

Financial Services Regulatory Highlights

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President Obama Outlines Regulatory Reform Principles	1
GAO Report on the TARP: Transparency and Accountability Efforts	2
Congressional Oversight Panel Report on Regulatory Reform.....	3
GAO Report on Modernizing the Financial Regulatory System	4
Interagency Statement on the Financial Stability Plan.....	5
OTS Urges Temporary Halt to Foreclosures.....	6
FTC Launches Redress Program	6
Final Rule for HOEPA Amendments	6
Final Rules Pertaining to the Asset-Backed Commercial Paper Money Market Fund Liquidity Facility (AMLF).....	7
Community Reinvestment Act: 2009 Interagency Q&A	7
FDIC to Tighten and Clarify Interest Rate Restrictions on Certain Institutions.....	8
FDIC Issues Final Rule on Processing of Deposit Accounts in the Event of Failure	8
FINRA Rule Change to Arbitration Procedures.....	9
Additional Information	9

President Obama Outlines Regulatory Reform Principles

On February 25, 2009, after attending a regulatory reform meeting with his economic team and key members of congress, President Obama made a statement to the press that outlined the administration's principles for regulatory reform that will shape the legislation that the Congress will be debating in the coming weeks and months. The principles, as outlined by the President, are:

- **Systemic Risk Oversight** -The Fed has acted and will continue to act as the "lender of last resort" during the financial crisis to insure troubled institutions. The Fed will be required to understand the risks taken by these institutions, and to protect the insurance that has been underwritten by American taxpayers by ensuring these institutions

are not taking risks that will cost taxpayers in the long term.

- **Streamlined Regulatory Structure** -The regulatory system must be able to monitor the scale and scope of risks that institutions take. The regulatory system and the major markets must also be able to withstand system-wide stress and the failure of one or more large institutions. This will require both modernization and streamlining of our regulatory structure.
- **Transparency** -Trust in the financial markets can only be regained through openness, transparency, and plain language in the regulatory system.
- **Supervision of Financial Products** - The markets require strong and uniform supervision of products marketed to investors and consumers. The creation of this supervisory model should be created by actual data of how people make investment decisions, rather than by abstract models created by the institutions marketing the products.
- **Accountability** - Strict accountability from the top down must be demanded. Executives must be held accountable for violations of public trust.
- **"Cherry Picking" of Regulators** - Regulations must be comprehensive and free of gaps. The system should cover the appropriate institutions and markets, and should prevent those being regulated from cherry-picking among competing regulators.
- **Global Coordination** - The United States must set high regulatory standards and appeal to other countries to do the same to avoid additional global financial crises.

GAO Report on the TARP: Transparency and Accountability Efforts

On January 30, 2009, the U.S. Government Accountability Office (GAO) released a second report on the Troubled Asset Relief Program (TARP). This report reviewed: (1) the nature and purpose of activities that were initiated under TARP as of January 23, 2009; (2) Treasury's Office of Financial Stability (OFS) hiring and transition efforts, use of contractors, and progress in developing a system of internal controls; and (3) preliminary indicators of TARP's performance. The report follows up on the nine recommendations from GAO's prior report, finding that Treasury has yet to fully address eight of the recommendations, and includes further recommendations on how to monitor TARP funds and more clearly articulate and communicate a strategic vision for the program.

As of January 23, 2009, Treasury had disbursed about \$293.7 billion of the \$700 billion in program funds. Most of the funds (about \$194.2 billion) went to purchase preferred shares of 317 financial institutions under the Capital Purchase Program (CPP). GAO's previous report emphasized the lack of monitoring and reporting for CPP investments and recommended stronger measures for ensuring that participating institutions use the funds to meet the program's purpose and comply with CPP certain requirements such as executive compensation and dividend payments. In response, Treasury developed plans to survey the largest twenty institutions monthly to monitor lending and other activities and analyze quarterly monitoring data for all institutions. While the monthly survey is a step toward greater transparency and accountability for the largest institutions, GAO continues to believe that additional action is needed to better ensure that all participating institutions are accountable for their use of program funds. Treasury has continued to develop a system for detecting non-compliance with key requirements of the

program but has not yet finalized its plans. Further, Treasury has made limited progress in formulating, articulating and communicating an overall strategy for TARP, continuing to respond to institution and industry-specific needs by, for example, making further capital purchases and offering loans to the automobile industry.

GAO's previous report also included recommendations about OFS's management infrastructure, including hiring, contract oversight, and internal controls. Treasury has taken steps to address these recommendations, but still faces several challenges. First, it took proactive steps to help ensure a smooth transition to the new administration by keeping positions filled and using an expedited hiring process, including direct hire authority. Moreover, after losing some potential candidates because of conflicts of interest, Treasury is asking candidates to address potential conflicts earlier in the recruitment process to avoid unnecessary delays in finalizing employment offers. However, it continues to face difficulty providing competitive salaries to attract skilled employees. OFS continues to rely on contractors to carry out program functions. Second, consistent with GAO's recommendation about contracting oversight, Treasury has enhanced such oversight by tracking costs, schedules, and performance and addressing the training requirements of personnel who oversee the contracts. As previously recommended, Treasury needs to continue to identify and mitigate conflicts of interest in contracting. Similarly, OFS has adopted a framework for organizing the development and implementation of its system of internal control for TARP activities, which is consistent with GAO's recommendation. However, it has yet to implement a disciplined risk-assessment process.

Congressional Oversight Panel Report on Regulatory Reform

On January 29, 2009, the Congressional Oversight Panel issued a Special Report on Regulatory Reform entitled *Modernizing the American Financial Regulatory System: Recommendations for Improving Oversight, Protecting Consumers and Ensuring Stability*. The Report is summarized here but can be reviewed in its entirety at <http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf>.

Key Failures: Risk management, Transparency and Fairness

- Risk Management: Failure to recognize that the activities of some market participants introduced systemic risk.
- Transparency: Rating agencies failed to provide accurate insight into the true risk of derivative instruments.
- Fairness: The mortgage and real estate industry engaged in deceptive practices.

The Panel identified eight specific risk areas and recommendations to address each risk area:

- Identify and regulate financial institutions that pose systemic risk.
 1. Mandate that a new or existing agency or an interagency task force regulate systemic risk within the financial system on an ongoing basis.
 2. Impose heightened regulatory requirements for systemically significant institutions to reduce the risk of financial crisis.
 3. Establish a receivership and liquidation process for systemically significant nonbank institutions (eg. hedge funds, broker/dealers, and investment advisers) that is similar to the system for banks.
- Limit excessive leverage in American financial institutions.
 1. Adopt one or more regulatory options to strengthen risk-based capital and curtail leverage.

- a. Objectives-based capital requirements - capital ratios would be made to increase progressively with the size of the firm's balance sheet.
 - b. Leverage requirements - a leverage ratio—"capital to assets measure"—is part of the regulatory capital regime.
 - c. Countercyclical capital requirements - more stringent when asset prices are rising and less stringent when they are falling.
 - d. Liquidity requirements - financial firms would have to hold a certain proportion of liquid assets as well as a liquidity buffer that could be used in a crisis.
- Increase supervision of the shadow financial system (hedge funds, private equity and instruments currently unregulated e.g. credit default swaps).
 1. Ensure consistency of regulation for instruments currently operating in the shadow financial system.
 2. Increase transparency in OTC derivatives markets through the possible use of:
 - a. Regulated clearinghouses
 - b. Exchange-traded derivatives
 - c. Public reporting requirements - (1) public reports of OTC transactions to improve transparency and pricing, and (2) reporting to the SEC derivatives positions that affect public securities
 - Create a new system for federal and state regulation of mortgages and other consumer credit products.
 1. Eliminate federal pre-emption of application of state consumer protection laws to national banks.
 2. Create a single federal regulator for consumer credit products.

- Create executive pay structures that discourage excessive risk taking.
 1. Create tax incentives to encourage long-term-oriented pay packages.
 2. Encourage financial regulators to guard against asymmetric pay packages in financial institutions, such as options combined with large severance packages.
 3. Regulators should consider requiring executive pay contracts to provide for clawbacks of bonus compensation for executives of failing institutions.
 4. Encourage corporate governance structures with stronger board and long-term investor oversight of pay packages.
- Reform the credit rating system.
 1. Adopt one or more regulatory options to address conflicts of interest and incentives at Credit Rating Agencies.
 2. Reform the quasi-public role of Nationally Recognized Statistical Rating Organization's (NRSRO) and create a Credit Rating Review Board.
- Make establishing a global financial regulatory floor a U.S. diplomatic priority.
 1. Build alliances with foreign partners to create a global financial regulatory floor - prevent regulatory arbitrage.
 2. Actively participate in international organizations that are designed to strengthen communication and cooperation among national regulators.
- Plan for the next crisis.
 1. Create Financial Risk Council of outside experts to report to Congress and regulators on possible looming challenges.

Issues Requiring Further Study

- Accounting rules - mark-to-market accounting, mark-to-model accounting, fair-value accounting, issues of procyclicality, accounting for contingent liabilities, and off-balance-sheet items.
- Securitization- logic and limits of securitization: institute reform such as requiring issuers to retain a portion of offering, phased compensation based on loan or pool performance, and other requirements.
- Short-selling- regulation of short-selling should be further studied and long-term policies should be developed.

GAO Report on Modernizing the Financial Regulatory System

On February 4, 2009, the Government Accountability Office (GAO) presented testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, outlining its framework for creating and evaluating regulatory reform proposals. The framework consists of the following nine characteristics that should be reflected in any new regulatory system:

- Include clearly defined regulatory goals;
- Be appropriately comprehensive;
- Include a system-wide focus;
- Be flexible and adaptable;

- Be efficient and effective;
- Include consistent consumer and investor protection;
- Provide regulators with independence, prominence, authority, and accountability;
- Include consistent financial oversight; and
- Consist of minimal taxpayer exposure.

The current regulatory framework, which was put into place over 150 years ago, is considered by the GAO to be outdated and includes significant limitations and gaps. GAO research noted that regulators have often failed to mitigate systemic risks posed by large financial conglomerates, have had to address problems in

financial markets caused by less regulated market participants such as nonbank mortgage lenders, and are challenged as to how to monitor risks posed by new and more complex investment products. Additionally, the fragmented system has complicated efforts to coordinate with international regulators and poses challenges to standard setters in ensuring that accounting and auditing standards appropriately respond to financial market challenges.

GAO research identified a number of topics for further discussion such as how having a single entity responsible for assessing threats to the overall financial system could prevent some of the crisis that occurred in

the past and whether financial regulators should play a role in approving new financial products and services. Consideration should also be given to whether to extend the customer suitability requirements that apply to securities brokers to mortgage and other products.

The GAO stated that if reforms were not made to the current regulatory structure, the nation's financial system would continue to be at risk. The application of the framework to new and existing reform proposals should help to identify the relative strengths and weaknesses and allow policymakers to focus on identifying tradeoffs and balancing competing goals.

Interagency Statement on the Financial Stability Plan

On February 10, 2009, the Department of the Treasury, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision announced a comprehensive set of measures to restore confidence in the strength of U.S. financial institutions and restart the flow of credit to households and businesses. This program will help lay the foundation for restoring the flows of credit necessary to support recovery.

The core elements of the Financial Stability Plan include:

- A new Capital Assistance Program (CAP) to help ensure that our banking institutions have sufficient capital to withstand the challenges ahead, paired with a supervisory process to produce a more consistent and forward-looking assessment of the risks on banks' balance sheets and their potential capital needs.
- A new Public-Private Investment Fund on an initial scale of up to \$500 billion, with the potential to

expand up to \$1 trillion, to catalyze the removal of legacy assets from the balance sheets of financial institutions. This fund will combine public and private capital with government financing to help free up capital to support new lending.

- A new Treasury and Federal Reserve initiative to dramatically expand, up to \$1 trillion, the existing Term Asset-Backed Securities Lending Facility (TALF) in order to reduce credit spreads and restart the securitized credit markets that in recent years supported a substantial portion of lending to households, students, small businesses, and others.
- An extension of the Federal Deposit Insurance Corporation's (FDIC's) Temporary Liquidity Guarantee Program to October 31, 2009. A new framework of oversight and governance to ensure that banks receiving funds are held responsible for appropriate use of those funds through stronger conditions on lending, dividends and executive compensation along with enhanced reporting to the public.

OTS Urges Temporary Halt to Foreclosures

On February 11, 2009, the Office of Thrift Supervision (OTS) urged OTS-regulated institutions to suspend foreclosures on owner-occupied homes until the Financial Stability Plan's "home loan modification program" is finalized.

The Financial Stability Plan unveiled by Treasury Secretary Geithner commits \$50 billion to prevent avoidable foreclosures by reducing monthly payments for homeowners. The Director of the OTS, John Reich, and other OTS officials participated in the interagency

effort led by the Treasury Department to develop the plan.

Preventing avoidable foreclosures is an essential ingredient for economic recovery. After proposing an OTS Foreclosure Prevention Proposal a year ago, agency leaders have been testifying on Capitol Hill about foreclosure prevention alternatives, discussing approaches with industry trade groups and working with other bank regulators to keep American families in their homes.

FTC Launches Redress Program

On January 23, 2009, the Federal Trade Commission (FTC) returned almost \$28 million to 86,000 consumers impacted by The Bear Stearns Companies, LLC and EMC Mortgage Corporation's mortgage servicing practices.

This program follows a settlement agreed to by Bear Stearns and EMC after the FTC charged the two

organizations with unlawful practices in servicing consumers' home mortgage loans. Specific charges included alleged misrepresentation of the amounts borrowers owed, charging unauthorized fees, and engaging in unlawful and abusive collection practices.

Final Rule for HOEPA Amendments

On February 19, 2009, the Office of the Comptroller of the Currency (OCC) published OCC Bulletin OCC 2009-7, "Truth in Lending Act: Final Rule for Home Ownership and Equity Protection Act Amendments." The Bulletin addresses amendments to Regulation Z under the Home Ownership and Equity Protection Act (HOEPA), which Federal Reserve System published in the July 30, 2008 Federal Register. The final rule is intended to protect consumers from unfair, deceptive, or abusive acts and practices in mortgage lending and to restrict certain mortgage practices.

Higher-Priced Mortgage Loans

The four key protections of the newly defined category of

"higher-priced mortgage loans" for loans secured by a consumer's principal dwelling will:

- Prohibit a lender from making a loan without regard to the borrower's ability to repay the loan from income and assets other than the home's value;
- Require creditors to verify the income and assets they rely upon to determine repayment ability;
- Ban prepayment penalties if the payment can change in the initial four years and, for other higher-priced mortgages, restrict the prepayment penalty period to no more than two years; and
- Require creditors to establish escrow accounts for property taxes and homeowner's insurance for first-lien higher-priced mortgage loans.

All Loans Secured by a Consumer's Principal Dwelling

In addition, the rules adopt the following protections for all loans secured by a consumer's principal dwelling though it may not be classified as a higher-priced mortgage:

- Creditors and mortgage brokers are prohibited from coercing a real estate appraiser to misstate a home's value.
- Servicers are prohibited from certain practices, such as pyramiding late fees. They must credit loan payments as of the date of receipt and provide a payoff statement within a reasonable time from receipt of a request.
- Creditors must provide a good faith estimate of loan costs and a schedule of payments within three days from receipt of a consumer's application for any

mortgage loan secured by a consumer's principal dwelling. The consumer cannot be charged any fee until after he or she has received the early disclosures, except for a reasonable fee for the credit report.

Advertising

Advertising rules for both open-end and closed-end mortgage transactions now require additional information about rates, monthly payments, and other loan features. The final rule also bans seven deceptive or misleading advertising practices for closed-end mortgage loans. This includes the practice of making a false statement that a rate or payment is fixed when, in reality, it can change.

The final rule becomes effective October 1, 2009, with the exception of the escrow requirement, which will be phased in during 2010. Interagency examination procedures will be issued at a later date.

Final Rules Pertaining to the Asset-Backed Commercial Paper Money Market Fund Liquidity Facility (AMLF)

On January 30, 2009, the Federal Reserve Board announced two final rules related to the Asset-Backed Commercial Paper Money Market Fund Liquidity Facility (AMLF), which extends loans to banking organizations to finance their purchases of high-quality asset-backed commercial paper from money market mutual funds.

The first rule provides a temporary limited exception from the Board's leverage and risk-based capital rules for bank holding companies and state member banks. The second rule provides a temporary limited exception from sections 23A and 23B of the Federal Reserve Act,

which establishes certain restrictions on and requirements for transactions between a bank and its affiliates.

The Board has also adopted a third final rule which provides a temporary exception to the limitations in section 23A of the Federal Reserve Act, allowing all insured depository institutions to provide liquidity to their affiliates for assets typically funded in the tri-party repo market. This exception expires on October 30, 2009, unless extended by the Board, and is subject to various conditions to promote safety and soundness.

Community Reinvestment Act: 2009 Interagency Q&A

On January 6, 2009, the Office of the Comptroller of the Currency, along with the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision ("the Agencies") published "Interagency Questions and

Answers Regarding Community Reinvestment" that provide comprehensive guidance regarding the Community Reinvestment Act (CRA) regulations.

The new and revised Questions and Answers (Q&As) encourage financial institutions to participate in foreclosure prevention programs with the objective of providing affordable, sustainable, long-term loan restructurings or modifications for homeowners facing foreclosure on their primary residences. The Q&As also address activities undertaken by a majority-owned financial institution in cooperation with a minority-owned or women-owned financial institution or a low-income credit union.

The Q&As also adopt nine new questions and answers and make substantive changes to 14 existing questions and answers. In addition, the agencies are proposing for comment one new question and answer as well as substantive revisions to two existing questions and answers.

The Q&As consolidate and supersede all previously published CRA credit union. The Agencies request comment on the proposed changes by March 9, 2009.

FDIC to Tighten and Clarify Interest Rate Restrictions on Certain Institutions

On January 27, 2009, the Federal Deposit Insurance Corporation (FDIC) proposed for comment a regulatory change in the way the FDIC administers its statutory restrictions on the deposit interest rates paid by banks that are less than well-capitalized.

The proposed regulation would define nationally prevailing deposit rates as a direct calculation of those national averages, as computed and published by the FDIC based on data available to it. Reliance on the Treasury yields in the regulation would be discontinued.

In recognition of the blurring of local deposit market boundaries brought about by the Internet and other innovations, the proposed regulation would also establish a presumption that locally prevailing deposit rates equal the national rates published by the FDIC. This presumption could be overturned by evidence presented by banks to the FDIC.

The full text of the proposed rule is available at <http://www.fdic.gov/news/news/press/2009/pr09009.html>

FDIC Issues Final Rule on Processing of Deposit Accounts in the Event of Failure

On January 27, 2009, the Board of Directors of the Federal Deposit Insurance Corporation issued a final rule on processing deposit accounts in the event of failure. The final rule, which is a follow-up to the FDIC's issuance of an interim rule in July 2008, establishes the FDIC's practices for determining, for deposit insurance and receivership purposes, deposit and other account balances at a failed depository institution. To a large extent, this rulemaking codifies the FDIC's long-standing policies and procedures at bank closings. The final rule applies to all FDIC-insured institutions.

The final rule requires, effective July 1, 2009, that insured depository institutions inform their sweep account customers of the nature of their swept funds and how those funds would be treated if the institution should fail. Excluded from the requirement are sweep arrangements where funds are moved between deposit accounts and the deposit insurance available to the customer is unchanged.

FINRA Rule Change to Arbitration Procedures

FINRA is proposing to amend the Code of Arbitration Procedure for Customer Disputes ("Customer Code") and the Code of Arbitration Procedure for Industry Disputes ("Industry Code") to insert rule language from the Code of Arbitration Procedure ("Old Code") that was inadvertently omitted when the Customer Code and Industry Code were adopted, to correct inaccurate cross-references, and typographical errors. The text of the proposed rule change can be found on FINRA's web site.

On January 24, 2007, the SEC approved a proposal to amend the Old Code by simplifying the language, codifying current dispute resolution practices and implementing several substantive changes to dispute resolution rules. The proposal reorganized the Old Code into three separate procedural codes: the Customer Code, the Industry Code and the NASD Code of Mediation Procedure. The Customer, Industry and Mediation Codes replace the old Code in its entirety.

Additional Information

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