THE IMPACT OF THE DODD-FRANK ACT: WHAT IT MEANS TO BE A SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTION

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

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THE IMPACT OF THE DODD-FRANK ACT: WHAT IT MEANS TO BE A SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTION

Wednesday, May 16, 2012

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:02 a.m., in room 2128, Rayburn House Office Building, Hon. Shelley Moore Capito [chairwoman of the subcommittee] presiding.

Members present: Representatives Capito, Renacci, Royce, Manzullo, Hensarling, McHenry, Luetkemeyer, Duffy, Canseco, Grimm; Maloney, Hinojosa, Baca, Miller of North Carolina, Scott, and Carney.

Ex officio present: Representative Bachus.

Also present: Representatives Garrett and Green.

Chairwoman CAPITO. This hearing is called to order. I want to welcome everyone.

This morning the Financial Institutions and Consumer Credit Subcommittee will examine the impact of being designated as a systemically important financial institution (SIFI) specifically for nonbank financial entities. But I couldn't begin the hearing without talking about the most topical subject of the day or of the week.

There is no doubt that this week's news of JPMorgan's trading losses has raised significant questions about the supervision of risks within an institution. The story is still unfolding, and although it appears that the firm had sufficient capital to absorb this significant loss, one of the questions I would ask is, would a less capitalized institution survive a similar loss? Are other financial firms that are determined systemically significant sufficiently capitalized? Where did the lapses in the internal risk controls within the firm occur? Were Federal financial regulators aware of the position that JPMorgan was taking? Transparency is a question, I think. Did they do an adequate job of supervising the firm's risk? Are they able to supervise the complexity of the firm's positions?

The losses at JPMorgan emanated from their London office, which begs the question, how well are our Federal financial regulators coordinating with their counterparts across the globe? And how did the provisions in Dodd-Frank help or exacerbate the problem?

I think there are plenty of questions that we will be answering, certainly in the next several weeks.

But this morning's hearing focuses on the effect of designating nonbank financial firms as systemically important. The Dodd-Frank Act grants the Financial Stability Oversight Council, better known as FSOC, the authority to designate firms as systemically important. While the statute is clear which financial institutions will be designated, it is less clear about designating nonbank financial institutions.

The FSOC was tasked with promulgating rules to determine the criteria for nonbank financial institutions to be designated as systemically important, and the Federal Reserve is in the process of finalizing rules to supervise the entities that are designated.

There are many questions again about the effect the systemically significant designation will have on these nonbank firms. We have already seen with the largest banks that systemic significance equates to market participants viewing these institutions as being too-big-to-fail and expects the government to intervene in times of severe distress. The implied government guarantee also results in lower borrowing costs.

It is less clear what effect this designation will have on nonbank entities. I know that many of our witnesses on the second panel have serious concerns about the standards used for not only designating the firm but also for the supervision of nonbank firms once it is designated. There are legitimate questions about how these standards will work with the various business models of nonbank firms.

Does the Federal Reserve have the expertise to supervise nonbank firms from different industries? How well will the FSOC and the Federal Reserve coordinate to ensure the standards for designation supervision are in harmony? And are they working with their counterparts across the globe to harmonize standards for systemic significance in the United States with global systems significance?

These are questions that deserve a robust discussion. I am hoping we get to that in this morning's hearing.

I would like to thank our witnesses for appearing before the subcommittee this morning.

I now recognize the ranking member of the subcommittee, the gentlewoman from New York, Mrs. Maloney, for the purpose of making an opening statement.

Mrs. MALONEY. First of all, I want to thank you, Madam Chairwoman, for calling this hearing, and I welcome our witnesses.

This hearing today is about a very important set of issues around designation of nonbank companies as systemically significant. There are certainly a lot of perspectives and issues around it that have been raised already by the Chair, but I think these are important issues and that we should stay focused on them.

If there was one area where we learned from the financial crisis in 2008, it was that the regulators did not have the tools to regulate complex, interconnected nonbank companies, like AIG, and did not have the ability to wind down these companies in the event of a failure without disrupting the system and without taxpayer funding. As a result, these highly-interconnected overleveraged firms nearly brought this entire country and its financial system to its knees, and it was quickly recognized that key supervision for these nonbank areas was missing.

We did two important things in Dodd-Frank to address this by eliminating the hiding places from regulation, and by ending too-big-to-fail. First, we gave the FSOC, the Financial Stability Oversight Council, the authority to require Federal supervision of nonbank financial companies that pose a systemic risk and required the Federal Reserve (Fed) to impose heightened regulatory requirements on these companies, as well as any bank holding company with at least $50 billion in assets. These changes also leveled the playing field between nonbanks and banks.

Second, if a company does fail in spite of the heightened requirements and supervision, we also provided an Orderly Liquidation Authority (OLA) in Title II of Dodd-Frank so that regulators would not be faced with the horrible choice between either bailing a company out at taxpayer expense, which we did with AIG, or letting it fail, to the great detriment of the broader financial system.

Designation of nonbank companies is a two-step process. The entities must first be identified as nonbank SIFIs, and then they must be subjected to heightened supervision. FSOC rule was not required by Dodd-Frank and really was done to provide clarity to the public and companies about how FSOC will designate nonbanks as SIFIs.

I understand it has been estimated that about 50 entities will be considered for heightened regulation based on the size and scope of their financial activities. Once designated, these companies will be subject to stricter standards under rules that the Fed is currently developing and on which it has asked for detailed input.

So, I look forward to hearing from the panels, and I also look forward to hearing from the firms.

I also would like to ask unanimous consent for Mr. Green to have privileges as a subcommittee member today so he may question the witnesses.

I welcome our panelists today, and I yield back.

Chairwoman CAPITO. Without objection, it is so ordered.

I would like to recognize the chairman of the full Financial Services Committee, Chairman Bachus, for 3 minutes for an opening statement.

Chairman BACHUS. I thank the chairwoman.

At today's hearing, we will have an opportunity to examine one of Dodd-Frank's most vague and potentially problematic mandates. We are here to better understand what it means to be systemically important, a euphemism for too-big-to-fail. Which institutions will be categorized is significantly important. What are the consequences of being deemed systemically important? What are the advantages and what are the disadvantages? How will these institutions be regulated? And how will counterparties and other market participants interact with them?

We have been told by the FDIC that part of this interaction will be to indemnify certain creditors and counterparties, and that seems very similar to AIG. And Members on both sides pledged that we would not get into another bailout situation.

Many companies are asking themselves the same questions and whether the regulators think they are systemically important. The Financial Stability Oversight Council's final rule is not at all clear. It is therefore my hope that the regulators testifying here today can help provide the committee and all affected parties with some much-needed clarity on these important issues. I look forward to this discussion and I thank the witnesses for being here.

I do want to say, in conclusion, that because of the JPMorgan Chase situation, we are again hearing from some of our colleagues that we need a law which will essentially prevent a business from losing money or taking risk, and no law can do that, nor should a law attempt to prohibit a company from taking risk. In fact, that is just an impossibility. Now, when taxpayer funds are at risk, and a bailout situation would certainly be one of those, or deposits, then that is another question.

Just to put it in perspective, JPMorgan Chase—and if you are concerned about deposits in that institution, let me put that trading loss in perspective. Their pre-tax profit last year was $25 billion, so a $2 billion loss would represent 1 month of earnings. If it had been last year, it would reduce their earnings to $23 billion. The loss is about 1/100th of the firm's $189 billion net worth and roughly 1/1000th of the firm's $2.3 trillion in assets.

Even with this loss, I believe they are one of the most profitable financial institutions in the country, and unless the facts are diametrically different from what we have heard, there is no risk from this loss to depositors or to taxpayers. JPMorgan Chase remains a very profitable and viable institution.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

Mr. Baca for 2 minutes.

Mr. BACA. Thank you, Madam Chairwoman.

I want to thank you for calling this hearing, along with the ranking member.

I also want to thank both of the panelists for being here with us today to offer their insight on this important topic.

As we know on the Financial Services Committee, Federal Reserve Chairman Greenspan came to us many times and said to, "trust them, they know what they are doing." I guess we are still trying to figure out if we should trust them, and apparently, we should not have trusted them. But we did.

One of the biggest developments during the economic crisis in 2008 was the realization of how much of the impact could be felt from the collapse of the too-big-to-fail firms. Until the problem arose, it seemed that no one quite understood the level of interconnectedness that some of these firms had. As a result, our government took drastic action to limit the stress the collapse of these institutions could have caused. And obviously, no one wants to see the events of 2008 repeated.

In writing and passing Dodd-Frank 2 years ago, I believe we created a sound framework. I state, I believe we created a sound framework that will allow us to stay ahead of the curve with these systemically important institutions, to make sure that we regulate them and also that we do a lot of the enforcement that needs to be done. It is not just regulating them, but how are we going to enforce them, and what action will actually be taken to make sure we don't develop additional crises and that we work to solve the problem?

This framework will allow the regulators to work with market participants in creating an efficient and secure regulatory structure. At the same time, it will allow the market to continue to operate in a free manner that will not be dictated by the needs and demands of the regulators.

Finally, if a firm does run into trouble, the market has the confidence that the mistakes of a few will not impact the actions of many, and that is only if the action is taken and it is brought before us to make sure that it doesn't affect a lot of the consumers or individuals involved.

At the end of the day, what everyone is looking for is certainty. Industries want to be certain that they can run their business in a manner where they don't fear becoming too unsuccessful but at the same time doing what is right. Regulators want to be certain that they can step in and act in a timely manner to correct the bad behaviors, and that is going to be the key right there. And the American public wants to know that all parties involved are doing their best to ensure that the abusive behavior is not something that will be allowed to be repeated.

Again, I want to thank the ranking member and the chairwoman for having this hearing.

Chairwoman CAPITO. Thank you.

Mr. Garrett for 1½ minutes.

Mr. GARRETT. I thank the Chair also for this important hearing with regard to the designation of firms that are systemically important financial institutions, or SIFIs. But instead of calling these firms systemically important financial institutions or SIFIs, I think what we should call them is what we all know they are and what the market calls them as well, and that is too-big-to-fail institutions. If you are honest about it, Dodd-Frank basically codified too-big-to-fail in the law and then just simply changed the name over to SIFIs or systemically important financial institutions.

And when you change the name, you really haven't changed anything about the characterization of them or the substance of them. You really haven't solved the too-big-to-fail problem.

The firms now that are on the list of firms were chosen by this Administration and FSOC that are formerly designated as too-big-to-fail, they basically still have funding advantages in the marketplace because of that designation and they are subject to a resolution process that still allows the government to use taxpayer money at the end of the day to decide which creditors are going to win and which creditors are going to lose.

So if you really ended too-big-to-fail, then Members on the other side of the aisle over here would not state that one of their goals for the next Congress is, "Let's end too-big-to-fail." And if we really had ended too-big-to-fail, then there would be no reason whatsoever in the media or anyplace else for people to be all concerned about JPMorgan's $2 billion loss, because the taxpayers would not be on the hook, and they would be protected from it.

So, lets's be honest here. The entire debate about SIFI designation is nothing more than a charade, and we should call it what it is. It is a debate about which financial institutions are too-big-to-fail. And we should not be debating which companies to call too-big-to-fail. We should be debating, how do we end the taxpayer being on the hook for these institutions?

I yield back.

Chairwoman CAPITO. Thank you.

Mr. Scott for 2 minutes.

Mr. SCOTT. Thank you very much, Madam Chairwoman.

I think we need to make sure that as we look at the situation we are in today, the results of our financial crisis from a few years ago, even the JPMorgan Chase situation, that we have to do everything we can to make sure it doesn't happen again, that all of that is taken into consideration.

But I caution on this point. I think we need what I refer to as a "delicate balance" here. We need to make sure we have the regulations to make sure this is done. Dodd-Frank is in place to do that. It is an excellent framework. It put the FSOC in there so that it could marshal our efforts for stability. There is no assignation for SIFIs within the Dodd-Frank bill. We are leaving those kinds of threats and identification up to the FSOC.

And I agree that the crisis we had a few years ago, the JPMorgan situation, certainly has to be avoided, but we have to make sure that any additional regulation for our financial institutions, including both banks and nonbanks, will not stifle the growth of our economy and the creation of American jobs. That is the most important thing before us today.

We have to create jobs. We have to get this economy better. We have to also make sure that the forces that generate the capital, that disburse the capital, that lend and keep this economy going, are not put in a straitjacket. I say that as a proud sponsor of Dodd-Frank and also one who understands we have to make sure that the abuses don't happen. But all I am simply saying is that it has to pass that "delicate balance" test. First and foremost, economic growth must not be stifled.

Now, we are making some great progress here. The jobless rate is coming down, all of this. So all I am saying is as we move forward, let's move forward with a jaundiced eye on this and do it correctly.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

Mr. Royce for 1 minute.

Mr. ROYCE. Thank you, Madam Chairwoman.

More than any other, Section 165 of Dodd-Frank is emblematic of Washington taking its eye off of the ball, because instead of focusing on those institutions everyone knows are too-big-to-fail, instead of getting back to less leverage and higher capital requirements for those few firms, government instead will publicly stamp institutions, potentially dozens of institutions, as systemic.

And the explicit statement to the market is that Washington believes these firms are special and the implicit statement to the market is also going to be that Washington will never allow these firms to fail. Given the precedent that has been set, given the propensity of government to err on the side of intervention, err on the side of bailouts to save systemically important firms, it is my hope that we can cast the smallest possible net in this and designate only the firms that everyone agrees are too-big-to-fail. But, frankly, the approach was the wrong approach.

I yield back.

Chairwoman CAPITO. The gentleman yields back.

Mr. Green for 2 minutes.

Mr. GREEN. Thank you, Madam Chairwoman.

And I thank the ranking member as well.

One thing I am totally absolutely and completely convinced of is this: Regardless of how we feel, the public is of the opinion that too-big-to-fail is the right size to regulate. It is the right size to deal with such that it does not bring down the economy.

AIG is a prime example of what we did not have the authority and the ability to properly deal with when it was going out of business, as it were. We cannot allow ourselves on our watch to simply say, we need to get back to business as usual. And I hear a lot of that in other words; let's get back to business as usual. We cannot afford business as usual because it brings down the economy with these institutions when they become so large that they have an impact across not only the American economy but the economy of the world.

So today, I think it is appropriate for us to examine the rules, but it is also appropriate to note that we cannot allow business as usual to become the order of the day.

I yield back the balance of my time.

Chairwoman CAPITO. The gentleman yields back.

I believe that concludes our opening statements. I will now recognize the witnesses for the purpose of a 5-minute summation of your written statements.

Our first panelist is Mr. Lance Auer, Deputy Assistant Secretary for Financial Institutions, U.S. Department of the Treasury.

Welcome.

STATEMENT OF LANCE AUER, DEPUTY ASSISTANT SECRETARY FOR FINANCIAL INSTITUTIONS, U.S. DEPARTMENT OF THE TREASURY

Mr. AUER. Thank you. Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee, thank you for the opportunity to discuss the Financial Stability Oversight Council's rule and guidance for identifying nonbank financial companies that will be subject to standards and supervision by the Federal Reserve.

In the 2008 financial crisis, financial distress at certain nonbank financial companies contributed to a broad seizing-up of the financial markets. To address potential risks posed to U.S. financial stability by these types of companies, the Dodd-Frank Wall Street Reform and Consumer Protection Act authorizes the Council to determine that certain nonbank financial companies could pose a threat to U.S. financial stability and will be subject to the supervision of the Federal Reserve and to enhanced prudential standards.

Although the Dodd-Frank Act specifically outlined substantive considerations and procedural requirements for designating nonbank companies, the Council elected to engage in a rulemaking process in order to obtain input from all interested parties and to provide increased transparency to the public. To these ends, the

Council provided the public with three separate opportunities to comment on its proposal.

After receiving significant input from market participants, non-profits, academics, and other members of the public, the Council approved its final rule in April of this year. The final rule provides a robust process for evaluating whether a financial company should be subject to Federal Reserve supervision and enhanced prudential standards. The Council will approach each determination using a consistent framework, but ultimately each designation must be made on a company-specific basis, considering the unique risk to the U.S. financial stability that each nonbank company may pose.

The Council's rule and guidance explain the three-stage process that the Council intends to use in assessing nonbank financial companies.

In stage one, the Council will apply uniform quantitative thresholds to identify those nonbank financial companies which will be subject to further evaluation. The use of clear thresholds in stage one enables the public to assess whether a particular company is likely to be subject to further evaluation by the Council.

In stage two, the Council will analyze the nonbank financial companies identified in stage one using a broad range of information available to the Council, primarily through existing public and regulatory sources. This review will include both quantitative and qualitative information.

In stage three, the Council will contact each nonbank financial company that the Council believes merits further review to collect information directly from the company which was not available in prior stages for an in-depth review. Each nonbank financial company that is reviewed in stage three will be notified that it is under consideration and will be provided an opportunity to submit written materials to the Council for the Council's consideration.

If the Council votes to approve a proposed determination, the nonbank financial company will receive a written explanation of the basis of the proposed determination. The company may also request a hearing to contest the proposed determination. After the hearing, a final determination requires a second vote of the Council.

The authority under the Dodd-Frank Act for the Council to designate nonbank financial companies for enhanced prudential supervision standards and Federal Reserve supervision is an important part of the Council's ability to carry out its statutory duties to identify risks to U.S. financial stability and respond to such threats in order to better protect the U.S. financial system.

Thank you, and I would be happy to answer any of your questions.

[The prepared statement of Mr. Auer can be found on page 56 of the appendix.]

Chairwoman CAPITO. Thank you.

Our second witness is Mr. Michael Gibson, Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System.

Welcome.

STATEMENT OF MICHAEL S. GIBSON, DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. GIBSON. Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee, thank you for the opportunity to testify today on implementation of the Dodd-Frank Act as it relates to the designation, supervision, and regulation of systemically important nonbank financial companies.

The recent financial crisis showed that some financial companies, including nonbank financial companies not historically subjected to consolidated prudential supervision, had grown so large, so leveraged, and so interconnected that their failure could pose a threat to overall financial stability. The sudden collapses or near collapses of major financial companies were among the most destabilizing events of the crisis.

The Dodd-Frank Act addresses key gaps in the framework for supervising and regulating systemically important nonbank financial institutions through a multi-pronged approach that includes: first, the establishment of the Financial Stability Oversight Council, which has the authority to designate nonbank financial companies that could pose a threat to financial stability; second, a new framework for consolidated supervision and regulation of nonbank financial companies designated by the Council; and third, improved tools for the resolution of failed nonbank financial companies.

With respect to the first prong, the Financial Stability Oversight Council was created to coordinate efforts to identify and mitigate threats to U.S. financial stability across a range of institutions and markets, including by establishing a framework for designating nonbank financial companies whose failure could pose a threat to financial stability.

On April 3rd, the Council issued a final rule and interpretive guidance setting forth the criteria and the process it will use to designate nonbank financial firms as systematically important. The Council's issuance of this rule is an important step forward in ensuring that systemically important nonbank financial firms will be subject to strong consolidated supervision and regulation.

With respect to the second prong, the enhanced prudential standards, Sections 165 and 166 of the Dodd-Frank Act require the Federal Reserve to establish enhanced prudential standards both for the largest bank holding companies and for nonbank financial companies designated by the Council. These enhanced prudential standards include requirements for enhanced risk-based capital and leverage requirements, liquidity, risk management, stress testing, and resolution planning, as well as single counterparty credit limits and an early remediation regime.

In December, the Federal Reserve issued proposed rules which would apply the same set of enhanced prudential standards to covered companies that are bank holding companies and covered companies that are designated nonbank financial companies. The Federal Reserve may tailor the application of the enhanced standards to different companies on an individual basis or by category.

Working out the exact details of how enhanced prudential standards will apply will certainly require a thoughtful and iterative analysis of each designated company over time. The Federal Reserve is committed to assessing the business model, capital structure, and risk profile of each designated company and tailoring the application of the enhanced standards to each company.

With respect to the third prong, resolution, the Dodd-Frank Act provides two important new regulatory tools, both of which extend to systemically important nonbank financial companies. First, each of the largest bank holding companies and each nonbank financial company designated by the Council is required to prepare and provide to the FDIC and the Federal Reserve a resolution plan or a living will for its rapid and orderly resolution under the U.S. Bankruptcy Code.

Second, Title II of the Dodd-Frank Act provides for an orderly resolution process to be administered by the FDIC.

Thank you very much for your attention. I would be pleased to answer any questions you may have.

[The prepared statement of Mr. Gibson can be found on page 66 of the appendix.]

Chairwoman CAPITO. Thank you.

Thank you both. I will begin with the questions.

As you are probably well aware, many different companies from various industries,—and both of you emphasized the tailoring of the designation procedure and the resolution procedure—some that have been mentioned as candidates for systemic designation, are concerned about a sort of one-size-fits-all, where let's say you are assessing a large insurance company on the same sort of criteria that you would judge a bank institution, and a nonbank institution the same.

You kind of mentioned this in your statement, but how will you deal with the differences in the industry business models? I will start with the Treasury.

Mr. AUER. Thank you, Madam Chairwoman.

The process that the Council developed in putting out its proposed rule for comment on three different occasions was to devise a three-stage framework. The first stage provides clarity and consistency by using uniform quantitative thresholds that are based on publicly available data, so that they could screen out the large number of firms that the Council is unlikely to consider for further evaluation.

It is very explicit in stages two and three that the Council plans to take an individualized look at each particular nonbank financial company under consideration, to look at all of its activities, all of its businesses, the types of business it is in, the type of activities it engages in, so that it can take into account the specific factors of that firm and of that industry in coming up with a final proposal for the Council.

Chairwoman CAPITO. Thank you.

Mr. Gibson?

Mr. GIBSON. We have made it clear in our proposal for enhanced financial standards that we do intend to tailor the standards to the characteristics of the companies that are designated by the Council. What we have proposed is a single set of standards that apply to both the bank holding companies and the nonbank companies, but we have said that once the firms are designated, we will consider tailoring the standards, and the Dodd-Frank Act explicitly gives us the authority to do that.

Now, we understand that there are some nonbank companies for which the bank-like standards that we proposed would likely be a bad fit and we have committed to looking at that when those companies are designated and doing what we can to tailor the standards. However, there are other companies that could be designated that are not that different from a bank, and for those companies, we would expect that the bank-like standards we have would require less tailoring.

Chairwoman CAPITO. Would the Federal Reserve be doing that particular exercise in terms of trying to tailor, let's say, if you are looking at enhanced capital or such, would that be done within the Federal Reserve or within the FSOC?

Mr. GIBSON. That would be done by the Federal Reserve.

Chairwoman CAPITO. Do you have the expertise to oversee all the different types of business models that you are probably looking at here, or am I making it more complicated than it is?

Mr. GIBSON. We have a lot of expertise across a range of activities.

Chairwoman CAPITO. Right. Financial activities, yes.

Mr. GIBSON. Bank holding companies engage in a lot of the activities that the nonbank companies are engaging in, so in a lot of cases, we feel like we would have sufficient expertise. But if there are cases where we need to bring in more expertise for nonbank companies that are designated, we would certainly do that.

Chairwoman CAPITO. I would assume that the designation just simply by the name obviously means that if one institution were to fail, that there would be systemic problems to other institutions, bank or nonbank. We obviously found that in 2008. Is that one of the main criteria to having the designation?

Mr. AUER. Yes. The statutory standard is that the Council should designate firms that could pose a threat to the financial stability of the United States. The Council in its rule and guidance has stated that a threat to the financial stability is where an impairment to financial remediation or financial activity could have a real effect on the real economy. So that is the standard on which a designation would ultimately be based.

Chairwoman CAPITO. Okay. One of the concerns I have is with the Orderly Liquidation Authority. You are probably aware that we tried to go with an enhanced bankruptcy look on this and failed and said the Orderly Liquidation Authority rests with the FDIC.

Again, I will go back to my original question. When you are looking at a nonbank entity, the FDIC obviously is more accustomed to working with banking entities. I want some confidence, and I know you probably can't make a judgment statement, but is the confidence there that the FDIC has the expertise, again, to make judgments when trying to unwind nonbank institutions? Is that a concern?

Mr. AUER. Madam Chairwoman, we, the Treasury Department and other FSOC members that will be involved in any Orderly Liquidation Authority have been working with the FDIC to understand what their approach will be to designating—I am sorry, to putting a firm in liquidation authority and how they would handle that. They have devoted significant resources to that process. But ultimately what resources and the details of their approach is a question you would have to pose to them.

Chairwoman CAPITO. All right. My time is up so I am going to go to Mrs. Maloney.

Thank you.

Mrs. MALONEY. Thank you.

I would like to ask Mr. Auer, I understand the criteria the Council has established by regulation and statute, but I would like more clarity on the exact metrics that will be used in designating nonbank financial companies as SIFIs. For example, how much interconnectedness makes a firm an SIFI? Could you elaborate in this area?

Mr. AUER. Certainly. Again, in the multiple rounds of public comment that we received, there was a desire that led to the development of a three-stage process. The first stage is based on publicly available data and easily calculable metrics in order to provide greater clarity to the public about the types of entities the Council is likely to want to examine further in stages two and three.

However, the Council is very clear that it wants to look in stages two and three on a firm-by-firm basis, and the rules and guidance layout a specific framework for it to do so. Interconnectedness is one of the elements that the Council will be looking at in stages two and stages three, but it is one of six broad categories of frameworks. The others are size, substitutability, leverage—

Mrs. MALONEY. How do you define interconnectedness?

Mr. AUER. After much analysis and work, the Council does not believe that there is a single metric or formula that can measure interconnectedness. The Council believes that rather than trying to have a one-size-fits-all measure of interconnectedness, interconnectedness is simply one of the measures that it must look at it when it looks at any particular firm, and different firms might be interconnected in different ways, which is why you can't have a formula for calculating that factor.

Again, the final determination of a firm for enhanced prudential standards for Federal Reserve supervision is if that firm can pose a threat to the financial stability of the United States, whether through interconnectedness, lack of substitutes or other factors.

Mrs. MALONEY. Thank you.

Mr. Gibson, will the Federal Reserve's prudential standards proposal for SIFIs be modified to adopt to the unique and distinct profile of nonbank SIFIs? Different businesses with different business models will require different regulatory standards, do you agree? And specifically, insurance companies are very different from banks. Private businesses are very different.

Mr. Gibson, could you elaborate on that?

Mr. GIBSON. We understand that different types of nonbank financial companies will have different characteristics and different business models that may make it necessary or desirable for us to tailor the enhanced prudential standards, and we have committed that we will do that when the companies are designated.

In terms of the proposed rule that we put out for comment in December, the comment period is still open. We have received many, many comments, including from many nonbank financial companies that were worried about the possibility of being designated, and we are currently in the process of weighing the comments. So I can't predict where the final rule will come out on that. But we have committed that after the companies are designated, we will take a look at the need for tailoring the standards.

Mrs. MALONEY. Okay. Mr. Auer, you said in your testimony you are going to be very transparent. So what are the plans to make the designation decisions transparent?

Mr. AUER. First, I should note that the Council was not required to issue any sort of rule around its nonbank designations process. However, in a desire to provide greater transparency and gain greater input from the public, it wouldn't actually—

Mrs. MALONEY. And what is the timing? When do you expect to make this public?

Mr. AUER. The rule and guidance were finalized in April and went into effect this month. The Council is now beginning its process for looking at calculating the stage one, which firms passed the stage one thresholds. It is collecting that data and making sure it is accurate. The Council will then move through stages two and three. As the Secretary has said publicly, at least he hopes that the Council will begin the first of its designations sometime this year.

Mrs. MALONEY. My time is almost over, but Mr. Gibson, what is the timing for the development of prudential standards for nonbanks, and do you need to know who they are before you develop these standards?

Mr. GIBSON. As to finishing our rulemaking on Sections 165 and 166—we have put the proposed rule out for comment. We have received a lot of comments. We are in the process of reviewing those comments, and we are working towards a final rule. But we will still have the possibility even after the final rule is done and once a specific nonbank company is designated to tailor our standards to that particular company.

Mrs. MALONEY. My time has expired.

Thank you.

Chairwoman CAPITO. I now recognize the chairman of the full Financial Services Committee, Chairman Bachus, for 5 minutes.

Chairman BACHUS. Thank you.

Mr. Gibson, I am reading Section 113—you have to read Section 113, I guess, in connection with Section 165, is that correct, in determining what is an SIFI and what is not?

Mr. AUER. Section 113 lays out the rules for designating firms, and Section 165 describes the standards that apply to the firms.

Chairman BACHUS. The standards that apply, right. It appears the prudential standards that are in Section 165, once you designate, are bankcentric, are they not?

Mr. GIBSON. Yes. The prudential standards in Sections 165 and 166 are bankcentric, and they are some of the traditional standards that we have had, such as capital liquidity, and the requirement is to enhance those standards, make them higher standards for systemically important firms.

Chairman BACHUS. I noticed when you read Section 113, which is really the section that determines whether something is designated, it says, "Nonfinancial activities of the companies shall not be subject to the supervision of the Board of Governors and prudential standards of the Board."

Would insurance activities be considered nonfinancial?

Mr. GIBSON. Insurance activities are considered financial.

Chairman BACHUS. They are. Okay. But the standards don't appear to apply to insurance. There is no discussion of reserves or policies. In fact, if you look at what you discuss in Section 113 and you talk about the extent and nature of—you talk about underserved low-income communities, their outreach there. Does there need to be a different set of standards developed for insurance companies?

Mr. GIBSON. The Federal Reserve currently in its role as bank holding company supervisor and savings and loan holding company supervisor already supervises some companies that have insurance operations, so we are already doing supervision and regulation of holding companies with insurance activities.

Chairman BACHUS. But would you agree that the standards are bankcentric, and these are not banks?

Mr. GIBSON. That is right. What we have done is in the existing cases of insurance companies that are supervised by the Federal Reserve because they have chosen to be bank holding companies or savings and loan holding companies, we have taken an approach that has applied some capital, the capital and leverage requirements to the holding company, but we do rely on the State functional regulators of the insurance companies which have traditionally focused on the risks and the individual legal entities that are insurance companies.

Chairman BACHUS. So you will consult with those State insurance regulators?

Mr. GIBSON. Yes, we already do work closely with them in the existing—

Chairman BACHUS. You will before a designation is made? For instance, you are trying to determine leverage or whether there is capital or enough cap reserves, and that would obviously—if you are talking about an insurance company, an important part of that would be their insurance policies.

Mr. GIBSON. The FSOC includes members who have insurance expertise.

Maybe I should let you respond, Mr. Auer?

Mr. AUER. Yes, the FSOC contains at least three members who are primarily focused on insurance expertise. And as the Council gets into stages two and three of looking at any particular firm, we do expect to be working with State insurance commissioners to ensure that we have a good understanding of the unique nature of those firms.

Chairman BACHUS. Is there any recognition by either of the two of you gentleman that these standards don't really appear to fit, say, asset managers or money markets or captive finance companies or insurance companies? You can look at them as a bank and tell what you are going to do, but they need a lot of work in nonbank financial companies.

Mr. GIBSON. Regarding some of the nonbank financial companies that you mentioned, such as asset management companies or captive finance companies, we would certainly have to look at the need to tailor the standards that are in the proposed rule to the specific characteristics of those companies. And as you point out, an asset management company is very different from a bank because the assets it manages are not on its own balance sheet; they are held in custody for customers. That is an important difference.

We have experience with asset management companies because there are large bank holding companies that are significant participants in asset management, but we don't have the experience of writing capital and other prudential standards for a company that only engages in asset management, and that is what we would need to tailor—if and when those companies are designated, we would tailor the standards.

Chairman BACHUS. But your original threshold is $50 billion, so that would capture—I know you said 50 or 60 companies, but wouldn't it be closer to 100 companies that could possibly be designated?

Mr. AUER. The stage one thresholds include a $50 billion consolidated assets test. As we say in the final rule and guidance, we expect that would capture less than 50 companies in total.

Chairman BACHUS. Okay.

Chairwoman CAPITO. The gentleman's time has expired.

Mr. Hinojosa for 5 minutes.

Mr. HINOJOSA. Thank you, Madam Chairwoman.

Most people agree that the lack of the regulation of the nonbank segments of the financial industry, such as the nonbank mortgage lenders and the derivatives market, was a very large contributor to the recent financial crisis. One of the cornerstones of the Wall Street Reform Act was to ensure that going forward, the regulators can reach any financial company whose failure or activities could threaten our whole system.

My question to Mr. Auer is, do you agree that the Wall Street Reform Act mechanism for designating nonbank financial companies for Fed supervision as implemented by the FSOC's recent final rule will help prevent future crises by ensuring that there is no place to hide from appropriate regulation?

Mr. AUER. Thank you, Congressman.

Yes, we view the authority to designate nonbank financial companies that could pose a threat to the financial stability of the United States as a key part of the Dodd-Frank reforms and an essential element to ensure that those types of firms that encounter distress and were at the heart of the last financial crisis can be better identified going forward and subject to heightened standards, better risk management, and capital and liquidity rules, so that they are less likely to get into distress in the future as well as being subject to an Orderly Liquidation Authority and a requirement to provide living wills that will describe how they can be wound down without government support in a bankruptcy without causing disruption to the rest of the financial system. We think this nonbank designation process is a key element of achieving those goals.

Mr. HINOJOSA. There has been, of course, a lot of effort made to go back to the old regulations. Do you think that this new regime for regulating significant nonbank financial companies will level the playing field between the banks and their nonbank competitors that provide comparable services?

Mr. AUER. I think the key goal and objectives of designating nonbank financial companies is if they pose a threat to the financial stability of the United States, regardless of their legal structure or business line. If a firm does pose such a threat, regardless of its activities, it ought to be designated and subject to heightened standards so that all firms that could pose such a threat are treated equally.

Mr. HINOJOSA. Mr. Gibson, I have heard repeated criticism from community banks I represent that Wall Street reform increased regulatory burdens on them, the community banks. Does anything in this regulation affect community banks directly? Do you think that the increased prudential standards on these larger, riskier companies could actually lead to an improved competitive atmosphere for our community banks?

Mr. GIBSON. The majority of Sections 165 and 166 does not apply to community banks. What we are doing is raising standards for bank holding companies that are $50 billion and above, which is far above the level of a traditional community bank. So any bank holding company that is above $50 billion in size would be subject to these higher standards.

You asked the question of whether that could give a competitive advantage to community banks. The potential is there for that to happen, because community banks will not be subject to the higher capital, liquidity, and the other standards to which the bank holding companies $50 billion and above or the nonbank companies will be subject.

Mr. HINOJOSA. I have seen that we have a small group of banks, then the medium-sized banks, and then the very large banks, the too-big-to-fail banks, and it seems to me that the medium-sized, those in the $12 billion, $13 billion in assets or larger, are coming together with community banks to come visit me in my office and together point out that these regulations are overreaching and that we should just throw them all out.

From listening to your answer, it seems to me that in most cases the Consumer Financial Protection Act exempts those community bankers, but that is not the perception that is out there. What can we do to clarify that?

Mr. GIBSON. I have encountered the same perception when I have talked to community bankers, and I think it is a fear based in part on what has happened in the past, that requirements which are imposed on the large banks eventually roll down and affect community banks as well. What we are trying to do as we implement the Dodd-Frank provisions is to make it clear, in both our rules and when we put out guidance, which parts apply to community banks and which parts do not apply to community banks. We have started to put statements at the beginning of both to say either this does not apply to community banks at all, or only these particular sections apply to community banks to try to counteract that perception.

Mr. HINOJOSA. Thank you for that explanation.

I yield back.

Chairwoman CAPITO. Thank you.

Mr. Renacci for 5 minutes.

Mr. RENACCI. Thank you, Madam Chairwoman, and I thank both of the witnesses for being here today.

As a business owner for the last 28 years before coming to Congress, one of the biggest challenges was not the regulation, but the certainty and predictability and timing of the regulation. And what I am hearing so far—I know when Ranking Member Maloney asked about timing, I really never thought I heard a good answer from either of you about timing, which is a problem for the business owner, but also the certainty and predictability. So those are things that concern me as we move down this path, not as much the regulations, but understanding where you are going.

Mr. Gibson, Title I of Dodd-Frank defines a nonbank financial company as a company that is predominantly engaged in financial activities. However, there has been some confusion over what it means to be engaged in financial activity. Doesn't this confusion need to be resolved before FSOC can start designating nonbank financial companies for supervision by the Federal Reserve?

Mr. GIBSON. The Federal Reserve has a proposed rule out for comment that would define the phrase in the Dodd-Frank Act as activities that are financial in nature, which defines the set of nonbank financial companies that could be designated.

We issued a proposed rule in February of 2011. We received a lot of comments on that proposed rule. In response to the comments, we issued a supplemental proposed rule in April of this year that clarifies certain aspects of that definition. But the FSOC has noted that they don't believe they have to wait until the Federal Reserve's rule is final to designate the companies.

Mr. RENACCI. So how did the Fed determine which activities are financial?

Mr. GIBSON. What we have defined as financial in nature are activities that are referenced in certain sections of the law that define what activities are permissible for a bank holding company. By referring to that section of the law, we are incorporating the existing definitions of what is a financial activity into this definition of nonbank financial company.

Mr. RENACCI. Are there really any limits then to what the Fed can determine as financial activities?

Mr. GIBSON. Yes.

Mr. RENACCI. Financial activities are widespread. You can almost go into any company and say they have financial activities.

Mr. GIBSON. Right. It is required that a certain percentage of your business has to be financial. Commercial companies that do a small amount of trade finance or the like would typically not be defined as financial if that is the only financial activity that they are doing. But the definition is designed to capture any company whose financial activity rises to a level that would put it into the category of posing a systemic risk.

Mr. RENACCI. So the answer really is any company with that particular—

Mr. GIBSON. There is a well-defined set of activities that are familiar to the legal community that deals with bank holding company regulation and what is permissible for a bank holding company, and they understand what these activities are. So, we are just trying to use the existing body of knowledge to say what is financial in this case. We are not trying to invent a new definition of what is a financial activity.

Mr. RENACCI. Are companies that are subject to a determination not entitled to an evidentiary hearing as part of the appeals hearing? And what recourse do they have if they are so designated?

Mr. AUER. So in the final rule and guidance that the Council published, the Council went above the statutory requirements in providing for opportunities for firms to challenge or present information about why they should or should not be designated.

Specifically, starting in stage three, a firm will be sent a notification that it is under consideration, and the firm would have the option to provide any material or arguments or information it wishes to the Council either in support or in opposition to its designation, and the Council will take those into account.

If the Council, after completing stage three, decides to vote for a proposed determination, the firm has the right to request a hearing in front of the Council to contest its proposed designation. If, after that hearing, the Council decides to vote in the affirmative for a final determination, the firm then has recourse to an appeal to the Federal court system.

Mr. RENACCI. Thank you.

I am running out of time, so I yield back.

Chairwoman CAPITO. Mr. Scott for 5 minutes.

Mr. SCOTT. Yes, thank you very much, Mr. Gibson and Mr. Auer.

Let me ask you this first question. Is the FSOC the only way to further regulate systemically important nonbanks, or have alternative methods been contemplated?

Mr. AUER. Some nonbank companies are already subject to some degree of regulation. Many insurance legal entities are subject to State insurance supervision, even if their holding companies are not. Hedge funds have to have certain reporting requirements, as do asset managers. So there are bits and pieces, elements in which nonbank financial companies may in some cases already be subject to supervision. But the rule in the Dodd-Frank Act that provides for the Council to identify those firms which are a threat to the financial stability of the United States is designed to ensure that those firms that could pose such a threat are subject to consolidated supervision and enhanced prudential standards.

Mr. SCOTT. Does it seem prudent to impose bank-like regulations on nonbanks?

Mr. GIBSON. In our proposed rule to implement Sections 165 and 166, it applies to both bank holding companies that are $50 billion and above and any nonbank companies that are designated by the Council. The standards that we have proposed are focused on the banks, but we have been given the authority in Dodd-Frank to tailor the standards to the characteristics of a nonbank company that is designated, and we have said that we will use that authorization to tailor the standards as appropriate.

Mr. SCOTT. Has is the FSOC conducted a thorough cost-benefit analysis on the designation of nonbanks as systemically important, specifically in regards to asset managers?

Mr. AUER. The FSOC member agencies are obviously very concerned about the costs and benefits of their actions. They want to bear in mind that this rule was not required in statute. The rule was designed to provide greater clarity about the purpose of the process by which the Council would engage in designations.

Mr. SCOTT. Let me just ask you also, have you all taken a look at or considered any adverse effects of the designation?

Mr. AUER. The effects of a designation are—

Mr. SCOTT. Adverse effects.

Mr. AUER. Right, well, there are certain effects that—for instance requirements for greater supervision, heightened capital standards, liquidity requirements—I don't think those are adverse effects. I think those are effects that are appropriate to a firm that could pose a threat to the financial stability of the United States.

Mr. SCOTT. Okay. And involved in this in an intricate way are indeed the asset managers. Now, asset managers do not invest with their own balance sheets. They invest on behalf of their clients. So when a client changes asset managers, it does not result in an immediate portfolio liquidation?

And the point that I am getting at is, where will this process end? If nonbank financials are designated systemic, will there be other nonbank industries that are systemic as well?

Mr. AUER. The Council's determination about whether a firm could pose a threat to financial stability and hence should be designated is going to be done, not on an industry-by-industry basis, but on a firm-by-firm basis.

So, the degree that an asset management firm largely has its activities in custody and on behalf of customers and, as a result, does not pose a threat to financial stability, it is unlikely to be designated. To the degree it engages in activities that could pose a threat to financial stability, then the Council would likely make such a designation, but that assessment will be done on a firm-by-firm basis.

Mr. SCOTT. And then, finally, will the FSOC evaluate business models, capital structures, and risk profiles as intended by Congress before pursuing designations?

Mr. AUER. As part of its designations, the Council will look at all of those factors you mentioned for each individual firm to see whether or not in total that firm could pose a threat to the financial stability of the United States.

Mr. SCOTT. Thank you very much, Madam Chairwoman.

Chairwoman CAPITO. Mr. Royce for 5 minutes.

Mr. ROYCE. Thank you, Madam Chairwoman.

I would like to ask a question of Mr. Auer just to get his feedback on a problem I see here that I don't think is going to go away, which is that the market is going to make a determination once these firms are designated systemically significant by you. And it is reflected in the credit rating agencies deciding already that the cost of borrowing, based upon their decision—they have shared with us that they believe that implicitly, there is a likelihood of government support. So the cost of borrowing is lower for these firms than their competitors.

And the consequences when you are in a situation like that, you can often gobble up your competitors, your smaller competitors especially. You can outperform them. Frankly, you can overleverage.

But you acquire your competition, and the competition shrinks in the market as a consequence of this reality.

Orderly liquidation authority was supposed to imply, I think at some point liquidation, but these firms will never fail. I just want to quote back to you the new head of the FDIC, Mr. Gruenberg's, recent comments, and get your reflection on this. He said, "Three of the goals of the OLA are to ensure financial stability, accountability, and viability, which means converting the failed firm into a new, well-capitalized and viable private sector entity."

Now, when the market hears that, they don't think that is a firm that he is going to fail. The implication here, and it may not be for the stockholders but certainly the creditors, is that if you loaned to that firm, there is a very good chance—that is, not to talk about death panels or what is going to happen to the firm. It sounds like the goal here is the same as it was in 2008, unfortunately. And although part of that goal is to stop the crisis from spreading, the other part is the nursing that insolvent firm back to health, essentially through either public dollars or new debt, which I think we can argue that it likely will be guaranteed by the government.

So the assumption here again is that these firms will be punished by the market by being designated as an SIFI. That is what we would like to believe is going to happen. But that does not seem to hold water, given the reaction by the market, given the reaction when we talked to the credit rating agencies about this, because the presumption is they are going to receive very favorable treatment by the agency tasked with unwinding it, by the FDIC.

Mr. Gruenberg's comments certainly would imply that, and I just wanted to get your take on that.

Mr. AUER. I can't speak for Mr. Gruenberg's comments, but I can say my understanding of the application of orderly liquidation authority is that when a firm is put into orderly liquidation, all of its equity holders would be wiped out, and its debt holders would be given haircuts or only paid back in part. The result is it will allow the new company that survives to be well-capitalized.

Mr. ROYCE. I understand that. But understand that the market arguably looks at that and says, that haircut is not the equivalent of what a haircut would be if they went through bankruptcy, and because they have now this potential pathy, we are going to evaluate that as an advantage for creditors. And it is implied through the decisions by the credit rating agency.

Last question: capital, capital, and more capital. Secretary Geithner said that, and it bears repeating. This is the only way to ensure that banks are going to be able to absorb unforeseen losses, and luckily, banks have been increasing the amount of cash on their books largely, I think, because of Basel III. And there were some that have been critical of the Fed and the international work being done by Basel as having the potential to harm economic growth. I hope that recent incidents put that argument at rest. I think that these requirements for more capital have been borne out here, and I would like your view on that.

Mr. AUER. One of the requirements of any firm that is designated on the basis that it may pose a threat to financial stability is enhanced prudential standards, including increased capital tailored to the risk that that firm poses.

Mr. GIBSON. I would certainly agree that the reforms to raise capital standards for the largest bank holding companies are an appropriate response to the crisis and are necessary.

Chairwoman CAPITO. Mr. Carney for 5 minutes.

Mr. CARNEY. Thank you, Madam Chairwoman.

Thank you for having this hearing today.

And thank you to the panelists for coming.

Mr. Auer, your written testimony provides I think a pretty clear walk-through for determination, but I would like to run through it and see if you could put a timetable and make sure that I understand.

So the first—as you said in your remarks—to cut is the stage one and just these quantitative measures that are listed on page 3 of your written testimony, the $50 billion, then $30 billion in gross notional credit default swaps, $3.5 billion derivatives, so on and so forth.

So you will look at all of these. When will that test—when will the process start?

Mr. AUER. The process has started. The final rule was published in April. It went into effect this month. So the Council, member agencies, and the Office of Financial Research are collecting data to assess which firms pass the stage one thresholds.

Mr. CARNEY. So you are in the stage one assessment process, determining which firms meet these criteria?

Mr. AUER. That is correct.

Mr. CARNEY. When you do that, will there be any notification to those firms? It is just not clear here. Will you just then go to stage two?

Mr. AUER. Then we go to stage two.

Mr. CARNEY. Explain that a little better, please. You mentioned quantitative—I guess additional quantitative measures and qualitative measures. What would they look like?

Mr. AUER. Stage two is designed around a six-factor framework for analysis. That are several factors that relate to sort of probability that a firm might get into distress, things like leverage, liquidity, existing regulatory scrutiny. There are also factors that indicate whether a firm might transmit that distress, including lack of substitutes, interconnectedness, and size.

The stage two process will look at all of those factors. It will take all publicly available data and any data already available to regulators and try to provide an in-depth and comprehensive analysis of how that firm might or might not pose a threat to financial stability.

Mr. CARNEY. So leading up to this stage three question—on page 5 of your written statement—which says whether the company's material financial distress or whether the nature, scope, size, scale, so on and so forth, could pose a threat to the U.S. financial stability. That is a judgment that is both subjective and objective. How would you characterize that judgment?

Mr. AUER. The Council used—in stage three, the firm will be notified that it is under consideration by the Council. The firm will have an opportunity to provide any arguments, information, or data that it feels would be useful to the Council in making its determination. The Council may also ask the firm—

Mr. CARNEY. Can I stop you there? So that after a two-thirds vote of the Council—

Mr. AUER. No.

Mr. CARNEY. So there is this process first, and then there is a two-thirds vote. And then there is an additional hearing and a process, and an additional vote if there is a hearing; correct?

Mr. AUER. That is correct.

Mr. CARNEY. It is a pretty involved kind of back-and-forth and certainly an adequate opportunity for the firm to question some of the conclusions that are made, but certainly a lot of opportunity for feedback.

Mr. AUER. There are multiple points at which a firm can engage with the Council and its member agencies about its designation.

Mr. CARNEY. So you get through this whole process, and you determine that here is a big firm which has a lot of this interconnectedness and meets all of these qualitative criteria and quantitative criteria and by a two-thirds vote is determined to pose a threat to the financial system. Do you expect that many of these nonbank firms will meet that type of criteria at the end of the day?

Mr. AUER. As we say in the final rule and guidance, we expect that less than 50 firms will pass the stage one thresholds. Stage one thresholds however are not meant to be definitive in any way. They are more of a screening device to identify those firms where the Council will spend more of its time and effort. I think it would be premature and inappropriate to speculate how many firms are designated before we have analyzed them.

Mr. CARNEY. Sure. Fair enough.

Thank you.

Chairwoman CAPITO. Mr. Hensarling for 5 minutes.

Mr. HENSARLING. Thank you, Madam Chairwoman.

Mr. Gibson, in your testimony you stated that the Dodd-Frank Act addresses the market perception that such firms are too-big-to-fail. It seems to be fairly well-documented that the larger investment banks still enjoy funding advantages over their smaller competitors, and since the passage of Dodd-Frank, we know that the big have gotten bigger and the small have gotten fewer. So I am curious about your observation of market perception.

Mr. GIBSON. It is certainly true that some market perceptions still exist, and as was mentioned previously by rating agencies and others, the market does not seem to be fully convinced that the tools given under Dodd-Frank will be used. I think we, the regulators, still have a ways to go to prove to the market that we will use those tools in a way—

Mr. HENSARLING. So you posit that the Act addresses market perception, it is just the market doesn't understand it? Is that what you are trying to tell me?

Mr. GIBSON. I think the market is skeptical that the regulators will have the means and the will to use the tools, and they are waiting to see.

Mr. HENSARLING. Count me as part of the market.

The other question I have, and I think the gentleman from Ohio, Mr. Renacci, asked a somewhat similar question, but when we are looking at potentially designating nonbank SIFIs, and if we are looking at the first part test of the financial activities, a company that the market may not perceive to be financial, if they, for example, import some type of raw material from overseas, they have to manage potentially currency risk, commodity risk, interest rate risk, operational and shipping risk, and I thank the Chamber for their upcoming testimony and helping to elucidate this question.

But if these activities are found to be financial in nature, if this helps trigger the threshold test, isn't it possible that some firms, nonbank financial firms or nonbank firms that wish to avoid an SIFI designation, may indeed decide not to hedge certain risk, in which case have we not perhaps concentrated more risk where we don't want it and maybe they will go naked on these positions?

Has that been considered?

Mr. Gibson, I will go to your rule.

Mr. GIBSON. The Federal Reserve has a proposed rule out for comment on the definition of what are financial activities that would make a firm potentially subject to designation. It has to be predominantly financial, a very high percentage financial.

Mr. HENSARLING. Are the activities that I just described financial or does it depend upon the motives? Does it depend upon the underlying business entity? What does it depend on?

Mr. GIBSON. It depends on the particular activities as they are defined in the current bank holding companies for what are permissible activities for bank holding companies. Some of those same definitions are being used for the definition of financial activities, but it is a very high threshold. So a commercial company that does a small amount of financial activities, hedging or financing, typically would not be deemed predominantly financial. But of course, it depends on the facts and circumstances of a particular company.

Mr. HENSARLING. But also included in FSOC's rules, once you outline the criteria by which one is adjudged in stage one to be a nonbank SIFI to go to stage two, isn't your last criteria essentially, we can ignore all of our other criteria and still decide to send a potential firm to stage two? I am trying to figure out, if you are trying to add some clarity to the definition, you seemingly take—whatever you provide with one hand, you take away with another. Where is the clarity here?

Mr. AUER. Let me make one point. In order for a firm to be designated and determined to be a nonbank financial company, at least 85 percent of its assets or 85 percent of its revenues in nature. So that should be very effective in limiting the types of firms that are merely engaging in some hedging activities of their commercial business. Such firms would be unlikely to trip the 85 percent threshold.

The Council, in designing the stage one thresholds, want to provide clarity about the types of firms that it was likely to focus on and for further evaluation and to give some clarity about its thinking in that regard and to act as an initial screen. However, the Council is reluctant to put itself in a position where a very risky firm, that through whatever gaming techniques was able to avoid the stage one thresholds—

Mr. HENSARLING. I see my time has expired. If I could, as I read the guidance provided from FSOC, it says, "FSOC may advance a nonbank company to stage two irrespective of whether such company makes the threshold in stage one." Again, I see no clarity here.

I yield back.

Chairwoman CAPITO. Mr. Green for 5 minutes.

Mr. GREEN. Thank you, Madam Chairwoman.

I thank you and the ranking member again.

Let's start with SIFI. To a good many members of the public, SIFI is "SciFi." It really is. And perhaps we can find a way to explain this in a much more intelligible fashion for persons who are not privy to much of the intelligence that you two fine witnesses are sharing with us. So let's start with a very basic question: Was AIG a nonbank financial institution?

Mr. Gibson?

Mr. GIBSON. Yes.

Mr. GREEN. Thank you. I tend to ask questions that you can answer yes or no.

Was AIG into many different kinds of products, exotic products, if you will, credit default swaps, derivatives? Was AIG into what we now refer to as exotic products, Mr. Gibson.

Mr. GIBSON. With the caveat that the Federal Reserve was not the supervisor of AIG, I am pretty sure the answer to your question is yes.

Mr. GREEN. I understand the Federal Reserve was not, and I am not going there. But I am going here: Was AIG the type of institution that FSOC would be designed to have an impact on?

Do you want to pass, Mr. Gibson? I am still with you.

Mr. GIBSON. I would say that looking at the quantitative screens in stage one of the FSOC's process, AIG would trip many or all of those.

Mr. GREEN. Of course, it would. It was over $50 billion, wasn't it?

Mr. GIBSON. Yes.

Mr. GREEN. Go on, elaborate. Tell us the reasons why AIG would come under the auspices of FSOC

Mr. GIBSON. Under the FSOC's rule, the characteristics that make up systemic importance, which have already been listed, some of the most important ones are the size of the company and the interconnectedness of the company.

And what we learned about AIG after its near failure was that its size was of an extent that was seen to pose a systemic failure, and its interconnectedness with other large financial firms was also substantial.

Mr. GREEN. Who knew that AIG was part of the glue that was holding the company together?

Mr. Auer, it was discovered after the fact that AIG was part of the glue holding the economic order together, true?

Mr. AUER. I think AIG was intimately involved in and highly interconnected with a great number of financial firms.

Mr. GREEN. And that would be your way of saying yes?

Mr. AUER. Thank you.

Now, given that we know that there are other AIG's, not in the sense that they are right now about to go out of business, but there are other big businesses that may pose systemic risk. They may become SIFIs and because we know that they may become or maybe they are SIFIs, is this not a means by which we can deal with them without making an attempt to prevent them from making bad business decisions?

Here is what I am saying: We can't stop businesses from making bad business decisions. My belief is that happens and that is a part of the ebb and flow of doing business. But we can deal with the consequences of bad decisions. Is that what we are attempting to do here, Mr. Gibson, to deal with the consequences of bad decisions by these mega businesses?

Mr. GIBSON. Yes, and one of the enhanced prudential standards that nonbank companies which are designated by the Council will be subject to are enhanced capital requirements that will make sure that a buffer exists to cover unexpected losses such as the type you are describing.

Mr. GREEN. And for edification purposes, those who would like to, go back to the stock market crash and read about how the resistance took place when we were trying to put the FDIC in place. And FDIC has proven to be very beneficial when we are looking for an orderly means by which we can liquidate banks.

True, Mr. Gibson?

Mr. GIBSON. Yes—

Mr. GREEN. Are we trying to do the same thing now with nonbank institutions?

Mr. GIBSON. The intention of the Title II Orderly Liquidation Authority is to extend what the FDIC currently has for banks to nonbanks.

Mr. GREEN. I would simply close with this: We can do this and not overregulate. And I think that is what we are trying to accomplish today.

Do you agree we can do this and not overregulate, Mr. Gibson?

Mr. GIBSON. That is what we are trying to do.

Mr. GREEN. Mr. Auer?

Mr. AUER. I would agree.

Mr. GREEN. Thank you very much.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Mr. Luetkemeyer?

Mr. LUETKEMEYER. I have a question with regards to FSOC. Coming from the small bank, community bank perspective, some of the things that have come down obviously do not affect them. But there are a lot of rules in Dodd-Frank that do. Is FSOC going to go through and look at some of the rules? I believe that Dodd-Frank was sort of a shotgun approach. Are we going to go back and take some of the pellets out the bullets so we can go back to a rifle approach and make sure that the rules are specific to the larger institutions and take some of those back off the smaller institutions and nonbank-lending folks?

Mr. AUER. The FSOC regularly discusses existing and upcoming regulations that are part of Dodd-Frank, and I expect it will continue to do so and try to encourage cooperation and consistency across the agencies as they develop the rulemaking process, and that helps ensure that any rules and regulations that are promulgated are handled appropriately.

Mr. LUETKEMEYER. But they are not going to go back and take some of them back out or make them streamlined or more appropriate to just the bigger folks, who are the problem areas here, and alleviate the smaller folks?

Mr. AUER. The FSOC itself is not a regulatory agency—

Mr. LUETKEMEYER. But they can surely provide some guidance, could they not?

Mr. AUER. Many of its members are regulatory entities and you discussed their upcoming regulations with other Council members. I don't know what those agencies' plans are for their previously issued—

Mr. LUETKEMEYER. With regard to the rules that are promulgated, is there a cost-benefit analysis done on any of those rules?

Mr. AUER. On which rules?

Mr. LUETKEMEYER. On the FSOC rules.

Mr. AUER. The FSOC has issued at least two rules that I am aware of today. One is the rule we are discussing, which was published in April. That is a rule which does not directly impose any restrictions.

Mr. LUETKEMEYER. My time is limited. Can you give me a yes or no?

Mr. AUER. There is no need to do a cost-benefit analysis.

Mr. LUETKEMEYER. What enforcement mechanisms are in place?

Mr. AUER. To enforce what?

Mr. LUETKEMEYER. The rules.

Mr. AUER. This rule does not, as I said, put in place any restrictions or limitations on firms. What it does is it helps explain the Council's process by which it will identify nonbank financial companies that can pose a threat to financial stability.

Mr. LUETKEMEYER. We leave that to the regulators then to enforce?

Mr. AUER. Yes, the regulators—

Mr. LUETKEMEYER. As a regulator, what is your enforcement mechanism?

Mr. GIBSON. We will have the same enforcement tools for enforcing the enhanced prudential standards on any nonbank companies that are designated that we currently have.

Mr. LUETKEMEYER. Which are what?

Mr. GIBSON. Which are our supervisory tools, examinations.

Mr. LUETKEMEYER. Which are? What is your enforcement? If they are bad actors, and they do something wrong, what are you going to do?

Mr. GIBSON. We can impose on them written agreements, memoranda of understandings, civil money penalties, the full range of tools we currently have with bank holding companies.

Mr. LUETKEMEYER. Okay. Whenever you designate someone as an SIFI, is this going to be public knowledge, or is this going to be just something that is internal between your agencies and the individual company?

Mr. AUER. The final designation of any particular firm is, for Federal Reserve supervision and enhanced prudential standards, would be a public event.

Mr. LUETKEMEYER. One of the things that I, quite frankly, like about the Dodd-Frank Act is the living will that these agencies—not agencies but entities—are going to have to put together. Can you describe to me some of the tenants that would be in a living will that would be important to you to see that were in there and how it would operate?

Mr. AUER. The living will requires that the company describe how it could be resolved under the Bankruptcy Code. So for companies that are very complicated, the living will needs to have a description of how different legal entities within the company interact with one another, so that if different legal entities are subject to different bankruptcy procedures or different regulatory procedures, exposures of one entity aren't so tied in with another that it just creates an intractable situation.

By having that information in advance, and especially by requiring the companies to produce that information and understand what those impediments to resolution could be, we can then use our supervisory process to push the companies to reduce the impediments to resolution and make them more resolvable.

Mr. LUETKEMEYER. What you are saying is a living will basically lays out the connectivity of all of the things that are going on within that company?

Mr. AUER. That is one of the important aspects of it, yes.

Mr. LUETKEMEYER. I see my time has expired.

Thank you, Madam Chairwoman.

Mr. Miller for 5 minutes.

Mr. MILLER OF NORTH CAROLINA. My questions are about the losses in Chase's synthetic credit portfolio, and I don't claim to understand that entirely. The details have been sort of sketchy, but it also appears that nobody at Chase really understood it, either. So that makes me feel a little better.

There has been some criticism by defenders of the banks that the critics of the banks are taking too much pleasure over the loss, are gloating over the loss. I don't think I have been gloating. But it is also hard to see this as something to grieve over. Because it is not like a factory, a $2 billion factory burned down that was making something useful and giving jobs to people who want to make an honest living. It has just sort of shifted $2 billion. It was Chase's $2 billion, around to probably some hedge funds.

So it really appears that the only thing to worry in all of that is the effect that it might have on the soundness of any given banks engaged in these kinds of transactions, or especially to the system as a whole, whether it creates a systemic risk.

I am wondering how on Earth we even have a fighting chance to figure that out. Ina Drew, the chief investment officer of Chase, who has now resigned, was making $14 million last year. And she apparently did not understand these transactions, and we are supposed to send in some examiners on government salaries, and they are supposed to figure out what kind of risks are involved in these transactions.

It would be easier for an examiner to say or to think, this kind of looks like it creates a risk, but it is a $2.3 trillion bank. Even if they lose money on this, they are probably making it somewhere else. They will be okay, which is the exactly the kind of attitude or the kind of thinking that can lead to a great risk for an institution that size if every division is taking risks like that.

What sense does it make to create banks this big, and they are actually even bigger now than they were before the crisis? Why do need to combine what appear to be just entirely discrete business all within one huge $2.3 trillion bank that will be impossible to regulate, to examine, that will be impossible for the market to discipline? Why not have smaller banks so that if we can't figure out what risks they have and a risk pulls them down, it won't create quite the same effect on the entire economy, and even if—and it should be possible to figure out more what their business is if it is smaller. So why not have smaller banks?

Mr. GIBSON. Under the Dodd-Frank Act, in particular Section 165 on enhanced prudential standards that we have been talking about today, the Dodd-Frank Act asks the Federal Reserve to apply—

Mr. MILLER OF NORTH CAROLINA. Part of my question is, does the Dodd-Frank Act go far enough? Or should we have done more to take apart the big banks? I know the Kanjorski amendment allows for breaking up banks based on a very high standard of risk, but should they just be smaller?

Mr. GIBSON. What we will be doing as we implement Dodd-Frank is to impose higher capital and other standards on the largest banks, and we will be doing that in a graduated way that imposes the highest capital standards, for example, on the largest banks and less stringent capital standards on the smaller banks. So it will have the effect of tilting the incentives away from becoming large simply for the sake of becoming large because the largest banks will be subject to the capital surcharge eventually once the Basel surcharge is implemented in the United States.

Whether that will work or not, I think, remains to be seen. We still have a lot of work to do to implement that, but for now, it is an approach that is going in the direction of putting higher requirements, stiffer requirements on the very largest companies and less stiff requirements on smaller companies.

And that is what we are implementing now.

Mr. MILLER OF NORTH CAROLINA. Why have apparently entirely discrete lines of business consolidated into one firm? There appear to be no economies of scale, no economies of scope. There appears to be no particular reason to do it, and it creates conflicts of interest. Why not have servicing units be—why do they have to be an affiliate of a bank that holds second mortgages on the same homes that they are servicing?

Mr. GIBSON. The approach we are taking by having larger capital standards on the largest banks will naturally create an incentive if an activity can be done outside of a big mega bank, to be done with a lower capital requirement, presumably more cost-effectively. So we are providing an incentive where there is not a synergy that creates a benefit that would then be passed along to the customers, then with those activities, logically, there would be an incentive to move them out of the largest banks.

Chairwoman CAPITO. Mr. McHenry?

Mr. MCHENRY. Thank you, Madam Chairwoman.

Mr. Auer, in designating nonbank SIFIs, how much weight will the FSOC give to companies that have existing regulators? Perhaps you have an international nonbank financial institution, and in their home country, they have supervisory authority that is very clear. Would the Fed be—would it be likely that the Fed would be designated or less likely?

Mr. AUER. Both in the 10 statutory or 11 statutory considerations as well as in the framework that the Council lays out in its rule and guidance for doing it in stages two and three, the Council does plan to take into account existing regulatory scrutiny, whether that scrutiny is domestic or foreign. Whether it is at the consolidated level or at a legal entity level, the quality and extent of that regulation will all be factors that would lead into the Council's ultimate determination about whether or not that firm poses a threat to our ultimate responsibility.

Mr. MCHENRY. Mr. Gibson, you said earlier that the Fed has the authority to "tailor standards as appropriate to nonfinancial companies." Isn't this uncharted territory for the Fed?

Mr. GIBSON. We have the authority to tailor the standards for nonbank financial companies. Commercial companies would not be subject to the FSOC designation, but nonbank financial companies would. And we have experience with different types of nonbank activities in which bank holding companies and financial holding companies already engage. There are bank holding companies and financial holding companies that own insurance companies, that own asset management companies and a variety of other nonbank companies. We will use that experience that we have and, if necessary, bring in more experience so that we are able to do a good job of supervising nonbank companies that are designated.

Mr. MCHENRY. Will you be consulting with the Federal Insurance Office?

Mr. GIBSON. We are already consulting with the Federal Insurance Office on our existing supervision of bank holding companies and financial holding companies that have insurance operations, so yes.

Mr. MCHENRY. Moving on to another issue, it is my understanding that the counterparty limits the Fed currently has put forward is a pretty significant shift in how financial institutions manage their risk. I appreciate the challenge of managing interconnectedness in the financial system. But what I am concerned about is whether the Fed is putting the cart before the horse in that there is not sufficient analysis that we have seen in the public sphere on the impact that this proposal would have on banks, on clearinghouses, on foreign sovereigns, and on the rest of the financial system.

Is there significant data within the Federal Reserve on measuring that?

Mr. GIBSON. We put out our proposal for Section 165 in December, and the comment period recently closed. One of the things we asked for comment on was exactly the question of what would the impact of the single counterparty credit level be, in terms of how constraining would it be for the banking organization's $50 billion and above. We have received a lot of comments from the public on that aspect of the proposal, and those comments do include some information about the impact, and we have done our own analysis through our supervisory process as well. And we will be using all that data as we move forward toward that final rule.

Mr. MCHENRY. Have you done a cost-benefit analysis on the proposal?

Mr. GIBSON. We look at the costs and benefits of every rule that we put out. On this particular proposal, we are still gathering information on the particular counterparty credit limits that were proposed, and the alternatives that were suggested by the commenters as well.

Mr. MCHENRY. Okay. Have you done any analysis on the current levels of exposure?

Mr. GIBSON. Yes.

Mr. MCHENRY. Would you be willing to share that data with us?

Mr. GIBSON. In the proper way that doesn't require me to talk about confidential supervisory information, I would be happy to provide more information, including the information we have gathered and the information that companies have submitted to us through the public comment letters which are available to you. Companies have also submitted confidential information to us through the supervisory process, which they intend for us to use as we move forward towards a final rule and have the best information available. So, we have all of that information.

Mr. MCHENRY. What information will be made public? That is sort of my question.

Mr. GIBSON. I can't predict how we are going to move forward toward the final rule, but when we do the final rule, we will certainly come out with a discussion of how we weighed the comments that we received and what judgments we made based on those comments to move from the proposed rule to the final rule

Chairwoman CAPITO. Mr. Canseco?

Mr. CANSECO. Thank you, Madam Chairwoman.

Good morning, Mr. Auer. I noticed that at the first February 1st FSOC meeting, you updated the Council on comments that had been received regarding the second notice of proposed rulemaking. The meeting that day was gaveled in at 1 p.m., and was concluded at 3:13 p.m., and your presentation was one of 5 or 6 items on that day.

I am not certain how long the Council discussed your presentation or what questions were asked, but I assume it couldn't have been more than 20 or 30 seconds. Could you shed some light for us on what was discussed that day and some concerns that were raised by the Council members?

Mr. AUER. The discussions at that particular Council meeting were not the first time that the nonbank designation rule had been discussed by the Council. The Council actually put out an advanced notice of proposed rulemaking, a first notice of rulemaking, and a second notice of proposed rulemaking. In all three cases, we received comments, and in all three cases, the Council discussed those comments, how the next iteration of the rule would incorporate and respond to those comments, so that there was a thorough conversation at each point in the process about how the final rule responded to the comments from the public.

Mr. CANSECO. Did you discuss the comments that you received?

Mr. AUER. Yes.

Mr. CANSECO. And were those comments and those comment letters discussed at that time?

Mr. AUER. Yes.

Mr. CANSECO. And what were some of the dissensions?

Mr. AUER. I don't know that there was any dissension. There was discussion among the principals about how—and questions about how the rule addressed the comments and what changes were necessary at various points to address the comments and how those were reflected in the final rule.

Mr. CANSECO. So everybody was on the same page?

Mr. AUER. All Council members asked a lot of questions, but the ultimate vote, I believe, if I recall correctly, was unanimous in supporting the publication of the rule and guidance.

Mr. CANSECO. The final rule was approved 2 months later, so can you shed some light on specifically how comments were incorporated into the final rule, or were they not incorporated into the final rule?

Mr. AUER. Many comments were not incorporated into the final rule throughout the process. The entire three-stage process that is enshrined in the rule is a result of comments received over the course of the rulemaking process, so that the very structure of the rule in fact is built around comments from industry. The comments drove other changes to the rule and amendments to the rule, for instance, the desire that many firms had that they be given some advanced notice that they were under consideration, which is what led to the stage three notification. I think that is an excellent example. There were other answers about ensuring the confidentiality of information that is provided to firms, information with regard to the Council, so we elaborated on that. So I think every serious comment that came in was addressed in one or another.

Mr. CANSECO. Were they incorporated, or were they thrown out?

Mr. AUER. Depending on the comment, I think the rules addressed every comment. Certainly, the preamble to the final rule described all significant comments and described whether that comment was adopted wholesale, adopted in a way that was adjusted, or deemed not relevant.

Mr. CANSECO. Thank you.

Mr. Gibson, in the final rule that was issued in April, it was noted that the Fed has authority to issue regulations for determining if a company is predominantly engaged in financial activities and has issued a proposed rule under this authority. So if I am interpreting it correctly, if I say that the FSOC has moved forward with a final rule on SIFI designations before the Fed has determined the definition of financial activities, who is engaging in that? Has it done that?

Mr. GIBSON. We have a proposed rule which has not been made final yet on the definition of "financial" as it applies to the nonbank regulation.

Mr. CANSECO. If that is the case, then when does the Fed expect to finalize this rule, and shouldn't it have been done before the final SIFI designation?

Mr. GIBSON. I don't think there is any legal requirement that it be done before the final FSOC rule, and indeed, the FSOC had said—

Mr. CANSECO. I am not asking about legal requirements. I am just specifically asking because it seems to me, it is putting the cart before the horse. And that is a very common occurrence these days.

Mr. GIBSON. I think the rule that defines what it means to be activities that are financial in nature will be relevant for companies where there is some uncertainty about whether they are financial enough. And I think, as we have mentioned, the cutoff is 85 percent financial. So there are undoubtedly some companies out there that are kind of on the boundary and are not sure. But I think there are a lot of companies that are clearly financial and where exactly the boundary is drawn is not going to affect whether they are determined to be financial or not.

Chairwoman CAPITO. Mr. Manzullo?

Mr. MANZULLO. Thank you, Madam Chairwoman, for calling this hearing.

I have problems with the fact that the proposed regulations sweep insurance companies into the same area as bank holding companies. What is unfortunate about the inability to have all of the witnesses on one panel is the fact that if you take a look at the testimony of MetLife—which will occur shortly when William Wheeler testifies—it discusses the fact that the asset and liability structures of banks are much different than insurance companies. Insurance companies are in for the long haul, very solid fixed-income, stable investments. Banks borrow money short term and then put it into long term, it could put them in a position where you would have a risk taking place. Would you agree with that?

Mr. AUER. Yes.

Mr. MANZULLO. That being the case, if MetLife failed, of all the questions to ask is this, if MetLife failed, would the failure of the company threaten the stability of the United States? We agree the answer is no, we cannot think of a single firm that would be brought down by its exposure to MetLife. Would you agree with that statement?

Mr. GIBSON. MetLife has been supervised by the Federal Reserve because it is a bank holding company.

Mr. MANZULLO. They are getting rid of their bank holding company.

Mr. GIBSON. Once they get rid of the bank holding company, they will no longer be supervised under the Federal Reserve.

Mr. MANZULLO. Would they come under the new regulations?

Mr. AUER. MetLife is now a nonbank financial company. I am fairly certain that more than 85 percent of its assets or revenues are financial in nature. So it would be eligible to be designated by the Council, but that does not mean the Council would choose to do so.

Mr. MANZULLO. I think it is the largest insurance company. If they are eligible, and then you say we are not going to regulate, then no insurance company would be regulated. Is that correct?

Mr. AUER. I don't think the Council has done an analysis—I know the Council has not done—

Mr. MANZULLO. This is a pretty easy question.

Mr. AUER. I don't know whether the Council plans to designate MetLife or not—

Mr. MANZULLO. Because that is not your decision.

Mr. AUER. It is not our decision.

Mr. MANZULLO. The reason I bring that up is the fact that if you take a large company like MetLife and you treat them like a bank holding company, are you gaining anything? Is anybody safer?

Mr. GIBSON. The difference in the regulation and supervision that the Federal Reserve has been engaged in with MetLife and other large insurance companies that chose to become bank holding companies is that we are a consolidated bank—

Mr. MANZULLO. Remember, they are shedding their bank holding company. They will be just an insurance company.

Mr. GIBSON. If you are talking about after they shed the bank holding company, then it will be completely up to the FSOC to decide if they should be regulated as a—

Mr. MANZULLO. What do you think? They propose no systemic risk.

Mr. GIBSON. Also, it is up to the FSOC to make the judgment—

Mr. MANZULLO. I understand that, but the reason for this hearing is the dragnet that we see taking place here. You are imposing standards—no, you are creating standards, and yet you don't know to whom they will apply. And then when we show—and I am not being critical—but when it is shown that a company like MetLife after it sheds its bank holding company would produce no systemic risk, then it follows they should not be regulated under this new regulation.

Mr. AUER. If the Council does decide to assess MetLife and it comes to the conclusion that MetLife does not pose a threat financial stability—

Mr. MANZULLO. But no insurance companies—three insurance companies got TARP funds. AIG—maybe two didn't need it. AIG got it, but that is because, even the insurance—under Illinois rules, they were walled off. Those assets were walled off because of Illinois liquidity requirements—I am sorry, reserve requirements.

So what I am just suggesting to you is that I don't see the need to drag the insurance companies into this particular rule when in fact they did not present a systemic risk in the event that—in the terms of MetLife, we cannot think of a single firm that would be brought down because of its exposure to MetLife.

You don't have to answer that question.

I yield back.

Chairwoman CAPITO. Thank you.

Mr. Grimm for 5 minutes.

Mr. GRIMM. Thank you, Madam Chairwoman.

And I thank the witnesses for being here today.

It is interesting, I will tell you that.

I think Mr. Manzullo's questions hit to the heart of why everyone is so confused. The amount of uncertainty has risen to an all-time high, and it is getting worse.

The gentleman from North Carolina asked before why we don't have more small banks. That should be obvious to everyone in the room because smaller banks can't compete—they can't keep up with the administrative costs of all of the rules and regulations. And I would purport to you that as we continue to add on, in the hopes of getting rid of systemic risk, you are going to be left with only a few large institutions that can afford to keep up, therefore making them systemically risky. But maybe I have it backwards. I don't know. Maybe I am missing something.

Let's talk a little bit about asset managers for a second. With regard to asset managers, has the Council considered the possible adverse effects of a designation for asset managers?

Mr. AUER. The Council, in its proposed rule and guidance, describes how it is going to go about assessing whether or not a firm poses a threat to the financial stability of the United States. The consequences of being designated are that a firm will be subject to enhanced capital requirements—I am sorry, the consequences of being designated will be the firm would be subject to enhanced prudential standards, including capital requirements, liquidity and requirement for living wills, among others.

Mr. GRIMM. Is that a yes?

Mr. AUER. The Council is aware of what the consequences of being designated an asset management firm are, yes.

Mr. GRIMM. So you have considered the adverse effects?

Mr. AUER. I am not sure what you mean by adverse effects.

Mr. GRIMM. Let me ask you this: Have asset managers been involved in the OFR study to date?

Mr. AUER. The OFR is engaging in an analysis of the extent to which there are potential threats to financial stability from asset management firms. The OFR has begun the process of talking with people in the asset management industry and will continue to do so. The OFR, the Council and its member agencies welcome any comments or—

Mr. GRIMM. Is there a formal process for conducting the due diligence for asset managers?

Mr. AUER. Any asset management firm or other entity that wants to meet with the Council staff or member agency staff about the designations process is welcome to contact any Council member agency or the OFR, and we will try to set up meetings for that firm.

Mr. GRIMM. What I am concerned with is, is the FSOC evaluating the substitutability of asset managers? Asset managers, they don't invest in their own balance sheets. They are investing on behalf of clients. So when a client changes an asset manager, that doesn't mean that the portfolio is immediately liquidated. So I just hope that the FSOC is looking at that and that there certainly would be adverse effects, and I wish they would certainly consider that.

Following up, before, we heard a little bit about the transparency. I have been hearing, and correct me if I am wrong, but I am hearing that it has not been a transparent process. I am hearing that the FSOC is almost working in a black box, so-to-speak. And I just want to know—let's take an example to make it easy. When a nonbank entity is put into designated stage three, it seems that there is no explanation why. Can you elaborate on that?

Mr. AUER. If any firm makes it, any particular firm makes it to stage three, that firm will be provided a notification that it is in stage three. That begins the process of having a discussion with the firm. The firm has the opportunity to provide comments, arguments, and data to the FSOC and its member agencies about why it should or should not be designated—

Mr. GRIMM. Let me just stop you there for a second, if I may. So a company may have to disclose this information, that they have been put in stage three, but all they have is a notification with no explanation. Do you see how that could be an untenable situation for these companies?

Mr. AUER. I think that the desire to create a stage three was put specifically at the request of companies in the comments that we received on the various stages of developing the rule where they wanted an advance notice of whether or not they would be under consideration. While the exact composition of what will be in that notice is yet to be determined, the Council can't, before finishing its analysis, provide a firm with all of the reasons that it thinks the firm may or may not be designated. That would prejudge the outcome.

Mr. GRIMM. The cart before the horse seems to be the theme of the day. Thank you so much.

I yield back.

Mr. RENACCI [presiding]. Mr. Garrett for 5 minutes.

Mr. GARRETT. I thank the Chair, and I thank the gentlemen on the panel.

So the Fed, Mr. Gibson, as has already been discussed, has proposed a rule to define "financial activity" for the definitions purposes of Dodd-Frank, but it would appear that a few additional lists of financial activities that are different from what Dodd-Frank had intended and from those activities as it is defined under bank holding companies are now included. In other words, Dodd-Frank clearly says that the Fed has the authority to define the criteria for falling into this category, but it doesn't give the Fed the option to redefine terms that are already set forth in Dodd-Frank.

So I guess my opening question is, why do you think the Fed has this authority to go beyond what Dodd-Frank is explicitly setting forth as far as defining terms?

Mr. GIBSON. I am not aware of any ways that the proposed rule is going beyond or trying to redefine terms. I think the proposed rule, which has been reproposed now for a second time, is responding to the comments we received in response to the first proposal with some suggested changes, and in order to incorporate those, we put out a second proposal.

Mr. GARRETT. Let me just give you an example. And I know how this all came down with regard to Dodd-Frank. Normally, during a thoughtful and deliberative piece of legislation, I think the Fed would be responsive to what that legislation is. I am not sure whether we are talking about the same thing. We are not talking about Dodd-Frank as being thoughtful and deliberative. But I know there was concern by the various industries, when there was talk about the Fed being able to designate nonbank financial institutions, that it might be overly broad going forward, so a specific amendment was adopted into the law. And what it says was to define this area was, "predominantly engaged in financial activities" defined under existing law, Section 4(k) of the Bank Holding Act.

But now, the Fed has gone beyond that, because here in Dodd-Frank it describes specifically, "predominately engaged in financial activities is described as Section 102(a)(6) to mean a company that derives 85 percent or more of its revenue or assets from activities that are financial in nature as defined in Section 4(k) of the Bank Holding Act of 1956. Section 102(b) further provides the Board of Governors shall establish by regulation the requirements for determining if a company is predominantly engaged in those sections, again," as defined in Section (a)(6).

It seems as though it is laying out there pretty clearly in the statute that financial activities are already defined in (a)(6). So it makes sense that the list of activities for financial companies, bank holding companies and the like, would be the same for nonbank holding companies. And yet, that is not what is occurring here. So that is why I make the supposition that the Fed is going beyond what is clearly set forth was part of that deliberation of Congress in that amendment to try to make sure that it would be limited to this area.

Mr. GIBSON. We have the reproposal out for comment. The comment period ends on May 25th. Part of the reproposal in April included a list of the activities that would be considered to be financial activities because we were requested, and to be responsive to that, to provide additional clarity on activities that are financial in nature for the purpose of determining whether a company is predominantly financial or not. So we are trying to be responsive to the request for more clarity, and we are open to the comments we receive and will use those comments as we go along.

Mr. GARRETT. Is that list then potentially or actually beyond what would be those lists of financial activities under the Bank Holding Act as defined in the statute?

Mr. GIBSON. I am not aware that it is, but I think that the comments that come in will help us determine whether we got it right or not in the proposal.

Mr. GARRETT. I am watching my time here—I think it was Mr. Royce who ran down the list and the possibility as far as the fact that once a company, once a bank, a financial institution becomes designated, there may be certain benefits to the institution as far as lending and the like, and so there is an anticompetitive nature, if you will, with regard to those bank financial institutions vis-a-vis other nondesignated institutions.

He didn't go this far, but I will go this far, now you carry that potentially one step further, right? Because now if you designate nonbank firms such as insurance companies or finance companies as an SIFI, that same aspect of benefits for that designation will now inure to their benefit, and whereas before you were trying to alleviate the anticompetitive effect for banking institutions, now we have just spread it over to nonbank institutions as well. Is that something that we really want to do?

Mr. GIBSON. The intent of what we are trying to do with the enhanced prudential standards that will be imposed on the nonbank companies that are designated is to impose tougher regulation, higher enhanced capital requirements, not easier. We meet with a lot of nonbank companies, and they are all more worried about being designated than desiring to be designated.

Mr. GARRETT. I see my time is up. I yield back. Thank you.

Mr. RENACCI. I recognize Mr. Duffy for 5 minutes.

Mr. DUFFY. I pass.

Mr. RENACCI. Okay. I want to thank the gentlemen for their testimony this morning.

At this time, this panel is dismissed. I will now recognize the second panel. The first witness is Mr. Scott Harrington, Alan B. Miller Professor at The Wharton School, University of Pennsylvania. You are recognized for 5 minutes for your testimony.

STATEMENT OF SCOTT E. HARRINGTON, ALAN B. MILLER PROFESSOR, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA

Mr. HARRINGTON. Good afternoon, Acting Chairman Renacci, Ranking Member Maloney, and members of the subcommittee.

I am the Alan B. Miller Professor at the University of Pennsylvania's Wharton School. I have been studying insurance markets for the better part of 30 years. I have done quite a bit of work on solvency prediction, capital standards, systemic risk, and market discipline in insurance markets. I am pleased to be here today to testify in this hearing as an independent expert.

Let me start by just saying the term "systemic risk" encompasses the risk of financial institutions with spillovers on the real economy from large macroeconomic shocks and/or extensive interconnectedness among firms. There is a distinction between losses from common shocks to financial firms and losses that arise from interconnectedness and contagion.

I think it is very important to keep in mind that a primary driver of the financial crisis in general and the collapse of AIG in particular was the bursting of the housing price bubble and declines in the value of mortgage-related securities and instruments.

It is also important to keep in mind that AIG's failure was primarily attributable to noninsurance activities, some of which were federally supervised, and the risk that there would have been significant damage and contagion from an AIG failure is still being debated.

Consistent with the generally favorable performance of core insurance activities during the crisis, however, the consensus is, and there is a lot of research being done on this, that systematic risk is minimal in insurance markets compared with banking. Banking crises have much greater potential to produce rapid and widespread harm to economic activity and employment, and this fundamental difference helps explain historical differences in regulation of insurance and banking.

Significant systemic risk strengthens the case for relatively broad guarantees of bank obligations and stringent financial regulation to help deal with the moral hazard that inherently flows from government guarantees. Because insurance poses little or no systemic risk, there is no need for broad guarantees of insurers' obligations to policyholders, and there is less moral hazard and less need for stringent capital requirements.

State insurance guarantees have been appropriately narrower in scope than Federal guarantees in banking. Insurance market discipline for safety and soundness is reasonably strong. Insurers generally hold quite a bit more capital than required by regulation and have not faced strong incentives for regulatory arbitrage.

The FSOC's final rule and accompanying guidance for determining systemically important nonbank financial companies under Section 213 are essentially the same as its second notice of proposed rulemaking issued in October 2011. Much of the detail remains in the interpretive guidance.

As we have heard this morning, it retains the six category analytical framework first set forth in the January 2011 notice. The final rules guidance retains the three-stage determination process originally proposed in October 2011.

As described by Mr. Auer, the first stage analysis would employ publicly available information and information from regulatory agencies and specific quantitative thresholds to identify nonbank financial companies for more detailed evaluation than stage two, with perhaps further evaluation in stage three prior to any designation.

A nonbank company would advance to stage two if it has over $50 billion of global assets and meets at least one of five additional quantitative thresholds. The inclusion of the quantitative thresholds provides some guidance to companies, presumably reflecting the Council's desire to provide them with some degree of guidance and certainty, but the metrics are inherently in part subjective and the thresholds are not binding. For example, the Council reserves the right at its discretion to evaluate further any nonbank financial company, irrespective of whether any such company meets the thresholds in stage one. The final rule and guidance thus provide the Council with very broad discretion for designating systemically important nonbank financial companies and companies will face considerable uncertainty about such designation.

Specific application of the final rule, in my opinion, should not result in any insurance companies being designated as systemically significant. As we have heard, and I think this is very important, there is a benefit and a cost associated with the overall procedure. Short run, there will be increased costs for companies that are so designated. In the longer run, I don't think there is any doubt they will be considered too-big-to-fail.

In insurance markets, this can be very problematic. Not only would it give companies an advantage in borrowing and raising capital, but it would give them an advantage in attracting customers in these markets, which could be very destabilizing over time to competition and safety and soundness in the business.

The enhanced prudential standards as currently proposed are certainly bankcentric. They would need to be tailored if they were to be applied, tailored significantly to any insurance company that would be designated as systemically significant if that in fact occurs. I would hope that those prudential standards, if an insurance company is designated, would piggyback to a great extent off existing capital requirements for insurance companies.

Thank you.

[The prepared statement of Professor Harrington can be found on page 72 of the appendix.]

Mr. RENACCI. Thank you.

Next, Mr. Thomas Quaadman, vice president, Center for Capital Market Competitiveness, U.S. Chamber of Commerce. You are recognized for 5 minutes.

STATEMENT OF THOMAS QUAADMAN, VICE PRESIDENT, CENTER FOR CAPITAL MARKETS COMPETITIVENESS, U.S. CHAMBER OF COMMERCE

Mr. QUAADMAN. Thank you, Chairman Renacci, Ranking Member Maloney, and members of the subcommittee. I appreciate the opportunity to testify today.

Reasonable risk taking is at the core of the free enterprise system. Businesses must have the right to fail in order to take risks to grow and create jobs.

Systemic risk, that is, the possibility of a firm imperiling the domestic and global financial system, is a matter that is much different. During the last financial crisis, it was very apparent that the government did not have the ability to identify, understand, and manage systemic risk.

In November 2008, the Chamber, as part of a larger financial regulatory reform package, called for the regulation of systemic risk and that it be used sparingly and when appropriate. That being said, a balance must be struck to manage systemic risk, to flag issues, and to prevent calamitous harm, while not constraining reasonable risk taking, which if limited will hurt economic growth and job creation.

In creating Title I of the Dodd-Frank Act, we think Congress for the most part got it right in striking that balance. So if you take a look at Title I, right off the bat, Congress immediately separated systemic risk for banks separately from systemic risk for nonbanks, and then Congress also created specific delineated tests to determine if a nonbank should be determined to be systemically important.

If you take a look at that system, you take commercial companies, mutual funds, insurance companies and the like, they then go through the very defined tests to see if they are predominantly engaged in financial activities. If they are then determined to be nonbank financial companies, then FSOC looks through a much broader criteria to determine if they should be designated, and if they are designated as systemically important financial institutions, then the Federal Reserve and the prudential regulator of that company work together in order to create enhanced regulations to deal with systemic risk, yet at the same time not impacting the nonfinancial activities of that company.

So if you take a look what Congress did, Congress understood that sometimes when you travel, you have to travel through a dense forest, and if you have to travel through a dense forest, you clear a path, you brightly mark it so that the travelers can know with safety how to get to where they are going. What the regulators are doing, however, is that they are taking the markings off of the path so the path is not illuminated and forcing more participants into the forest than what Congress had envisioned.

So we have six problems with the way that the regulators are implementing Title I.

Number one, and I think we heard a discussion of it this morning, is that the regulators are actually using discretion to go around the very specific tests that Congress put in place to determine if nonbanks should be designated or considered to be predominantly financially engaged.

We are seeing a one-size-fits-all bankcentric approach in order to regulate systemically important financial institutions that are nonbanks, but they do not take into account the different business models. We are seeing that there is not a consideration of conflicts between systemic risk and existing regulations. So, for instance, if you have a public company that goes into this process, at what point in time does this become a material issue that that public company is going to have to disclose this to investors? If you do it too soon, you could harm capital formation. If you do it too late, the company can actually put itself into legal jeopardy.

We are seeing that the process issues, so that is when FSOC is acting as a regulator, that FSOC isn't following the same transparency and accountability processes that other regulators engage in when they are writing rule makings. We agree if FSOC is engaged in discussions about a systemically important problem or Title II issue, that should be done in private. But when they are acting as a regulator writing rules, that is something that is much different.

I think we have heard testimony this morning which buttresses our point about the lack of a cost-benefit analysis. During the April discussion of finalization of rules on designation, it was determined that to designate systemically important financial institutions was not economically significant, meaning that it would not have a cost to the economy of $100 million or more. Commenters cannot understand what the costs and the burdens are.

Finally, rules are being considered out of order. We are going into designations, we have designation rules, but we are talking about predominantly financially engaged rules now, which is really the start of the process. So we started backwards and started to work forward so that people cannot understand how the process is going to work or how it meshes.

Finally, if these issues are resolved, the balanced system that Congress put in place can move forward. If these issues are not resolved, systemic risk regulation will be impaired and normal everyday business practices constrained, harming economic growth and job creation.

I am happy to answer any questions you may have.

[The prepared statement of Mr. Quaadman can be found on page 78 of the appendix.]

Mr. RENACCI. Thank you, Mr. Quaadman.

Next is Mr. William J. Wheeler, president, Americas, MetLife, Inc.

STATEMENT OF WILLIAM J. WHEELER, PRESIDENT, AMERICAS, METLIFE, INC.

Mr. WHEELER. Acting Chairman Renacci, Ranking Member Maloney, and members of the subcommittee, my name is Bill Wheeler and I am the president of the Americas Division of MetLife. Thank you for the opportunity to testify on behalf of MetLife.

MetLife recognizes the importance of managing systemic risk and the need for sensible regulations to protect taxpayers from costly bailouts. Coming up with the appropriate regulatory formula will not be easy, either for the Financial Stability Oversight Council and designated nonbank firms that are systemically important, or for the Federal Reserve in determining the prudential standards to be applied to those firms. Nevertheless, we must get the prescription right. The stakes are too high to allow the costs or the benefits of regulation to be miscalculated.

MetLife is the largest life insurer in the United States. We are the only one that is also a bank holding company. Our experience as an insurance company regulated by the Federal Reserve has provided us with unique insights into the pitfalls of applying bankcentric rules to nonbank financial companies. Indeed, it is because we do not believe our insurance business should be governed by regulations written for banks that we have decided to sell our depository business and join our peers in being regulated as an insurance company.

I plan to discuss three topics in my testimony today: first, why regulated insurance activities generally do not pose systemic risk; second, why naming only a few companies as systemically important financial institutions, or SIFIs, would needlessly upset the competitive landscape in the insurance sector; and third, in the event that we are named as a nonbank SIFI, why the prudential regulations must be tailored to our unique asset and liability characteristics.

Far from presenting systemic risk to the U.S. economy, traditional life insurance activities are a force for financial stability. Life insurance companies protect policyholders and their beneficiaries from the loss of income that occurs as a result of death, disability or retirement.

In order to make good on these promises, we invest in primarily investment-grade fixed-income securities that provide us with reliable returns. Unlike banks, insurers generally have a stable portfolio of in-force insurance policies with regular premium payments and contractual features that prohibit or limit early calls by policyholders, such as surrender charges or tax penalties.

Insurance company financial distress occurs far less frequently than bank distress. As of mid-2009, only three insurance companies had received taxpayer assistance through the Troubled Asset Relief Program (TARP), compared with 592 banks. Quite frankly, I do not believe TARP money needed to be provided to at least two of these insurers to prevent any sort of systemic event.

Rather than designate a handful of insurance companies as SIFIs and design a whole new set of prudential standards for them, a more sensible approach would be to identify and regulate those activities that fueled the financial crisis in the first place. During the crisis, certain firms that expanded significantly into nontraditional and noninsurance activities suffered significant distress. Indeed, the main reason insurance companies are even part of the discussion about systemic risk is because of AIG.

Yet, AIG's troubles did not stem from traditional insurance activities operated within the regulated insurance company. As Dodd-Frank recognized, the Office of Thrift Supervision did not appropriately regulate the activities of AIG Financial Products. Insurance law and insurance regulators would not have permitted these activities to occur in the same manner within a regulated insurance company.

If FSOC names only certain insurance companies as SIFIs, it will inadvertently be picking winners and losers in the insurance industry. Some commentators believe that naming MetLife and other life insurance companies as SIFIs would give us a competitive advantage over our smaller rivals. An SIFI designation would be the Federal Government's signal that we are indeed too-big-to-fail and that if we got into financial trouble, Federal funds would be used to rescue the firm. The implicit backing of the Federal Government could strengthen perceptions of our creditworthiness and may give us a significantly cheaper cost of funds than our peers.

At the other end are those who believe that insurance companies deemed SIFIs would be placed at a competitive disadvantage. They would have to hold more capital and maintain higher liquidity levels, which would reduce returns on equity for shareholders and impose higher prices on customers. In addition, they would have to deal with two levels of regulation compared with one for the rest of the industry. I am in the second camp, having lived with the Federal Reserve regulation and been forced to stand on the sideline as nearly all of MetLife's competitors, including those that took Federal bailouts, returned capital to shareholders while bankcentric rules prevented us from doing so.

But whether an SIFI designation is a help or a hindrance, it seems certain that naming a handful of insurance companies as too-big-to-fail will needlessly distort the competitive landscape and misallocate capital in the insurance sector.

In the event FSOC feels compelled to name MetLife and a few other life insurers, SIFIs, it would be essential to tailor the new prudential rules for insurance companies. Bankcentric regulations are wholly inappropriate for an insurance company. If the Nation's largest life insurers are named SIFIs and subjected to unmodified bank style capital and liquidity rules, our ability to issue guarantees would be severely constrained at a time when governments are facing their own fiscal challenges. Faced with costly requirements, insurers would either have to raise the price of the product they offer, reduce the amount of capital or risk they take on, or stop offering certain products altogether.

In closing, let me reiterate that I do not believe MetLife is or should be designated too-big-to-fail. Even in the event of insolvency, we would not threaten the stability of the financial system of the United States. Naming only a few large insurance companies as SIFIs would needlessly upset the competitive landscape in the insurance sector. If FSOC names the largest life insurers as SIFIs, I believe it will be imperative for regulators to get the prudential rules for nonbank SIFIs right.

Thank you.

[The prepared statement of Mr. Wheeler can be found on page 93 of the appendix.]

Mr. RENACCI. Thank you, Mr. Wheeler.

Our final witness, Mr. Douglas Elliott, a Fellow at the Brookings Institute, is recognized for 5 minutes.

STATEMENT OF DOUGLAS J. ELLIOTT, FELLOW, THE BROOKINGS INSTITUTION

Mr. ELLIOTT. Thank you. Thank you for the opportunity to testify here before you again today.

Regulating SIFIs is crucial. They are the institutions most capable of triggering financial crises and therefore merit closer regulation than other firms and should be held to a somewhat higher standard of financial conservatism.

The need for closer regulation is not erased by the steps taken to reduce the potential for government bailouts. Even if creditors and shareholders picked up all the losses, with no help from taxpayers, a serious financial crisis would still lead to a severe contraction of credit, sending the economy into a deep recession. As you know, the recent recession cost taxpayers far more than did the bailouts.

In my brief time, let me just emphasize a few points made in my written testimony and in a comprehensive paper that Bob Litan and I wrote last year.

First, no part of the financial industry should receive an automatic exclusion from SIFI designation because there is too much danger of regulatory arbitrage if we just go by legal category.

Second, there are no absolutes in determining systemic importance. There are multiple ways of measuring the level of significance and no clear consensus on the exact methods, which is why the proposed rules allow for considerable judgment. Even within a single measurement approach, there are degrees of systemic importance with no bright line where an institution flips from unimportant to important.

Third, we must strive for the right balance between the dangers of overdesignation and underdesignation. There will be an economic cost to designating firms as SIFIs. Therefore, we should do so whenever the safety benefits outweigh those costs, but only when they do.

Your invitation letter and much of the discussion here has been around a question as to whether firms might benefit from being named as SIFIs. I would just emphasize a point, which is that if it is true that funding costs will be lower after designation, the primary beneficiaries of that will be the managements and the shareholders of these companies. I have been heavily lobbied by these companies to take the position they shouldn't be SIFIs. I am sure you as actual Members of Congress have been lobbied much more heavily. So you may find yourself in an ironic position of someone making an argument to you that you shouldn't do something to their advantage. I simply do not believe for that and other reasons that there would be a significant funding cost advantage.

Fourth, the additional oversight applied to nonbank SIFIs must be appropriate to the systemic risk they represent and be coordinated as effectively as possible with their existing regulation. We need to avoid overlap, conflicting requirements, and gaps where no one regulates.

Fifth, similar activities should be regulated in similar ways with similar safety margins to the extent possible, regardless of the legal form of the institution doing the activity. Otherwise it will be easy to fall prone to regulatory arbitrage as well as the inefficiencies that are produced by arbitrary differences and competitive advantage.

So evaluating the proposed rules in light of these key points, the regulators appear to be generally on the right track, although there is a great deal that cannot be judged yet. The rules focus on the right sources of systemic risk, and they recognize the need to carefully review the specific facts and to apply considered judgment to questions that are inherently somewhat subjective.

It makes sense that the regulators are casting a quite wide net in the initial phase in order to determine which institutions they will need more information about. As I have stressed, there are no straightforward quantitative methods to find the answers here so there is a need to gather information on a wide array of candidates for designation in order to assess each in a deeper way.

The regulators have also said the appropriate things about recognizing the diversity of business models in different parts of the financial system. Although there remains cause for concern as to whether this will be reflected in actual practice, I do share that concern.

From my point of view, I do not think there are currently many true SIFIs among the nonbank financial institutions. But I would stress, since this has been an area of much discussion today, it is possible that life insurers will fall within that. I would dispute the point made earlier that there is a clear consensus that life insurers do not present systemic risk. There are arguments coming from both sides, which is why I think it is premature to form a conclusion on that.

So, in conclusion of my points, designating a nonbank SIFI is by its nature a complex endeavor that requires a careful balancing act and substantial human judgment. The rules proposed by the regulators generally reflect those considerations and I believe that the resulting uncertainty about the ultimate outcomes is unavoidable unless we either abandon the effort to designate such SIFIs or use cruder measurements that would almost certainly produce worse results. My larger concern, as I mentioned, is whether the rules might indeed be too bankcentric.

Thank you.

[The prepared statement of Mr. Elliott can be found on page 62 of the appendix.]

Mr. RENACCI. Thank you, Mr. Elliott.

We will now recognize Members for 5 minutes. I recognize myself first.

Mr. Quaadman, although the FSOC has finalized its rules on the SIFI designation process and the Federal Reserve has yet to finalize its rules on enhanced prudential standards, as a result no one can actually know what the effect of SIFI designation will have. Should the FSOC wait for the Fed to finalize its rule on enhanced prudential standards before it begins designating nonbank firms as SIFIs?

Mr. QUAADMAN. I think what is interesting is that while there is a lot of discussion of the process, there is also discussion that they are looking at 50 different companies. A big problem that is posed here is that we have the bankcentric model that they are not willing to move off of, they are not looking at business models of companies, and that if they have these 50 companies, they should start to look at whether or not there are unique characteristics that they should be looking at, as well as discussing that with prudential regulators as well.

Mr. RENACCI. Thank you.

Mr. Harrington, how optimistic are you that enhanced supervision of individual companies will reduce the likelihood of any future financial crisis?

Mr. HARRINGTON. I am not optimistic about that given the historical record and the dynamism of the markets. I think it is very, very difficult to anticipate what is likely to happen and what the sources of risk may be. In the near term, I think it is likely that there will be heightened scrutiny and some reduction in the likelihood of excess risk-taking. But over time, as memories tend to fade, I think it is likely that we will be in an environment where the inherent risks will be very difficult to identify and control.

Mr. RENACCI. Would you agree that the last crisis taught us that looking at individual companies in isolation is an ineffective way to monitor the systemic risk?

Mr. HARRINGTON. I think it is preferable to try to look at activities, and you can look at companies that are then involved in those activities. Looking at individual companies is necessary as part of prudential regulation, but I do distinguish that from identifying specific companies as subject to heightened scrutiny and in, the case of the insurance industry, basically Federal regulation that could involve an implicit or explicit guarantee of their obligations.

Mr. RENACCI. Thank you.

Mr. Quaadman, you criticized the Fed in your testimony, stating that the Board appears to be creating a one-size-fits-all bankcentric approach that will not work well with nonbanks spanning diverse industries unrelated to banking. What should the Fed have done differently?

Mr. QUAADMAN. I think they should be doing a number of things differently. One is, you also have to look at the Fed historically. They are a bank regulator. That is what they are used to. That is what they are involved with. If you take a look at a manufacturing company, right, if a manufacturing company uses derivatives to actually accept raw materials because they need to lock in prices and also prevent price volatility for consumers, as well as then have a financing arm to finance the purchase of their finished goods and services, that is a much different model than the bank model.

So the question is when you go to the start of the process, and this is actually an FSOC issue, Congress specifically defined what should be looked at in order to determine what a company that is predominantly engaged in financial activities. The issue that I just raised about the use of derivatives to accept goods is specifically not in Reg 4(k), which Congress wrote into law in Title I through the Pryor-Vitter amendment. So then, from there, the Federal Reserve is now expanding out what the regulation should be at the end of the process.

The problem here, and this is why we also raise the issue in terms of the rules being taken out of order, is if you start at the beginning of the process and start to have a flawed process of review that goes away from what Congress defined, then that also affects how the regulation happens at the end, and then you overlay on top of that the historic nature of the Fed and you create a flawed system.

Mr. RENACCI. Thank you.

Mr. Wheeler, I know I am running out of time, but I do want to get your answer on this: How would naming only a few insurance companies as systemically important financial institutions upset the competitive landscape of the insurance sector?

Mr. WHEELER. There are a couple of reasons why. One is it could be the halo effect, where customers or consumers or distributors would think because we have implicit Federal backing, we are therefore better to buy products from somebody like us if we were named.

I don't actually think that is what is likely to happen. I think the opposite is going to happen. We will be held to higher capital standards. We will be seen as an insurer that you don't want to buy stock in, that frankly you should buy stock in insurance companies that don't have these standards because frankly the capital levels won't be quite as high.

So we think at the end of the day, those few insurance companies, which, by the way, will be the largest in the industry probably, will be somewhat punished by the marketplace for the tighter regulation and higher capital standards.

Mr. RENACCI. Thank you.

I now recognize Mrs. Maloney, the ranking member, for 5 minutes.

Mrs. MALONEY. First of all, I would like to welcome all of the panelists, especially Mr. Wheeler, whose company is headquartered in the great State of New York, and I want to compliment your many contributions to the economy in providing services to Americans.

During the financial crisis, we really had only two ways to approach a troubled institution. We could either let it fail, which we did with Lehman, or we could bail it out, which we did with AIG. Neither alternative was a particularly good one. And what we tried to do in the Wall Street Reform Act was to try to have other tools to help regulators not only manage large institutions and hopefully make sure they don't fail, but in the event that they did, that we would have a way to structure it, like we did with the FDIC, which I think did a brilliant job in structuring failing banks and putting them with stronger ones and really managing the economy in a way that was less disruptive. So that is what we did.

During that time, we did have a lot of debate over insurance companies, and many insurance companies testified. I don't know if you did, Mr. Wheeler, or not, but many, many CEOs and academics testified that insurance was not the problem, that in fact it had been a rock in our troubled economic times and had performed well, with the exception of AIG. And although many people agreed that most types of insurance activities conducted in isolation would not pose a systemic threat, AIG is an important and I would say tragic example of how insurance activities in combination with other financial risky activities could literally threaten and bring down a great company, a large organization, and really be a threat to the entire financial system.

The Wall Street Reform Act does not exclude any company for that matter or any area. They don't exclude insurance or any type of company, because the whole thrust was to make sure there were not shadow areas of financial institutions that had risk-based factors that could do systemic risk to our entire economy.

I would like to ask the panel, do you agree that a framework that applies broadly and evaluates a number of riskiness measures is preferable to a framework that categorically excludes some companies? Because under the definition that I am hearing before the panels today, AIG would have been excluded because it is primarily an insurance company. That excludes some companies and thereby creates hiding places or shadow places where risky activities could take place.

So I would really like to ask, how is MetLife different from AIG, and how does your international expansion impact on MetLife's risk profile? As we know, AIG was a very strong international company.

So I throw that out to anyone who would like to answer.

Mr. WHEELER. Maybe I will start, since you referenced MetLife, how is it different versus AIG. Of course, what got AIG in trouble was its noninsurance activities. The financial products division in London was not inside a regulated insurance activity. And I think the premise of your question makes perfect sense. I think we have to find these areas in the shadows. But I worry about—and, for instance, if MetLife were doing something outside of its regulated insurance activity which was deemed very risky and very interconnected, I think that activity should absolutely be regulated by the Fed.

What I worry about is regulated insurance activity, which is not in our opinion systemically risky, and is already, by the way, highly regulated.

So I think that is what I think the Fed, when they think about nonbank SIFIs and what kind of activities they should regulate, I think that is what they should be focused on. We worry about the Fed regulating—being yet another regulator to the insurance industry.

Mrs. MALONEY. But could you comment on the fact that your firm acquired a good portion of AIG, as I understand it, in 2010, and what did MetLife pay for this acquisition, and did the Federal Reserve have to approve this transaction? Was there this a decision by your company, or was this part of the government trying to manage risk in the overall economy?

Mr. WHEELER. During the financial crisis, MetLife performed well, and we had to—even though we were a bank holding company and eligible for TARP money, we did not take it. We were the only large bank holding company that did not. And I suppose that is a testimony to how we were managed and our capital solvency. But, frankly, I think it is also a testimony to the fact that we are not very interconnected with the banking system. So problems in the banking sector didn't really spill over to Met.

Coming out of the financial crisis, we were in a strong position. AIG, obviously, having been taken over by the government, needed to start selling assets to repay the government. We acquired a large international life insurance division of AIG called Alico for

$16 billion. And because we are a bank holding company, the Fed did have to approve that transaction, and they did, and obviously that money was then used to pay back—or a large portion of that money was used to pay back the Treasury. So that was good for the Treasury, ultimately good for helping AIG get back on its feet, and sort of showed kind of the stability of the insurance industry throughout this crisis.

Mrs. MALONEY. My time has expired.

Mr. RENACCI. Thank you.

Mr. Luetkemeyer for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Mr. Wheeler, you did a good job of explaining the lack of risk with the insurance portion of the financial services industry. I think it is fair to say that the insurance companies are not the problem; it is whenever they get into these other financial products, other financial services, that they get in trouble. Would that be a fair statement?

Mr. WHEELER. Yes.

Mr. LUETKEMEYER. Does your company engage in any other financial services products, other than life insurance?

Mr. WHEELER. We own a small bank.

Mr. LUETKEMEYER. You own a small bank. Okay. But your small bank apparently doesn't deal in derivatives or default credit swaps, is that correct?

Mr. WHEELER. It does not.

Mr. LUETKEMEYER. Very good. In your judgment, where do you think—of course, I guess it is a hypothetical question here in trying to figure out what is going on in the minds of the Feds. That is always dangerous, isn't it? But where do you think this should go, I guess is a better way to put it, from the standpoint of, as the ranking member indicated, at least putting some protections in place or transparency in place to be able to see those groups of folks who are in the business of dealing with those instruments and then how to separate that out from folks, like yourself, who are not involved in that?

Mr. WHEELER. I am a little worried that the Federal Government is just focused on if you are big, ipso facto you must be systemically significant. Okay, MetLife is big. There is no doubt about it. But the insurance industry itself, especially life insurance, is probably not very interconnected, probably not systemically significant. If we were to engage—there may be the other nonbank SIFIs where that is not the case, who are not primarily insurance companies, and so, obviously, they should be scrutinized.

I guess I would also say that if insurers get involved in something besides insurance, which could happen and obviously did under AIG, if they get involved in something else, and that is being a derivatives trader or a creator and seller of derivatives or anything else which really connects them to the banking sector, then, I think that is fair game. I think that should be scrutinized by the Fed and regulated.

Mr. LUETKEMEYER. So you believe that there should be some sort of rules in place that describe the connectivity between your activity and the financial services markets, and if you go over the line, then you fall into the category that you should be designated as an SIFI. Is that a fair statement?

Mr. WHEELER. Yes, I do.

Mr. LUETKEMEYER. Very good.

Mr. Quaadman, I am just curious. I know the Chamber is very concerned about this one-size-fits-all—in your testimony, I think that is the way you put it—approach that the Fed is taking. What is your solution or what is your suggestion for them, for the FSOC people, to look at the regulations and come up with a tiered system or a system that allows certain folks to get out of it or to go back and review the existing rules to see how they are negatively impacting some of the small folks who don't need to be in this. Insurance companies that are not in the financial services industry, they don't need to be regulated. Community banks, other nonlending folks, nondeposit folks, they don't need to be in this. They are not a systemic risk. Yet the rules that have been put out so far have had a dramatic impact on some, I am sure, of your members.

Mr. QUAADMAN. Thank you for that question. I think number one is that they should follow the law. So if you take a look at the predominantly engaged test, which is the first stage to see if a company should even be considered, Congress sort of constructed that as a 1-inch pipe and now the Federal Reserve and FSOC, they are trying to make it a 12-inch pipe. They want to try and bring in as many companies as possible, whereas it really should be done sparingly.

I think Mr. Wheeler also made an excellent point as well as we are also looking at size. And size isn't necessarily determinative either. What is also important as well is that the marketplace investors and companies, they need to assess how the system works, how it is going to impact companies and the like. By taking rules out of order, by not following transparency in writing rules, it is impossible to decide that.

One example is, Vince Lombardi when he started training camp every year, he would say, "This is a football." He didn't start training camp by saying, "This is the last play we are going to play in the Super Bowl." So FSOC and the Federal Reserve are starting at the very end trying to work forward, where you really should start at the beginning.

Mr. LUETKEMEYER. With regards to the promulgation of the rules and the process they are going through, are you gentlemen, are your associations, are you at the table with the discussions that are going on?

Mr. QUAADMAN. We have commented extensively. We have met with the regulators in different forums on these issues.

Mr. LUETKEMEYER. Are they receptive to your ideas and your concerns?

Mr. QUAADMAN. I can say in this and other areas where we have spoken to them, we have always brought forth how this impacts nonfinancial companies. And, there are times where we had very good discussions, but there are also times where it is very clear that they are coming at it from a bank approach and then are not willing to move off of that.

Mr. LUETKEMEYER. Mr. Wheeler?

Mr. WHEELER. I think I would agree with that. We are obviously very engaged. This is very important to us in dealing with the regulators. Obviously, we are regulated by the Fed today, so we have conversations with them a lot. Whether we are having an impact, whether they are listening, I honestly don't know.

Mr. LUETKEMEYER. We won't know until we get the rules, will we?

Mr. WHEELER. Right.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Mr. RENACCI. Mr. Manzullo for 5 minutes.

Mr. MANZULLO. Thank you.

Is there anybody in the room here from the Department of the Treasury or the Federal Reserve?

See? That is the problem. They testify first; then they leave, and they don't listen to you. It is a chronic problem with the agencies. They refuse to be on the same panel as those who are regulated. These Departments and Agencies ought to be ashamed of themselves, because it deprives you of the ability to interact with the people who represent the Government. That is why, Mr. Wheeler, I asked the questions that you wanted to ask. And that is the problem with Washington. That is why this City is broken, because people who make the regulations don't think they have to stick around in order to listen to the people impacted.

Mr. Chairman, I would suggest that at the next hearing we have, we put the people impacted first. Force the government bureaucrats to listen to the testimony. There is no reason why they should have to go first.

That brings me to another point. It wasn't until October 1, 2009, that the Fed actually adopted a policy, are you ready for this, requiring written proof of a person's earnings before that person could even fill out a mortgage application. Now, I would say that is pretty basic. They took an entire year to review everything, as Chairman Bernanke said, a bottom-up review as to what would be necessary. And if it took that long to figure out that you don't condone the so-called "liar laws" that allowed people to do that, I just wonder how the Fed is going to start to be able to regulate insurance companies.

I think all of you generally agree, with the exception of Mr. Elliott, who also agrees that insurance companies generally should not be regulated but may under certain circumstances. Can you guys tell me, what would the Fed do in messing up MetLife? Do you like that question?

Mr. WHEELER. That is a great question. Look, as Mr. Quaadman said a bit ago, the Federal Reserve, at least part of their mandate is to regulate the banking industry. So the people who work at the Fed, that is their training, that is their experience. They regulate banking. So now MetLife is a bank holding company, and therefore regulated by the Fed, and I can tell you there was a very strong reluctance on the part of the Fed to look at us as anything other than a bank, even though, of course, 98 percent of our business is insurance.

And we were very frustrated by that, and, of course, that is probably why I am here today is because of that experience.

So, I would also tell you that the Federal Reserve—I have met a lot of people at the Federal Reserve but I have yet to meet somebody who I thought had what I call a sophisticated understanding of the insurance industry.

Mr. MANZULLO. It is a mismatch.

Mr. WHEELER. Right. So it worries me. We are already highly regulated by the States. The New York Insurance Department in the State of New York is, I would argue, the most sophisticated State regulator which regulates us today, and they know what they are doing.

Mr. MANZULLO. Can I ask you a question? AIG, I think, was in five pieces of the company. Did the insurance division—was that ever at risk, or were the Illinois requirements so profound that none of the policyholders were imperiled at any time? Professor?

Mr. HARRINGTON. If you look at AIG's total capital and surplus in its insurance subsidiaries, it was substantially positive throughout the crisis, and the laws were in place that overall if you aggregated across those subsidiaries, AIG had plenty of capital to meet its obligations to all policyholders.

There has been some debate about the extent to which specific subsidiaries may have run into capital shortfalls, and that would raise the question of how fungible the capital held by different AIG subsidiaries would be so that heavily capitalized subsidiaries, the resources could somehow make up for any shortfall at a few of the entities that may have been underfunded.

So that has been debated, and I have not seen a really clear coherent analysis that would document whether any of those specific subsidiaries would have actually had a crisis that would have required regulatory intervention. Overall, though there was plenty of money, and the overall system of insurance regulation, with the strong walls between the subsidiaries and the holding company—

Mr. MANZULLO. So you don't know if those walls could have been breached surrounding the insurance division?

Mr. HARRINGTON. They wouldn't have been breached by having money sucked out to support the noninsurance activities.

Mr. RENACCI. Mr. Duffy for 5 minutes.

Mr. DUFFY. Thank you. One of the boogymen of the financial crisis was AIG, which was a nonbank financial company. We have touched on this a little bit. But just maybe again, and I don't mean to pick on Mr. Wheeler, who has been answering a lot of questions, but what is the difference between MetLife and AIG?

Mr. WHEELER. I think for purposes of your question, if you look at all our subsidiaries that are the holding company, how many of them are engaged in insurance, and how many of them do something else? And MetLife is I would say, other than the small bank we own, which we are in the process of selling because we don't want to be a bank holding company anymore, other than the fact of our bank, almost everything we own in the holding company is in the business of insurance, whether that is P&C insurance or life insurance, in this country and around the world.

AIG was in all those insurance businesses as well in the United States and around the world, but they also engaged in a lot of other, what I would call noninsurance activity. And the one that got so much attention, of course, was something called the AIG Financial Products, which was a business they ran in London, where they sold credit default swaps on all kinds of securities and sold them to banks and other financial institutions. And, when the crisis occurred, they weren't able to pay, and therefore threatened the security of the bank system that was relying on that money. So that is the big difference between us.

And, by the way, most of the insurance industry looks like MetLife, okay? They are pretty much pure play insurance companies. They aren't involved in a lot of other activities.

Mr. DUFFY. If you are looking at AIG, wasn't the credit default swaps and the mortgage-backed securities, wasn't that an investment strategy for AIG on the insurance side?

Mr. WHEELER. That is a good question, and we use derivatives, too, in our insurance entities and I think there is something you have to understand here. So what Financial Products did was create and sell derivatives to others.

We purchased derivatives from Wall Street, and I will talk maybe about why that is okay to do. We have to hold collateral against those derivative positions, and they get trued up every day. So Lehman Brothers, for instance, which was a big derivative counterparty of ours, when they failed, we didn't lose any money because we held collateral against their derivative positions, and that is the way good derivative management practice works.

We do use derivatives in our insurance company to manage risk, and most major financial institutions do. Just investing in derivatives to manage risk doesn't in my mind make you systemically important.

Mr. DUFFY. Switching gears a little bit, you guys are all aware of the three-stage process set up by FSOC for the SIFI designation. Do you guys as a group of four agree with that three-stage process. Do you think that is a good process to go through? Does anyone disagree with the three-stage process? Does anyone have a recommendation to change the three-stage process?

You all like it?

Mr. WHEELER. Look, it is good to have a process. I think it is more about the substance of the decision-making. What we have heard a lot about is, when somebody said, well, define interconnectedness,—I think that was on the last panel—measure interconnectedness. They can't, of course, because it is judgmental.

And if you think about the six criteria they are going to use to designate something systemically important, they talk about business being one, but almost everything else is very judgmental. And I guess, I am hoping the FSOC has I would say a robust discussion about those other more qualitative factors.

Mr. DUFFY. Mr. Harrington or Mr. Quaadman?

Mr. QUAADMAN. That is a great question. I think, number one, Congress had a process in place to do this system, and the regulators are trying to go around this that.

I think one thing to also think about, and I think this also gets overshadowed by the general financial crisis, but if you actually look back a few years ago, there was a problem with monoline insurance companies that led to liquidity problems in State and municipal securities. That is a $3.6 trillion dollar market. I think the question you should all be asking the regulators is, could they find the problem with monoline insurance companies with the processes they have set up, because if you are just looking at size, you are trying to use a searchlight when in fact you probably should be using a flashlight.

Mr. DUFFY. Mr. Harrington?

Mr. HARRINGTON. In general, a three-stage process where you do a broad screen and work down is sensible. Actually having a process where in the first stage, you get the right criteria and the right thresholds, that is very difficult, and I don't think there is sufficient information to evaluate the specifics in the first stage.

I am troubled by the overriding amount of discretion in the overall system, including the fact that if you don't meet the first stage test, you can still be advanced through the screen. Unfortunately, I don't have any sharp ideas of how you would fix this to optimally trade off the specificity that would be desirable versus some degree of discretion.

Mr. DUFFY. I will ask one more question: Would everyone agree that nonbank financials should be considered an SIFI? Do you all think that is a reasonable area for us to look at? Or does anyone on the panel say, no, no, we just want to look at banks.

Mr. WHEELER. No, no. I totally think that is necessary, that we catch these activities in the shadows.

Mr. QUAADMAN. It should be done through exacting standards, so it is only used sparingly but when it is appropriate.

Mr. HARRINGTON. I am very skeptical of identifying individual nonbanks as being systemically significant because of the disruptions it can create in competition and incentives for safety and soundness. I wish more attention would be paid to looking at how we might do this without identifying specific companies, but instead looking overall at areas that could create systemic risk and having some sort of supervisory regime that could deal with that without labeling companies as systemically significant, which ultimately will translate into "backed by the safety and soundness of the Federal Government."

Mr. DUFFY. I have to say, I don't see a way to do what Scott just described. Ultimately, we need each of these institutions to be able to handle the claims on them. So in the end, we have to say these institutions have enough capital, enough liquidity, and enough safety margins in general.

My time has expired. I will yield back.

Mr. RENACCI. I want to thank all of the witnesses for their testimony this afternoon.

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

This hearing is adjourned.

[Whereupon, at 1:03 p.m., the hearing was adjourned.]

A P P E N D I X

May 16, 2012

Embargoed until delivery

Testimony of Mr. Lance Auer, Deputy Assistant Secretary
U.S. Department of the Treasury
Before the House Financial Services Financial Institutions Subcommittee
Hearing on "Implementing Title I of the Dodd-Frank Act: The New Regime for Regulating Systemically Important Nonbank Financial Institutions"
May 16, 2012

Chairman Capito, Ranking Member Maloney, and members of the Subcommittee, thank you for the opportunity to discuss the Financial Stability Oversight Council's (the Council) rule and guidance for identifying nonbank financial companies that will be subject to enhanced prudential standards and supervision by the Federal Reserve. I serve as the Deputy Assistant Secretary for Financial Institutions at the U.S. Treasury, where I helped coordinate the work of the Council's members in developing the rule and guidance setting out the Council's process and analysis for evaluating nonbank financial companies for supervision and regulation.

In the 2007-2008 financial crisis, financial distress at certain nonbank financial companies contributed to a broad seizing up of financial markets. These nonbank financial companies were not subject to the type of regulation and consolidated supervision applied to bank holding companies, nor were there mechanisms in place to resolve the largest and most interconnected of these nonbank financial companies without causing further instability.

To address potential risks posed to U.S. financial stability by these companies, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) authorizes the Council to determine that certain nonbank financial companies will be subject to supervision by the Board of Governors of the Federal Reserve System (the Board of Governors) and to enhanced prudential standards. This authority is one of the Council's important tools to carry out its statutory duty to identify risks to financial stability and respond to emerging threats. The Council acts as a collaborative body, chaired by the Secretary of the Treasury, that brings together the expertise of the federal financial regulators, an insurance expert appointed by the President, and state regulators.

Although the Dodd-Frank Act specifically outlines the substantive considerations and procedural requirements for designating nonbank financial companies, the Council determined that a rulemaking would provide increased transparency and guidance that would be beneficial. The Council went to great lengths in its rulemaking to foster additional transparency and to obtain input from all interested parties. The Council issued an advance notice of proposed rulemaking in October 2010 and a first notice of proposed rulemaking (the First NPR) in January 2011 providing guidance on the statutory criteria and specifying the procedures that the Council will follow in assessing nonbank financial companies for designation. The Council elected to issue a second notice of proposed rulemaking (the Second NPR) in October 2011 to provide additional details regarding the framework for assessing nonbank financial companies and to offer further opportunity for public comment on the Council's proposed approach. After receiving significant input from market participants, non-profits, academics, and other members of the public, the Council's members worked in close collaboration to develop a final rule. The final rule, issued in April 2012, describes an analytic framework for designations that provides a consistent approach to determinations that incorporates both quantitative analyses and qualitative judgments.

Council members are also working closely with their international counterparts on the process for identifying global systemically important financial institutions. Treasury and U.S. regulators are active participants in the G-20 and Financial Stability Board (FSB). G-20 Leaders, at the Seoul Summit in November 2010, endorsed a policy framework developed by the FSB to address the moral hazard posed by systemically important financial institutions. Most recently, at the Cannes Summit in November 2011, G-20 Leaders requested extension of this policy framework beyond global systemically important banks to nonbanks of global systemic importance. Council members are continuing to cooperate with their international partners to ensure consistency across frameworks and the development of international standards of the highest quality. For example, the International Association of Insurance Supervisors (IAIS) is working, in cooperation with the FSB, to extend the FSB's policy framework to the insurance sector, and is developing criteria and a methodology for identifying global systemically important insurers (G-SIIs). The Federal Insurance Office (FIO) of the Treasury Department, whose director is also a member of the Council and a member of the IAIS and the IAIS Executive Committee, is pursuing an international consensus that aligns the IAIS criteria, methodology, and timing with the final rule issued by the Council. At the same time, the Council's designations under the Dodd-Frank Act are an important part of the U.S. financial reform process, and the Council will continue to move forward in implementing its framework in a timely manner.

Process for Determinations

The Council has developed a robust process for evaluating whether a nonbank financial company should be subject to Board of Governors supervision and to enhanced prudential standards. The Council will approach each determination using a consistent framework, but ultimately each designation must be made on a company-specific basis, considering the unique risks to U.S. financial stability that each nonbank financial company may pose.

The Dodd-Frank Act requires the Council to assess ten considerations when evaluating nonbank financial companies, as well as any other risk-related factors that the Council deems appropriate. The Council has grouped these ten statutory considerations into a six-category framework for its analysis. Three of these six categories seek to assess the potential impact of a company's financial distress on the broader economy: size, interconnectedness, and substitutability. The remaining three categories seek to assess the vulnerability of a nonbank financial company to financial distress: leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. An assessment of all six categories will encompass all ten of the statutory considerations.

The Council's interpretive guidance issued with its final rule explains the three-stage process that the Council generally intends to use in assessing nonbank financial companies:

> *Stage 1*: First, the Council will apply uniform quantitative thresholds to identify those nonbank financial companies that will be subject to further evaluation.
>
> *Stage 2*: The Council will analyze the nonbank financial companies identified in Stage 1 using a broad range of information available to the Council primarily through existing public and regulatory sources.
>
> *Stage 3*: The Council will contact each nonbank financial company that the Council believes merits further review to collect information directly from the company that was not available in the prior stages. Each nonbank financial company that is reviewed in Stage 3 will be notified that it is under consideration and be provided an opportunity to submit written materials related to the Council's consideration of the company for a proposed determination.

If the Council approves a proposed determination, the nonbank financial company will receive a written explanation of the basis of the proposed determination. The company may then request a hearing to contest the proposed determination. After any hearing, a final determination requires a second vote of the Council.

Stage 1 Analysis

Much attention has been focused on the Stage 1 thresholds. Stage 1 is not intended to identify nonbank financial companies for a final determination. Instead, the Council developed the uniform quantitative thresholds in Stage 1 as a tool that the Council, nonbank financial companies, market participants, and other members of the public may use to assess whether a nonbank financial company will be subject to further evaluation by the Council. As noted in the final rulemaking, based on data currently available to the Council through existing public and regulatory sources, the Council has estimated that fewer than 50 nonbank financial companies meet the Stage 1 thresholds. The Council recognizes, however, that the Stage 1 thresholds may not capture all types of nonbank financial companies and all of the potential ways in which a nonbank financial company could pose a threat to financial stability. Therefore, the Council reserves the right to subject any nonbank financial company to further review if the Council believes that further analysis of the company is warranted to determine if the company could pose a threat to U.S. financial stability, regardless of whether such company meets the thresholds in Stage 1.

A nonbank financial company will be subject to further evaluation beyond Stage 1 if it has at least $50 billion in total consolidated assets and meets or exceeds any one of the following Stage 1 thresholds:

- $30 billion in gross notional credit default swaps outstanding for which the nonbank financial company is the reference entity;
- $3.5 billion in derivative liabilities;
- $20 billion of total debt outstanding;
- 15 to 1 leverage ratio, as measured by total consolidated assets to total equity; or
- 10 percent ratio of short-term debt (having a maturity of less than 12 months) to total consolidated assets.

The Stage 1 thresholds and their levels reflect the collective judgment of the Council members, in light of the statutory standards and considerations and an extensive review of applicable data and various analyses. The Council selected the Stage 1 thresholds based on their applicability to nonbank financial companies that operate in diverse financial industries and because the data underlying these thresholds for a broad range of nonbank financial companies are generally available from existing public and regulatory sources. The Council reviewed distributions of various samples of nonbank financial companies and bank holding companies to inform its judgment regarding the appropriate thresholds and their quantitative levels. The Council also considered historical testing of the thresholds to assess whether they would have captured nonbank financial companies that encountered material financial distress during the financial crisis of 2007–2008.

For U.S. nonbank financial companies, the Council intends to apply each of the Stage 1 thresholds based on the global assets, liabilities, and operations of the company and its subsidiaries. For foreign nonbank financial companies, the Council intends to calculate the Stage 1 thresholds based solely on the U.S. assets, liabilities, and operations of the foreign nonbank financial company and its subsidiaries. These thresholds add significant transparency to the designation process, beyond the statutory requirements, by helping nonbank financial companies assess whether they are likely to be subject to additional review by the Council. In addition, the Council may develop additional guidance regarding potential metrics or thresholds, as appropriate, as more data and information about firms and industries, such as asset managers, hedge funds, private equity firms, and swaps entities, become available. Any additional guidance will be released to the public.

While the Board of Governors has not issued regulations under section 170 of the Dodd-Frank Act to exempt certain types or classes of nonbank financial companies from designation, the Stage 1 thresholds provide a significant level of transparency and certainty for the public regarding the nonbank financial companies that are most likely to be subject to evaluation for designation.

Stage 2 Analysis

In the second stage of the process, the Council will conduct a comprehensive analysis of each nonbank financial company identified in Stage 1. In contrast to the application of uniform quantitative thresholds to a broad group of nonbank financial companies in Stage 1, the Council intends to evaluate the risk profile and characteristics of each individual nonbank financial company in Stage 2 based on a wide range of quantitative and qualitative industry-specific and company-specific factors. The analysis will use the six-category analytic framework described above – size, interconnectedness, substitutability, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. To the extent data are available, the Council also intends in Stage 2 to consider the impact that resolving a failing nonbank financial company could have on U.S. financial stability.

In general, this analysis will be based on a broad range of information already available to the Council through existing public and regulatory sources, including information possessed by the company's primary financial regulatory agency or home country supervisor, as appropriate, and any information voluntarily submitted by the company. The Council also intends to fulfill its statutory obligation to rely whenever possible on information available through the Office of Financial Research (the "OFR"), member agencies, or the nonbank financial company's primary financial regulatory agencies before requesting the submission of information from any nonbank financial company in Stage 3.

Based on the Stage 2 analysis, the Council intends to contact those nonbank financial companies that the Council believes merit further evaluation in Stage 3.

Stage 3 Analysis

The Council will conduct a review of each nonbank financial company in Stage 3 using information collected directly from the nonbank financial company, as well as the information used in the first two stages. At the beginning of Stage 3, the Council will send a notice of consideration to each nonbank financial company that will be reviewed in Stage 3. Notified companies will be provided an opportunity to submit materials to the Council. This opportunity for the company to submit materials to contest the Council's consideration of the company for a proposed determination is an additional protection, not statutorily required, that the Council provided in its final rule.

The notice of consideration likely will also include a request that the nonbank financial company provide information that the Council deems relevant to its evaluation. This information will generally be collected by the OFR. Before requiring the submission of reports from any nonbank financial company that is regulated by a Council member agency or any other primary financial regulatory agency, the Council will coordinate with such agencies and will, whenever possible, rely on information available from the OFR or from such agencies. The Council will also consult with appropriate foreign regulatory authorities, to the extent appropriate. Council members and their agencies and staffs will maintain the confidentiality of such information in accordance with applicable law.

In its analysis under the six-category framework, the Council will consider both quantitative and qualitative information. The Council expects that the information necessary to conduct an in-depth analysis of a particular nonbank financial company may vary significantly based on the nonbank financial company's business and activities and the information already available to the Council from existing public sources and domestic or foreign regulatory authorities. Information relevant to the Council's analysis may include confidential business information such as internal assessments, internal risk management procedures, funding details, counterparty exposure or position data, strategic plans, resolvability, potential acquisitions or dispositions, and other anticipated changes to the nonbank financial company's business or structure that could affect the threat to U.S. financial stability posed by the nonbank financial company. The Council will also consider qualitative factors that include considerations that could mitigate or aggravate the potential of the nonbank financial company to pose a threat to U.S. financial stability, such as the nonbank financial company's resolvability, the opacity of its operations, its complexity, and the extent and nature of its existing regulatory scrutiny.

The objective of the Stage 3 analysis is to assess whether a nonbank financial company meets one of the statutory standards for a determination: that is, whether the company's material financial distress, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company, could pose a threat to U.S. financial stability.

At the end of Stage 3, based on the results of the analyses conducted during each stage of review, the Council may, by a vote of at least two-thirds of the Council's voting members then serving, including an affirmative vote by the Chairperson of the Council, make a proposed determination regarding the company. If a proposed determination is made, the Council will provide the nonbank financial company with a written explanation of the basis of the proposed determination. The company may request a hearing to contest the proposed determination. After any hearing, in order to make a final determination, the Council must again vote by a two-thirds majority of the Council's voting members then serving, including an affirmative vote by the Chairperson. The Council will publicly announce all of its final determinations, as required by the Dodd-Frank Act. The Council is also required, by statute, annually to reevaluate currently effective determinations and rescind any determination if the Council determines that the nonbank financial company no longer meets the standards for determination.

Revisions to the Rule and Interpretive Guidance Based on Public Comment

In response to comments on the First NPR, the Council incorporated numerous additions and changes in the Second NPR. Most notably, the Council added extensive interpretive guidance that outlined the three-stage process described above, including the addition of the uniform, quantitative Stage 1 thresholds and sample metrics for each item in the six-category analytic framework. In response to requests from commenters, the Council also added definitions of the terms "threat to the financial stability of the United States" and "material financial distress" with respect to the statutory determination standards to the interpretive guidance, and added a confidentiality provision to the rule. In addition, the Second NPR included greater safeguards for nonbank financial companies under evaluation, including a requirement for a notice from the Council to companies upon completion of the Council's evidentiary record in Stage 3, and a 180-day deadline for a proposed determination after that notice is sent; and greater clarity on the process for emergency waivers or modifications of the otherwise applicable procedural requirements.

In developing the final rule and guidance, the Council made a number of additional changes in response to comments on the Second NPR. The final rule provides greater clarity on the confidentiality provisions that will apply to information submitted voluntarily by nonbank financial companies and information that is collected from regulators that are not Council members. The final rule and guidance also include additional procedural steps to benefit nonbank financial companies and aid the Council's analysis, including an intention to consult with primary financial regulatory agencies of a company's significant subsidiaries in Stage 2, when appropriate; an intention to provide at least one business day's notice to a firm before publicly announcing its designation following a final determination; and additional notice and opportunity for firms to submit information in annual reevaluations of designated companies. The final rule also provides greater clarity on a number of issues, including the definition of "company"; how the

Council may consider managed funds and fund advisors; and several clarifications to the definitions, calculations, and processes for applying the Stage 1 thresholds.

Determinations

The Council will exercise its judgment as it considers both quantifiable metrics and the unique risks that a particular nonbank financial company may present to the financial system. This flexibility will allow the Council to address the diverse range of business models among nonbank financial companies. Moreover, given the dynamic nature of financial markets and the evolution of financial products and services, the Council will need the ability to take such changes into account in its determinations. Ultimately, in accordance with the Dodd-Frank Act, all designations will be based on a determination that a company's material financial distress – or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company – could pose a threat to U.S. financial stability.

Every designation decision will be firm-specific, and every firm will receive robust due process protections, including the opportunity for judicial review of any final designation. Even before the Council votes on a proposed designation, a company under consideration will have the opportunity to submit written materials to the Council addressing whether, in the company's view, it meets the standard for designation. Only after Council members have reviewed that information will they vote on a proposed designation, which requires the support of two-thirds of the Council (including the affirmative vote of the Chairperson) and after which the Council will provide the company with a written explanation of the basis of the proposed designation. If challenged, the proposed designation is subject to review through a formal hearing process and another two-thirds Council vote. The Council must report to Congress annually on all final designations and the basis for such designations.

In the wake of the 2007-2008 financial crisis, Congress included in the Dodd-Frank Act the authority for the Council to designate nonbank financial companies that could pose a threat to U.S. financial stability. The designations process described in the Council's rule and guidance is the result of over a year of dialogue with market participants, non-profits, academics, and members of the public. The resulting rule and guidance form an important part of the Council's ability to carry out its statutory duties to identify risks to financial stability and respond to such threats in order to better protect the U.S. financial system.

Thank you. I would be happy to answer your questions.

Douglas J. Elliott

Thank you for the opportunity to testify again today, this time on systemically important non-bank financial institutions. I should note that while I am a Fellow at the Brookings Institution, my testimony today is solely on my own behalf. Brookings does not normally take policy positions as an institution.

In Dodd-Frank, Congress wisely gave regulators a wider mandate to oversee systemically important financial institutions (SIFIs). These institutions are the ones most capable of triggering financial crises through mistakes or bad luck, due to their importance as financial intermediaries and their interconnections with the rest of the financial system. As such, they merit more attention from regulators, more tools should be available for regulatory intervention, and they should be held to a somewhat higher standard of financial conservatism.

The need for closer supervision is not erased by the steps that have been taken to reduce the potential for government bailouts of failing institutions. First, because it is impossible to totally eliminate the potential for a financial crisis to be severe enough to merit further taxpayer-financed rescues. Second, because even if this goal were achieved, so that creditors and shareholders picked up all the losses with no help from taxpayers, a serious financial crisis would still lead to a severe contraction of credit, sending the economy into a deep recession, such as we just experienced. You will recall that the recent recession cost taxpayers far more than did the bailouts.

Banks are among the most likely institutions to be systemically significant, but other types of financial institutions can certainly be SIFIs and it is good that Dodd-Frank recognized this. Prior to this legislation, it was very difficult for the regulators to track the systemic risk of non-bank financial institutions, much less affect the level of that risk.

Robert Litan and I wrote an extensive paper on non-bank SIFIs, to which I refer the members for a fuller explanation of my views.
(http://www.brookings.edu/papers/2011/0116_regulating_sifis_elliott_litan.aspx). Today's testimony will focus on a few key beliefs about how to identify and regulate non-bank SIFIs and some thoughts on the proposed regulations.

First, no part of the financial industry should receive an automatic exclusion from SIFI designation. There is too much danger of a firm taking advantage of its legal form to acquire the importance of a SIFI without the appropriate oversight. Regulatory arbitrage is a fact of life against which we must guard.

Second, there are no absolutes in determining systemic importance. There are multiple ways of measuring the level of significance and no clear consensus on the exact methods, which is why the proposed rules allow for considerable judgment. Even within a single measurement approach, there are degrees of systemic importance, with no bright line where an institution flips from unimportant to important. In essence, the entire SIFI concept, like much of regulation, is about costs and benefits. The benefits of the improved information, more careful supervision, and higher capital and other safety margins must outweigh the costs of imposing the extra regulation.

Third, as a result, we must strive for the right balance between the dangers of over-designation and under-designation. Clearly, as many as possible of the true SIFIs should be captured in the formal designation process, since oversight of the financial system as a whole will be stronger with the right information and with the regulatory tools to ensure safe operations of the key institutions. However, there are also costs to naming a firm as a SIFI when it does not really merit that designation. The additional level of regulation, and the higher required safety margins, will make credit and other financial products more expensive, which is only worthwhile if there is an increase in systemic safety that more than offsets the costs.

The subcommittee's invitation letter asked specifically about one part of this trade-off, which is whether there will be a market advantage for those firms that are designated as SIFIs. Some have raised the possibility that a firm which is named as a SIFI will have an implicit government guarantee, or at least seal of approval, which will give them a competitive advantage on their funding costs and their ability to sell products. I do not believe this to be a significant issue. Those firms likely to be designated as SIFIs are already viewed by the markets as being safer because of their larger size and importance. This perception sometimes includes a residual belief in the possibility of a government rescue, despite the steps Congress and the regulators have taken to counter this belief. My experience in the financial markets, where I was an investment banker for almost twenty years, convinces me that the marginal effect of a formal designation would be small. Regardless of my own views, both the managements and investors of firms potentially designated as SIFIs are sending very strong signals that they see such a designation as a negative. I can assure you that a number of those firms are working very hard to avoid designation, as you have doubtless noticed yourselves. It seems very unlikely that this would be the case were there a significant financial advantage to the designation.

Fourth, the additional oversight applied to non-bank SIFIs must be appropriate to the systemic risk they represent and be coordinated as effectively as possible with their existing regulation. Ideally, the regulatory framework for non-bank SIFIs would be designed in parallel with the designation process, to facilitate the cost/benefit analysis inherent in choosing whether to subject a firm to the rigors of designation. Unfortunately, the deadlines in Dodd-Frank push the regulators towards designating the SIFIs prior to deciding exactly how to regulate them. This creates uncertainty as to whether the regulation in practice will inadvertently harm desirable activities by those firms.

Fifth, similar activities should be regulated in similar ways with similar safety margins, to the extent possible, regardless of the legal form of the institution doing the activity. Otherwise, it will be easy to fall prone to regulatory arbitrage as well as the inefficiencies that are produced by arbitrary differences in competitive advantage.

Evaluating the proposed rules in light of these key points, the regulators appear to be generally on the right track, although there is a great deal that cannot be judged yet. The rules focus on the right set of sources of systemic risk and they recognize the need to carefully consider the specific facts and to apply considered judgment to questions that are inherently somewhat subjective. It makes sense that the regulators are casting a wide net in the initial phase, to determine which institutions they will need more information about. As I have stressed, there are no straightforward quantitative methods to find the answers here, so there is a need to gather information on a wide range of candidates for designation, in order to assess each in a deeper way. I am sure that everyone would prefer that there existed a straightforward numerical test that could be used for the final determination, but the situation is much too complex to avoid the application of substantial amounts of human judgment.

The regulators have also said the appropriate things about recognizing the diversity of business models in different parts of the financial system, although there remains cause for concern as to whether this will be reflected fully in actual practice. For example, the stress tests applied to banking groups appear, at least from what I can glean from news reports, not to have taken sufficient account of the differences between MetLife's insurance operations and the banking businesses that were the core of all the other groups subject to the full test. Hopefully, this was a byproduct of the specific circumstances and not an indicator of the broader approach regulators will take.

In my view, there are currently no true SIFIs in most of the financial sectors, including: private equity, venture capital, hedge funds, property-casualty insurance, and mutual funds management, with the possible exception of money market funds. This is not a matter of principle, but rather due to the fact that these are sectors which tend to generate quite low systemic risk per dollar of assets and none of them have enough assets for their absolute risk to come close to systemically important levels. It is possible that one or more of these sectors could develop SIFIs over time, particularly in the hedge fund sector where there is a wide range of business models. Therefore, as noted earlier, a blanket exception by class of institution is inappropriate.

It is possible that SIFIs might exist among money market funds, since they can be of large size and their activities are somewhat analogous to deposit-taking, potentially giving them a great economic importance in a crisis. I have not studied money market funds sufficiently to reach a conclusion as to whether there is presently a SIFI among them. Regardless of the status of individual funds or funds managers, though, money market funds in aggregate clearly have systemic significance and it is good that their structure and regulation is being carefully considered through other processes at the moment.

I do believe that there are probably several SIFIs among the largest life insurers. These firms, like banks, are financial intermediaries that take funds from the public and operate with quite substantial leverage compared to a non-financial firm, and therefore are prone to some of the same risks as banks. At the same time, their business models tend to generate less systemic risk, particularly because they have much longer liabilities than banks do, giving them considerably more time to react to problems without being forced into a fire sale of assets. Thus, life insurers do generate systemic risk, but substantially less risk per dollar of assets than is true for banks. Some insurers are so large, however, that their size more than makes up for their low risk generation per dollar of assets. As a separate matter, political and bureaucratic pressures are quite likely to result in SIFI designation in order to underline that the FSOC has taken its responsibility seriously to designate non-bank SIFIs.

It is very important, however, that any life insurers designated as SIFIs should be regulated in a manner consistent with the major differences between insurance and banking. The regulators appear sincere in wanting to do this, but it remains a question as to whether ingrained ways of viewing the world may make it difficult to make the full transition in viewpoint in time for the initial SIFI regulations for non-banks. It may become a cumbersome iterative process of starting with regulations that are far from a perfect fit and working out improvements over time, which would be a shame.

The finance company business model is one that can generate even more systemic risk per dollar of assets than banking does. There is a similar maturity mismatch between short-term borrowings and medium- to longer-term loans, but the wholesale nature of the finance company's funding model makes them even more vulnerable to runs than banks are. In fact, this vulnerability largely eliminated the big finance companies in the crisis or forced them to adopt a banking-type business model that brings them into effective SIFI status already. There is one well-known exception among the large finance companies which I strongly assume will be designated as a non-bank SIFI.

In sum, designating non-bank SIFIs is by its nature a complex endeavor that requires a careful balancing act and substantial human judgment. The rules proposed by the regulators generally reflect those considerations and I believe that the resulting uncertainty about the ultimate outcomes is unavoidable, unless we either abandon the effort to designate such SIFIs or use cruder measurements that would almost certainly produce worse results. I am more concerned about whether those non-banks that are designated as SIFIs will be regulated in a way that fully reflects their differences with banks, but I am hopeful that this can eventually be worked out.

Thank you again for the opportunity to testify today. I look forward to your questions.

For release on delivery
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May 16, 2012

Statement of

Michael S. Gibson

Director

Division of Banking Supervision and Regulation

Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions and Consumer Credit

of the

Committee on Financial Services

U.S. House of Representatives

May 16, 2012

Chairman Capito, Ranking Member Maloney, and other members of the Subcommittee, thank you for the opportunity to testify on implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) as it relates to the designation, supervision, and regulation of systemically important nonbank financial companies.

Systemically Important Nonbank Financial Companies and the Problem of "Too Big to Fail"

The recent financial crisis showed that some financial companies, including nonbank financial companies not historically subject to consolidated prudential supervision, had grown so large, leveraged, and interconnected that their failure could pose a threat to overall financial stability. The sudden collapses or near-collapses of major financial companies, and in particular major nonbank financial companies, were among the most destabilizing events of the crisis. The crisis also demonstrated weaknesses in the existing framework for supervising, regulating, and otherwise constraining the risks of major financial companies, as well as deficiencies in the government's toolkit for managing their failure.

As a result of the imprudent risk-taking of major financial companies and the perceived severe consequences to the financial system and the economy associated with their disorderly failure, the U.S. government (and many foreign governments) intervened to reduce the impact of, or prevent, the failure of these companies. Before the crisis, market participants had assumed that major financial companies likely would receive government assistance if they became troubled. The actions taken by governments in response to the crisis, although necessary, helped to solidify the market view that such financial firms were too big to fail.

The Dodd-Frank Act addresses key gaps in the framework for supervising and regulating systemically important financial institutions and the market perception that such firms are too big to fail. Specifically, the Dodd-Frank Act seeks to mitigate the threat to financial stability posed by systemically important nonbank financial companies that were historically outside the existing regulatory framework for bank holding companies. The Dodd-Frank Act takes a multi-pronged approach to do so, including: (i) the establishment of the Financial Stability Oversight Council (the Council), which has the authority to designate nonbank financial companies that could pose a threat to financial stability; (ii) a new framework for consolidated supervision and regulation by the Federal Reserve of nonbank financial companies designated by the Council; and (iii) improved tools for the resolution of failed nonbank financial companies.

I will briefly discuss the Federal Reserve's work to date in each of these key areas.

Designation of Nonbank Financial Companies by the Financial Stability Oversight Council

As you know, the Dodd-Frank Act created a council of regulators, the Financial Stability Oversight Council, to coordinate efforts to identify and mitigate threats to U.S. financial stability across a range of institutions and markets. Among the Council's most important responsibilities are establishing a framework for designating nonbank financial companies whose failure could pose a threat to financial stability, and applying that framework to designate and reassess individual firms over time. Once designated, these firms would be subject to consolidated supervision by the Federal Reserve and would be required to satisfy enhanced prudential standards established by the Federal Reserve under title I of the Dodd-Frank Act.

The Federal Reserve has been working closely with the other member agencies of the Council to put this designation framework in place. On April 3, the Council issued a final rule and interpretive guidance setting forth the criteria and process it will use to designate nonbank financial firms as systemically important. The Council's rule provides detail on the framework that it intends to use to assess a particular firm's potential to threaten U.S. financial stability.

The analysis would take into account the firm's size, interconnectedness, provision of critical products or services, leverage, and reliance on short-term funding, as well as its existing regulatory oversight.

The Council's issuance of this rule is an important step forward in ensuring that systemically critical nonbank financial firms will be subject to strong consolidated supervision and regulation. The Council and its member agencies' staffs currently are using these criteria to analyze the potential systemic importance of individual nonbank financial companies in different industries. As the Council gains experience with the designation process, we expect it will make adjustments to its rule and procedures as appropriate.

Regulation and Supervision of Systemically Important Nonbank Financial Companies

Of course, the identification and designation of systemically important nonbank financial companies is only an initial step. Just as important is the establishment of a strong, effective regulatory framework for constraining the systemic risk posed by such firms. In this regard, sections 165 and 166 of the Dodd-Frank Act require the Federal Reserve to establish enhanced prudential standards both for bank holding companies with total consolidated assets of $50 billion or more and for nonbank financial companies designated by the Council. These standards include enhanced risk-based capital and leverage requirements, liquidity requirements, single-counterparty credit limits, stress testing, risk-management requirements, an early remediation regime, and resolution-planning requirements. Sections 165 and 166 also require that these prudential standards become more stringent as the systemic footprint of the firm increases.

In December, the Federal Reserve issued a package of proposed rules to implement sections 165 and 166 of the Dodd-Frank Act. The Federal Reserve's proposed rules would apply the same set of enhanced prudential standards to covered companies that are bank holding companies and covered companies that are nonbank financial companies designated by the Council. As we made clear in the proposal, however, the Federal Reserve may tailor the application of the enhanced standards to different companies on an individual basis or by category, taking into consideration each company's capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors that the Federal Reserve deems appropriate. Working out the exact details of how enhanced prudential standards will apply to nonbank financial companies will certainly require a thoughtful and iterative analysis of each designated company over time. Once the Council designates one or more nonbank financial companies, the Federal Reserve is committed to thoroughly assessing the business model, capital structure, and risk profile of each designated company and tailoring the application of the enhanced standards to each company on an individual basis or by category, as appropriate. The Federal Reserve will also give careful consideration to the appropriate transition period required for newly designated nonbank financial companies to comply with the enhanced prudential standards and other regulatory requirements.

The comment period for the Federal Reserve's enhanced prudential standards proposal closed on April 30, 2012. Nearly 100 comments letters were received. The Federal Reserve is currently reviewing those comments carefully as we work to develop final rules to implement sections 165 and 166.

Living Wills and Orderly Resolution

Ending "too big to fail" also requires that a systemically important financial institution be allowed to fail if it cannot meet its obligations--and to fail without inflicting serious damage on the broader financial system. Thus, the Dodd-Frank Act empowers the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) to reduce the impact on the system in the event of the failure of a systemically important nonbank financial company through two important new regulatory tools. First, section 165(d) of the Dodd-Frank Act requires each bank holding company with total consolidated assets of $50 billion or more and each nonbank financial company designated by the Council to prepare and provide to the FDIC and the Federal Reserve a resolution plan, or "living will," for its rapid and orderly resolution under the U.S. bankruptcy code. Second, title II of the Dodd-Frank Act provides for an orderly resolution process to be administered by the FDIC. Importantly, both of these new tools extend to systemically important nonbank financial companies, in addition to bank holding companies with total consolidated assets of $50 billion or more.

Thank you very much for your attention. I would be pleased to answer any questions you might have.

Statement of Scott E. Harrington
Alan B. Miller Professor
The Wharton School
University of Pennsylvania

On "Implementing Title I of the Dodd-Frank Act: The New Regime for Regulating Systemically Important Nonbank Financial Institutions"

Before the
Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
United States House of Representatives

May 16, 2012

Chairman Capito, Ranking Member Maloney, and members of the Subcommittee:

I am the Alan B. Miller Professor at the University of Pennsylvania's Wharton School, where I also serve as director of the Wharton/Penn Risk and Insurance Program and executive director of the S.S. Huebner Foundation for Insurance Education. I have spent much of my career conducting research and teaching on insurance markets and regulation, including solvency regulation and capital requirements.[1]

I am pleased to have this opportunity to testify as an independent expert on the Financial Stability Oversight Council's (FSOC's) final rule on the Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies and the Federal Reserve's proposed rule for supervising such firms. My testimony first contrasts systemic risk between insurance and banking. I then provide specific comments on the FSOC's final rule and the Federal Reserve's proposed rule.

Systemic Risk in Insurance vs. Banking

The term "systemic risk" encompasses the risk to financial institutions with spillovers on the real economy from large, macroeconomic shocks and/or extensive interconnectedness among financial firms. There is a distinction, however, between the

[1]I am a member of the Federal Advisory Committee on Insurance, which was created in November, 2011 to advise the Federal Insurance Office established by the Dodd-Frank Act.

risk of common shocks to financial firms and risk that arises from interconnectedness and attendant contagion. Rather than interconnectedness and contagion, the principal driver of the financial crisis in general and the collapse of American International Group, Inc. (AIG) in particular was direct exposure to the housing bubble and declines in values of mortgage related securities and instruments. The extent to which noninsurance activities at AIG presented significant risk of contagion is uncertain.

Consistent with the generally favorable performance of core insurance activities during the crisis, the consensus is that systemic risk is minimal in insurance markets compared with banking. Banking crises have much greater potential to produce rapid and widespread harm to economic activity and employment. This fundamental difference helps explain historical differences in regulation across the insurance and banking sectors.

Significant systemic risk strengthens the case for relatively broad government guarantees of bank obligations and relatively stringent financial regulation, including capital requirements. Because insurance poses little systemic risk, there is less need for relatively broad guarantees of insurers' obligations to policyholders and stringent capital requirements. State insurance guarantees have been narrower in scope than federal guarantees in banking, and market discipline for safety and soundness is reasonably strong in insurance markets. Insurers commonly have held much more capital than required by regulation and have not faced strong incentives for regulatory arbitrage to evade capital requirements.

The FSOC's Final Rule

Section 113 of the Dodd-Frank Act gives the FSOC the authority by a two thirds vote to designate a nonbank financial company as systemically important (by imposing a threat to the financial stability of the United States) and subject to enhanced regulation and supervision by the Federal Reserve. The Federal Reserve is required to establish, with input from the FSOC, enhanced risk-based capital requirements, leverage rules, resolution standards, and other requirements for systemically important nonbank financial companies. Section 113 specifies factors the FSOC must consider in determining whether a company will be subject to enhanced supervision including its leverage; off-balance sheet exposure; importance as a source of credit and liquidity for households, businesses, state and local governments, and low-income communities; the nature, scope, size, and interconnectedness of its activities; the amounts and nature of its assets and liabilities; the degree to which it is already regulated by one or more primary regulators; and "any other risk-related factors that the Council deems appropriate."

The FSOC issued an advanced notice of rulemaking for Section 113 in October, 2010, a notice of proposed rulemaking in January, 2011, a second notice of proposed rulemaking in October, 2011, and a final rule in April, 2012. Apart from a number of clarifications, the final rule and accompanying guidance are essentially the same as the notice of proposed rulemaking issued in October, 2011. Much of the detail concerning implementation remains in the interpretive guidance, which retains the six-category analytical framework first set forth in the January, 2011 notice. The categories include firm size, substitutability of its products/services, interconnectedness, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. The final rule's interpretative guidance retains the three stage determination process proposed in October, 2011, including specific quantitative thresholds to be used in the first stage.

Stage 1 of the analysis would employ publicly available information and information from member regulatory agencies to identify nonbank financial companies for more detailed evaluation in Stage 2. A nonbank financial company would be evaluated further in Stage 2 if global consolidated assets are $50 billion or greater and it meets at least one of the following thresholds:

- $30 billion in gross notional credit default swaps
- $3.5 billion of derivative liabilities
- $20 billion of total debt outstanding
- 15 to 1 leverage ratio (total consolidated assets to total equity, excluding separate accounts)
- 10 percent ratio of short-term debt (maturity less than 12 months) to total consolidated assets (excluding separate accounts)

While the guidance refers to analysis of historical data as the basis for the thresholds, it provides little detail, and it is not clear why dollar amounts are used for credit default swaps, derivative liabilities, and outstanding debt, as opposed to thresholds that are scaled by relevant measures of firm size.

The inclusion of the quantitative thresholds provides guidance to companies regarding their potential for designation. The thresholds presumably reflect the FSOC's attempt to balance the desire of companies for some degree of certainty versus maintaining flexibility to designate nonbank financial companies that may not be readily identified by more precise quantitative standards. Indeed, the interpretive guidance indicates that "the Council may initially evaluate any nonbank financial company based on other firm-specific qualitative or quantitative factors, irrespective of whether such company meets the thresholds in Stage 1." Thus, the $50 billion size threshold and requirement that a company meet at least one of the other thresholds are sufficient but not necessary for inclusion of a company in the "Stage 2 Pool" for further analysis.

Stage 2 would entail a review and prioritization of Stage 2 Pool entities based on analysis of each company using information available to the FSOC through existing public and regulatory agencies and information obtained from the company voluntarily. The analysis would use a wide range of quantitative and qualitative industry-specific and company-specific factors. The FSOC also would evaluate whether resolution of the company could pose a threat to U.S. financial stability and the extent to which the company is subject to regulation. Based on this analysis, the FSOC would notify companies it believes merit further evaluation in Stage 3 (the Stage 3 Pool).

In Stage 3, the FSOC (with assistance from the Office of Financial Research) would review each company identified for further analysis in Stage 2, including analysis of additional information collected directly from the company. The evaluation would consider the company's resolvability, and the FSOC would consult with the company's primary regulator. Following such analysis, a Proposed Determination would require a two-thirds vote of the FSOC, followed by a hearing if requested by the company, and, if so, a final vote by the FSOC.

Overall, the final rule and interpretive guidance provide the FSOC with broad discretion for designating systemically important nonbank financial companies. Some nonbank companies will likely face considerable uncertainty about possible designation and actions they might take to reduce risk and avoid that result. The specific application of the final rule by the FSOC will determine whether the net is cast broadly or narrowly. In my opinion (and excluding AIG), appropriate application by the FSOC of the statutory criteria and the final rule *should not* result in designation of any companies that predominantly write property/casualty insurance as systemically important and very few, if any, life insurers. Given the uncertainty associated with the designation process and possible unintended consequences, consideration could be given to establishing some form of safe harbor that would reduce uncertainty and increase the likelihood of that result.

Effects of Designation on Competitive Dynamics

The designation of individual insurance entities and other nonbank financial companies as systemically significant, as opposed to a system of heightened scrutiny and supervision of specific types of activities that pose systemic risk, has significant drawbacks. There is little cause for optimism concerning the ability of enhanced supervision of individual companies designated as systemically important to reduce significantly the likelihood of any future crisis. Greater capital requirements and tighter regulation for individual companies designated as systemically important raise the risk that they could face excessive burdens and costs that would disrupt competition and harm customers, at least in the near term when memories of the financial crisis are fresh. On the other hand, sooner or later a "systemically important" designation of a nonbank financial company would likely translate as "too big to fail," regardless of assertions that creditors and shareholders of companies will not be bailed out in the event of financial distress. That result would provide designees with a competitive advantage in attracting customers and capital and significantly undermine market discipline and incentives for safety and soundness.

These drawbacks favor narrow application of the FSOC's statutory charge to identify systemically important companies. In the specific case of insurance, the potential benefits from designating some companies as systemically important are small, and the potential costs are large.

The Federal Reserve's Proposed Rule for Enhanced Prudential Standards

The Federal Reserve's January, 2012 proposed rule for enhanced prudential standards and early remediation requirements for large bank holding companies and nonbank financial companies designated by the FSOC, including capital requirements, liquidity standards, and stress testing, is bank centric. Unless modified significantly for nonbank financial institutions, the proposed rule would apply standards developed for large banks to nonbanks without regard to fundamental differences in operations and risk profiles, with the potential for significant market disruptions and unintended consequences. This result obviously should be avoided.

Enhanced prudential standards for nonbank financial companies identified by the FSOC as systemically important should be tailored to the distinct nature of the operations and risks of specific nonbank financial services. In the case of insurance, careful consideration should be given to linking enhanced prudential standards to existing risk-based capital requirements for insurers and related state regulation.

100 Years Standing Up for American Enterprise
U.S. CHAMBER OF COMMERCE

Statement of the U.S. Chamber of Commerce

ON: "Implementing Title I of the Dodd-Frank Act: The New Regime for Regulating Systemically Important Nonbank Financial Institutions"

TO: The Subcommittee on Financial Institutions and Consumer Credit

DATE: May 16, 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.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance – is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 115 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

Chairman Capito, Ranking Member Maloney and members of the Financial Institutions and Consumer Credit Subcommittee, my name is Tom Quaadman. I am vice president for the Center for Capital Markets Competitiveness at the U.S. Chamber of Commerce. I appreciate the opportunity to testify before the Subcommittee today on behalf of the businesses that the Chamber represents.

To compete, grow, and create jobs, America's businesses need efficient capital markets. Efficient capital markets allow businesses to have the access to the resources needed to operate on a daily basis and strategically plan for long-term success. Effective regulators who understand these markets create a regulatory regime that promotes balance and allows good actors to play on an even playing field while identifying and acting against bad actors through vigorous oversight and enforcement.

Monitoring and regulating systemic risk, whereby the collapse of a firm could imperil the entire domestic and/or global financial system, is an important part of a regulatory structure needed for America's businesses to compete in a 21st century economy. While systemic risk is a very broad subject, I will confine my remarks to the issues related to the subject of today's hearing—identifying and regulating nonbank companies that are engaged in financial activities to such a degree and on such a scale that they pose a systemic risk to U.S. and global financial markets..

1. Overview

In 2007, the Chamber created the Center for Capital Markets Competitiveness. The Center was established to advocate for financial regulatory reforms needed to ensure that American businesses had access to efficient flows of capital necessary to compete in a 21st century global economy.

It became apparent during the 2007-2008 financial crisis that the Federal Government did not have the regulatory apparatus necessary to identify, assess and, when appropriate, manage systemic risk. In November, 2008, the Chamber called for the establishment of a systemic risk regulator as part of a larger financial regulatory reform effort. Congress included systemic risk regulation in Title I and II of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). While the Chamber opposed the final passage of the Dodd-Frank Act, the Chamber supported legislative efforts to properly address systemic risk. In particular we supported the efforts that resulted in the Pryor-Vitter amendment which creates the "predominantly engaged in financial activities" test for nonbank companies. We continue to believe that this amendment provided needed clarity to the process of identifying nonbank financial institutions that may be subject to designation for additional regulatory scrutiny as systemically important institutions.

In looking at means of managing systemic risk, Congress recognized that with respect to nonbank companies, it was crucial to provide a clear delineation between nonbank financial institutions, and those companies whose financial activities are incidental to a primary commercial focus.

We believe that Congress did a good job in striking that balance. However, we are very concerned that the implementation of Title I of the Dodd-Frank Act by regulators is being done in a manner that is manifestly contrary to the clear and unambiguous language Congress used to strike this important balance.

Congress clearly recognized that care must be exercised in distinguishing nonbank companies that may be systemically important from nonbank companies whose financial activities are ancillary to other commercial activities and have not posed such a threat. Thus, Congress established a two-part test for determining if nonbank companies should be considered to be financial companies, and potentially designated as systemically important. This process can be thought of as two inverted funnels sitting on top of each other.

Under Title I of the Dodd-Frank Act nonbank companies first have to pass through a narrow stem of exacting criteria established by the Pryor-Vitter amendment to determine if a company is a financial company—that is, a company that is predominantly engaged in financial activities. A company is considered to be predominantly engaged if 85% of its consolidated revenues or assets are derived from financial activities as defined in section 4k of the Bank Holding Company Act. Section 4k defines specific activities, that when conducted subject to specific conditions, are considered "financial in nature" such that a regulated bank may engage in them.

Those companies that meet this high threshold for being U.S. or foreign "nonbank financial companies" then pass through to the "second funnel." In part two, or the wide part of the second funnel, Financial Stability Oversight Council ("FSOC") determines if a U.S. or Foreign nonbank financial company should be designated as a systemically important financial institution ("SIFI") by using a broad set of criteria including leverage and off balance sheet exposures. Going through the narrow stem of the second funnel, once a company is designated, it is subject to enhanced prudential regulation and oversight by the Board of Governors of the Federal Reserve ("the Board"), though the SIFI's prudential regulator is given the lead role in shaping regulations to meet the unique needs of the company.

We believe that Congress struck the right equilibrium with this system. It ensures that only nonbank companies engaging on a considerable scale in financial activities permissible for a regulated bank to undertake are even candidates to be assessed for designation by the FSOC. Once this initial sifting has been completed, Congress further required that banks and nonbank financial companies labeled as SIFIs by the FSOC should be treated differently from one and other. This is why the Dodd-Frank Act acknowledges the need for nonbank SIFIs to have enhanced regulations that meet the parameters of their business model and are different from the enhanced regulations mandated for systemically important banks.

In short, Congress determined that the power to designate and regulate nonbank SIFIs should be used only sparingly and, if used, it must result in regulations that take into account the unique circumstances of each company and the markets in which it competes. This system allows for the assessment and regulation of threats to the system, without causing undue stress or harm to the economy.

Unfortunately, the Board and FSOC are disregarding the carefully balanced structure Congress passed into law. In doing so regulators are creating exactly the uncertainty and potential for regulatory overreach that prompted the Pryor-Vitter Amendment. If they are allowed to obtain by regulatory fiat a scope of power and discretion Congress denied them, regulators may create economic imbalances harming businesses and consequently economic growth and job creation.

Instead of the narrow "stem" of the first inverted funnel that limits inclusion to those nonbank businesses that meet the exacting "predominantly engaged" standard, the regulators are broadening the criteria to create a high-capacity pipeline. This flies in the face of both the intent and specific language of the Pryor-Vitter amendment. This may ensnare companies into the systemic risk web who should not be there. By broadening the range of activities counted towards whether nonbanks are threatened with being placed in the pot of entities that may be considered for nonbank SIFI designation by the FSOC, regulators are overreaching into commercial activities that had nothing to do with the recent financial crisis. In doing so, they do not lessen systemic risk. They simply compel responses that have adverse consequences throughout the economy.

The fear and uncertainty that this regulatory overreach imposes is further enhanced by the fact that, as will be discussed further, the Federal Reserve has not given prudential regulators the lead role in shaping specific regulations for specific nonbank businesses that are ultimately designated. Instead, the Board appears to be creating a one-size-fits-all, bank-centric approach that will not work well with nonbanks, spanning diverse industries unrelated to banking.

2. Nature of Risk and Adverse Consequences of Circumventing the "Predominantly Engaged" Standard

Risk, like energy, can neither be created nor destroyed, but only transferred. So when discussing systemic risk we cannot be tricked into thinking that risk disappears. It simply moves elsewhere. Our system relies on the presence of actors who view the potential rewards of accepting this risk as sufficient to prompt them to do so. If they should come to view the costs and risks as outweighing any potential reward, the flow of capital will come to a standstill.

To truly minimize the probability of future financial crises, we must understand how this risk moves and where it will show up next. Risk is managed most efficiently when it is transparent and properly understood, and the market responds with robust, efficient and liquid hedging solutions.

By creating a balanced system of clear criteria for nonbank financial companies to be subjected to systemic risk regulation, Congress went down the path of transparency to provide understandable guideposts. For instance, a corporate treasurer whose company imports a raw material from overseas, must manage currency risk, commodity price risk, interest rate risk, and operational shipping risks. By defining activities that are "financial in nature" to be different than the activities banks may undertake pursuant to section 4(k), regulators defy the clear and unambiguous command of Congress. If the above described activities were to be considered in the scope of activities that are financial in nature under a predominantly engaged test broadened by regulators, companies may conclude that some risk management techniques and heretofore efficient transactions will no longer be available, or, if they are available, they will no longer be cost effective. They will decide to "go naked" and retain more risk internally, ultimately shifting risk back to shareholders. The upshot of this is that they will hold even more precautionary cash on their balance sheets as a buffer. This will take money out of the real economy, stall economic growth, stunt the creation of new jobs, and destroy existing jobs.

3. Process Concerns

a. Lack of Transparency

We fully understand and agree that FSOC discussions regarding SIFI designations, the affairs of a designated company, and, if need be deliberations regarding the use of Title II Orderly Liquidation Authority should be kept *in camera*. The very nature of those discussions could have damaging impacts upon the markets, the company and its investors. However, when the FSOC is acting in its quasi-legislative capacity to establish the framework for its designation work, its actions should be subject to the same procedural safeguards that typically attach to such rulemaking efforts. This ensures that regulatory deliberations are happening with the same level of transparency and care as the deliberation of prudential regulators.

By not following basic procedural standards and safeguards generally applicable to federal regulators, the FSOC has created needless uncertainty and concern as to the logic and motivations behind the regulations it promulgates. It reduces the ability of the regulated community to understand and comply with FSOC's rules. Although the FSOC has provided an opportunity to comment, in many instances there is no evidence that the comments are considered and, if so, to what extent. There is often no reasoned explanation in final rules responding to the comments of the regulated community. This discourages stakeholders from providing the FSOC with informed commentary that may improve a proposed regulation. It also decreases the regulated community's acuity as to what regulators may decree next, which increases uncertainty in the business community.

The Chamber believes that Congress needs to ensure that when the FSOC issues regulations bearing on a matter as important as the security of the financial markets of America and the world, it abides by the same legal and procedural requirements that other administrative agencies must when promulgating rules on much less significant matters.

b. Lack of Cost Benefit Analysis

Additionally, in the rulemaking process, FSOC did not provide a cost-benefit analysis to allow stakeholders to determine the potential impacts of proposed regulations. In finalizing the rules on designating companies, the FSOC went so far as to state that the designation of systemically important companies was not economically significant as the Office of Management and Budget did not deem this rule a significant regulatory action. This is logically inconsistent reasoning that either implies that systemic risk regulation is meaningless or unnecessary, or that the statement is factually incorrect in stating that the regulations will not have a cost to companies and the economy.

The Chamber believes that the FSOC should have to provide an economic analysis in promulgating a rule. The FSOC should also conduct an economic analysis during Phase 3 of the SIFI designation process to ensure that designation is the most appropriate path for a company rather than enhanced regulation by its prudential regulator. Furthermore, the Chamber believes that Congress should study the possibility of streamlining the FSOC rulemaking along the lines of Executive Order 13563 which places upon agencies the requirement, when promulgating rules to:

1) Propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs (recognizing that some benefits and costs are difficult to justify);

2) Tailor its regulations to impose the least burden on society, consistent with obtaining regulatory objectives, taking into account, among other things, and to the extent practicable, the costs of cumulative regulations;

3) Select, in choosing among alternative regulatory approaches, those approaches that maximize net benefits (including potential economic, environmental, public health and safety and other advantages; distributive impacts; and equity);

4) To the extent feasible, specify performance objectives, rather than specifying the behavior or manner of compliance that regulated entities must adopt; and

5) Identify and assess available alternatives to direct regulation, including providing economic incentives to encourage the desired behavior, such as user fees or marketable permits, or providing information upon which choices can be made to the public.[1]

Additionally, Executive Order 13563 states that "[i]n applying these principles, each agency is directed to use the best available techniques to quantify anticipated present and future benefits and costs as accurately as possible."

This provides a valuable guidepost to strengthen the FSOC rulemaking process.

c. Rules Considered Out of Order and Not Completed

The consideration and promulgation of rules needed to implement Title I have been taken out of sequence and much has yet to be completed. The logical sequence of rules under Title I should be as follows: 1) the Board 's definition of "predominantly engaged in financial activities"; 2) the Board's criteria for exempting certain types or classes of U.S. nonbank financial companies or foreign nonbank

[1] Executive Order 13563

financial companies from supervision under section 170 of the Dodd-Frank Act; 3) the FSOC's authority to require supervision and regulation of certain nonbank financial companies; and 4) the Federal Reserve's enhanced prudential standards and early remediation for covered companies. Promulgation of these rules in the proper sequence would allow interested parties, including those companies that could potentially be caught in any of the earlier rules in the logical sequence, to determine whether they will be subject to a subsequent rule and have certainty as to how any proposed subsequent rule will impact them, so that they can provide comment accordingly.

Unfortunately, financial regulators have taken a different and illogical approach. The following outlines the actual sequence of the systemic risk rulemaking process:

- October 2010 – FSOC issues advanced notice of proposed rulemaking regarding authority to require supervision and regulation of certain nonbank financial companies.

- January 2011 – FSOC issues notice of proposed rulemaking regarding authority to require supervision and regulation of certain nonbank financial companies.

- February 2011 – Federal Reserve issues notice of proposed rulemaking regarding the definitions of "predominantly engaged in financial activities" and "significant nonbank financial company."

- October 2011 – FSOC issues second notice of proposed rulemaking regarding authority to require supervision and regulation of certain nonbank financial companies.

- December 2011 – Federal Reserve issues notice of proposed rulemaking regarding enhanced prudential standards and early remediation requirements for covered companies.

- April 2012 – FSOC issues final rule regarding authority to require supervision and regulation of certain nonbank financial companies.

- April 2012 – Federal Reserve issues supplemental notice of proposed rulemaking regarding the definitions of "predominantly engaged in financial activities" and "significant nonbank financial company."

- Yet to be issued are proposed rules regarding criteria for exempting certain types or classes of U.S. nonbank financial companies or foreign nonbank financial companies from supervision under section 170 of the Dodd-Frank Act.

This haphazard approach to incomplete rulemakings has made it impossible for stakeholders to understand how the systemic risk regulatory system will work and whether it will be subject to further rules under this regime. The Federal Reserve's rules regarding the definition of "predominantly engaged in financial activities" and the criteria for exempting certain types or classes of U.S. nonbank financial companies or foreign nonbank financial companies from supervision should have been completed before the FSOC issued its proposal on authority to require supervision and regulation of nonbank financial companies. Instead, companies have been subject to an unfair and inappropriate rulemaking process that has not provided clarity in terms of whether they will be subject to such rules. This handicaps their ability to provide meaningful comments on the rules that should logically have come at a different point in the implementation process.

It is important also to note that although the FSOC has indeed finalized rules and guidance on the SIFI designation process, the Board has yet to finalize its rules on enhanced prudential standards. Until the Board completes this rulemaking, the FSOC cannot know what the consequences of SIFI designation are, and therefore cannot meaningfully assess whether a nonbank financial company should be designated. Accordingly, the Chamber recommends that the designation process not commence until the entire systemic risk rulemaking process is completed.

d. Regulatory Coordination and Investor Uncertainty

Obviously, the FSOC rulemakings will conflict or overlap with other pre-existing rules that may have been in place for some time. For instance, the Exchange Acts requires that companies disclose to the Securities and Exchange Commission ("SEC") and investors any conditions that are material to the company. Clearly, at some point in time, the consideration of a nonbank financial company as systemically important qualifies as a material condition that should be disclosed to investors. However, neither the FSOC nor the SEC has provided guidance on when, how, or if this consideration should be disclosed.

The Chamber recommends that the FSOC and prudential regulators examine existing regulations and coordinate an approach to give stakeholders clarity and legal certainty as to their duties and actions.

4. Other Substantive Concerns

a. One Size Does Not Fit All

The systemic risk designation process and regulation of nonbank financial companies will implicate varied companies with different business models spread over many industries. Congress recognized that the prudential regulators should take the lead in molding the appropriate regulatory structures to meet the unique needs of nonbank financial companies. This has not occurred, to date, and there is a great concern that a one-size-fits-all bank-centric approach will be imposed because of the Federal Reserve's experience as a bank regulator.

Taking a one-size-fits-all approach goes against Congressional intent as reflected in the Dodd-Frank Act. It will increase potential risk rather than reduce it. Congress clearly delineated between the treatment of systemically important nonbank financial companies and systemically important banks by setting up a detailed designation process for nonbank companies while instituting automatic designation for bank holding companies with total consolidated assets of $50 billion or more.

A one-size-fits-all approach will not produce more effective oversight. Shoehorning nonbank financial companies into a banking regulatory framework will disrupt how these companies compete within their industry and in our global economy. Each financial company fulfills the need for a specific product or service in the marketplace. In the long run, imposing bank-like regulations on a diverse group of nonbank financial companies will force these companies to alter their business model such that the financial services industry becomes homogenized. In some instances, bank-like capital requirements might make certain business lines no longer economically feasible, even though these businesses are not inherently risky. Instead of mitigating systemic risk, such regulation would concentrate it and increase it exponentially, while reducing competition, customer choice and economic efficiency. Furthermore, this would accelerate the flight to less regulated products and jurisdictions, expanding moral hazard.

Accordingly, the Chamber recommends that Congress work with FSOC to ensure that the prudential regulators have an enhanced role and develop nonbank financial systemic risk regulatory structures that more appropriately suit the different business models throughout the financial services industry.

b. Federal Reserve Discretion

In its notice of proposed rulemaking for enhanced prudential standards and early remediation under section 165 of the Dodd-Frank Act, the Board acknowledges that the proposal is not designed or structured to address the special circumstances of nonbank financial companies. The proposal states:

"While this proposal was largely developed with large, complex bank holding companies in mind, some of the standards nonetheless provide sufficient flexibility to be readily implemented by covered companies that are not bank holding companies. In prescribing prudential standards under section 165(b) (1), the Board would [sic] to take into account the differences among bank holding companies and nonbank financial companies supervised by the Board. Following designation of a nonbank financial company by the Council, the Board would thoroughly assess the business model, capital structure, and risk profile of the designated company to determine how the proposed enhanced prudential standards and early remediation requirements should apply. The Board may, by order or regulation, tailor the application of the enhanced standards to designated nonbank companies on an individual basis or by category, as appropriate. [Footnotes omitted]"

This paragraph raises a series of important issues regarding the validity of this rulemaking proceeding with respect to SIFIs:

- Why is the Board seeking to apply the Enhanced Standards to a class of entities –nonbank financial companies—that it apparently did not have in mind when it drafted the proposal?

- What is the Board's rationale for not carefully considering the circumstances presented by nonbank financial companies that might be designated as SIFIs and to draft Enhanced Standards to address and accommodate the differences between these nonbank SIFIs and Large Bank Holding Companies ("large BHC's")?

- Has the Board considered and quantified the costs to potential SIFIs, the financial system and the economy of imposing Enhanced Standards designed for Large BHCs on nonbank SIFIs, and of SIFIs revising their business models and investment strategies to comply with Large BHC-centric metrics that may be inappropriate, ineffective and even counter-productive for achieving increased systemic financial stability?

- Why has the Board not advised the public as to which specific standards it believes can be readily implemented by non-BHC SIFIs and which it believes cannot?

- The Board appears to indicate that only after a SIFI is designated will it consider how the rules should apply to it and that, depending on that review, the Board may amend the rules or issue an order to tailor the application of the rules to a particular SIFI or a category of SIFIs. Under this approach, how can anyone, including the FSOC, a potential SIFI's functional regulators, the markets, or a potential SIFI itself, understand how the rules would apply to it if it were to be designated? The Board's indicated approach would appear to ignore the assessment made of each SIFI by the FSOC in order to make its designation. Indeed, it would put the FSOC in the position of designating a SIFI without being able properly to consider how effectively or efficiently the rules would operate to mitigate the perceived threat to financial stability posed by the company. The Board's attempt to maximize its reservation of discretion to deal with SIFIs is, therefore, not only fundamentally unfair to SIFIs but also destructive of the intended gate keeping function of the FSOC.

The proposal would apply the rules to Large BHCs and SIFIs. As a result, it is incumbent on the Board to consider how the rules would apply to both categories of institutions. Without providing commenters with a reasonable description of how the rules would apply to the wide variety of unidentified companies that may be designated as SIFIs, the Board's approach does not the public to provide input that the promulgating agency is required to evaluate and incorporate into its final rulemaking, including in a statement of basis and purpose. Here, the Board acknowledges that it has not made any effort to craft the Rules with SIFIs in mind. As a result, a potential nonbank SIFI is subject to the risk that the Board will adopt Rules that may not appropriately apply to the company, but that nevertheless on their face would be applicable to critical aspects of the company's operations. The Rules provide no indication of whether or how they would be tailored to the actual situation and circumstances of a newly designated SIFI.

To take just one example, a potential SIFI may operate under a capital structure and regulatory capital requirements that do not meaningfully correlate with the capital standards to which Large BHCs have long been subject. In such a situation, the potential SIFI might not have sufficient capital to meet the capital requirements imposed under the rules because of its organizational form, statutory or regulatory restrictions or long-standing business or operating considerations. If the company were to be designated as a nonbank SIFI and had inadequate capital under Large BHC-centric regulatory capital requirements, it could be subject to severe regulatory restrictions on its business under the early remediation structure established by the rules.

If the Board proceeds on this course, it would place potential nonbank SIFIs in the very difficult position of being forced to speculate both on (i) whether it would ultimately be designated as a SIFI and (ii) how the Board might seek to tailor the application of the Large BHC-centric rules to it.

During what could be an extended period of uncertainty, a potential SIFI would have to decide whether to proactively restructure its business operations, capital structure and strategic plan to seek to respond to a potentially inappropriate and inapplicable regulatory structure. To the extent that this situation holds the potential of significant harm to the company, including the prospect of adverse market valuation movements in response to public disclosures regarding the potential adverse impact of the rules if applied to the company following its designation, it underscores the defective nature of the current rulemaking proceeding and presents a presumably unintended and wholly avoidable threat to financial stability and the economy. Moreover, restructuring or other actions taken by potential SIFIs to address the possible application of the rules to them may have an adverse impact on financial markets and a destabilizing impact on U.S. financial stability.

A fundamental element of a rulemaking proceeding is the promulgating agency's obligation to support the policy and legal choices that it has made in light of the comments received. The statement of basis and purpose should lay out the agency's thought processes and evaluation of the arguments in the comments it received. If the Board continues on the path that it has outlined in the proposal, it will not be able to meet this requirement and will not provide fair or transparent treatment to companies that are ultimately designated as SIFIs. Therefore, we recommend that the Board terminate this rulemaking proceeding with respect to SIFIs and expressly limit it to companies that qualify as Large BHCs under section 252.12(d)(2) of the Proposal. In addition, in order to satisfy the statutory requirements of section 165 of the Dodd Frank Act and the requirements regarding notice and comment and the statement of basis and purpose, the Board should undertake a separate SIFI rulemaking that meets the principles enumerated above.

The current proposed rules give the Board wide ranging discretion to change rules and practices, seemingly on a whim. This fails to give designated companies, or potentially designated companies any legal certainty and harms the ability of investors to appropriatey evaluate their options. This will create economic harm.

5. Conclusion

In crafting Title I, Congress wisely went to great pains to create a balanced approach to address systemic risk while minimizing the impact upon non-financial companies. The regulators are, contrary to Congressional directive, creating an open-ended hunting license that will bag companies, which if the law was followed, would have been considered off limits. By disregarding the bounds established by Congress, the regulators are possibly creating the unintended consequences Congress hoped to avoid creating adverse impacts within the nonbank sectors of the economy. In recognizing that we must observe and manage systemic risk, we must at the same time acknowledge that reasonable risk taking is a necessary component for growth conducive for prosperity.

This is a difficult balance to achieve, but one that must be struck in order to have the efficient and effective capital markets needed for businesses and a growing economy that creates jobs.

I will be happy to take any questions that you may have.

Testimony of William J. Wheeler
President, Americas
MetLife, Inc.

United States House of Representatives
Financial Institutions and Consumer Credit Subcommittee
Hearing Date: May 16, 2012

Introduction

Chairwoman Capito, Ranking Member Maloney, members of the Committee, my name is Bill Wheeler and I am the President of the Americas Division at MetLife. Thank you for the opportunity to testify on behalf of MetLife.

MetLife recognizes the importance of managing systemic risk and the need for sensible regulations to protect taxpayers from costly bailouts. Coming up with the appropriate regulatory formula will not be easy – either for the Financial Stability Oversight Council in designating nonbanking firms as systemically important, or for the Federal Reserve in determining the prudential standards to be applied to those firms. Nevertheless, we must get the prescription right: The stakes are too high to allow the costs or the benefits of regulation to be miscalculated. Striking the right balance is a large part of the challenge to ensure that we capture the benefits of regulation without imposing unnecessarily burdensome costs.

By way of background, I was named President of the Americas for MetLife late last year, after serving for roughly eight years as the company's Chief Financial Officer.

As you may know, MetLife is the largest life insurance company in the United States. We are the only one that is also a bank holding company. Our experience as an insurance company regulated by the Federal Reserve has provided us with unique insight into the pitfalls of applying bank-centric rules to non-bank financial companies. Indeed, it is because we do not believe our insurance business should be governed by regulations written for banks that we have decided to sell our depository business. Through this sale, MetLife will cease being a bank holding company and join its peers in being regulated as an insurance company.

I plan to discuss three topics in my testimony today.

- First, why regulated insurance activities generally do not pose systemic risk.
- Second, why naming only a few insurance companies as Systemically Important Financial Institutions ("SIFIs") would needlessly upset the competitive landscape in the insurance sector.
- Third, in the event that we are named a non-bank SIFI, why the prudential regulations must be tailored to our unique asset and liability characteristics.

True Systemic Risk

One of the principal purposes of the Dodd-Frank Act is, quote, "to protect the American taxpayer by ending bailouts." The failure of a financial firm, by itself, is not sufficient grounds for heightened regulation for systemic risk. Only when such a failure would "threaten the stability of the financial system of the United States" is additional regulation warranted.

Far from presenting systemic risk to the U.S. economy, traditional life insurance activities are a force for financial stability. Life insurance companies protect policyholders and their beneficiaries from the loss of income that occurs as a result of death, disability or retirement. In order to make good on these promises, we invest hundreds of billions of dollars in primarily investment grade fixed-income securities that provide us with reliable returns. At a time of increasing budgetary strain on governmental social insurance and transfer programs, it is becoming more important than ever that insurers be able to offer financial protection that is attractively priced.

Insurance company financial distress occurs far less frequently than bank distress. As of mid-2009, only three insurance companies had received taxpayer assistance through the Troubled Asset Relief Program, compared with 592 banks.[1] Quite frankly, I do not believe TARP money needed to be provided to at least two of these insurers to prevent any sort of systemic event. The asset and liability structures of insurance companies and banks are dramatically different. Banks generally borrow funds short term and invest long term, creating maturity mismatches than can lead to liquidity crises and runs on the bank. Insurance companies tend to make long-term promises to policyholders and invest in long-term fixed-income securities, better matching assets and liabilities and posing less liquidity risk. Unlike banks, insurers generally have a stable portfolio of in-force insurance policies with regular premium payments and contractual features that prohibit or limit early calls by policyholders, such as surrender charges or tax penalties.

"From that essential difference flows the reason why integrated regulators tend in a crisis to sleep easier at night about their insurance company charges than about their banks," according to Adair Turner, chairman of the United Kingdom's Financial Services Authority, which oversees both insurers and

[1] "Systemic Risk in Insurance: An Analysis of Insurance and Financial Stability," The Geneva Association, March 2010

banks.[2] Similarly, in a detailed analysis of insurance and financial stability, the International Association of Insurance Supervisors concluded that "for most lines of business, there is little evidence of traditional insurance either generating or amplifying systemic risk within the financial system or in the real economy." [3]

Rather than designate a handful of insurance companies as SIFIs and design a whole new set of prudential standards for them, a more sensible approach would be to identify and regulate those activities that fueled the financial crisis in the first place. In fact, Senator Dodd expressed a similar view in an exchange with Senator Collins prior to the Senate vote in favor of the Dodd-Frank Act.[4]

During the crisis, certain firms that expanded significantly into non-traditional and non-insurance activities suffered significant distress. Indeed, the main reason insurance companies are even part of the discussion about systemic risk is because of AIG. Yet AIG's troubles did not stem from traditional insurance activities operated within a regulated insurance company. As Dodd-Frank recognized, the Office of Thrift Supervision did not appropriately regulate the activities of AIG Financial Products. AIG experienced significant losses due to credit default swaps on securities backed by sub-prime mortgages, as well as from securities lending activities where proceeds were invested in risky real estate securities. With the fall in the housing market and overall credit crisis, counterparties required additional collateral to be posted, straining AIG's capital

[2] Speech by Adair Turner before the International Association of Insurance Supervisors, October 2010
[3] "Insurance and Financial Stability," International Association of Insurance Supervisors, November 2011
[4] Discussion of Section 113 – Designation of Insurance Companies as Nonbank Financial Companies, Congressional Record 156:105 (July 15, 2010), p. S5902.

and liquidity positions. Insurance law and insurance regulators would not have permitted these activities to occur in the same manner within a regulated insurance company.

The relevant question to ask of MetLife is: Would the failure of our company "threaten the financial stability of the United States"? We believe the answer is no. We cannot think of a single firm that would be brought down by its exposure to MetLife.

Picking Winners and Losers

If FSOC names only certain insurance companies as SIFIs, it will inadvertently be picking winners and losers in the insurance sector. The marketplace is very competitive today. Innovation and growth in market share can and does come from companies both big and small.

Some commentators believe that naming MetLife and other large life insurance companies as SIFIs would give us a competitive advantage over our smaller rivals. A SIFI designation would be the federal government's signal that we are indeed "too big too fail," and that if we got into financial trouble, federal funds would be used to rescue the firm. The implicit backing of the federal government could strengthen perceptions of our creditworthiness and may give us a significantly cheaper cost of funds than our peers.

Similarly, these commentators believe the Federal Reserve would have a powerful incentive to ensure the financial success of those insurance companies under its supervision.

At the other end are those who believe that insurance companies deemed SIFIs would be placed at a competitive disadvantage. They would have to hold more capital and maintain higher liquidity levels, which would reduce returns on equity for shareholders and impose higher prices on customers. In addition, they would have to deal with two levels of regulation compared with one for the rest of the industry.

I am in the second camp, having lived with Federal Reserve regulation and been forced to stand on the sideline as nearly all of MetLife's competitors – including those that took federal bailouts – returned capital to shareholders while bank-centric rules prevented us from doing so. But whether a SIFI designation is a help or a hindrance, it seems certain that naming a handful of insurance companies as "too big to fail" will needlessly distort the competitive landscape and misallocate capital in the insurance sector.

Getting the Rules Right

In the event FSOC feels compelled to name MetLife and a few other large insurers as SIFIs, it will be essential to tailor the new prudential rules for insurance companies. Bank-centric regulations are wholly inappropriate for an insurance company.

I would prefer that federal regulators simply adopt the risk-based capital rules that state insurance regulators have been using successfully for decades, but this may not happen based on the proposed prudential standards rule issued by the Federal Reserve in December of last year. As a second-best option, I hope any bank-centric rules used will be modified to take into account the unique asset and liability characteristics of life insurers.

Conclusion

If the nation's largest life insurers are named SIFIs and subjected to unmodified bank-style capital and liquidity rules, our ability to issue guarantees would be severely constrained at a time when governments are facing their own fiscal challenges. Faced with costly requirements, insurers would either have to raise the price of the products they offer, reduce the amount of risk they take on, or stop offering certain products altogether.

In closing, let me reiterate that I do not believe MetLife is or should be designated "too big to fail." Even in the event of insolvency, we would not "threaten the stability of the financial system of the United States." Naming only a few large insurance companies as SIFIs is an unsettling thought – it would needlessly upset the competitive landscape in the insurance sector and possibly discourage these large insurance companies from offering the insurance products average Americans rely upon as part of their financial planning. I cannot tell from reading the FSOC's SIFI criteria regulation the exact metrics that will be used in designating nonbank financial companies as SIFIs, so it is hard to predict outcomes. If FSOC names the largest life insurers as SIFIs, I believe it will be imperative for regulators to get the prudential rules for non-bank SIFIs right. At the very least, they should regulate insurance companies as insurers, not as banks.

Thank you.

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DRAFT

Statement
of the
Financial Services Roundtable
Submitted to the
Subcommittee on Financial Institutions and Consumer Credit
of the
Committee on Financial Services
U.S. House of Representatives
on
The Impact of the Dodd-Frank Act:
What it Means to be a Systemically Important Financial Institution

May 16, 2012

The Financial Services Roundtable (the "Roundtable") appreciates the opportunity to submit this statement for inclusion in the record of the Subcommittee's hearing entitled "The Impact of the Dodd-Frank Act: What it Means to be a Systemically Important Financial Institution."

The Roundtable is a trade association for 100 of the nation's largest financial services firms. Our members provide banking, securities, and insurance products and services to millions of consumers and businesses in the United States and other countries.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act") establishes a new supervisory regime for nonbank financial companies that are "systemically important." Section 113 of the Act authorizes the Financial Stability Oversight Council (the "Council") to designate a nonbank financial company for supervision by the Federal Reserve Board (the "Board") if two-thirds of the members of the Council, including its Chairman, conclude that the company could pose a threat to the financial stability of the United States based upon either material financial distress within the company or the nature, scope, size, scale, concentration, interconnectedness, or mix of activities of the company. Companies subject to such a determination are then subject to a set of enhanced prudential standards, which are set forth in section 165 of the Act. In April, the Council finalized its rules on the procedures for designation nonbank financial companies as "systemically important" ("Final Rule").

<u>The Roundtable believes that the designation of nonbank financial companies should be integrated with other provisions of the Dodd-Frank Act.</u>

The Roundtable has urged the Council to integrate this designation process with the other related provisions in the Dodd-Frank Act. We believe that linking the implementation of the designation process with other related regulations would enhance the transparency and consistency of the designation process. It would enable all stakeholders, including the Council, to better understand the implications and impact of designation. It also would ensure that the process is sufficiently integrated with other related provisions in the Dodd-Frank Act. The provisions of the Dodd-Frank Act that should be integrated with the designation process are as follows:

The Board's Regulation on the Meaning of the Phrase "Predominantly Engaged In Financial Activities"

The phrase "predominantly engaged in financial activities" is integral to the designation of nonbank financial companies. Under the terms of the Dodd-Frank Act, a nonbank financial company may not be subject to supervision by the Board unless the company is "predominantly engaged in financial activities." The Dodd-Frank Act includes a definition of this phrase, but directs the Board to issue a regulation establishing the criteria for determining whether a company meets this definition. The Board proposed a regulation in February of 2011, but has yet to finalize that regulation. This regulation should be finalized before the Council begins the designation process.

In the preamble to its proposed rule, the Board clearly assumed that the regulation governing the meaning of the phrase "predominantly engaged in financial activities" would be finalized before the Council began the designation process. The Board noted that such a sequence not only would aid in the public's ability to comment on the designation process designed by the Council, but also would permit the Council to act promptly on designations after its procedural rule was final.

The Board's Section 165 Regulation

The section 165 regulation should be finalized before the Council begins the designation process. As noted above, section 165 of the Dodd-Frank Act directs the Board to establish enhanced prudential standards for nonbank financial companies that have been designated by the Council under the terms of section 113 of the Act. Those standards must include risk-based capital requirements and leverage limits, liquidity requirements, risk management requirements, resolution planning requirements, and concentration limits. They also may include contingent capital requirements, enhanced public disclosure requirements, short-term debt limits, and other prudential standards deemed appropriate by the Board.

The Board has issued a proposed rule for comment, and the comment period on that proposal has just closed. We believe that no designations should occur until that rule is finalized. Issuance of the final regulation would reduce much of the uncertainty surrounding the impact of designations on the operations and activities of nonbanking financial companies. Until the section 165 regulation is final, neither the Council nor industry can fully appreciate the significance and impact of a designation.

The Board's Safe Harbor Regulation

In recognition of the fact that not all nonbank financial companies pose systemic risks, section 170 of the Dodd-Frank Act directs the Board to issue regulations setting forth the criteria for exempting certain types or classes of nonbank financial companies from supervision by the Board. While the Final Rule only notes that the Board is authorized to promulgate such rules on behalf of, and in consultation with, the Council, we would like to reiterate that the Dodd-Frank Act mandates that the Board issue these rules. This safe harbor regulation should be finalized before the Council begins the designation process since the two rulemakings are intrinsically linked because of the implications with respect to the application of enhanced prudential standards and early remediation requirements. Publication of this regulation would further clarify the scope and impact of the designation process for the Council and industry.

Intermediate Holding Companies Under Title I and Title VI

In the Dodd-Frank Act, Congress recognized that some companies have both financial activities, including ownership of banks and thrifts, and nonfinancial activities, including manufacturing and retailing. It created a legal framework for such companies providing that the financial activities of such companies would be regulated, but that their nonfinancial activities would not be subject to regulation. To that end, section 167(b) of the Act provides for establishment of an intermediate holding company ("IHC") by a designated nonbank financial company when "necessary to (i) appropriately supervise activities that are determined to be financial activities, or (ii) to ensure that supervision by the Board does not extend to commercial activities."

Section 626 provides a parallel structure for unitary savings and loan holding companies permitted to have nonfinancial activities ("Unitary SLHCs") and uses the same language as section 167(b). Title VI further provides that when an IHC is established by a Unitary SLHC, the nonfinancial parent will cease to be regulated as a SLHC. The statute thus contemplates the establishment of an IHC by a Unitary SLHC to ensure that the parent's nonfinancial activities will not be regulated.

The corollary under the Dodd-Frank framework is that an IHC established under Title VI is the obvious and appropriate entity in that corporate structure to consider for possible designation under section 113. This is precisely the harmonization called for in a colloquy between Rep. Himes and then Chairman Frank on the House floor at the final passage of Dodd-Frank. Accordingly, we urge that the Council not begin its consideration of a Unitary SLHC or subsidiary thereof for possible designation under section 113 until the Board has made its IHC determination under Title VI for that SLHC.

The Guidance Issued by the Council Should be Incorporated into the Regulation

As an appendix to the Final Rule, the Council has issued an extensive "guidance" that it will follow in making designations. We believe that this guidance should be issued as a regulation. The guidance includes many key details regarding the designation process. For example, it defines the terms "threat to the financial stability of the United States" and "material financial distress," which are central to the statutory designation standards; it includes the six-category analytical framework that groups the statutory factors the Council must consider in making designations; and it includes the three-stage determination process the Council proposes to use in making designations. These and other matters addressed in the guidance should be part of the regulation.

Incorporating the guidance into the regulation also ensures that any changes to the process will be subject to formal notice and public comment. The Council has acknowledged that changes in the guidance are likely – especially changes in the metrics used in Stage 1. In its current form, however, any changes to the guidance would not be subject to public notice or comment, even though those changes could have a significant, and material, impact upon which companies may or may not be subject to designation. Incorporating the guidance into the regulation would ensure that any changes to the designation process would be made in an open and transparent manner, following public notice and comment. Should the Council not incorporate the guidance into the regulation, we recommend the Council otherwise provide for public notice and comment on any changes to the guidance.

The Council Should Clarify that the Threat to Financial Stability is a High Bar

Under the terms of the Dodd-Frank Act, a nonbanking company cannot be designated unless the company poses a "threat to the financial stability of the United States" as a result of the activities of the company or material financial distress at the company. The guidance accompanying the Council's regulation provides some insight into the meaning of this phrase. It states that such a threat exists if "there would be an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy." Additional detail on the meaning of this phrase would enhance public understanding of, and appreciation for, the designation process.

Specifically, we recommend that the Council clarify that this is a high bar; that "significant" damage to the broader economy means a widespread disruption to the economy over a period of time; and that short-term market disruptions do not constitute a threat to the financial stability of the U.S. Furthermore, we recommend that the Council define what constitutes "financial stability."

The Council Should Define What Constitutes Material Financial Distress

Again, the guidance accompanying the Final Rule provides some insight into the meaning of the term "material financial distress." However, we recommend that the Council revises its Final Rule and place some time frame on the period of distress and provide additional detail on the macroeconomic environment applicable to a determination of material financial distress.

The Council Should Revise its Interpretation of "Company"

The Council states its intention to interpret the term "company" broadly to include any corporation, limited liability company, partnership, business trust, association (incorporated or unincorporated), or similar organization. The Council also states that it may consider "the aggregate risks posed by separate [investment] funds that are managed by the same adviser, particularly if the funds' investments are identical or highly similar." Such an interpretation is not supported by the statute. Therefore, the Council cannot act as if a company exists if one has not been formed; nor can it act as if separate companies are one and the same or assume that they share the same types of relationships that make consolidated analysis and supervision possible in the bank holding company context if, as is the case with investment funds, they do not.

We also believe that even if such an interpretation were authorized by the statute, it is too expansive from a practical perspective for purposes of the designation process and for the regulatory regime that is required to be applied to any designated company. It suggests that the Council would disregard the legal separation between entities that might have different governance, ownership and regulatory structures. To aggregate such entities during the designation process would be to adopt a distorted view of their actual structures and thereby increase the risk of erroneous analysis and ill-advised determinations.

Furthermore, even if the Dodd-Frank Act permitted the Council to disregard companies' distinct legal identities during the designation process, it does not empower the Federal Reserve Board to do so when regulating designated companies and applying the enhanced prudential standards contemplated by Section 165. The consolidated supervisory regime and enhanced prudential standards that are required to be applied to designated companies are based on the bank holding company regulatory model. The Federal Reserve Board could not ignore the legal, regulatory and operational separations among companies that would prevent, or render inappropriate, the application of that model to separate companies as a group. We believe the Council should adopt a narrower definition of this term.

We Support the Use of Metrics, but Have Several General Recommendations Regarding Their Design

We support the establishment of quantitative metrics to serve as a screening mechanism by the Council. However, we have some concerns with the metrics established by the Council.

The CDS Metric

We have serious reservations with the CDS metric. Unlike the other metrics, this metric is outside the control of a nonbank financial company because it is based on the nonbank financial company's status as a reference entity. Moreover, it is subject to manipulation by competitors and other parties. For these reasons, we recommend that the Council reconsider the use of this metric.

If the Council decides to keep a CDS metric, we recommend that it be based on ownership of a CDS rather than being a reference entity for a CDS. Also, we recommend that the tripwire be linked to a net amount of exposure to the holder of the CDS rather than a gross amount since companies typically hedge or offset credit default swap exposures. Netting exposure for this metric would be consistent with the manner in which the Council plans to measure a company's exposure to derivative liabilities.

The Tripwire for Derivatives Liabilities Should be Revised Upward and Embedded Derivatives Liabilities Should Be Excluded

We believe that the $3.5 billion tripwire for derivatives liabilities is too low for larger companies. For larger companies, losses from $3.5 billion derivatives portfolio are not sufficient to endanger the company or to meet the definitions of "threat to the financial stability of the United States" or "material financial distress." As an alternative to a fixed $3.5 billion tripwire, we recommend that the Council adopt a tripwire based upon a percentage of the size of the company. For example, if the percentage is set at 7 percent, the tripwire would be $3.5 billion for a company with $50 billion in consolidated assets, and $7 billion for a company with $100 billion in consolidated assets. Presumably, some ceiling on the tripwire may be appropriate under this alternative.

We applaud the fact that the guidance appropriately defines the derivatives liability standard after adjusting for the existence of bilateral netting and offsetting collateral. Taking into account the effects of master netting agreements and cash collateral held with the same counterparty accurately depicts a nonbank financial company's exposure to its counterparties and interconnectedness to the financial markets. The Final Rule includes in the definition of a derivative liability derivatives embedded in contracts where there is no derivative counterparty (i.e., guarantees embedded in life insurance products such as variable annuities). We disagree that these derivatives should be included in this definition, as these embedded derivatives have no counterparty risk and do not expose the institution to the financial markets. We recommend the language in the Final Rule regarding the derivative liability threshold be revised to exclude these types of embedded derivatives.

The Metric for Total Debt Outstanding Should Be Revised Upward

The $20 billion tripwire for total debt outstanding is too low for larger companies. It is not unusual for well-managed companies with $50 billion or more in assets to have more than $20 billion in total debt outstanding. We recommend some greater threshold amount or an amount that scales up or down depending on the size of the company (see recommendation above related to derivatives liabilities).

The Metric for Short-Term Debt Should Be Adjusted

The tripwire for short-term debt is 10% of a company's total debt outstanding. We do not believe that this metric is particularly indicative of risk. During the recent financial crisis it was not short-term debt per se that contributed to the financial distress at some companies, but a mismatch between short-term debt and long-term assets. Further, we believe that this tripwire is far too low for large financial companies. We recommend that it be adjusted to exclude cash and other liquid assets that pose little, if any risk, to a company. Liquid assets would include loans and other receivables due in less than one year.

The Council Should Clearly Develop the "Other" Qualitative and Quantitative Factors that Could Result in a Company Moving to the Stage 2 Pool.

The interpretive guidance attached to the Final Rule states that the Council may initially evaluate any nonbank financial company based on "other firm-specific qualitative or quantitative factors, irrespective of whether such company meets the Stage 1 thresholds." The introduction of the foregoing language is overly broad and operates to undo the certainty that the Stage 1 thresholds were intended to create. We recommend that the Council clearly develop what these other "firm-specific qualitative or quantitative factors" are intended to cover in order to provide nonbank financial companies with a greater degree of certainty as to whether they will face further review under Stage 2.

Stage 3 Should Include a "Targeted" Cost-Benefit Analysis

Stage 3 of the designation process is undoubtedly the most important stage for any company. It is during Stage 3 that the Council will actively engage with a company and collect information about the company's activities and systemic risk profile. Moreover, the conclusions drawn by the Council at the end of this stage will affect whether or not a company receives a Determination Notice from the Council.

Given the significance of the Stage 3 review, we believe the Council should conduct a "targeted" cost-benefit analysis of the impact of designating a company as part of the Stage 3 review. This analysis would require the Council to consider whether designation is the best means for mitigating the systemic risk posed by the company or whether some other forms of regulation, such as industry-wide standards, would mitigate the identified risk more effectively or efficiently.

Federal Reserve Board Governor Daniel Tarullo spoke to this issue in a speech earlier this year when he noted that "...prudential standards designed for regulation of bank-affiliated firms may not be as useful in mitigating risk posed by different forms of financial institutions." [1] In those cases, he suggested sound regulation for the particular industry as a whole or the particular instrument may be more appropriate than designation under the section 113 process.

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[1] Speech by Federal Reserve Board Governor Daniel K. Tarullo at the 2011 Credit Markets Symposium, Charlotte, North Carolina, March 31, 2011, page 3.

On-Going Consultation with Other Regulators

In each stage of the designation process, the Council indicates that it will consult with other regulators. We recommend that the Council exercise this authority early and on an on-going basis with U.S. and foreign regulators. A company's primary U.S. regulator or its home country regulator will have a current and in-depth understanding of the company. The Council should take full advantage of this knowledge base.

Registration Process

Section 114 of the Dodd-Frank Act provides for a nonbank financial company to register with the Board within 180 days of a final determination. We recommend that the Board provide necessary details on the mechanics of registration.

Additionally, we recommend that this regulation, or the section 165 regulation, address the time frames for compliance with the section 165 prudential standards after a company has registered with the Board. Specifically, we recommend that a nonbank financial company be given 24 to 36 months following registration to comply with applicable section 165 standards. This will enable the company to make the changes in systems, policies and procedures necessary to comply with such standards. Such a phase-in period also is consistent with other provisions in the Dodd-Frank Act that require significant operational adjustments by financial companies, such as the conformance period associated with the Volcker Rule.[2]

Conclusion

The authority of the Council to determine whether a nonbank financial company should be subject to Board supervision and enhanced prudential standards is one of the Council's most important powers. Such a determination will have a material impact on the company, its customers and the markets in which it operates. The recommendations made in this statement are intended to ensure that the Council exercises this power in a transparent, effective and consistent manner.

[2] See 75 FR 72741, November 26, 2010.

National Association of Insurance Commissioners & The Center for Insurance Policy and Research

April 20, 2012

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Docket No. 1438, RIN 7100-AD86: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies

Dear Ms. Johnson:

We write on behalf of the National Association of Insurance Commissioners (NAIC) regarding the Federal Reserve's notice and proposed rulemaking on "Enhanced Prudential Standards and Early Remediation Requirements for covered Companies." Founded in 1871, the NAIC is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and the five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S. The NAIC respectfully submits the following comment to the Notice of Proposed Rulemaking and Request for Comment published in the January 5, 2012 issue of the Federal Register.[1]

As noted in the proposed rule, the market perception associated with "too big to fail" can pose a significant threat to the financial system.[2] It reduces market discipline, encourages competitive distortions through funding advantages, and artificially encourages further consolidation and concentration in the financial system. We, therefore, think it is appropriate for the Federal Reserve to implement strong prudential standards to offset the advantages that may accrue to firms perceived as "too big to fail" as well as mitigate the other negative externalities associated with Financial Stability Oversight Council (Council) designation.

The measures selected should seek to ensure critical protections to the financial system, while at the same time minimizing the harmful consequences that can result from such a designation. As it relates to any non-bank financial company the Council determines poses a grave threat to financial stability[3] and is designated for oversight by the Federal Reserve, we believe that the enhanced prudential standards

[1] Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (proposed January 5, 2012) (to be codified at 12 C.F.R. pt. 252).
[2] *Id. at 595.*
[3] *Id.*

applied should be tailored to the specific business model and structure of the financial institution, the characteristics of the markets in which the firm operates, and the activities that make the institution systemically risky. With respect to insurance companies, systemically risky activities are antithetical to the interests of policyholders. Insurance consumers should not be materially exposed to such activities and we are actively working to ensure that is the case.

Standards should minimize negative market implications

Our interest in the proposed rule is the impact of federal policy on insurance markets and companies, and ultimately insurance consumers. Consumers value the financial strength of their insurer.[4] They are often purchasing promises extending decades into the future, for payment upon the occurrence of an insured event. Although state insurance guaranty funds serve as a backstop for some coverages up to specified limits, an insurer's obligations to a consumer may exceed those limits. Thus, the value of those promises depends fundamentally on the ability of the insurer to survive into the future.

Given the value placed on financial strength by insurance consumers, state insurance regulators are concerned that the creation of a two-tiered system of supervision, where some insurance companies are perceived as safer than others, could create competitive distortions, artificially advantage some companies, and encourage undesirable consolidation and concentration in the insurance sector. Our priority is to avoid such unintended and undesirable consequences in our sector.

To prevent these consequences, we encourage the Federal Reserve to impose policies that will strongly discourage non-bank systemically important financial institution (SIFI's) from engaging in activities that resulted in their designation as a SIFI. In particular, enhanced prudential standards applied to insurance groups that have been identified as SIFIs should be aimed at returning them to non-SIFI status, thus avoiding a market perception that some insurance companies are safer than others.

Recommendations

As supervisors of the insurance sector, we are keenly aware of the need to have a strong and competitive market to serve our policyholders. The inherent nature of most traditional insurance activities is such that government support is not essential. Traditional insurance activities typically do not add systemic risk to the financial system—they generally do not involve the transformation of short term liabilities into long term assets and do not lend themselves to run risk.

To the extent that any insurance company is designated a SIFI, the rules for implementing enhanced prudential standards will have critically important, and potentially detrimental implications for the industry that we regulate and ultimately for the policyholders we serve to protect. Even the perception of implicit support could interfere with competitive insurance markets. We do not believe insurance companies should engage in systemically risky activities that would lead to designation by the Council, nor be materially exposed to companies that are engaging in such activities.

[4] It is not surprising that scholars have found evidence that consumers place considerable value on the solvency of their insurer. Among other evidence, researchers have found an inverse relationship between insurance premium and firm risk, an inverse relationship between default risk and policyholder willingness to purchase insurance, and a direct relationship between rating downgrades and an increase in life insurer lapses and a decrease in premium revenue. These findings are consistent with consumer preference for insurers that are perceived to have a stronger financial condition. *See, e.g.* Sommer, D.W., *The Impact of Firm Risk on Property-Liability Insurance Prices*, Journal of Risk and Insurance 63(3): 501-514 (1996).

To that end, state insurance regulators have already taken measures to improve their ability to identify systemically risky activity within an insurance group. We have recently enhanced the solvency framework to provide more "windows" into group activities and developed assessment tools to better identify, quantify, and account for risk in various stress scenarios. In addition, holding companies will be required to identify activities of affiliates that could pose contagion or reputational risks to the insurer. These tools will allow state insurance regulators to work with insurers in a timely manner to limit the impact of systemically risky activities. We intend to continue to develop these tools and work with our fellow regulators toward the goals of protecting policyholders and the financial system from systemically risky activity by insurers.

It is with these efforts in mind that we recommend the standards adopted by the Federal Reserve reflect these important features:

- To the extent that the systemically risky activities reside at an affiliate of an insurance company (as was the case with AIG), the affiliate should be walled-off from the insurance legal entities. That is, the affiliated company should not be able to leverage off the assets of the insurance company to support its risk taking activities. Among other measures, the affiliate should be required to hold sufficient capital to provide a strong disincentive for excessive risk taking. Cross subsidies, loans and guarantees of the affiliate's balance sheet by the insurance legal entities should be prohibited. Dividends provided by the insurance company to the holding company should be limited to those provided in the normal course of business. Any diversification benefits recognized in the capital framework should be eliminated. The measures to wall-off the systemic activities should be made fully transparent to the market so that financial strength ratings do not reflect implicit support from affiliate insurance companies. These measures will ensure that the risky activities of the affiliate are constrained and policyholder interests are not threatened by such activities.

- To the extent that an insurer engages in activities that result in its designation by the Council, state regulators have committed to curtailing such activities that could result in designation in the first place. State regulators have improved mechanisms to identify and address potential threats. In this regard, we strongly encourage the Federal Reserve to work closely and collaboratively with us. Any measures applied should be mindful of the interests of policyholders in addition to being consistent with desired outcomes from a macro perspective.

Conclusion

We appreciate the opportunity to comment. Should you wish to discuss this comment or any other matter relating to the NAIC's views on this proposed rule, please do not hesitate to contact Ethan Sonnichsen, Director of Government Relations, at (202) 471-3980 or Mark Sagat, Counsel and Manager of Government Relations, at (202) 471-3987.

Sincerely,

Kevin M. McCarty
Florida Commissioner of Insurance and
NAIC President

Therese M. Vaughan, Ph.D.
NAIC Chief Executive Officer

Questions for Dr. Michael S. Gibson, Director, Division of Research and Statistics, Board of Governors of the Federal Reserve System, from Chairman Capito:

1. Is it the Board's intention to significantly narrow the value of the thrift charter by subjecting SLHCs to BHC rules–and if not, can you describe the factors that are important in distinguishing the regulatory treatment of SLHCs and BHCs?

Congress transferred authority for the supervision of SLHCs from the Office of Thrift Supervision to the Federal Reserve effective on July 21, 2011. In preparing for that responsibility, the Board conducted extensive outreach with SLHCs to learn about their structure activities and practices. The Board also carried over existing Office of Thrift Supervision rules with respect to the activities of SLHCs and made no changes to the scope of permissible real estate activities for SLHCs.[1]

In addition, the Board has sought to tailor its supervisory approach to the characteristics of SLHCs. Federal Reserve supervision of SLHCs has, as an initial matter, focused on risk management practices,[2] and, as required under the Home Owners' Loan Act ("HOLA"), involves regular consultations with state insurance commissioners, the SEC, and other functional regulators.[3]

The Board's supervision of SLHCs also recognizes that different supervisory programs applied to SLHCs and BHCs prior to July 2011. During the current first round of inspections of SLHCs, Federal Reserve examiners are becoming acquainted with each SLHC's management and are seeking to fully understand the organization's operations and business model. Examiners are discussing the Board's supervisory expectations and rating system with SLHC management, but are not issuing final Federal Reserve ratings.[4]

Because regulatory capital requirements (including specific minimums) were not applied to SLHCs at the holding company level prior to July 2011, the Board currently is using both a qualitative and quantitative approach to evaluating capital at SLHCs. To be clear, the Board currently is not using the regulatory ratios used for BHCs to evaluate capital of SLHCs. Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Act") provides that depository institution holding companies must meet consolidated minimum capital requirements that are at least as stringent as those applied to insured depository institutions. Consistent with section 171, the Board recently sought comment on a proposed rule implementing such consolidated minimum capital requirements for SLHCs (available at http://www.federalreserve.gov/newsevents/press).

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[1] 12 CFR 238.52(a)(i) and 238.53(b)(4) – (8).
[2] This approach is described in Attachment B to SR letter 11-11. For your reference, SR letter 11-11 and its attachments are appended to this response.
[3] 12 U.S.C. § 1467a(b)(4)(C).
[4] The Board's approach to the first round of SLHC inspections is discussed more fully in SR letter 11-11.

2. Regarding insurance companies, it is well-established that the risk-based capital standards utilized to regulate insurance companies and banks are starkly different—and is like comparing apples to oranges. Can you detail the benefits, if any, of applying incongruent bank-based capital standards (e.g., Basel) to insurance-based SLHCs, how this would work in practice, and how the benefits outweigh the costs?

It has long been the Board's general practice to apply consistent consolidated minimum capital requirements to all bank holding companies with $500 million or more in total consolidated assets, including bank holding companies that control functionally regulated subsidiary insurance companies. This approach helps to ensure the safety and soundness of each bank holding company and a level playing field across bank holding companies. The Board does not, however, apply its capital standards to an insurance company subsidiary of a bank holding company. Instead, the Board relies for the insurance company subsidiary on the capital requirements established by the appropriate state insurance regulator.

The Board is required under section 171 of the Act to apply to all bank holding companies and savings and loan holding companies minimum risk-based and leverage capital requirements that are not less than the minimum capital requirements applicable to insured depository institutions. However, the Board has recognized that some insurance company assets and activities are not permissible for banks and so has proposed tailored capital requirements that take account of these differences consistent with section 171 of the Act.

For example, the Board recently sought public comment on proposed revisions to its regulatory capital requirements that included a specific capital treatment for certain lower-risk assets, such as non-guaranteed separate accounts, that are commonly held by insurance companies but not by depository institutions. In contrast, the Board proposed identical treatment under its capital rules with respect to assets that are commonly held by both insurance companies and banks, such as bonds and other extensions of credit.

3. Do you support and advocate establishing distinct regulatory standards governing insurance-based SLHCs that more accurately reflect the insurance business model over the BHC model?

Please see response to question 4.

4. Although all of us are familiar with AIG, how many insurers today are engaged in the types of financial engineering activities that caused AIG's collapse? Is the AIG-experience justification for imposing bank-centric holding company requirements upon companies engaged only in traditional insurance activities?

Approximately 27 SLHCs primarily engage in insurance activities ("ISLHCs"). As explained in SR letter 11-11 (July 21, 2011), the Board is using the first cycle of SLHC inspections to learn more about the particular operations of each ISLHC. Supervisory assessments are currently being conducted at each ISLHC and its subsidiaries to more fully understand the activity make up of each ISLHC and determine if any activities pose safety and soundness concerns.

In April 2011, the Board stated its intention, to the greatest extent possible taking into account any unique characteristics of SLHCs and the requirements of HOLA, to assess the condition, performance, and activities of SLHCs on a consolidated basis in a manner that is consistent with the Board's risk-based approach regarding bank holding company supervision. State insurance regulators currently supervise insurance companies only on an individual entity basis. The Board's consolidated supervisory program is applied in a risk-focused manner and supervisory activities (such as, continuous monitoring, discovery reviews, and testing) vary across portfolios of institutions based on size, complexity, and risk. Board and Reserve Bank staffs are working to create supervisory plans that specifically address the risks associated with the activities of ISLHCs.

In its recent proposal that would revise regulatory capital requirements, the Board emphasized the importance of using a uniform approach to capital requirements for all depository institution holding companies in order to mitigate potential competitive equity issues, limit opportunities for regulatory arbitrage, and facilitate comparable treatment of similar risks.

5. Regarding the Collins Amendment, do you believe it makes sense to apply bank-oriented Basel risk-based capital (RBC) and leverage requirements to insurance companies? Does the Fed believe it has the discretion to use insurance-based measures of RBC and leverage-so long as the Fed determines these insurance measures satisfy the minimum floor requirements of the Collins Amendment?

As indicated in the response to question 2, the Board is required under section 171 of the Act to apply minimum risk-based and leverage capital requirements, on a consolidated basis, to bank holding companies and savings and loan holding companies that are not less than the minimum capital requirements applicable to insured depository institutions. The Board expects also to consider insurance-based measures of an insurance company's capital to evaluate capital as a supplemental measure of capital adequacy and to assess the risk of the insurance company subsidiary as it relates to the consolidated structure.

Questions for the Record from Chairman Shelley Moore Capito
May 16, 2012
Subcommittee on Financial Institutions
and Consumer Credit
Hearing entitled "The Impact of the Dodd-Frank Act: What It Means to be a Systemically Important Financial Institution"

Question for Treasury

Federal financial regulators have repeatedly stressed the benefits of working with other regulatory agencies in developing rules for affecting different types of financial companies. We have been told that this cooperation helps avoid establishing standards or requirements that might make sense for some companies, but not for others. Unfortunately, since the States remain the primary regulator for insurance, it does not appear that insurance expertise is available in federal rulemaking affecting insurance companies.

Recognizing that Treasury might not have final regulatory jurisdiction, can you tell us to what extent, if any, the Federal Insurance Office Director has participated or been consulted with in rulemakings such as setting enhanced prudential standards for SIFs, the Volcker Rule, or the regulation of insurance-based SLHCs?

The Department of the Treasury's Federal Insurance Office (FIO) provides insurance expertise to the Financial Stability Oversight Council (Council) and participates in Council committees, studies, rulemakings and other activities of the Council. FIO participated in the development of the Council's final rule and interpretive guidance regarding determinations under section 113 of the Dodd-Frank Act, and also provided insurance expertise in the Volcker rulemaking process. Additionally, FIO consulted with the Federal Reserve on the development of enhanced prudential standards for nonbank financial companies, and large bank holding companies under section 165 of the Dodd-Frank Act. FIO will continue to be consulted on any potential recommendations by the Council to the Federal Reserve concerning the refinement of such standards, including with respect to the regulation of insurance-based savings and loan holding companies. The Council also includes an independent member with insurance expertise and a state insurance commissioner, in addition to the Director of FIO, who have significant insurance expertise and who also participate in Council activities.