for rating agencies, holding them legally accountable for knowing or reckless misconduct (§933) and removing their special protection from expert liability when ratings are used in a prospectus (§939G); and
- Reducing regulatory reliance on ratings through elimination of references to ratings in financial system rules and laws (§939A).

We were pleased to learn that the SEC recently appointed a director of the Office of Credit Ratings and anticipate the Office will conduct efficient and effective reviews of the agencies and we look forward to analyzing the Office's final inspection reports. We believe objective performance reviews of credit rating agencies will improve credit analysis and transparency.

The SEC has also finalized rules that removed references to credit ratings for issuers using "short form" registration and proposed a series of other rules in spring 2011. However, the SEC has yet to finalize any of those other rules. In addition, through two no-action letters, the SEC provided relief for issuers who were unable to obtain a credit ratings after the agencies' refused to allow their ratings to be included in securities filings.

We are hopeful the SEC will act swiftly to issue final rules in this area and withdraw the no-action letter that allows credit rating agencies to avoid legal liability for false ratings in securities filings. Once completed, we expect these rules to positively impact investor protections and capital formation.

Shareowner Rights – Investor Protection

It is widely acknowledged that the 2008 financial meltdown represented a massive failure of oversight.[6] Too many CEOs pursued excessively risky strategies or investments that bankrupted their companies or weakened them financially for years to come.[7] Boards of directors were often complacent, failing to challenge or rein in reckless senior executives who threw caution to the wind.[8] And too many boards approved executive compensation plans that rewarded excessive risk taking.[9]

[6] *See* Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report *xviii* (Jan. 2011), http://www.gpoaccess.gov/fcic/fcic.pdf ("We conclude dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis") [hereinafter FCIC Report. IWG Report, *supra* note 1, at 22.

[7] IWG Report, *supra* note 1, at 22.

[8] *See* Staff of S. Permanent Subcomm. on Investigations, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse 185-86 (Apr. 13, 2011), http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf (providing evidence that board oversight of Washington Mutual, Inc., including oversight of enterprise risk management, was "'less than satisfactory'"); IWG Report, *supra* note 1, at 22.

[9] FCIC Report, *supra* note 1, at *xix* ("Compensation systems—designed in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences); *see also* Deputy Secretary of the Treasury Neal Wolin, Remarks to the Council of Institutional Investors 4 (Apr. 12, 2010), http://www.ustreas.gov/press/releases/tg636.htm (noting that ""irresponsible pay practices . . . led so many firms to act against the interests of their shareholders"); IWG Report *supra* note 1, at 22.

Accountability is critical to motivating people to do a better job in any organization or activity.[10] An effective board of directors can help every business understand and control its risks, thereby encouraging safety and stability in our financial system and reducing the pressure on regulators, who, even if adequately funded, will be unlikely to find and correct every problem.[11] Unfortunately, long-standing inadequacies in investor protection have limited shareowners' ability to hold boards accountable.[12]

Fortunately, the Dodd-Frank contains a number of reforms that when fully implemented and effectively enforced will provide long-term investors like CalPERS with better tools, including better information, to hold directors more accountable going forward.[13] These included provisions that:

- Provide for a shareholder vote on executive compensation (§951);
- Enhance disclosure requirements about role of, and conflicts involving, compensation consultants. Also requires the SEC to direct that exchanges adopt listing standards that include certain enhanced independence requirements for members of issuers' compensation committees and to establish competitive neutral independence factors for all who are retained to advise compensation committees (§952);
- Include additional disclosure requirements involving executive compensation including pay-for-performance and the ratio between the CEO's total compensation and the median total compensation for all the other company employees (§953);
- Require that the SEC direct the exchanges to prohibit the listing of securities and issuers that have not developed and implemented compensation claw-back policies (§954);
- Impose disclosure requirements involving whether directors and employees are permitted to hedge any decrease in market value of the company's stock (§955);

[10] Press Release, *supra* note 5, at 2.
[11] *Id.*
[12] IWG Report, *supra* note 1, at 22 ("shareowners currently have few ways to hold directors' feet to the fire").
[13] S. Comm. On Banking, Housing, & Urban Affairs, Rep. On The Restoring American Financial Stability Act 30 (Mar. 22, 2010), http://banking.senate.gov/public/_files/RAFSAPostedCommitteeReport.pdf (Noting that the Senate version of Dodd-Frank contained provisions designed to give investors "more protection" and shareholders "a greater voice in corporate governance") [hereinafter S. Rep.].

- Clarify the authority of the SEC to issues rules allowing for meaningful proxy access for board of director nominations (§971); and
- Require disclosure by issuers on board chair and chief executive officer (§972).

We are pleased the SEC adopted final rules executive compensation in January 2011[14] and we just completed our first proxy season under these rules. We see a positive impact. Dialogue with companies has improved – and companies are making sensible reforms in response to shareowner concerns.

Last month, the SEC issued final rules on listing standards for compensation committees. In September, 2010, the SEC issued final rules providing meaningful proxy access,[15] however those rules were overturned by the DC Circuit Court due to an inadequate cost-benefit analysis. In March 2011, the SEC issued proposed rules relating to audit committee independence but has yet to finalize the rules. The SEC has not issued rule proposals on any of the remaining corporate governance provisions. We note that the Investor Advisory Committee has now been formed, and await the appointment of the Investor Advocate in the near term.

We are hopeful the SEC will act swiftly to issue final rules in these areas and expect the rules to positively impact investor protections and capital formation. .

Regulatory Agency Funding

The SEC and CFTC play vital roles in fostering capital formation and protecting investors in financial markets. CalPERS has long recognized that for the SEC and CFTC to achieve their stated objectives, they must be well-managed, well-staffed and that means they must be well-

[14] Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 76 Fed. Reg. 6010 (final rule Apr. 4, 2011) http://www.gpo.gov/fdsys/pkg/FR-2011-02-02/pdf/2011-1971.pdf
[15] Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668 (final rule Sept. 16, 2010), http://www.gpo.gov/fdsys/pkg/FR-2010-09-16/pdf/2010-22218.pdf

funded. Rules without enforcement are little better than useless. In 2001, CalPERS testified in support of legislation that would put SEC staff salaries on par with other financial regulators and was pleased that pay-parity provisions were enacted into law that year. More recently, we called for lawmakers to provide the SEC and CFTC with stable, independent funding. Although no such mechanisms were included in Dodd-Frank, it remains imperative that the SEC and CFTC be given sufficient resources to effectively police the U.S. capital and futures markets.

We believe the SEC and CFTC's FY2013 funding requests reflects the importance of their traditional core responsibility, as well as the new authority granted it in Dodd-Frank, and we urge you to support their funding requests.

Thank you, Mr. Chairman for inviting me to participate at this hearing. I look forward to the opportunity to respond to any questions.

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February 13, 2012

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RE: PROHIBITIONS AND RESTRICTIONS ON PROPRIETARY TRADING AND CERTAIN INTERESTS IN, AND RELATIONSHIPS WITH, HEDGE FUNDS AND PRIVATE EQUITY FUNDS

Dear Ladies and Gentlemen:

I am writing on behalf of the California Public Employees' Retirement System (CalPERS), the largest public pension fund in the United States, with approximately $234 billion in global assets and equity holdings in approximately 11,000 publicly traded companies. CalPERS provides retirement benefits to more than 1.6 million public workers, retirees, and their families and beneficiaries.

CalPERS strongly supports the efforts by the Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation and Securities and Exchange Commission (the "Agencies") to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protections Act (Dodd-Frank), commonly referred to as the "Volcker Rule." The present system of bank regulation allows too much downside risk in the financial system, and we applaud the Agencies' efforts to minimize that risk.

The Volcker Rule will help reduce the risks brokerage operations pose to their financial holding companies and, if effectively implemented, will help mitigate the risks SIFI's (Systemically Important Financial Institutions) pose to the overall financial system. Accordingly, we support the rule's intent to ensure that a bank's trading activity is consistent with underwriting and market making related activities and not prohibited proprietary trading.

With this in mind, we would like to offer the following observations on the proposed rules by the Agencies.

- Implementation of the Volcker rule will increase the cost of transacting and reduce liquidity to all markets (e.g., equity, fixed income, derivative) where SIFI's conduct proprietary trading. Thus, we acknowledge that the systemic protections afforded by the Volcker Rule come at price. Specifically to the debt markets, it will impose higher transaction costs and cause spreads to rise. Thus, our portfolio values will be reduced due to the higher spread or yield investors demand to compensate for the higher transaction costs. In addition, when we do transact in our portfolios, the cost will be higher. Since our portfolio turnover rate is relatively low, the expected rise in annual transaction costs is an acceptable cost for reducing risk in the financial system. However, institutions with higher turnover, like hedge funds, mutual funds or other high volume traders, are likely to be more negatively impacted by the increased transaction costs.

- We believe that a decline in bank proprietary trading will increase the volatility of the corporate bond market, especially during times of economic weakness or periods where risk taking declines. However, corporate bond portfolio managers have experienced many different periods when markets have been illiquid:1997 – Asian Crisis, 1998 - Long Term Capital, 2000 – Tech Bubble Crash, 2001-2002 Corporate Malfeasance, and 2009 Recession/Financial Crisis. We believe, post the implementation of the Volcker rule,that the market will adapt. Portfolio managers will increase their use of CDS to reduce economic risk to specific bond positions as the liquidation process of cash bonds takes more time. We also believe that alternative market matching networks will be developed to match and cross sellers with buyers. The Agencies should seek to increase the disclosure of trade data in TRACE by increasing the universe of securities covered and to include greater disclosure on size of trades. This will provide investors with more transparency on price discovery during periods when markets are illiquid. The Agencies should plan in advance to measure and monitor how the implementation of the Volcker rule impacts the markets and whether unintended risks develop as transaction volume moves to alternative markets, counterparties or pools of liquidity.

- The Agencies' common framework, applied to all covered financial institutions, should communicate the acceptable level of position limits, P&L, inventory turnover, customer facing trades and portfolio risk limits based on specific market size, volatility and correlation of risks. This will ensure that the implementation of the rules is consistently applied across all SIFIs and a priority is established for deviations from the rules and enforcement.

- We believe that a daily trade level and backward assessment of what constitutes market making versus proprietary trading may be impractical and impose onerous reporting requirements on both banks and regulators.

- As asset managers, not unlike market makers, we manage the daily mark to market risk and correlation of positions and know how a position's size and weight can impact results. Our experience in this area suggests that regulators consider a softer stance on inventory accumulation that is held for a short time period (1-5 days) if it is "right sized" relative to a bank's capital, volatility and potential investor demand. At the same time, we would suggest that regulators use a vintaging methodology that would create disincentives for market makers to hold positions beyond a short term period, by imposing increasingly higher capital requirements on aged inventory and identified portfolio risks. We think this less stringent implementation may help ease the impact on investor liquidity needs during all market environments.

- Treasury futures should be treated in a consistent manner as US treasury debt and be exempt from proprietary trading rules. Treasury futures have a return profile similar to cash treasuries and are used by many market participants and primary dealers as hedging instruments. We would also advocate allowing inventory in dollar denominated Sovereign bonds for short time periods, subject to vintaging rules that require increased capital based on the age of a position, as described above.

- For the Volcker Rule to work effectively, it should be implemented globally. Without multilateral agreements with regulators in other countries, establishing Volcker type restrictions on US financial market making institutions may put them at a competitive disadvantage. Simply imposing a ban on proprietary trading by US financial institutions, without comparable restrictions in the global marketplace, would reduce systemic risk to the US financial system but would likely result in increased counterparty risk for investors that execute trades with off shore counterparties that provide better liquidity.

- Dodd Frank and the Volcker Rule represent the most significant reregulation of the banking industry since Glass-Steagall. With the implementation of these rules, the SEC should also promulgate enhanced and expanded financial reporting requirements for SIFI's, at both the holding company and significant operating company levels. SIFI's are complex financial institutions that have and will continue to require significant invested capital from the debt markets. During the last financial crisis, management teams were reluctant to provide increased detail and segmentation of risks to investors, arguing that disclosure informs competitors of important trade secrets. SEC disclosure directives should be broad in the scope of risks covered (interest rates, credit, liquidity, geographic, product, concentration, etc.) and provide quantitative (not qualitative) measures of risk with standardized computation methods to ensure comparability across time and institutions. Lastly, debt holders should be seeking greater transparency from SIFI's due to the powers given to the FDIC, in the Dodd-Frank Bill, to carry out an orderly liquidations of SIFI's, in a manner that maximizes the value of the institution's assets and ensures that creditors and shareholders bear any loss without putting the financial system at risk.

- Finally, most financial institutions fail due to the write down of poor quality assets that are the result of poor underwriting decisions. In the prior crisis, many SIFI's were not under stress because of proprietary trading losses of their market making function, but because of the retention of poor quality assets after underwriting securities and unsuccessfully distributing that risk. Many SIFI's underwrote and retained risk in Sub Prime mortgages, CDO tranches, and the High Yield debt of LBO issuers that needed to be written down. Thus, we suggest the Agencies consider whether they have sufficient provisions to reduce the risk posed by this very common revenue generating activity that poses heightened financial risk at the top of economic cycles.

Thank you for considering our comments. If you have any questions, please do not hesitate to contact me at (916) 795-2062.

Sincerely,

JANINE GUILLOT
Chief Operating Investment Officer
CalPERS

Cc: Joe Dear, Chief Investment Officer – CalPERS
Curtis Ishii, Senior Investment Officer – CalPERS
Eric Baggesen, Senior Investment Officer – CalPERS
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Lou Zahorak, Portfolio Manager - CalPERS

CRE Finance Council®
The Voice of Commercial Real Estate Finance

TESTIMONY OF PAUL VANDERSLICE ON BEHALF OF
THE COMMERCIAL REAL ESTATE FINANCE COUNCIL

BEFORE THE
UNITED STATES HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON THE IMPACT
OF DODD-FRANK ON CUSTOMERS, CREDIT AND JOB CREATORS

July 10, 2012

The Commercial Real Estate ("CRE") Finance Council is grateful to Chairman Garrett and the Members of the Subcommittee for holding this hearing to examine the impact of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* ("Dodd-Frank")[1] on credit availability.

The CRE Finance Council is the collective voice of the entire $3.1 trillion commercial real estate finance market, including portfolio, multifamily, and Commercial Mortgage-Backed Securities ("CMBS") lenders; issuers of CMBS; loan and bond investors, such as insurance companies, pension funds, and money managers; servicers; rating agencies; accounting firms; law firms; and other service providers. Our principal missions include setting market standards, facilitating market information, and providing education at all levels, including securitization, which has been a crucial and necessary tool for growth and success in commercial real estate finance. Because our membership consists of all constituencies across the entire CRE finance market, the CRE Finance Council has been able to develop comprehensive responses to policy questions that promote increased market efficiency and investor confidence.

We appreciate the opportunity to share our views on the impact of Dodd-Frank regulations on credit availability in the CMBS component of the securitization markets. As explained in more detail below, the cumulative impact of the regulations implementing the Dodd-Frank Act poses a serious threat to sustaining the nation's overall economic recovery. It is critical that the agencies charged with implementing the Dodd-Frank Act coordinate their rulemakings and consider the cumulative impact of the numerous regulations on credit availability in the CRE finance market before promulgating final rules. We are not suggesting that this consideration should impede issuance of final rules. Indeed, the tremendous uncertainty

[1] Pub. L. No. 111-203.

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created by the multitude of required financial regulatory changes serves as a direct, independent impediment to private lending and investing, as the markets attempt to anticipate the impact these developments may have on the availability of commercial real estate credit, capital and liquidity.

Executive Summary

- The commercial real estate market in the United States is funded by $3.1 trillion in commercial mortgages and has approximately $1.5 trillion in equity.

- Approximately $2 trillion of the commercial mortgage debt is scheduled to mature over the next five years.

- Traditional portfolio lenders – primarily banks and life insurance companies – are projected to be capable of funding less than $200 billion per year of this demand, and they simply lack the balance sheet capacity to completely satisfy the aggregate CRE financing need. This fact leads to a natural funding gap between the credit portfolio lenders can provide and the credit necessary to refinance existing debt and to fund new commercial loans that are essential to economic recovery and growth.

- For the last two decades, CMBS has filled the CRE funding gap between what these traditional portfolio lenders can supply and the needs of CRE borrower demand. Some traditional portfolio lenders also rely on the availability of CMBS as an exit strategy and the majority of portfolio loans therefore are structured to be eligible for securitization.

- The CMBS industry is in the midst of a very fragile recovery. Currently, there is approximately $600 billion in outstanding CMBS, with only between $30-35 billion in new issuance projected for 2012. While we are recovering, the industry has not seen issuance this low since 1997. There is growing concern that the size of the CMBS market will soon be insufficient to support the vast infrastructure necessary to sustain a viable CMBS market.

    - This insufficiency could be particularly problematic for the secondary markets – or, better said, the businesses in the small and midsized towns across America that CMBS traditionally funds.

- As the market attempts to recover, CMBS also confronts a series of exogenous headwinds that include, among others, weak growth in the U.S economy and the intensifying sovereign crisis in Europe.

- That said, the complex and overlapping sets of Dodd-Frank and other, related financial sector regulations are a controllable component of these headwinds.

- The CRE Finance Council fully supports many aspects of Dodd-Frank, including risk retention, better disclosure and more transparency.

- In fact, the SEC pointed to the CRE Finance Council CMBS disclosure package as a model for the entire ABS industry, and we are working as an industry to continue to perfect this transparency model.

- However, we are concerned that each individual regulation may be going beyond Congressional intent and, when these regulations are aggregated, the combined effect will curtail credit further than you intended.

- As an example, the Premium Capture Cash Reserve Accounts ("PCCRA") included in the proposed risk-retention regulations, but not contemplated in the Dodd-Frank Act itself, are intended to bolster the retention regime. However, they will do so (if they do so at all) at the expense of borrowers in terms of restricted credit availability and increased borrowing costs. Investors also would be affected, as they will not have sufficient CMBS product to provide the risk diversification and yield needed to meet, for example, life insurance and pension benefit payment obligations.

  - According to a recent survey of the CRE Finance Council Board, 78% of the respondents – and 73% of the Investment Grade Investor respondents the PCCRA is purportedly designed to protect – believed that implementation of the PCCRA requirement would hinder CMBS.

  - In addition, in a separate survey, 92% of issuer respondents said that imposition of the PCCRA would decrease loan origination volume from current levels. Almost 62% of those respondents said that volume decreases would be more than 50%. Some indicated reductions would be as high as 90-100%.

  - All respondents indicated that the cost of liquidity to borrowers would increase – over 92% said the cost increase would be 50 basis points or more; 46% indicated that the cost increase would be more than 100 basis points.

- The Basel III proposed capital credit rules also will function to decrease credit availability, especially from smaller banks, and increase the cost of that credit to borrowers.

- The regulators are required to ensure that the benefits of any proposed regulations are fully justified by the cumulative costs they will impose. We recognize the fine line that regulators must walk between the need to safeguard the markets and allow healthy liquidity to flow. Ultimately, the question is, "What is the appropriate level and extent of regulation?"

- The Board of Governors of the Federal Reserve Report also recognizes the importance of considering the totality of the regulatory changes before promulgating final rules. It noted recently that retention requirements could, in combination with other regulatory initiatives, significantly impede the availability of financing.

- Therefore, we urge Congress to use its oversight authority to ensure that the regulators are following both Congressional intent and Administrative Policy by fully evaluating the potential costs and benefits before adopting final securitization-related rules.

- It also is imperative that the regulators get the rules done; they just need to be done right.

Discussion

Industry Background

Commercial real estate is a multi-trillion dollar component of the American economy. Commercial real estate provides the space where we work, shop, live, meet and recreate. Specifically, commercial real estate comprises the apartments, manufactured housing, office buildings, strip malls, grocery stores, and other retail establishments where goods are sold and food purchased; the small business spaces on main street; the industrial complexes that produce steel, build cars, and create jobs; the hospitals where doctors tend to the sick; and the hotels where relatives, vacationers, and business executives stay.

The commercial real estate market in the United States is still emerging from a period in which it faced serious duress brought on by the severe economic downturn, and significant hurdles remain to recovery. Prior to the onset of the economic crisis, CMBS was the source of approximately half of all CRE lending, providing approximately $240 billion in capital to the CRE finance market in 2007 alone. In addition, many portfolio lenders also rely on the availability of securitization to provide a safety valve exit strategy, and it has been estimated that in 2007, for example, as many as 80% of all loans were securitization eligible. After plummeting to a mere $2 billion in 2009 at the height of the crisis, the CMBS market began to see signs of life in 2010 with $12.3 billion in issuance; issuance of approximately $30 billion in 2011; and issuance of $18 billion in 2012 (to date). The total CMBS issuance for 2012 is expected to be between $30-35 billion.

In the next five years, however, approximately $2 trillion in outstanding commercial mortgages – including $600 billion in CMBS loans – will mature, many of which are smaller properties located in secondary markets where traditional portfolio lending often is not available. Borrower demand to refinance those obligations will be at an all-time high.[2] Last year alone, for example, approximately $700 billion in commercial mortgages matured but there was capital available to refinance only $200 of the $700 billion in loans. Bank portfolio lending provided $80 billion of the $200 billion in financing; life insurance company portfolio lending provided another $50 billion; Government Sponsored Enterprises (GSEs) provided another $40 billion, almost exclusively to finance multi-family housing projects; and the $33 billion balance was

[2] The Dodd-Frank NPR: Implications for CMBS, April 12, 2011, Morgan Stanley at 1.

supplied by CMBS. For the $500 billion of mortgages where capital was unavailable for refinance, those loans were either extended, foreclosed or borrowers were required to input additional equity into the underlying property.

Portfolio lenders – primarily banks and life insurance companies – simply lack the balance sheet capacity to satisfy total CRE borrower demand. This will be even truer due to the new constraints on their portfolio lending capacity that will be imposed by the new Basel III capital requirements. Going forward, the maturity-related refinancing alone will average about $250-300 billion per year, and the portfolio lenders and the GSEs can only fund slightly more than one-half of that burden. The rest of the overall financing load (including both refinancing and new lending demand) has been filled over the course of the last two decades by CMBS, which utilizes sophisticated institutional investors – pension funds, mutual funds, and endowments, among others – who bring their own capital and expertise to the table and fuel lending. CMBS lending is especially critical for small businesses as the average CMBS securitized loan is $8 million and, as of July 2010, there were more than 40,000 CMBS loans that were less than $10 million.

One of the overarching questions we are facing at this juncture is whether CMBS will be able to continue to help satisfy the impending capital needs posed by the refinancing obligations that are coming due. Without CMBS, there simply is not enough balance sheet capacity available through traditional portfolio lenders, such as banks and life insurers, to satisfy these demands. And without a securitization exit strategy, there also would be less credit available from portfolio lenders and the cost of that credit also would increase.

It is for these reasons that Treasury Secretary Geithner noted more than three years ago that "no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to businesses – large and small."[3] Similarly, then-Comptroller of the Currency John C. Dugan noted that, "[i]f we do not appropriately calibrate and coordinate our actions, rather than reviving a healthy securitization market, we risk perpetuating its decline – with significant and long-lasting effects on credit availability."[4]

[3] Remarks by Treasury Secretary Timothy Geithner Introducing the Financial Stability Plan (Feb. 10, 2009) available at http://www.ustreas.gov/press/releases/tg18.htm.

[4] Remarks by John C. Dugan, Comptroller of the Currency, before the American Securitization Forum (Feb. 2, 2010), at 2 (available at http://www.crefc.org/uploadFiles/CMSA_Site_Home/Government_Relations/CMBS_Issues/TALF_Treasury_Plans/DuganRemarksatASF201.pdf.).

The Outlook for the CMBS Industry

The CMBS market is in the early stages of what we hope will be a robust recovery. But, make no mistake; the recovery is in a very fragile and challenged state today. There are over $2 trillion in commercial loans across America that must be refinanced by 2017. At an issuance rate of about $30 billion per year and with an overall market of under $600 billion of outstanding CMBS issuances, the CMBS industry is struggling to both heal and maintain itself.

The overall size of the CMBS market is shrinking as the rate of legacy loans maturing and rolling off the books is greater than the rate of new issuance. At this rate, the size of the CMBS market eventually will lose the critical mass necessary to continue to be a viable market. This would deal a blow to CRE liquidity as issuance of new CMBS will face a serious headwind of there being no viable secondary market for investors to trade and exit their positions.

A new issuance market of approximately $30 billion a year is not nearly large enough to provide the capacity for pending CRE mortgage maturities that must be refinanced. In a survey of CREFC Board of Governors, 76% of respondents noted that the annual level of CMBS issuance required to provide healthy liquidity levels to the CRE marketplace would be between $50-100 billion. 22% said it should be over $100 billion. Whether one considers this a self-serving industry viewpoint or not, the fact underpinning it is that the status quo is not an acceptable business model. Investment capital will flow to where it will get its best risk-adjusted return.

In addition, it is a costly enterprise to establish and maintain a CMBS securitization platform. It is a personnel intensive business that requires capable and experienced finance professionals. There must be sufficient volume in the industry to house and pay the teams of originators, analysts, traders, brokers and other specialists and intermediaries required to run an efficient CMBS platform. A $30 billion per year rate of issuance is simply insufficient and is stressing the industry's financial ability to maintain that requisite infrastructure. If firms determine that their CMBS platforms are not viable and profitable enough, they will reduce or close them. In fact, many analysts predict that the CMBS market will be too costly to maintain if the secondary market falls below $300 billion. Once this capacity leaves the system, it will take a long time to bring it back.

The CMBS marketplace faces many headwinds on its road to recovery. The sovereign crisis in Europe affects credit and economic confidence around the globe. In the United States, we face stubbornly high unemployment and low job growth. Consumer confidence is weak. The business sector is cautious about capital expenditures as it nervously assesses the uncertainty in the public and private sectors. Investment of all types seems to be on hold for 2012 as we await the outcome of the presidential election and what Congress and the President will do regarding the numerous fiscal policy imperatives that lie ahead. "Taxmaggedon", budget sequestering, raising the debt ceiling, the deficit, and the federal government's credit rating all loom ominously on the horizon.

The Dodd-Frank CMBS Statutory Framework & Market Reforms

Against this backdrop, Congress adopted a credit risk retention and transparency framework for asset-backed securities in Dodd-Frank. It is essential to highlight at the outset that The CRE Finance Council supports that Dodd-Frank statutory framework and advocated for the inclusion of the risk retention requirements in that framework. We believe the Dodd-Frank legislation outlines how an effective risk retention construct and enhanced transparency can be achieved, and provides the appropriate flexibility to do so for both regulators and market participants.

The CRE finance industry also has taken its own direct steps to strengthen the CMBS market and to foster investor confidence through the completion of "market standards" in the areas of representations and warranties; underwriting principles; and initial disclosures. Scores of members of The CRE Finance Council across all of the CMBS constituencies worked diligently on these market reforms for more than a year.

Those market reforms built on a CMBS transparency regime anchored by The CRE Finance Council's trademarked disclosure packages that already had been the universally acknowledged leader in asset-backed securities market transparency. Specifically, our Investor Reporting Package™ for ongoing transparency and our Annex A™ for initial CMBS issuances are the disclosure packages demanded by investors and required to be used under every CMBS contract. The SEC recognized CREFC's IRP in its proposed Reg AB II changes as a model disclosure for other ABS classes. But the industry has not rested on its laurels. We are continuously updating our disclosure product to remain the market leader, and we have recently begun to develop a robust set of servicer disclosures that will be added to the IRP in reaction to investor demands for more loan work-out process transparency.

Cumulatively, The Regulatory Regime Should Preserve –
And Not Unduly Restrict – Access To Affordable Credit

Dodd-Frank requires the agencies to issue an array of implementing rules and the agencies have issued a series of proposed rules in accordance with these requirements. We agree with the overarching Dodd-Frank objective that these rules should enhance investor ability to invest with the confidence that the investment markets are fair, transparent and safe. Safe markets, however, do not mean riskless markets, as all investment carries some amount of risk. But, investors should have confidence that, with adequate transparency, proper retention, and the ability to conduct their own requisite due diligence, they can fairly, reasonably and reliably assess the risk factors underlying any CMBS investment opportunity.

The question is, "What is the appropriate level and extent of regulation?" Not enough and investor safety and confidence can be compromised. Too much and industry capacity is diminished with no real marginal increase in benefit to investors. Larger businesses and high profile properties in the country's major urban centers will continue to enjoy ready access to CRE portfolio financing. But smaller businesses and businesses in the secondary markets that are the core of our national economy – main street America cities and towns like those listed below – will not have adequate access to the financing that is their lifeline without a viable CMBS market:

- Paramus in New Jersey's 5th Congressional District, where CMBS financed a $9 million industrial facility whose principal tenant, Topcon America, is a leading provider of laser-based ophthalmic equipment;

- Inglewood in California's 35th Congressional district, where CMBS financed a local grocery store, as well as an $8 million industrial loan which houses a variety of local manufacturers and distributors;

- Tempe in Arizona's 5th Congressional District, where CMBS financed almost 20 different multifamily projects, which provided housing to over 5,000 families;

- Granada Hills in California's 27th Congressional District, where CMBS financed the Granada Hills Town Center which provides grocery, pharmacy and hardware stores for the community of 450,000; and

- Naperville in Illinois' 13th Congressional District, where CMBS provided $16 million to finance an assisted living facility.

The investors that provide the capital for these borrowers do not benefit from regulation if it erodes their CMBS returns to the point where CMBS is no longer competitive with their other investment options. As the Board of Governors of the Federal Reserve aptly noted, the agencies implementing the Dodd-Frank securitization credit retention requirements must "ensure that the regulations promote the purposes of the Act without unnecessarily reducing the supply of credit."[5] Federal Reserve Board Governor Tarullo also separately has highlighted the importance of implementing retention "in order to properly align the interests of originators, securitizers, and investors without unduly restricting the availability of credit or threatening the safety and soundness of financial institutions."[6]

The Proposed Regulations' Potential Threat to CRE Credit Availability

The proposed rules – especially when considered cumulatively – pose a threat to the continued recovery and on-going viability of CMBS and the credit it supplies. Each rule, in and of itself, may have its own justifiable merit and its compliance requirements may not seem

[5] Board of Governors of the Federal Reserve System, Report to Congress on Risk Retention (October 2010), at 3 (available at http://federalerserve.gov/boarddocs/rtpcongress/securitization/riskretention.pdf).

[6] Daniel Tarullo, Federal Reserve Governor, Statement Before The House Committee on Financial Services (Oct. 26, 2009).

unduly burdensome. However, the multitude of proposed Dodd-Frank-related rules, including risk retention, will have a significant impact – both individually and when considered as a package – on credit availability in the CRE market.

As the International Monetary Fund has cautioned, the proposed retention rules and "effects induced by interaction with other regulations will require careful consideration."[7] Unfortunately, the agencies generally have failed to consider the impact of individual rules on credit availability, and they have made no effort whatsoever to evaluate the cumulative impact of all of the proposed rules. The following examples underscore the importance of agency coordination and study of the cumulative impact of regulations on credit availability before finalizing the proposed rules.

The PCCRA: The Premium Capture Cash Reserve Account rule proposal would require securitizers to retain all revenue from excess spread (which is virtually all revenue) for the life of the transaction in a separate account for the life of the security and to hold this account in a first-loss position even ahead of (and subordinate to) the B-piece investor retained interest unless 5% of the fair market value of the issuance is retained in accordance with the credit retention requirements. Such a mechanism will inhibit an issuer's ability to pay operating expenses, transaction expenses, and realize profits from the securitization until, typically, 10 years from the date of a securitization, assuming there were no losses on the portfolio.

Furthermore, this premium not only reflects profits, but also is used to recoup the costs associated with the origination platform used for the securitization process. Essentially, issuers would take a loss on every CMBS securitization if they are required to establish a PCCRA. Finally, the PCCRA would also fully expose current CMBS issuers to changes in interest rates. In a simple example, if $100 in loans has a 5% origination interest rate, but the market rates drop to 4% at securitization, a 1% premium is charged on the certificates to reflect this change. Unfortunately, the PCCRA, as written, would capture this premium.

Alternatively, if rates rose from 5% to 6% from origination to issuance, the certificates would be required to have a 1% discount to sell. The securitizer would then absorb the loss. In short, the PCCRA fundamentally alters the economics of the securitization by creating a timing mismatch: it exposes the issuer to all the downside risk/losses associated with their interest rate exposure while requiring the issuer to wait until all the mortgages mature to recognize any profit for taking that risk. Without either a profit motive or the ability to recoup the origination costs, it would be unlikely that many CMBS issuers would continue to securitize at the same volumes if at all.

It is understandable, therefore, that many in our industry have significant concerns about the PCCRA having an adverse impact on the viability of the CMBS market by reducing credit

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[7] International Monetary Fund, "Restarting Securitization Markets: Policy Proposals and Pitfalls," Chapter 2, Global Financial Stability Report: Navigating the Financial Challenges Ahead (October 2009), at 109 ("Conclusions and Policy Recommendations" section) available at http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf.

availability and increasing the cost of borrowing. In response to a recent survey of the CRE Finance Council Board, for example, 43 of the 55 respondents (or 78.2%) believe that imposition of the PCCRA requirement will hinder CMBS and the other 12 respondents were equally divided between believing the requirement would help CMBS and being undecided. The 15 Investment-Grade Investor Board Member responses are similar, as 11 of those respondents (or 73.3%) believe that imposition of the PCCRA requirement will hinder CMBS; only one Investment Grade Investor responded that they believed it would be helpful; and the remaining three respondents were undecided.

In addition, in a separate survey, over 92% of issuer respondents said that imposition of the PCCRA would decrease loan origination volume from current levels. Almost 62% of those respondents said that volume decreases would be more than 50%. Some indicated reductions would be as high as 90%-100%. All of the respondents indicated that the cost of liquidity to borrowers would increase – 92% said the cost increase would be 50 basis points or more and 54% indicated that the cost increase would be 100 basis points or more.

In line with these views, Mark Zandi, Chief Economist of Moody's Analytics, concluded that the PCCRA requirement would significantly increase the cost of credit for borrowers "on the order of an increase of 1 to 4 percentage points depending on the parameters of the mortgages being originated and the discount rates applied."[8] Bank of America estimated that "the actual rate *increase* to borrowers as a result of the PCCRA would be approximately 2 to 5%."[9] Deutsche Bank concluded that implementing the PCCRA would conservatively cost $8 billion and would indirectly cost hundreds of billions in the lost opportunity cost of missed deal opportunities.[10] Given these estimates, it is not surprising that the risk retention rules in Europe do not include the PCCRA or anything else like it, and implementing the PCCRA provisions thus also would be inconsistent with the goal of harmonizing our regulatory rules with international requirements.

Members of Congress also have expressed concern with the PCCRA proposal. Chairman Garrett wrote a joint letter with Chairman Bachus of the Committee on Financial Services to the agencies expressing concern that the PCCRA "would greatly reduce or perhaps even eliminate the securitization market for many asset classes, thereby reducing a vital source of capital that businesses of all types need."[11] They urged the agencies to conduct a cost-benefit analysis to determine the effect of the PCCRA *before* finalizing the risk retention rule.

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[8] Christian deRitis, Director, and Mark Zandi, Chief Economist, Moody's Analytics, Special Report: A Clarification on Risk Retention (Sept. 20, 2011).

[9] Response of Bank of America, Credit Risk Retention Proposed Rule, Appx. B at v n.98 (July 13, 2011), available at http://www.fdic.gov/regulations/laws/federal/2011/11c84ad74.PDF.

[10] Harris Trifon, Research Analyst of Deutsche Bank Securities Inc., CMBS CRE Debt Research: How to "Fix" the Proposed Risk Retention Rules for CMBS (Apr. 12, 2011).

[11] Letter from Committee Chairman Spencer Bachus and Subcommittee Chairman Garrett (Mar. 26, 2012).

Last month, a bipartisan letter from 12 senators reiterated the concern that the PCCRA "would negatively impact capital formation," stated that the PCCRA "goes well beyond Congressional intent" in Dodd-Frank, and therefore urged the agencies to reconsider inclusion of PCCRA in the final rule.[12] Similarly, for these reasons, more than 20 separate trade organizations representing many different types of constituencies – borrowers and lenders and investors in different asset classes – jointly signed a letter in 2010 urging careful consideration of the entirety of the reforms to ensure that there is no disruption or shrinkage of the securitization markets.[13]

Finally, in a recent IOSCO report, it was noted that out of 16 countries that have implemented risk retention, none of them have a PCCRA or other comparable concept to the proposed U.S. rules.[14] Inclusion of the requirement therefore also is in conflict with the Administration's goal to harmonize international regulations.

Third-party Risk Retention/B-Piece Transferability. The CRE Finance Council appreciates that the regulators have sought to develop risk retention regulations that are tailored to the unique characteristics of the CRE finance market and to offer some flexibility in certain respects. The proposed Dodd-Frank credit risk retention rules recognize, for example, that CMBS bond issuances typically include a first-loss, non-investment grade bond component and the rules expressly permit these "B-piece investors" to bear the mandated retention obligation provided that they conduct their own extensive due diligence. The B-piece investor due diligence usually includes site visits to every property in the loan pool, a full review of all transaction documents and independent third-party reports, and essentially re-underwriting every loan in the proposed pool. That re-underwriting includes a tenant analysis, borrower analysis, cash-flow modeling, and competitive property and demographic analyses along with other financial and statistical reviews.

The proposed rule would, however, prohibit a B-piece investor from selling its B-piece investments if they are bearing the retention obligation, which will reduce the incentive for B-piece investors to invest in CMBS. No other investor is subject to this type of buy-and-hold mandate, and B-piece investors (and their owners) may balk at making an investment that they then will be unable to sell or transfer. In light of the proposed limitation on B-piece transferability and the risk retention rules, Morgan Stanley has concluded that "it is unlikely that the two provisions can be met simultaneously in a way that is economically viable" because both proposals reduce the market value of CMBS.[15]

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[12] Bipartisan Letter from 12 Senators (June 19, 2012).

[13] A copy of the March 25, 2010 letter is attached.

[14] Global Developments in Securitization Regulation, International Organization of Securities Commissions, June 2012, at 16.

[15] The Dodd-Frank NPR: Implications for CMBS, April 12, 2011,Morgan Stanley at 1.

Basel III Rules: The Basel III proposed rules will further reduce credit for capital invested in securitized investments relative to whole loans. The proposal to implement the Basel international capital standards would assign a 150% risk weight to "high-volatility commercial real estate" exposure, which increases the current risk weight of 100% for CRE exposures.[16] Furthermore, a recent study pointed out that the largest banks will better be able to adjust to the increased capital required by Basel III. Smaller and mid-sized banks will be more constrained due to the differences in the size of their balance sheets.[17] While we are still studying the impact of the Basel III rules on the CRE market, the proposed rule could further limit credit for CRE investments, especially from smaller banks. The question remains - will the cost of increased capital standards not only create an unlevel playing field among large and small institutions, but also not allow commercial liquidity to flow responsibly?

Conflicts of Interest: Another proposed rule would prohibit "material conflicts of interest" in securitizations. The proposed rule does not, however, define "material," and the SEC plans to rely on interpretive guidance in the future to determine whether activities are consistent with the rules. Market participants face greater uncertainty in determining whether their activities could be viewed as violating the regulation. The proposed rule could have unintended consequences for securitization, which could impact the availability of credit at a time when credit markets are constrained. Indeed, the SEC recognized that its proposed conflict of interest rules "might have unintended effects, such as potentially limiting investment opportunities for investors if a securitization participant refrains from structuring and selling ABS in reaction to this proposal."[18]

Volcker Rule: In implementing the so-called "Volcker Rule," which is codified in Section 619 of Dodd-Frank and is intended to bar banking institutions from engaging in proprietary trading activities for their own accounts, the agencies have proposed a broad definition of "Covered Fund." This broad definition would sweep in certain types of securitization issuers and activities even though securitization and securitization "market making" activities are specifically exempt from the scope of the rule under the statute.[19] Failure to appropriately limit the "Covered Fund" definition could create a host of functional difficulties

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[16] Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements, Notice of Proposed Rulemaking (June 7, 2012).

[17] Financials: CRE Funding Shift: EU Shakes, US Selectively Takes, May 25, 2012, Morgan Stanley at 15.

[18] Proposed Rule; Prohibition Against Conflicts of Interest in Certain Securitizations, Release No. 34-65355; File No. S7-38-11, 76 Fed. Reg. 60320, 60330 (Sept. 28, 2011).

[19] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, Notice of Proposed Rulemaking, 76 Fed. Reg. 68846 (Nov. 7, 2011).

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for banks and affected nonbank financial companies that have engaged in sound and long-established interactions with these securitization entities. This conflicts with the rule of construction in Dodd-Frank that directs that the Volcker Rule should not be construed to limit or restrict lawful securitizations sponsored or participated in by banks and regulated nonbank financial entities.

While we have pointed out concerns with five regulations that will affect liquidity in the CMBS space, there are 12 more regulations with cost-benefit concerns to take into account when looking at the cumulative effect, including; but not limited to: the SEC's proposed changes to Regulation AB; the FDIC's final "Safe Harbor" rule; the "Franken Amendment" requirements related to credit ratings for structured products; the SEC's rule 17g-5 credit rating transparency; and the SEC's rule 17g-7 for reporting repurchases.

The combined impact of these proposed rules on the industry is further compounded by recent securitization accounting changes (known as Financial Accounting Standard (FAS) 166 and 167). The new regulatory capital guidelines and accounting changes could significantly limit the capacity and the overall amount of capital that can be directed toward such lending and investing at the same time when the securitization markets are attempting to recover from a historic decline and regulators are drafting new rules intended to govern the industry.

Evaluating & Understanding the Cumulative Effect of Proposed Regulations on the CRE Market is Both Essential & Required

Before promulgating final rules, it is critical that the agencies charged with implementing the Dodd-Frank Act coordinate their rulemakings and consider the cumulative impact of the numerous regulations on credit availability in the CRE finance market. This cumulative impact analysis is important to help Congress and the regulators understand the total impact of the regulations on the CRE market.

The cumulative cost effect of these regulations will determine whether financing companies decide to grow, shrink or leave the commercial lending business altogether. And, as explained in detail above, the regulations under Dodd-Frank are likely to *negatively* impact credit availability by restricting the overall amount of capital that is available through the securitization finance markets and by making the CMBS capital that is available more expensive to access. The proposed rules impose additional costs on and will – in some cases – disincentivize issuers and investors and disrupt the efficient execution of capital structures that securitization provides.

As Morgan Stanley put it in a recent report, the cumulative impact of the proposed regulations has the potential to cause a "dramatic decline in the amount of financing available to the commercial real estate sector, especially for small to medium-sized properties. This, of course would increase the cost of borrowing and almost surely push cap rates up as well."[20] A more recent Morgan Stanley report reiterated that if the risk retention rules are implemented as

[20] The Dodd-Frank NPR: Implications for CMBS, April 12, 2011, Morgan Stanley at 1.

proposed, "CMBS is severely marginalized giving rise to a potentially very large US CRE financing gap," which would "mean much more expensive financing and further pressure on commercial real estate prices as well."[21]

If not properly constructed, the Dodd-Frank related rules could potentially result in a significantly smaller secondary market, less credit availability, and increased cost of capital for CMBS borrowers. Small borrowers – those that are not concentrated in the major urban areas and that need loans in the sub-$10 million space – would be the primary victims of these developments. And these borrowers – or would-be borrowers – reside in every Congressional district and are a driving economic force nationwide. Moreover, if the CMBS market is so overburdened by regulation that the very viability of that market is threatened, this also may constrict the availability of portfolio loans because, as discussed above, portfolio lenders rely on access to the CMBS market as a safety-valve exit strategy.

The Board of Governors of the Federal Reserve Report has previously recognized the importance of considering the totality of the regulatory changes before promulgating final rules:

> [R]ulemakings in other areas could affect securitization in a manner that should be considered in the design of credit risk retention requirements. Retention requirements that would, if imposed in isolation, have modest effects on the provision of credit through securitization channels could, in combination with other regulatory initiatives, significantly impede the availability of financing.[22]

Federal law requires just this type of assessment. President Obama's Executive Order 13563, for example, expressly requires that, "to the extent permitted by law, each agency must, among other things:

> "(1) propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs, (2) tailor its regulations to impose the least burden on society, taking into account, among other things, and to the extent practicable, the cost of cumulative regulations; (3) select, in choosing among alternative regulatory approaches, those approaches that maximize net benefits; (4) to the extent feasible, specify performance objectives, rather than specifying the behavior or manner of compliance that regulated

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[21] Morgan Stanley Blue Paper, Financials: CRE Funding Shift, at 9 (May 25, 2012).

[22] Board of Governors of the Federal Reserve System, Report to Congress on Risk Retention (October 2010), at 84 (available at http://federalerserve.gov/boarddocs/rtpcongress/securitization/riskretention.pdf).

> entities must adopt; and (5) identify and assess available alternatives to direct regulation[.]"[23]

The Courts also have noted the "unique obligation" of the SEC "to consider the effect of a new rule upon efficiency, competition, and capital formation, and its failure to apprise itself – and hence the public and the Congress – of the economic consequences of a proposed regulation makes" the very issuance of that rule impermissible.[24]

Needless to say, the stakes are high with the impact on credit availability weighing in the balance. As required by the Executive Order, Congress should insist that the agencies coordinate their rulemaking efforts to minimize the potential negative impact on credit availability in the CRE market. They also should be required to factor the cost to credit into final regulations and to report their analysis to Congress. This analysis would help Congress and regulators understand the burden of the Dodd-Frank related regulations as currently proposed, as well as their impact on the CRE market.

The Financial Stability Oversight Council would be well suited to conduct a study analyzing the cumulative impact of Dodd-Frank regulations on the availability of credit in the CRE market. The CRE Finance Council is prepared and willing to work with regulators to help them understand and assess the impact of their proposed rules.

It is critical to note that we are not suggesting that this consideration should impede issuance of final rules. Indeed, the uncertainty related to regulatory changes and their interaction with accounting rules itself is now a significant, independent impediment to the expanded private lending and investing that is critical to a CRE – and therefore broader economic – recovery. Some paralysis is developing in the investor, issuer and servicer communities as they struggle to attempt to understand what the final regulatory framework will look like and how it will affect their interests. The rules do need to get done.

Conclusion

Today, the CMBS market is showing some positive signs that it is slowly moving toward recovery, but, with $2 trillion in commercial mortgage loans maturing in the next few years, it is critically important that regulations under Dodd-Frank be implemented in way that does not severely constrict or shut down the securitization markets. For it is the small businesses, factories, multifamily housing units, offices, hotels and nursing homes in your home districts where restrictions to CMBS lending will be felt most severely.

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[23] Federal Register, Volume 76, Number 14, Friday, January 21, 2011, at 3821. Although this rule technically does not apply to the independent agencies, it does apply with full force to the OCC which is one of the joint rulemakers here and to the Department of Treasury whose Secretary is charged under Dodd-Frank with chairing the credit risk retention joint rulemaking proceedings.

[24] *Business Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (internal quotations and citations omitted).

The impact of the many Dodd-Frank regulations on credit availability and the cost of credit are interconnected and mutually compounding. Therefore, CREFC believes it is imperative that the regulators do what they should do and what they are required to do by law – take into account the cost of cumulative regulations, adopt regulations where the benefits justify the costs, and ensure regulations impose the least burden on society. It also is imperative that the regulators get the rules done right.

We look forward to continuing to work with Congress and the regulators to ensure a regulatory framework that supports a sound and vibrant securitization market, which is critical to the U.S. economy.

The New York Times
DealB%k
Edited by Andrew Ross Sorkin

JULY 9, 2012, 8:38 PM

After MF Global, Another Brokerage Firm Collapses With $200 Million Missing

By AZAM AHMED

After the failure of the futures brokerage firm MF Global left customers missing more than $1 billion, regulators promised to tighten rules, enhance oversight and crack down on wayward firms.

But months later, regulators are scrambling to deal with the collapse of another brokerage firm.

After discovering accounting irregularities, regulators on Monday essentially shut down PFGBest, a prominent player in the small world of futures trading.

Now, banks accounts with customer funds appear to be short more than $200 million, regulators said. On Monday morning, according to a statement to clients, the brokerage firm's chairman and chief executive, Russell R. Wasendorf Sr., tried to commit suicide.

While regulators are still trying to piece together what happened, the National Futures Association said the bank statements from U.S. Bank, where the money was held, might have been fabricated. The discrepancies date back a couple of years. In February 2010, an account that purported to have some $218 million, in reality contained just $10 million.

The loss of customer capital -- just months after the bankruptcy of MF Global -- could have major implications for regulators. Authorities recently conducted reviews of brokerage firms in the wake of the MF

Global scandal, and found nothing alarming.

"How on earth can a regulated entity can just make up the bank statements for three years?" asked James Koutoulas, the head of the Commodities Customer Coalition, a group of customers still fighting for the return of their missing money following the collapse of MF Global. "I don't even know what to say - I'm so shocked that you can forge bank statement for years, and the regulator wouldn't just check the account balance at the bank directly."

The futures group did not immediately respond to requests for comment.

Mr. Koutoulas, a hedge fund manager, said his firm held less than $3 million with PFGBest. Regulators said Monday that no one would be allowed to withdraw their money from the firm for the time being.

"How do you trust the financial industry," asked a bewildered Mr. Koutoulas.

The specifics of the firm's downfall remain hazy. Regulators said that on June 29 the firm indicated that it had about $400 million in customer money. Of that, about $225 million was located at U.S. Bank.

On Monday, the association received information that Mr. Wasendorf "may have falsified bank records." The regulator called U.S. Bank and discovered the firm only had about $5 million on deposit.

In the futures industry, customer money is not insured, meaning that if the cash is not recovered clients will have little recourse. Regulators have proposed a number of fixes, including setting up an insurance fund to guarantee the money.

"We continue to witness circumstances which make a futures insurance fund a needed option," said Bart Chilton, a commissioner at the Commodity Futures Trading Commission. "Such a fund is critically important. Futures customers should be protected like banking and security customers are protected."

PFGBest is one of a handful of futures firms, which essentially line up buyers and sellers of futures contracts for commodities. The firm was wholly owned by Mr. Wasendorf. While not the size of MF Global, which held more than $5 billion in customer cash before its collapse, PFGBest was a major player in the tight-knit world of Chicago brokers.

But the industry has been under fire in recent years. Commissions have flattened, as new entrants and online trading take a bite out of business. Even the interest typically earned for simply holding customer money has been close to zero, amid the low-rate environment in the United States.

It was that weak business outlook that prompted the head of MF Global to pursue risky strategies, in an effort to bolster profit and pay for the company's transformation into an investment bank. But the bets that Jon S. Corzine made as leader of MF Global were too risky, the market lost confidence and the firm went under. As it collapsed, the firm misused customer money in an effort to stay afloat, leaving farmers, traders and others missing more than $1 billion.

On Monday, Mr. Wasendorf, the head of PFGBest, was discovered in his car outside his company's Iowa headquarters, according to local press reports. He was flown to University of Iowa Hospitals and Clinics in critical condition.

In addition to his financial firm, Mr. Wasendorf founded several publications during his career, including SFO - Stocks, Futures and Options, the Official Advocate for Personal Investors, according to a biography on the firm's Web site. He also serves on the FCM Advisory Committee of the National Futures Association.

PFGBest has previously faced scrutiny. In February of this year, PFGBest was fined $700,000 for failing to detect a Ponzi scheme perpetrated by a Minnesota man who used the firm as a broker.

» Print

RPT-INSIGHT-Fed knew of Libor issue in 2007-08, proposed reforms

5:24pm IST

* Questions over whether Fed did enough over Libor concerns
* May have known as early as August 2007 about flaws
* Geithner calendar included "Fixing LIBOR" meeting in 2008
* Fed says got anecdotal Barclays reports of Libor problems
* Fed says shared suggestions for reform with UK authorities

By Carrick Mollenkamp

July 10 (Reuters) - The Federal Reserve Bank of New York may have known as early as August 2007 that the setting of global benchmark interest rates was flawed. Following an inquiry with British banking group Barclays Plc in the spring of 2008, it shared proposals for reform of the system with British authorities.

The role of the Fed is likely to raise questions about whether it and other authorities took enough action to address concerns they had about the way Libor rates were set, or whether their struggle to keep the banking system afloat through the financial crisis meant the issue took a backseat.

A New York Fed spokesperson said in a statement that "in the context of our market monitoring following the onset of the financial crisis in late 2007, involving thousands of calls and emails with market participants over a period of many months, we received occasional anecdotal reports from Barclays of problems with Libor.

"In the Spring of 2008, following the failure of Bear Stearns and shortly before the first media report on the subject, we made further inquiry of Barclays as to how Libor submissions were being conducted. We subsequently shared our analysis and suggestions for reform of Libor with the relevant authorities in the UK."

The Fed statement did not provide the precise timing of the communication with the British authorities. Bear Stearns collapsed in early March 2008 and was then acquired by JPMorgan.

Barclays last month agreed to pay $453 million to British and U.S. authorities to settle allegations that it manipulated Libor, a series of rates set daily by a group of international banks in London across various currencies.

The rates are an integral part of the world financial system and have an impact on borrowing costs for many people and companies as they are used to price some $550 trillion in loans, securities and derivatives.

By manipulating Libor, banks could have made profits or avoided losses by wagering on the direction of interest rates. During the enormous liquidity problems in the financial crisis they could, by reporting lower than actual borrowing costs, have signaled that they were in better financial health than they really were.

So far, the scandal has been more of a British affair, prompting the resignation of Barclays top three executives, condemnation from the British government amid a public outcry, and questions about the lack of oversight from British regulators.

The Bank of England's Deputy Governor Paul Tucker on Monday even had to deny suggestions that government ministers had pressured him to encourage banks to manipulate Libor.

But the deepening investigation by regulators in Britain, the United States, and other countries is expected to uncover problems well beyond Barclays and British banks.

More than a dozen banks are being investigated for their roles in setting Libor, including Citigroup, JPMorgan Chase & Co, Deutsche Bank, HSBC Holdings Plc , UBS and Royal Bank of Scotland..

JAWBONING

Regulators, including the New York Fed, had a responsibility "to force greater integrity and cooperation," and it had clearly reviewed the situation and had the resources to investigate, said Andrew Verstein, an associate research scholar at Yale University, who has written about Libor. "Obviously they considered this to be within their orbit."

Many of the requests for improper Libor submissions came from traders in New York.

As one of the world's most powerful regulators, the New York Fed has the power to "jawbone" banks to force them to make tough decisions, said Oliver Ireland, former associate general counsel at the Federal Reserve in Washington and now a lawyer at Washington law firm Morrison & Foerster.

Still, he said by the autumn of 2008, the New York Fed's focus was locked on the impact of the meltdown of Lehman Brothers and AIG as it sought to prevent a global economic disaster.

Barclays said in documents released last Tuesday that it first contacted Fed officials to discuss Libor on Aug. 28, 2007, at a time when credit problems arising from the U.S. housing bust were beginning to mount. It communicated with the Fed twice that day.

Between then and October 2008, it communicated another 10 times with the U.S. central bank about Libor submissions, including Libor-related problems during the financial crisis, according to the documents.

In its document listing those meetings as well as ones with British authorities, Barclays said: "We believe that this chronology shows clearly that our people repeatedly raised with regulators concerns arising from the impact of the credit crisis on LIBOR setting over an extended period."

As a bank doing business in the United States, Barclays U.S. operations would have come under the Fed's purview. This would have been even more the case after it acquired the investment banking and trading operations of the bankrupt Lehman Brothers in September 2008.

Officials with the New York Fed talked to authorities in Britain about problems with the calculation of Libor and also heard from market participants about whether an alternative could be found for Libor, people familiar with the situation said.

In early 2008, questions about whether Libor reflected banks' true borrowing costs became more public. The Bank for International Settlements published a paper raising the issue in March of that year, and an April 16 story in the Wall Street Journal cast doubts on whether banks were reporting accurate rates. Barclays said it met with Fed officials twice in March-April 2008 to discuss Libor.

"FIXING LIBOR"

According to the calendar of then New York Fed President, Timothy Geithner, who is now U.S. Treasury Secretary, it even held a "Fixing LIBOR" meeting between 2:30-3:00 pm on April 28, 2008. At least eight senior Fed staffers were invited.

It is unclear precisely what was discussed at this meeting or who attended. Among those invited, along with Geithner, was William Dudley, who was then head of the Markets Group at the New York Fed and who succeeded Geithner as its president in January 2009. Also invited was James McAndrews, a Fed economist who published a report three months later that questioned whether Libor was manipulated.

"A problem of focusing on the Libor is that the banks in the Libor panel are suspected to under-report the borrowing costs during the period of recent credit crunch," said that report in July 2008 that examined whether a government liquidity facility was helping ease pressure in the interbank lending market.

When asked for comment, McAndrews directed questions to a New York Fed spokeswoman. Dudley could not be immediately reached for comment.

To be sure, the Fed's reports have sometimes been inconclusive. One from last month - only shortly before the Barclays settlement was announced - found that "while misreporting by Libor-panel banks would cause Libor to deviate from other funding measures, our results do not indicate whether or not such misreporting may have occurred."

However, a 2010 draft of a related paper had said that banks appeared to be paying higher rates to borrow from other banks during the financial crisis compared with the levels they reported.

One step the New York Fed could have taken in 2008 when questions initially were raised was to find a way to get its staff embedded in the Libor calculation process, Yale's Verstein said.

There, they could use the Fedwire Funds Service - an electronic system through which banks settle interbank loans between one another - as a backstop to measure whether banks were accurately reporting borrowing costs. Then after the financial crisis had passed, regulators could have helped "urge on a newer and better system," he said.

The New York Fed was not part of the Barclays settlement, which was the first major resolution in the Libor probe.

The U.S. Commodity Futures Trading Commission, the U.S. Department of Justice, and the Financial Services Authority in Britain, settled with Barclays.

NO ULTIMATE RESPONSIBILITY

The scandal has thrown into sharp relief a potential regulatory gap: No single regulator appears to have had ultimate responsibility for making sure rates banks submitted were honest.

On Monday, the Bank of England's Tucker called the issue of banks improperly submitting rates a "cesspit."

In documents released with the Barclays settlement, the CFTC said Barclays traders on a New York derivatives desk asked another Barclays desk in London to manipulate Libor to benefit trading positions.

"For Monday we are very long 3m (three-month) cash here in NY and would like the setting to be set as low as possible," a New York trader emailed in 2006 to a person responsible for setting Barclays rates.

Darrell Duffie, a Stanford University finance professor who has followed the Libor issue for several years, said that he believed regulators were "on the case reasonably quickly" after questions were raised in 2008.

"It appears that some regulators, at least at the New York Fed, indeed knew there was a problem at that time. New York Fed staff have subsequently presented some very good research on the likely level of distortions in Libor reporting," Duffie said. "I am surprised, however, that the various regulators in the U.S. and UK took this long to identify and act on the misbehavior."

Bond Dealers of America

Written Statement of

Michael Nicholas
Chief Executive Officer
Bond Dealers of America

Submitted to

House Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises
United States House of Representatives

Hearing on the Impact of Dodd-Frank on Customers, Credit, and Job Creators

Tuesday, July 10, 2012

I. Introduction

This written statement is submitted on behalf of the Bond Dealers of America (BDA), and the BDA appreciates the opportunity to set forth our views for the record of this important hearing. The BDA, with over fifty members headquartered coast to coast, is the Washington, DC, based organization that represents securities dealers and banks predominantly focused on the U.S. fixed income markets. The BDA is the only organization representing the unique interests of national, middle-market securities dealers. In addition to federal advocacy, the BDA hosts a series of meetings and conferences specific to domestic fixed income, in addition to spearheading industry cooperation on surveys and market practice documents.

Additional information about the Bond Dealers of America can be found by reviewing our website at www.bdamerica.org.

II. The Volcker Rule Should Not Be One Size Fits-All

While the BDA has many concerns with the Dodd-Frank Wall Street Reform Act of 2010 (Dodd-Frank or DFA), one of our primary concerns is the DFA requirement of a so-called Volcker Rule. Lost in the chorus of commentary about the impact of the multi-billion dollar trading loss incurred by JP Morgan Chase & Co. is the devastation that the Volcker Rule could impose on financial institutions and communities all around our country if the Rule is not drafted carefully and appropriately tailored. Little of this commentary has focused on the fact that the vast majority of banks - middle market and regional banks headquartered nationwide - do not engage in "portfolio hedging" to the tune of billions of dollars, if they engage in the practice at all. Yet, thus far, there appears to be an absence of recognition by the drafters of the Rule that not all banks or markets should be treated the same.

There are many securities broker-dealers affiliated with banks that specialize in the fixed-income markets that are likely to be subject to the restrictions on proprietary trading under the Volcker Rule, even though they do not represent any systemic risk to the financial system and did not cause the financial crisis that led to the enactment of Dodd-Frank. These bank affiliated broker-dealers are actively making markets in fixed income securities by acting as principal and thus are increasing efficiencies and reducing costs for investors. They are not engaging in proprietary trading in the manner originally addressed by former Chairman Paul Volcker. These firms represent middle-market brokers and dealers who are headquartered in cities all over the country, doing business throughout the United States coast to coast. They help communities around the country finance their schools, roads and bridges. They help businesses raise the funds they need to grow. They provide individuals and institutions with fixed income investment opportunities in municipal, corporate and agency-backed securities. They also provide liquidity for the investors in those securities.

The markets in fixed-income securities are not like the equity markets or the market in Treasury obligations. Most bonds do not trade very frequently, and they do not trade on exchanges. In the municipal market alone, there are over 50,000 issuers, most of which do not issue often; and each of which is unique. In such a market, broker-dealers play an important role by being familiar with the issuers and their credit, by selling bonds from their inventories to investors, and by purchasing bonds from investors to hold in their inventory for later resale – at a profit governed by the markup and markdown rules of the Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority, and the Municipal Securities Rulemaking Board.

It usually goes like this. An investor approaches his or her broker-dealer in search of a suitable investment. The broker searches what is available – including what is in the broker's own inventory – and proposes an investment. Or, on the other side, an investor seeks to liquidate an investment; and unless his or her broker can find an immediate buyer, the broker purchases the bonds. As one can tell from that description, this looks a lot like proprietary trading; but it in fact is crucial to the operation of these markets. A Volcker Rule that makes no distinction on the basis of size and market type, principal trading versus proprietary trading could disrupt these markets, resulting in less liquidity and higher transactional costs for investors.

The Volcker Rule is supposed to have several exceptions that Congress intended to preserve the businesses and market functions of broker-dealers. Those include statutory exceptions for market making and for state and local obligations. However, if not crafted properly, the Volcker Rule could be too narrow, complex, and ultimately unworkable for these exceptions to be meaningful.

For example, the exception for market makers could be particularly troubling when it comes to fixed-income securities. This is because the SEC has never put forward a definition of market making for fixed-income securities, and the definition for equity market making is unsuitable for the fixed-income markets. Further, under the proposed Volcker Rule, only bonds that were issued by units of general government – such as a state, a county or a city – would be exempt from the Volcker Rule. Bonds issued by agencies or authorities – such as turnpike authorities, water and sewer districts, school districts, levee districts, housing authorities – would not be exempt. These latter bonds could face a diminished market, as bank-affiliated broker dealers would not be able to purchase or sell them from their inventory.

At a minimum, the Volcker Rule should provide that all state and local government bonds, including those of agencies and instrumentalities, are exempt from the Rule. Otherwise, the result could be that municipal securities investors will have less liquidity, issuers will have higher costs (which are ultimately passed on to taxpayers in the form of higher taxes or fees), and the current network of middle market broker-dealers who have served those investors and issuers will face greater stress.

The consequences of a broad, severe Volcker Rule that makes no distinctions on the basis of firm size or market type could be immense. A poorly drafted, overly-broad Rule with a one size fits-all approach could increase the costs to issuers of fixed-income securities, reduce investor liquidity, bifurcate the market in state and local bonds, and increase the business challenges of middle market broker-dealers. A fair cost-benefit analysis of such a Volcker Rule would undoubtedly establish that the Rule, as applied to fixed-income broker-dealers, is simply not worth the cost.

III. Conclusion

The BDA has several recommendations to the drafters of the Volcker Rule in order to avoid the adverse ramifications to the fixed-income markets set forth in this statement. Our foremost recommendation is that the Volcker Rule should not apply at all to fixed-income broker-dealers, even if they are affiliated with a financial institution. Alternatively, if that recommendation is not to be adopted, our secondary recommendation is that the Volcker Rule should not apply to securities broker-dealers affiliated with a financial institution with balance sheet assets of less than $10 billion. For certain, all state and local government bonds, including those of agencies and instrumentalities, should be expressly exempt from the Rule. And, finally, the Rule should incorporate by reference a definition of market making for fixed-income securities to be defined by the SEC.

Again, the Bond Dealers of America appreciates the opportunity to submit this written statement to the Subcommittee on Capital Markets and Government Sponsored Enterprises. If you have any questions or need any further information, please contact me at 202-204-7901 or at mnicholas@bdamerica.org.

MORTGAGE BANKERS ASSOCIATION
Investing in communities

Statement for the Record

Mortgage Bankers Association

U.S. House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises

Hearing on "The Impact of Dodd-Frank on Customers, Credit, and Job Creators"

July 10, 2012

1717 Rhode Island, NW | Washington, DC 20036 | www.mortgagebankers.org | (202) 557-2700

INTRODUCTION

The Mortgage Bankers Association (MBA)[1] appreciates the opportunity to submit this statement for the hearing of the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises entitled "The Impact of Dodd-Frank on Customers, Credit, and Job Creators."

We commend Chairman Garrett and Ranking Member Waters for holding this important hearing that addresses the impacts of the Dodd-Frank Wall Street Reform and Consumer Protection Act[2] (Dodd-Frank Act) on a variety of constituencies. While the Dodd-Frank Act is broad in its scope, we will primarily focus our comments to the area of the law that most significantly impacts commercial, multifamily and single family real estate lenders: credit risk retention.[3]

CREDIT RISK RETENTION AND IMPORTANCE OF SECURITIZATION

On April 29, 2011, the federal regulatory agencies[4] (Agencies) issued for comment a proposed rule that seeks to implement the Dodd-Frank Act's risk retention requirements. MBA notes that a well-designed and robust regulatory framework can be fully compatible with a vibrant securitization market for commercial, multifamily and residential real estate debt. MBA is committed to facilitating the establishment of a fully-functioning, transparent, liquid and responsible securitization market for these debt categories.

MBA appreciates a number of aspects of the proposed rule on risk retention. We strongly support the optional menu approach for risk retention structures in the proposal, because it provides flexibility for a broad range of market participants. A one-size-fits-all approach for the form of risk retention would not adequately address the range of issues that arise for RMBS and

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[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

[2] Public Law 111-203, 124 Stat.1276-2223 (July 21, 2010).

[3] The credit risk retention requirement is set forth in section 941 of the Dodd-Frank Act.

[4] Office of the Comptroller of the Currency, Treasury ("OCC"), Board of Governors of the Federal Reserve System ("Federal Reserve Board"), Federal Deposit Insurance Corporation ("FDIC"), U.S. Securities and Exchange Commission ("Commission"), Federal Housing Finance Agency ("FHFA"), and Department of Housing and Urban Development ("HUD").

CMBS. Therefore, MBA supports the flexibility provided in the proposed rule and seeks additional, optional risk retention structures that meet the statutory risk retention requirement.

Unfortunately, as proposed, other elements of the proposed rule have the potential to severely curtail or shut down new issuance for the commercial mortgage-backed securities (CMBS) market and the private label residential mortgage-backed securities (RMBS) market.

For commercial real estate, the reduction or elimination of this important source of capital would have dire consequences. The lack of CMBS capital would likely increase borrowing costs and in some instances could prevent borrowers from refinancing their commercial or multifamily projects. For residential real estate, private label RMBS issuance could be stalled, which would memorialize the existing reliance on government guarantees for residential mortgages. Consequently, addressing the challenges in the proposed rule is important not just to the commercial, multifamily, and residential mortgage markets, but to the national economy.

Premium Capture Cash Reserve Account Proposal

A proposal that would be highly problematic for both the CMBS and RMBS markets is the Premium Capture Cash Reserve Account (PCCRA). We urge its elimination. The PCCRA calls for securitization profits to be placed into a separate account that would be placed in a first-loss position in the securitization structure. As proposed, we believe the PCCRA would be exceedingly disruptive to the CMBS market and effectively would remove the financial incentive to issue CMBS, potentially eliminating CMBS as a source of permanent mortgage capital for commercial and multifamily real estate borrowers. For RMBS, the PCCRA would effectively stall the return of the private label RMBS market.

Recommendations Specific to Commercial and Multifamily Real Estate

A vibrant and sound commercial and multifamily real estate ("CRE") market is integral to our nation's economy. The securitization market represents an important source of capital for CRE. At $575 billion[5], CMBS is the second largest source of outstanding commercial and multifamily real estate finance debt and represents 24 percent of total commercial and multifamily debt. Due to the tumultuous capital markets, CMBS issuance plummeted from $230 billion in 2007 to a total of $28 billion from 2008 through 2010.[6] With $30 billion of issuance in 2011, the CMBS market has started to strengthen. This fragile recovery of the CMBS market could be imperiled if the proposed rule is not properly implemented.

<u>Risk Retention Hold Period</u>. The CMBS market provides extensive and robust transparency with regard to the performance of underlying loans, which allows investors the opportunity to

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[5] This number also includes collateralized debt obligations (CDOs) and other asset-backed securities (ABS) issuance.

[6] MBA Commercial Real Estate/Multifamily Finance, *Quarterly Data Book*, First Quarter 2012, p. 52.

determine loan performance and identify loans or securitizations that are not performing as expected. Accordingly, the required risk retention hold period should be three years for all risk retention holders, including issuers, originators, and first-loss B-piece buyers.

Third-Party Risk Retention. The Dodd-Frank Act specifically takes into account the critical role served by third-party purchasers of the first-loss, B-piece CMBS position. We support the role of the B-piece buyer serving the risk retention function and emphasize the importance of the economic viability of this structure, consistent with the statutory language. For example, MBA is concerned that if B-piece buyers must hold the risk retention portion of the securitization for the duration of the security, they would be reluctant to serve the risk retention role. This could result in only those CMBS issuers who have balance sheet risk retention holding capacity being able to issue CMBS.

Operating Advisor. The proposed rule calls for the appointment of an "Operating Advisor" with broad unilateral powers beginning at the inception of the securitization. In lieu of this proposal, MBA recommends a framework that would more effectively and efficiently serve the investor-protection objectives of the proposal. Specifically, a special servicer (affiliated with the third-party B-piece buyer fulfilling a risk retention role) would be required to provide enhanced disclosure of relevant information in one consolidated place that is maintained by an independent third-party source. In addition, governing documents would set forth a dispute resolution mechanism available for investors. Finally, the Operating Advisor's role should only begin when a "change in control event" occurs through the application of appraisal reductions and realized losses to a level specified by the CMBS loan documents.

Financing of Risk Retention Interests. MBA recommends allowing sponsors and third-party purchasers to use some financing to fund its risk retention position, including first-loss, horizontal "B-piece" interests. Prohibiting all such financing would limit the incentive to engage in securitizations and, in particular, reduce the number of third-party purchasers willing to assume the risk retention role and increase the cost of securitization (and ultimately, the cost to borrowers).

Underwriting Standards for Zero Risk Retention. As proposed, the underwriting standards for CMBS are so restrictive that a negligible percent (less than 1 percent) of existing CMBS loans would qualify for zero risk retention. Accordingly, MBA has provided regulators with recommended revised metrics for a low-risk loan and changes to the proposed rule that would make the standards consistent with long-held CRE lending practices, ultimately providing a more meaningful exemption under the low-risk loan statutory directive.

Recommendations Specific to Residential Real Estate and QRM

MBA supports efforts to enhance the accountability of all housing finance transaction participants including borrowers, lenders, securities issuers and investors. A risk retention requirement is an important step in establishing a better regulatory plan to protect borrowers and investors, and ensure a safe and reliable mortgage system. At the same time, it is essential that any risk retention requirements be done without unnecessarily constraining liquidity. Without a viable securitization market, the nation's housing finance needs cannot be met.

MBA believes that Congress' intent in crafting the Dodd-Frank Act's risk retention requirements was to address errant securitizer and originator behavior inherent in the originate-to-sell model by aligning the interests of borrowers, lenders and investors in the long-term performance of loans. This "skin in the game" requirement, however, is not a cost-free policy option. Recognizing these costs, the Dodd-Frank Act establishes an exemption from risk retention requirements for qualified residential mortgages (QRMs). By requiring a QRM exemption, the statute would keep consumer costs lower for QRMs, with higher costs for non-QRM loans. Congress has repeatedly expressed in statements and letters to regulators its belief that the QRM should be broadly defined.[7]

Below are recommendations for specific elements of the proposed rule that MBA has provided to the Agencies:

Align QRM with QM. The risk retention regulations should operate in concert with proposed regulations implementing the "Qualified Mortgage" (QM) definition under Dodd-Frank's "Ability to Repay" requirements. This section of the Dodd-Frank Act requires lenders to verify a consumer's ability to repay a mortgage.

Loan-to-Value (LTV). The rules should not hardwire a specific LTV amount, but instead permit offsetting factors in the context of prudent underwriting. Higher LTV loans may pose greater risks. However, these risks can be mitigated by compensating factors such as strong credit and appropriate documentation.

Debt-to-Income (DTI). In lieu of the QRM's hardwired proposed front-end and back-end DTI ratios, the final rule should instead require lenders to consider and verify a borrower's income, assets and obligations.

Credit History. The proposed rule's mandatory thresholds for individual negative credit events should be eliminated. This requirement may disproportionately penalize consumers for potentially minor offenses. Instead, lenders should be required to consider and verify credit history using widely accepted government or non-government standards.

Risk Retention Duration. The rule should provide for the sun-setting of risk retention requirements between two to three years from loan origination. Defaults due to improper

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[7] See for example Credit Risk Retention comment letter submitted by Senators Mary Landrieu, Kay Hagan, and Johnny Isakson (May 26, 2011) and comment letter submitted by Representative Tom Price (April 15, 2011).

underwriting or other defects typically occur during the first two years. Beyond that period, most defaults are caused by life events or other external economic circumstances.

Exempt Seasoned Loans. The rule should exempt seasoned loans from risk retention requirements. A loan seasoned for two to three years prior to securitization and current at all times during that period should be exempt from risk retention requirements.

Permit Commingled QRM and non-QRM Pools. The rule should permit blended pools of QRM and non-QRM loans that meet the QM definition. If a securitizer must wait until it has assembled a "critical mass" of QRM loans sufficient to support an MBS offering, the liquidity of these loans could be significantly impaired.

MBA believes that without substantial revisions, the proposed risk retention regulations will have a significant negative impact on credit availability and affordability for first-time, minority, low-to-moderate income homebuyers as well as others in the marketplace. While we endorse the promotion of safe and sound lending standards through the statutory QRM exemption, we urge that the proposed exemption be redrawn to more closely follow the parameters set by Congress.

Other Elements of the Dodd-Frank Act

An element of the Dodd-Frank Act that is outside of risk retention but may require future legislative action is section 939A, which requires all federal agencies to remove reliance on credit ratings from their regulations and replace them with appropriate alternatives for evaluating creditworthiness of a securitization. We understand that this provision was added to the Dodd-Frank Act because policymakers had concerns that structured security purchasers were overly reliant on ratings and did not perform adequate independent due diligence.

Unfortunately, the unintended consequences of section 939A have already been realized in the bank regulatory capital context. Specifically, the alternative to credit ratings that has been finalized for risk-based capital standards for market risk in the simplified supervisory formula approach (SSFA). This approach contains structural issues that can cause it to unfairly increase risk-based capital for structured securities, including CMBS.[8]

The SSFA is also part of the Basel III proposed rule that provides an updated regulatory capital framework for banks.[9] MBA would urge Congress to monitor the implementation of the SSFA and be prepared to take corrective action if the SSFA or other consequences of section 939A significantly harm the securitization market.

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[8] See MBA comment letter: Risk Based Capital Guidelines: Market Risk, Alternative to Credit Ratings for Debt and Securitization Positions, February 3, 2012.

[9] Basel III is comprised of three rules and can be accessed from the following website: http://www.federalreserve.gov/newsevents/press/bcreg/20120612a.htmut

In addition to the Dodd-Frank Act, there are far reaching proposed bank regulatory capital rules (such as Basel III), securitization rules (such as Regulation AB), as well as rapidly evolving financial accounting reporting rules that have combined to create regulatory uncertainty for financial institutions. The inability to quantify pending regulatory compliance costs and business operational changes has resulted in financial institutions retaining capital that could be more efficiently deployed in the private sector. Consequently, when implementing the Dodd-Frank Act, MBA would urge policy makers to be mindful of the aggregate compliance costs of new regulations, as well as the regulatory capital and financial accounting reporting regimes that financial institutions are and will be required to implement on a concurrent basis.

CONCLUSION

The proposed risk retention regulations are of the utmost importance to restoring a strong and stable housing market. MBA urges Congress to request the Agencies conduct a more substantive economic impact analysis and publish revised proposed regulations in order to give interested parties another opportunity to review and comment. MBA greatly appreciates the opportunity to provide the single family, commercial and multifamily perspectives on the impact of the Dodd-Frank Act.