The Dodd-Frank Act requires the Council to make annual recommendations to (1) enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets; (2) promote market discipline; and (3) maintain investor confidence. The Council fulfills this requirement by recommending (1) heightened risk management and supervisory attention in specific areas; (2) further reforms to address structural vulnerabilities in key markets; (3) steps to address reform of the housing finance market; and (4) coordination on financial regulatory reform.

The Council recommendations work together to balance the stated requirements of integrity, efficiency, competition, market discipline, and investor confidence, while maintaining financial stability. For instance, recommendations to improve capital and liquidity planning, address vulnerabilities in the money market fund and tri-party repo markets, and coordinate implementation of the Dodd-Frank Act will improve the stability of the financial system. To promote market discipline, the Council recommends responsible credit underwriting standards; housing finance reforms, including mortgage servicing standards and servicer compensation; and effective implementation of orderly liquidation authority for the largest financial firms. To maintain investor confidence, the Council also recommends that market participants keep pace with infrastructure and technological advances and conduct heightened due diligence on emerging financial products. Collectively, the Council recommendations address the identified vulnerabilities in the system and emerging threats to financial stability. Regulatory agencies and market participants should take these steps to enhance the resilience and integrity of the system. The discussion below outlines the Council recommendations and their fulfillment of the Council’s statutory mandate.

I. Heightened Risk Management and Supervisory Attention

In the following areas, market participants should employ heightened risk management, and Council member agencies should enhance ongoing supervisory attention to determine whether any of these market dynamics rises to a level that merits a regulatory response.

- **Construct robust capital, liquidity, and resolution plans.** To support stability in the financial system, financial institutions should ensure that they have in place robust capital, liquidity, and resolution planning processes. The Federal Reserve’s Comprehensive Capital Analysis and Review exercise found that all of the largest banking companies need to bolster their capital planning processes. The largest financial institutions must also incorporate within their planning processes contingencies for resolution that would facilitate resolvability under bankruptcy without government assistance. In addition, the largest banks
should plan further improvement in their capital levels and liquidity risk profiles to support funding models without any assumption of government assistance and their continued smooth transition to new global standards.

- **Bolster resilience to unexpected interest rate shifts.** In light of a sustained, historically low interest rate environment, market participants should work to ensure that they have robust processes for measuring and, where necessary, mitigating their exposure to a range of interest rate scenarios. Preparedness to face unexpected rate changes or yield curve shifts will enable market participants to make a stable transition to a new rate environment, minimizing potential disruption to the system.

- **Maintain discipline in credit underwriting standards.** Although it is difficult to make definitive determinations regarding the appropriateness of risk pricing, there have been some indicators that credit underwriting standards might have overly eased in certain products, such as leveraged loans, reflecting the dynamics of competition among arranging bankers. Greater market discipline can be supported through robust due diligence practices and processes for monitoring and responding to developments in credit underwriting standards, including deal features that may allow borrowers to take on excessive risk. Sound underwriting standards, which were abandoned in the run-up to the crisis, will encourage greater investor confidence and stability in the market.

- **Employ appropriate due diligence for emerging financial products.** Council agencies are highly attentive to the emergence and growth of financial products, particularly those that may be designed to arbitrage new capital and accounting standards by moving financial activities outside the regulated core. A robust financial system should facilitate innovation. Market participants, as issuers or investors, should work to ensure that they have an adequate understanding of the risks that products such as exchange traded funds and structured notes present, including impacts under strained market conditions.

- **Keep pace with competitive, technological, and regulatory market structure developments.** Equity trading markets in the United States have experienced changes in market structure over the past several years, including an expansion of the number of trading venues and the rise of electronic trading. The flash crash of May 6, 2010 demonstrated that regulators and market participants should continue to monitor these changes and take action as necessary to help ensure that the market structure regulatory framework and operational policies keep pace with changes to trading and other market practices. Regulators and market participants should also continue to foster investor confidence by promoting market integrity, efficiency, and competition.
II. Additional Reforms to Address Structural Vulnerabilities

Financial systems are vulnerable to shocks that can be exacerbated by weaknesses in the structure of financial institutions, markets, and infrastructure.

The Council recommends reforms to address structural vulnerabilities in the tri-party repo market, for money market mutual funds, and in mortgage servicing:

- **Elimination of most intraday credit exposure and reform of collateral practices in the tri-party repo market to strengthen the market.** Given the vital importance and size of tri-party repo financing and the broad array of financial institutions active in this market, the regulatory community should exert its supervisory authority over the industry’s reform efforts to ensure that the Tri-Party Repo Infrastructure Reform Task Force meets its commitments as promptly as possible. The Task Force’s efforts should ultimately improve market functioning, but several important structural reform issues require coordinated supervisory and regulatory attention. Chief among these priorities are enhancing dealer liquidity risk management practices, alleviating the propensity of cash investors to withdraw funding and exit the market when risk surfaces, and implementing mechanisms to manage a potential dealer default. The fragility of broader market liquidity facilities and the constraints on the types of collateral that certain investors are prepared to take (particularly money market funds) heightens the risk of contagion in the market. Reform efforts should practically eliminate intraday credit exposures of clearing banks to borrowers and strengthen collateral management practices to improve the stability of this critical short-term funding market.

- **Implement structural reforms to mitigate run risk in money market funds.** When the SEC adopted new rules for money market funds (MMFs) in February 2010, it noted that a number of features still make MMFs susceptible to runs and should be addressed to mitigate vulnerabilities in this market. To increase stability, market discipline, and investor confidence in the MMF market by improving the market’s functioning and resilience, the Council should examine, and the SEC should continue to pursue, further reform alternatives to reduce MMFs’ susceptibility to runs, with a particular emphasis on (1) a mandatory floating net asset value (NAV), (2) capital buffers to absorb fund losses to sustain a stable NAV, and (3) deterrents to redemption, paired with capital buffers, to mitigate investor runs.

- **Improve the overall quality of mortgage servicing by establishing national mortgage servicing standards and servicer compensation reform.** The mortgage servicing industry was unprepared and poorly structured to address the rapid increase in defaults and foreclosures. To address this...
structural vulnerability, regulators should establish national mortgage servicing standards and promote alternative servicer compensation models.

» National mortgage servicing standards should provide clarity to borrowers and investors, and servicers should be held to the same quality and responsiveness standards regardless of whether the loans being serviced are held on the originator’s books, have been sold, or have been securitized. National standards would align incentives and provide clarity and consistency to borrowers and investors, especially in the case of delinquency. These standards will enhance the integrity and efficiency of mortgage servicing and help reestablish investor confidence in the housing finance market.

» Today, the structure of servicing compensation generally does not adjust to reflect the amount of servicing effort and expense required. This flat-fee structure does not appropriately incent servicers to invest the time and effort to work with borrowers to avoid default or foreclosure. The FHFA and the Department of Housing and Urban Development should continue to coordinate a review of the structural flaws in the current mortgage servicing compensation model and should consider alternatives.

III. Housing Finance

The U.S. housing finance system required extraordinary federal government support during the crisis. Over 90 percent of the market continues to function on the basis of this government support and without sufficient return of private capital. This dynamic is not sustainable over the long term. The Council member agencies and the Department of Housing and Urban Development should continue their work to strengthen the housing finance system, which includes developing a framework for the return of private capital to the system. The framework should include regulatory activities that set forth standards and guidelines for participants in the housing finance system, and other actions that strengthen mortgage underwriting. To give further confidence to the market and provide long-term stability to the U.S. financial system, the Council believes Congress must pass responsible legislation to reform the housing finance system. The reform efforts should not further destabilize the fragile housing market.

IV. Financial Regulatory Reform

Council member agencies are committed to implementation of financial regulatory reform. While important steps have been taken, both domestically and in the international policy arena, much work remains to be done. The agencies are approaching reform carefully, mindful of the need for sufficient public comment and the risks of unintended consequences.
Coordinated implementation of regulatory reform will enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets; promote market discipline; and maintain investor confidence by closing regulatory gaps that contributed to the crisis and previous market dislocations.

**Dodd-Frank Act**

The Dodd-Frank Act provides comprehensive reforms and protections across the financial regulatory system. These reforms include the creation of a regulatory framework for the over-the-counter derivatives market; investor protection measures that increase disclosure, transparency, and confidence; reporting for managers of hedge funds and other private funds; and the establishment of a single agency dedicated to ensuring consumer financial protection and the integrity of the market for consumer financial products and services. The Dodd-Frank Act also requires regulators to impose heightened prudential standards on certain large financial firms to help foster market discipline and stability, and to make clear that no firm will be considered too big to fail, by creating a new authority to break up and wind down a failing financial firm in a manner that protects taxpayers and the economy. In addition, the Dodd-Frank Act created the Council to monitor risks that could build across the system in a way that threatens the stability of the financial markets in the United States, and the OFR to collect data on the Council’s behalf, working closely with supervisors.

The Council member agencies have made significant progress in implementing the many reforms that the Dodd-Frank Act requires. The Council and its member agencies recognize that successful implementation of reform across complex areas of the financial system requires independent agencies to coordinate their efforts, even if such consultation is not statutorily required. Coordination is critical to implementing reforms that not only work together in a sensible, coherent way, but also appropriately balance market efficiencies, competitiveness, and stability while providing for innovation. To meet the challenges of designing and enforcing these new rules, the quality and scale of resources dedicated to financial oversight must increase. Agencies must have sufficient resources to attract and retain talented individuals and invest in systems to monitor market activity and enforce the new rules.

**International Coordination**

At the September 2009 summit in Pittsburgh, the G-20 heads of state agreed that reforms were needed to build high-quality capital and mitigate pro-cyclicality in the financial system; improve compensation practices to support financial stability; reform the over-the-counter derivatives markets for greater transparency and risk management; and address cross-border resolutions and systemically important financial institutions. The implementation of the Dodd-Frank Act will accomplish many of these goals within the United States, but international coordination is required to ensure that similar reforms are applied consistently across the global financial system to mitigate regulatory gaps.
and level the playing field. Council member agencies are committed to working with their international counterparts to implement these reforms in a timely manner. Key reforms include the following:

- **Capital and liquidity standards.** In 2010, central banks and supervisors reached agreement on the core elements of new global capital and liquidity standards, Basel III. As a result of this agreement, internationally active banks will have to hold substantially more capital in the form of common equity against the risks they take. This agreement was the foundation of a comprehensive new capital framework to further stabilize global markets, but it left open several areas for further analysis, including the size and composition of additional capital requirements to impose on the largest global institutions, how to implement the new liquidity standards, and how to bring more consistency to the risk weighting of assets across countries.

- **Globally active systemically important banks.** The Financial Stability Board, a global body of finance ministers, central bankers, and supervisors, has been working to develop guidelines for cooperation in the supervision of large, globally active financial institutions, and to develop a consistent international framework for the orderly resolution of such companies. These initiatives complement Dodd-Frank Act requirements, and Council members are actively supporting efforts to promote international consistency on resolution frameworks.

- **Derivatives markets.** A core element of the international framework for reform of the over-the-counter derivatives market is a requirement for standardized derivatives to be centrally cleared. While there will continue to be bilaterally executed derivatives transactions that are not cleared, there is international agreement that non-centrally cleared derivatives should be subject to higher capital requirements. In addition, Council member agencies are committed to working with international counterparts to develop global standards for central counterparties and margin requirements for swaps and security-based swaps that are not centrally cleared. Other key elements of reform are the reporting of over-the-counter derivatives to trade data repositories and the trading of standardized over-the-counter derivatives on exchanges or electronic trading platforms. In each of these areas, Council member agencies are committed to working with international counterparts to harmonize requirements.

- **Infrastructure.** International authorities have released revised standards for financial market infrastructures that provide a single set of principles (CPSS-IOSCO Principles for financial market infrastructures) for greater consistency in the oversight and regulation of financial infrastructures worldwide, including enhanced requirements for governance and risk management practices, and new standards on transparency and general business practices. These principles should provide greater consistency in the oversight and regulation of financial infrastructures worldwide and thus enhance the integrity of markets and global investor confidence.