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OVERSIGHT OF DODD-FRANK IMPLEMENTATION: A PROGRESS REPORT BY THE REGULATORS AT THE HALF-YEAR MARK

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

CONTINUING THE OVERSIGHT OF THE DODD-FRANK WALL STREET REFORM ACT

FEBRUARY 17, 2011

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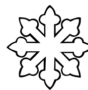

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OVERSIGHT OF DODD-FRANK IMPLEMENTATION: A PROGRESS REPORT BY THE REGULATORS AT THE HALF-YEAR MARK

THURSDAY, FEBRUARY 17, 2011

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee convened at 10:03 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I would like to call to order the first Banking Committee meeting of the 112th Congress.

The last several years have been a historic time for this Committee. I have big shoes to fill, following in the footsteps of my recent predecessors, Chairman Sarbanes, Chairman Shelby, and Chairman Dodd. I am thankful and humbled by this opportunity and I look forward to working with all of my colleagues on this Committee to make this a productive session of Congress.

We have five new Members joining our Committee and I would like to welcome Senators Hagan, Toomey, Kirk, Moran, and Wicker. I look forward to working with all of you.

There is important work ahead of us. I am committed to an agenda that will bolster our economic recovery, make our financial regulations world class, and ensure that consumers and investors have the protections they deserve.

Two vital parts of this agenda are overseeing the implementation of the Dodd-Frank Wall Street Reform Act and beginning the process of housing finance reform. We have compiled a further list of issues the Committee may consider which will be posted on the Committee's Web site today.

This morning, we hold the first in a series of many oversight hearings on the Dodd-Frank implementation. There are certainly no shortage of topics for us to discuss with the regulators today, and in the coming weeks and months, we will take a closer look at many issues important to myself and the Members of this Committee. The Committee's oversight will seek to ensure that the letter and the spirit of the new law are being implemented by the regulatory agencies, public comment on proposed rules is being appropriately solicited and considered and that the new law is being enforced, legitimate concerns are recognized and addressed, and that the regulators have the resources they need. The regulators have

been hard at work and I look forward to learning more about their progress implementing the Dodd-Frank Act.

I want to be clear. The Dodd-Frank Act has brought significant and much-needed reform to our financial system. It improves consumer and investor protection, fills regulatory gaps by bringing oversight to the over-the-counter derivatives market, and helps prevent another financial crisis. The effective and timely implementation of the Dodd-Frank Act will help strengthen the economy by creating certainty for the business community, consumers, and investors. In turn, that certainty will bring market participants back to the table and restore consumer and investor confidence.

A task of this complexity with such a global impact must be done with great care to avoid unintended consequences that could impair economic growth or send good-paying jobs overseas. Our oversight agenda will make sure we stay on the right track.

I commend the hard work of all of the regulators. I look forward to working closely with all of you to be sure we get this right and I thank you for being here today in an incredibly busy week, with both the release of the budget and hearings in the House. Because of the busy schedules of our regulators, we will limit opening statements today to myself and Ranking Member Shelby and I ask the other Members of the Committee to please submit their opening statements for the record.

With that, I turn to Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Last year, Congress passed the Dodd-Frank Financial Reform Act, as the Chairman has mentioned. The President and the majority proclaimed the Act a historic legislative accomplishment. At the signing ceremony, the President declared that the Act would provide certainty to our markets and lift our economy to a more prosperous future.

Eight months later, the sober realities of what Dodd-Frank will mean for our economy, I believe, are now setting in. Our unemployment rate still stands at record levels. While the political forces that drove the passage of Dodd-Frank have waned, the huge costs of the Act are now becoming very clear. The Dodd-Frank party, I believe, is over. Unfortunately, our economy is now preparing to pay the tab.

Our financial regulators have begun to implement Dodd-Frank and the decisions they make over the new few months will impact every American. Regulators will determine if Americans can buy a home or a car and if they can get loans to start businesses. They will also determine what financial products are available and to whom they may be sold.

In Dodd-Frank, the majority party delegated an unprecedented amount of authority and discretion to the bureaucracy. Accordingly, our financial regulators now have more than 200 rulemakings to complete, many by July. The work required to implement these rules is staggering. For lobbyists, lawyers, and Government bureaucrats, Dodd-Frank is providing to be a gold mine. For the rest of us, however, it means more red tape, more governance, fewer choices, and higher fees.

Today, I hope to learn more about how our regulators plan to manage this unprecedented workload. Already, concerns have been raised about the quality and the fairness of the rulemaking process. In the rush to comply with the unrealistic deadlines set in Dodd-Frank, the regulators have had to focus on speed rather than deliberation. And while our regulators will do their best to comply with the deadlines, Congress, I believe, should seriously examine whether the speed of the process is undermining its integrity. There are early indications that it is.

One of the hallmarks of our regulatory process is openness. Yet with so many rulemakings being considered simultaneously, public participation could be stifled. It may be practically impossible for parties to provide thorough comments on so many rules and for regulators to fully consider every comment in such a short timeframe. And although the regulators will receive an enormous quantity of comments, what really matters is the quality of the interaction between the commentators and the regulators. With that in mind, I believe we should begin considering whether the final rules would be better if our regulators had more time to hear from the public.

Another consequence of the hasty rulemaking process is that our regulators may not be properly conducting economic analysis of proposed rules. Any thorough consideration of a proposed rule obviously should include an understanding of its cost. Unfortunately, there are serious questions regarding the willingness and the ability of our regulators to conduct such analysis. At the SEC, the position of Chief Economist has been vacant for 10 months. At the CFTC, the position of the Chief Economist was vacant for 11 months before finally being filled this past December.

I believe the failure to promptly fill these key positions suggests that economic analysis is not a high priority for our regulators. In light of the fact that the cost imposed by these rules may cause some Americans to lose their jobs, our regulatory agencies should, at the very least, make themselves aware of the economic impact of proposed rules before adopting them.

And while improvements in the rulemaking process can smooth the implementation of Dodd-Frank, I am under no illusions that it can dramatically alter its long-term consequences. Absent legislative action, Dodd-Frank is going to be very, very expensive. Dodd-Frank may not raise taxes directly, but consumers will soon feel its cost when they pay higher regulatory fees, higher compliance costs, and higher prices for financial services.

Just this past week, the President's budget calls for the CFTC to impose $117 million in new taxes in the form of user fees to pay for the cost of Dodd-Frank. Over the coming months, the hidden costs of Dodd-Frank will grow as our regulators steadily impose new rules and regulations. I hope that the Committee will focus at least as much attention on the cost as it does the rules over the next few months.

Thank you, Mr. Chairman.

Chairman JOHNSON. The Committee will now turn to Executive Session.

[Whereupon, at 10:13 a.m., the Committee moved to Executive Session, and reconvened at 10:19 a.m.]

Chairman JOHNSON. Before I begin the introductions of our witnesses today, I want to remind my colleagues that the record will be open for the next 7 days for any materials you would like to submit.

The Honorable Ben S. Bernanke is Chairman of the Board of Governors of the Federal Reserve System. He is currently serving his second term as Chairman, which began on February 1 of last year. Prior to becoming Chairman, Dr. Bernanke was Chairman of the President's Council of Economic Advisors from 2005 to 2006. Also, he served the Federal Reserve System in a variety of roles in addition to serving as Professor of Economics at Princeton University.

The Honorable Sheila Bair is Chairman of the Federal Deposit Insurance Corporation. Prior to her appointment in 2006, Ms. Bair was a Dean's Professor of financial regulatory policy for the Isenberg School of Management at the University of Massachusetts at Amherst. She was also Assistant Secretary for Financial Institutions at the U.S. Department of the Treasury from 2001 to 2002.

The Honorable Mary Schapiro is Chairman of the U.S. Securities and Exchange Commission. She is the first woman to serve as permanent Chairman of the SEC and was appointed by President Obama in January of 2009. Previously, she was CEO of the Financial Industry Regulatory Authority, or FINRA. Chairman Schapiro also served as Commissioner of the SEC from 1988 to 1994 and Chairman of the Commodities Futures Trading Commission from 1994 to 1996.

The Honorable Gary Gensler is Chairman of the Commodities Futures Trading Commission, which oversees the commodity futures and options markets in the U.S. Chairman Gensler recently served in the Treasury Department as Under Secretary of Domestic Finance and Assistant Secretary of Financial Markets. In addition, he served as Senior Advisor to Paul Sarbanes on the Senate Banking Committee.

Mr. John Walsh is Acting Comptroller of the Currency of the Office of the Comptroller of the Currency. Mr. Walsh assumed the position last August. He previously served as Chief of Staff and Public Affairs. He has been with the OCC since 2005 and prior to that was the Executive Director of the Group of Thirty. Mr. Walsh also served with the Senate Banking Committee from 1986 to 1992.

I thank all of you for being here today. I regret that I had my surgery on my voice box recently, but I hope it will clear up.

Chairman Bernanke, you may begin your testimony.

STATEMENT OF BEN S. BERNANKE, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. BERNANKE. Thank you. Chairman Johnson and Ranking Member Shelby and other Members of the Committee, thank you for the opportunity to testify about the Federal Reserve's implementation of the Dodd-Frank Act.

The Dodd-Frank Act addresses critical gaps and weaknesses in the U.S. regulatory framework, many of which were revealed by the recent financial crisis. The Federal Reserve is committed to working with the other U.S. financial regulatory agencies to implement the Act effectively and expeditiously. We are also cooperating

with our international counterparts to further strengthen financial regulation, to ensure a level playing field across countries, and to enhance international supervisory cooperation. And we have revamped the supervisory function at the Federal Reserve to allow us to better meet the objectives of the Act.

The Act gives the Federal Reserve important responsibilities both to make rules to implement the law and to apply the new rules. In particular, the Act requires the Federal Reserve to complete more than 50 rulemakings and sets the formal guidelines as well as the number of studies and reports. We have also been assigned formal responsibility to consult and collaborate with other agencies on a substantial number of additional rules, provisions, and studies.

So that we meet our obligations on time, we are drawing on expertise and resources from across the Federal Reserve system in banking supervision, economic research, financial markets, consumer protection, payments, and legal analysis. In all, more than 300 members of the Federal Reserve staff are working on Dodd-Frank implementation projects. We have created a senior staff position to coordinate our efforts and have developed project reporting and tracking tools to facilitate management and oversight of all of our implementation responsibilities.

We have made considerable progress in carrying out our assigned responsibilities. We have been providing significant support to the Financial Stability Oversight Council, of which the Federal Reserve is a member. We are assisting the Council in designing its systemic risk monitoring and evaluation process and in developing its analytical framework and procedures for identifying systemically important nonbank firms and financial market utilities.

We also are helping the new Office of Financial Research at the Treasury Department develop potential data reporting standards to support the Council's systemic risk, monitoring, and evaluation duties.

We contributed significantly to the Council's recent studies, one on the Volcker Rule's restrictions on banking entities' proprietary trading and private fund activities, and a second one on the Act's financial sector concentration limit, and we are now developing for public comment the necessary rules to implement these important restrictions and limits.

Last week, the Board adopted a final rule to ensure that activities prohibited by the Volcker Rule are divested or terminated in the time period required by the Act.

We also have been moving forward rapidly in other areas. Last fall, we issued a study on the potential effect of the Act's credit risk retention requirements on securitization markets as well as an Advanced Notice of Proposed Rulemaking on the use of credit ratings in the regulations of Federal banking agencies.

In addition, in December, the Board and the other Federal banking agencies requested comment on a proposed rule that would implement the capital floors required by the Collins Amendment. In December, we also requested comment on proposed rules that would establish standards for debit card interchange fees and implement the Act's prohibition on network exclusivity arrangements and routing restrictions.

In January, the Board, together with the OCC, FDIC, and OTS, provided the Congress a comprehensive report on the agency's progress and plans relating to the transfer of the supervisory authority of the OTS for thrifts and thrift holding companies. In addition, as provided by the Act, we in the Federal Reserve Banks each established offices to consolidate and build on our existing equal opportunity programs to promote diversity in management employment and business activities.

We continue to work closely and cooperatively with other agencies to develop joint rules to implement the credit risk retention requirements for securitizations, resolution plans or living wills for large bank holding companies and counsel-designated nonbank firms, and capital and margin requirements for swap dealers and major swap participants. We are consulting with the SEC and the CFTC on a variety of rules to enhance the safety and efficiency of the derivatives markets, including rules that would require most standardized derivatives to be centrally traded and cleared, require the registration and prudential regulation of swap dealers and major swap participants, and improve the transparency and reporting of derivatives transactions.

We also are coordinating with the SEC and the CFTC on the agencies' respective rulemakings on risk management standards for financial market utilities, and we are working with market regulators and central banks in other countries to update the international standards for these types of utilities.

The transfer of the Federal Reserve's consumer protection responsibilities specified in the Act to the new Bureau of Consumer Financial Protection is well underway. A team at the Board headed by Governor Duke is working closely with the staff at the CFPB and at the Treasury to facilitate the transition. We have provided technical assistance as well as staff members to the CFPB to assist it in setting up its functions. We have finalized funding agreements and provided initial funding to the CFPB. Moreover, we have made substantial progress toward a framework for transferring Federal Reserve staff members to the CFPB and integrating CFPB employees into the relevant Federal Reserve's benefit programs.

One of the Federal Reserve's most important Dodd-Frank implementation projects is to develop more stringent prudential standards for all large banking organizations and for nonbank firms designated by the Council. Besides capital, liquidity, and resolution plans, these standards will include Federal Reserve and firm conducted stress tests, new counterparty credit limits, and risk management requirements. We are working to produce a well-integrated set of rules that will significantly strengthen the prudential framework for large, complex financial firms and the financial system.

Complementing these efforts under Dodd-Frank, the Federal Reserve has been working for some time with other regulatory agencies and central banks around the world to design and implement a stronger set of prudential requirements for internationally active banking firms. These efforts resulted in the adoption in the summer of 2009 of more stringent regulatory capital standards for trading activities and securitization exposures.

And, of course, it also includes the agreements reached in the past couple of months on the major elements of the new Basel III prudential framework for globally active banks. Basel III should make the financial system more stable and reduce the likelihood of future financial crises by requiring these banks to hold more and better quality capital and more robust liquidity buffers.

We are committed to adopting the Basel III framework in a timely manner. In December 2010, we requested comment with the other U.S. banking agencies on proposed rules that would implement the 2009 trading book reforms, and we are already working to incorporate other aspects of the Basel III framework into U.S. regulations.

To be effective, regulation must be supported by strong supervision. The Act expands the supervisory responsibilities of the Federal Reserve to include thrift holding companies and nonbank financial firms that the Council designates as systemically important, along with certain payment, clearing, and settlement utilities that are similarly designated.

Reflecting the expansion of our supervisory responsibilities, we are working to ensure that we have the necessary resources and expertise to oversee a broader range of financial firms and business models. The Act also requires supervisors to take a macroprudential approach. That is, the Federal Reserve and other financial regulatory agencies are expected to supervise financial institutions and critical infrastructures with an eye toward not only the safety and soundness of each individual firm, but also taking into account risks to overall financial stability.

We believe that a successful macroprudential approach to supervision requires both a multidisciplinary and a wide-ranging perspective. Our experience in 2009 with the Supervisory Capital Assessment Program, popularly known as the bank stress test, demonstrated the feasibility and benefits of employing such a perspective. Building on that experience and other lessons learned from the recent financial crisis, we have reoriented our supervision of the largest, most complex banking firms to include greater use of horizontal or cross-firm evaluations of the practices and portfolios of firms, improved quantitative surveillance mechanisms, and better use of the broad range of skills of the Federal Reserve staff. And we have created a new Office of Financial Stability within the Federal Reserve which will monitor financial developments across a range of markets and firms and coordinate with the Council and with other agencies to strengthen systemic oversight.

The Federal Reserve is committed to its longstanding practice of ensuring that all of its rulemakings are conducted in a fair, open, and transparent manner. Accordingly, we are disclosing on our public Web site summaries of all communications with members of the public, including banks, trade associations, consumer groups, and academics, regarding matters subject to a proposed or potential future rulemaking under the Act.

We have also implemented measures within the Act to enhance the Federal Reserve's transparency. In December, we publicly released detailed information regarding individual transactions conducted between December 1, 2007, and July 20, 2010, across a wide range of Federal Reserve credit and liquidity programs and we are

developing the necessary processes to disclose information concerning transactions conducted after July 20, 2010, on a delayed basis as provided in the Act.

To conclude, Mr. Chairman, the Dodd-Frank Act is a major step forward for financial regulation in the United States. The Federal Reserve will work closely with our fellow regulators, the Congress, and the Administration to ensure that the law is implemented expeditiously and in a manner that best protects the stability of our financial system and our economy.

Chairman JOHNSON. Thank you, Chairman Bernanke.

Ms. Bair.

STATEMENT OF SHEILA C. BAIR, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. BAIR. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today on the FDIC's progress in implementing the Dodd-Frank Act.

First, I would like to congratulate Senator Johnson on becoming Chairman, and it is a real honor to be called to testify at your first hearing as Chairman. We have appreciated your efforts in the past on issues like deposit insurance reform and we look forward to your leadership as we address future challenges in the financial industry.

The recent financial crisis exposed grave shortcomings in private sector risk management and our framework for financial regulation. When the crisis hit, policy makers were faced with a choice of propping up large failing institutions or risking disruptive bankruptcies, as we saw with the Lehman failure. The landmark Dodd-Frank Act, enacted last year, created a comprehensive new regulatory and resolution regime to protect the American people from the severe economic consequences of financial instability. It gives regulators tools to curb excessive risk taking, enhance supervision, and facilitate the orderly liquidation of large banks and nonbank financial companies in the event of failure.

The Act requires or authorizes the FDIC to implement some 44 regulations, including 18 independent and 26 joint rulemakings, which we are doing as expeditiously and as transparently as possible. Many of the FDIC's rulemakings stem from the mandate to end "too big to fail." First, in implementing our new orderly resolution authority, we are making clear that there will be no more bailouts of large financial institutions. Our goal is that market expectations and financial institution credit ratings should, over time, fully reflect this reality.

Consistent with the Dodd-Frank mandate, our recent interim rule requires that creditors and shareholders, not taxpayers, bear the losses of a financial company failure and makes clear that the FDIC's resolution powers will not be used to bail out another institution. To make most effective use of these new resolution authorities, it is essential that we have access to the information we need to monitor the health of systemic entities and conduct advance planning to wind them down without disruption to the broader system.

To this end, the FDIC and the Federal Reserve are working to establish requirements for these firms to maintain credible, action-

able resolution plans that would facilitate their orderly resolution. If these entities are unable to demonstrate that they are, quote, "resolvable," we should be prepared to require structural changes so that they can be wound down, and if they cannot make needed structural changes, we should require divestiture. The FDIC is working closely with its FSOC counterparts to develop criteria for designating systemically important institutions that will be subject to enhanced supervision and the need to maintain resolution plans.

The FDIC Board has also implemented its authority under Dodd-Frank to strengthen and reform the Deposit Insurance Fund. The Act will enable us to maintain a positive fund balance during crisis periods while also maintaining steady and predictable assessment rates over time. We have expanded the assessment base used for Deposit Insurance assessments and we have removed reliance on credit ratings while also making large bank assessments more sensitive to risk.

Also, under the Collins Amendment, capital requirements for bank holding companies and nonbanks will be made as strong as those applied to community banks. The Federal banking agencies are in the early stages of rulemaking to implement this provision and are also taking steps to implement Basel III proposals for strengthening capital and liquidity standards, as Chairman Bernanke mentioned.

The Dodd-Frank Act addresses misaligned incentives in securitization by requiring the FSOC agencies to develop risk retention standards for loan securitizations and to define standards for qualifying residential mortgages that would not be subject to risk retention. As this interagency process moves forward, we believe the standards must include incentives to appropriately service securitized loans. Research and recent experience show the importance of servicing to mortgage performance and risk, but most securitizations currently do not provide the proper resources or incentives for servicers to effectively engage in loss mitigation.

As implementation moves forward, the industry should understand that Dodd-Frank reforms are in no way intended to impede the ability of small and midsized institutions to compete in the marketplace. Instead, they should do much to restore competitive balance by subjecting systemically important institutions to greater market discipline and regulatory oversight.

History reminds us that financial markets cannot function in an efficient and stable manner without strong, clear regulatory guidelines. Millions of Americans have lost their jobs, their homes, or both, even as so many of our largest financial institutions received Government assistance that enabled them to survive and recover. We have a clear obligation to members of the public who have suffered the greatest losses as a result of the crisis to prevent such a severe episode from ever recurring.

Thank you very much.

Chairman JOHNSON. Thank you, Chairman Bair.

Ms. Schapiro.

STATEMENT OF MARY L. SCHAPIRO, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Ms. SCHAPIRO. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission regarding the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Act is intended to fill a number of significant regulatory gaps, bring greater public transparency and market accountability to the financial system, and give the SEC important tools with which to better protect investors. It also assigns the SEC new authority for over-the-counter derivatives, hedge funds, and credit rating agencies, among others.

To respond, we have brought together experts from across the agency, creating cross-disciplinary teams to draft rules and conduct the required studies. We put in place measures to ensure maximum input from the public and a highly transparent process. And we continue to consult frequently with our fellow regulators domestically and internationally.

We have made significant progress to date. The Commission has issued 25 proposed rule releases, seven final rule releases, and two interim final rules. We have reviewed thousands of public comments, completed five studies, and hosted a number of public roundtables jointly with the CFTC.

While my written testimony contains a detailed discussion of our work, I would like to highlight just a few areas of particular interest.

A key portion of the Act seeks to reduce a source of financial instability by improving transparency in the derivatives markets and facilitating the centralized clearing of swaps. The SEC has proposed rules regarding swaps which together provide a clear blueprint for a more stable and transparent derivatives market. These include proposals that, to mention just a few, would lay out the reporting requirements for market participants and obligations of swap data repositories, seek to mitigate potential conflicts of interest to clearing agencies, and establish the duties and core principles of swap execution facilities. We are also working with the Federal Reserve, the CFTC, and the Financial Stability Oversight Council to develop a framework for supervising market utilities that are designated as systemically important.

In addition to derivatives, the Dodd-Frank Act provides the agency with authority over hedge funds and private equity funds with assets under management in the U.S. of over $150 million. Here, we have proposed rules that would facilitate the registration of private fund advisors, and together with the CFTC, we have proposed rules to require advisors to hedge funds and other private funds to report information for use by the FSOC in monitoring systemic risk.

The SEC also is acting to give investors more information about asset-backed securities, another focus of the legislation. In this area, we have adopted rules requiring ABS issuers to disclose the history of asset repurchase requests received and repurchases made, and we have also adopted rules requiring issuers to review the assets underlying the ABS, to disclose the nature of the re-

views, and to provide reasonable assurances that the prospectus disclosures are accurate.

The Dodd-Frank Act also includes provisions related to executive compensation. In furtherance of these provisions, last month, the Commission adopted rules requiring companies to allow shareholders to cast an advisory say-on-pay vote at least once every 3 years and requiring a separate advisory vote on the frequency of say-on-pay votes at least every 6 years.

Additionally, the legislation substantially expands the agency's authority to compensate whistleblowers. In November, we proposed a rule mapping out a procedure for would-be whistleblowers to provide useful information to the agency. The rule makes it clear that whistleblowers play a critical role in protecting investors. At the same time, it is designed to complement, not circumvent, existing compliance regimes that companies operate.

In recent weeks, the SEC also released two studies which examine ways of improving the investment advisor and broker-dealer regulatory frameworks. First, the Commission published a staff study describing potential approaches for Congress to consider to increase examinations of investment advisors. And second, we issued a staff study looking at the differing standards of conduct required of investment advisors and broker-dealers. Most importantly, that study recommended that the Commission implement a uniform fiduciary standard of conduct for broker-dealers and investment advisors when they are providing personalized investment advice about securities to retail investors.

In short, the Commission has moved steadily and responsibly to implement the Dodd-Frank Act. As we continue to make progress, we look forward to working closely with Congress, our fellow regulators, the financial community, and investors to craft rules that will strengthen the financial markets.

Thank you for inviting me here today and I look forward to answering your questions.

Chairman JOHNSON. Thank you, Chairman Schapiro.

Chairman Gensler.

STATEMENT OF GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Mr. GENSLER. Good morning. Thank you, Chairman Johnson, Ranking Member Shelby, Members of the Committee, and congratulations on assuming the Chair. Congratulations to the five new Members of the Committee, as well. I guess I am a little partial, having once staffed a chair of this Committee.

I thank you for inviting me here today to testify on behalf of the Commodities Futures Trading Commission. I want to thank my fellow Commissioners and the staff for such hard work at the CFTC in fulfilling their statutory mission. I am also pleased to testify alongside the fellow regulators here today.

In 2008, the financial system failed the American public, and the regulatory system, as well, failed the American public. The effects of that crisis have reverberated throughout America and the global economies. In the U.S., hundreds of billions of taxpayer money were used to bail out the financial system that was at the brink

of failure, and millions of jobs have been lost and have yet to fully come back.

The CFTC is working very closely with the SEC, the Federal Reserve, the FDIC, the Office of the Comptroller of the Currency, Treasury, and other regulators to implement the Dodd-Frank Act and we are coordinating and consulting closely with international regulators to harmonize oversight of the swaps market and ensure that there is a level field. We have received thousands of comments from the public and had hundreds of meetings, which we all post on our Web site. For the vast majority of the proposed rulemakings, we have solicited public comments for a period of 60 days.

One area where the CFTC is seeking input from the public relates to the timing and implementation of various requirements under the rules. Public comments will help inform the Commission as to what requirements can be met sooner and which can be phased and can be implemented later.

We are also under the Act to propose rules, along with the other regulators here, with regard to margin requirements. The Congress recognized that there are different levels of risk posed by transactions between financial entities and those involving nonfinancial entities. This was the so-called end-user exception from clearing. Consistent with this, proposed rules on margin requirements from the CFTC, we believe, should focus only on the transactions between financial entities rather than those transactions that involve nonfinancial end-users, consistent with how Congress did the clearing requirement.

Aside from proposing rulemakings to implement Dodd-Frank, the CFTC is also supporting the work of the Financial Stability Oversight Council, providing both data and expertise relating to a variety of systemic risks. We also have had the opportunity to coordinate with Treasury and the Council and the Office of Financial Research on the studies and proposed rules by the FSOC.

To adequately fulfill our statutory mandate, the CFTC does require additional resources. The U.S. futures market which we currently oversee is about $40 trillion in size. The U.S. swaps market that we will jointly oversee with the SEC is about $300 trillion in size, or roughly seven times the size of the U.S. Futures markets. We do not need seven times the people, but we do need more people and we need more technology.

On Monday, the President submitted a fiscal year budget of $308 million for the Commission. This is essential for fulfilling our mission. In 1992, we had 634 staff at the CFTC. We are currently between 670 and 680. We actually shrank about 23 percent in the prior decade, and with this Committee and Congress' help, we grew back to where we were in the 1990s. But only last year did we get back to where we were in the 1990s.

Furthermore, the CFTC's funding, if it were returned to fiscal year 2008 levels, the agency would not be able to fulfill our statutory mission. Every program would be affected. We would be unable to pursue fraud and Ponzi schemes, market manipulations. Though it did take, Senator Shelby, time to fill the Office of Chief Economist, we would not even be able to fill any jobs. We would have to go the other way and have to unfortunately let people go.

I do not think that is what the American people need us to do at this time after the crisis of 2008.

The CFTC fundamentally is a good investment. The mission is to promote transparent, open, and competitive markets so end-users, hedgers, and investors can get the benefit of the markets and the transparency in those markets and the competition in those markets. The CFTC is also a cop on the beat to ensure against fraud and manipulation and other abuses.

I thank you and I would be happy to answer any questions.

Chairman JOHNSON. Thank you, Chairman Gensler.

Mr. Walsh.

STATEMENT OF JOHN WALSH, ACTING COMPTROLLER OF THE CURRENCY, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. WALSH. Thank you, Chairman Johnson, Senator Shelby, and Members of the Committee. I appreciate the opportunity today to describe the activities the OCC has undertaken to implement the Dodd-Frank Act. Let me begin, as others have done, by saying what a pleasure it is to appear before Chairman Johnson for the first time and by expressing our hope for a continuing productive working relationship with my old committee, including with its five new Members.

I am pleased to report that much has been accomplished during the past 6 months on implementation of the Dodd-Frank Act. Progress in a number of areas is discussed in my written statement. Our single largest task is integration of the employees and functions of OTS into our supervisory mission, and we are on track to complete all transfers by the target date of July 21. We firmly believe that the talent and experience of OTS staff will be essential for effective supervision of Federal savings associations going forward and we are fostering an environment that will maximize career opportunities while ensuring they enjoy the full protections afforded employees by the Dodd-Frank Act.

We are also engaged in extensive outreach to the thrift industry, addressing concerns and clarifying expectations. We anticipate an orderly transfer of authority that will ensure the combined agency can continue to provide effective supervision of both national banks and Federal savings associations.

In the area of rule writing, we are making progress on the many projects assigned to us, but a few present particular challenges. An issue I raised in testimony last September is the prohibition on use of credit ratings. We recognize that the misuse of credit ratings, especially in structured finance, contributed importantly to the financial crisis, but this was not true of corporate and municipal ratings, and after significant study and comment, we have found no practical alternative for such ratings that could be used across the banking sector. We have heard concerns from regional and community banks that attempting to replace ratings with internal assessments of creditworthiness would be prohibitively costly and complex for them. Although we certainly do not advocate a return to total reliance on credit ratings, their use within defined limits is essential for implementation of capital rules, including the Basel

III capital framework, and we urge Congress to modify this prohibition.

A more general concern is the need to coordinate implementation of Dodd-Frank requirements for capital and liquidity with Basel III. While the two share many common objectives, it is essential to implement these reforms in a coordinated, mutually reinforcing manner that enhances safety and soundness without damaging U.S. competitiveness or restricting access to credit. My testimony describes our efforts to enhance the capital and liquidity standards of U.S. financial companies with this coordination challenge in mind.

Finally, I would like to update the Committee on steps the OCC has taken in response to the foreclosure crisis since I last testified on this issue. The Federal banking agencies have concluded examinations of foreclosure processing at the 14 largest federally regulated mortgage servicers. The examinations, which we undertook in late 2010 with the Federal Reserve, the FDIC, and the OTS, found critical deficiencies and shortcomings that resulted in violations of State and local foreclosure laws, regulations, or rules. Despite these clear deficiencies, we found that loans subject to foreclosure were, in fact, seriously delinquent and that servicers had documentation and legal standing to foreclose.

In addition, case reviews showed that servicers were in contact with troubled borrowers and had considered loss mitigation alternatives, including loan modifications. That said, our work identified a small number of foreclosure sales that should not have proceeded because of an intervening event or condition. We are now finalizing remedial requirements and sanctions appropriate to remedy comprehensively the problems identified. Our actions will address identified deficiencies and will hold servicers to standards that require effective and proactive risk management and appropriate remedies for customers who have been financially harmed.

We are also discussing our supervisory actions with other Federal agencies and State Attorneys General with a view toward resolving comprehensively and finally the full range of legal claims arising from the mortgage crisis. Equally important, we are drawing on lessons from these examinations to develop mortgage servicing standards for the entire industry. The OCC developed a framework of standards that we shared with other agencies and we are now participating in an interagency process to establish nationwide requirements that are comprehensive, apply to all servicers, provide the same safeguards for all consumers, and are directly enforceable by the agencies. While we are still in a relatively early stage, we share the common objective to achieve significant reform in mortgage servicing practices.

Thank you for the opportunity to testify. I would be happy to answer your questions.

Chairman JOHNSON. Thank you, Mr. Walsh. Thank you for your testimony.

I will remind my colleagues that we will keep the record open for statements, questions, and any other material you would like to submit. As we begin questioning of the witnesses, I will put 5 minutes on the clock for each Member's questions.

Chairman Schapiro and Chairman Gensler, with the arrival of the President's budget to Congress this week and the failure yet to appropriate the funds authorized by the Dodd-Frank Act, please describe how you are addressing funding constraints in your respective agencies as you continue to implement the Dodd-Frank Act.

Ms. SCHAPIRO. I am happy to go first with that, Mr. Chairman. For the purposes of conducting the studies and writing the rules that are required under Dodd-Frank, we are using cross-agency teams of employees who are already on board and have been long-time employees in many instances, and we are not really feeling the pressure of the Continuing Resolution with respect to that. In order to operationalize any of the rules that we are writing, we will require additional resources that are laid out in the President's budget request because we do not have the capacity now to, for example, take on the examination of hedge funds, the examination of municipal advisors which is required under the legislation, the registration and supervision of the new entities that are part of the over-the-counter swaps market.

With respect to our current core functions, we are feeling the pressure of operating under a Continuing Resolution. We are making some difficult choices. We are restricting hiring across the agency and selectively hiring only very special positions. We have cut travel, and to me most importantly, we have delayed very significant technology programs that would help bring the SEC's technology up into at least this century, if not this year. That is having an impact on our ability, I believe, to achieve our core mission as effectively as we could, and quite frankly, at the level at which the American people have a right to respect.

Chairman JOHNSON. Mr. Gensler, please elaborate.

Mr. GENSLER. Our agency just this past year, with the help of Congress, got back to our staffing levels of the 1990s, having been shrunk, unfortunately, in the prior decade. But today's staff is not enough to take on the implementation. We can write the rules and have the meetings. About a quarter of our staff right now is working in one way or another on the rule writing.

This year under the Continuing Resolution have had to make hard choices. Our technology budget, only $31 million last year. This year, under the Continuing Resolution, we will probably have to cut it about 45 percent. We are cutting travel and all the other things to be efficient. But technology is the key to move forward.

We are also working hand-in-glove with the self-regulatory organization, the NFA, to see what can they pick up, can they pick up registration and examination functions and so forth. To take on the task of overseeing a market that is about seven times the size of our current agency, it is a new task to take on something that large. This small agency needs to be larger. The President has asked for $308 million for next year. I know this Nation of ours has a great budget deficit that we all have to come together and understand better and grapple with, so I feel a little bit—it is daunting to ask for more money for this agency at this time, but I really do think this is a good investment for the American public to avoid crises like in 2008.

Chairman JOHNSON. Chairman Bernanke, Chairman Bair, and Comptroller Walsh, community banks and credit unions are the backbone of our economy, which is why we have worked hard to protect their viability in drafting the Dodd-Frank Act. As the regulators of depository institutions holding under $10 billion in assets, could you please speak to the impact of the Dodd-Frank implementation on these small institutions, including the impact of the debt interchange rule and the qualified residential mortgage, QRM, rulemaking, to ensure that there are no unintended consequences moving forward.

Mr. BERNANKE. Chairman Johnson, we fully agree with you that community banks and small regional banks, play a very important role in our banking system and it is very important to minimize the excess regulatory burden on these institutions. We have tried to institutionalize that effort within the Federal Reserve. We have created a special committee that looks only at smaller banks and tries to ensure that rules that are written for the banking system broadly are not excessively burdensome on the smallest institutions. We have also created a Community Bank Council that meets three times a year with the Board of Governors to give us their views. And so we are trying to reach out and understand particular problems.

Our rulemaking activities are focused primarily, given the nature of the crisis and the fact that most of the problems were with large institutions, on the largest institutions. We are currently developing, as Dodd-Frank requires, a new set of regulatory, capital, liquidity, risk management, and other rules that would apply primarily to those banks of $50 billion or larger, and even those banks, the rules are tighter the larger the bank. So we are very sensitive to this issue and are trying to do our best to minimize the impact on small banks.

I will speak to the interchange rule. Perhaps Chairman Bair would like to say something about QRMs. The interchange provision has an exemption for banks, smaller banks, which we will put in the rule. I think this is something we are trying to better understand through the comments and through our outreach; we are not certain how effective that exemption will be. It is possible that because merchants will reject more expensive cards from smaller institutions or because networks will not be willing to differentiate the interchange fee for issuers of different sizes, it is possible that that exemption will not be effective in the marketplace. It is allowable, not a requirement. And so there is some risk that that exemption will not be effective and that the interchange fees available to smaller institutions will be reduced to the same extent that we would see for larger banks.

Ms. BAIR. Thank you. I welcome that question. I guess I would like to note, first of all, that one of the things Dodd-Frank did was change the assessment base for deposit insurance premiums from one based on domestic deposits to one focused on assets. We just recently finalized rules on that and it will be effective in the third quarter, and that will reduce community banks—in aggregate, reduce community banks' deposit insurance premiums by about 30 percent. It tends to shift more of the burden to entities that rely less on deposit insurance and really hits those that rely on secured

liabilities, which tend to be the larger institutions. So I think that is going to have a significant benefit for community banks.

On the QRM rule, I do not want to front-run the rulemaking process, but that rule is close to being done and I think I can assure the Committee the direction on the QRM rule, it will be focused on issuers of securitizations, not small mortgage originators. So I think the impact will not be burdensome for community banks. I think we have all strived to realize community banks were not the problem, that the curing rules are trying to correct, and so I think that you will—if you are concerned about that, you will be pleased when you see the rule that goes out for public comment.

I would also, back to my opening statement about orderly liquidation authority, I think robust implementation of Title 2 and orderly liquidation authority will help further level the competitive playing field between small and large. I anticipate that funding costs for many of the large institutions will go up as that authority is implemented and that will also help the community banking sector.

I would also share Chairman Bernanke's concerns about the effectiveness of the interchange rules and statutory provisions to truly protect community banks, particularly if networks are not required to have a two-tiered pricing structure, so the community banks can continue to charge the higher fees. So we are in consultations with the Fed on this and reviewing what the legal authorities might be there from a regulatory standpoint. But I do think this is a real issue for community banks.

Chairman JOHNSON. Mr. Walsh, my time has expired, but please sum up quickly.

Mr. WALSH. Just to echo some others on QRM and interchange, we are working with the other agencies there. I would just note that our community banking population is going to go up by half when we integrate the OTS, from 1,400 to 2,100 institutions. We have a division devoted to community banking. We have examiners around the country who are attentive to their concerns. We have been doing quite a bit of outreach to community banks to try to understand their concerns. As was noted, most of the significant changes in Dodd-Frank are aimed at larger institutions, but the smaller institutions do worry about the increasing weight of regulation that the changes imply. And as I noted, we have one concern with credit ratings, and if it were simplified could be of benefit to community banks.

Chairman JOHNSON. Thank you, Mr. Walsh.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

I will direct this question first to Chairman Bernanke and then some others. In a recent *Financial Times* article, Secretary Geithner talked about the difficulty of designating nonbank financial institutions as systemic. He said, and I will quote, "it depends too much on the state of the world at the time. You won't be able to make a judgment about what is systemic and what is not until you know the nature of the shock."

I find the Secretary's comments interesting given his strong support of Title 1 of Dodd-Frank when we went through this. If it is impossible to know what firms are systemic until a crisis occurs,

the Financial Stability Oversight Council will have a very difficult time objectively selecting systemic banks and nonbanks for heightened regulation.

Mr. Chairman, as a member of the Council, what is your view on whether firms can be designated as systemic without creating some type of arbitrary process here?

Mr. BERNANKE. Senator, it is a difficult problem.

Senator SHELBY. I know it is.

Mr. BERNANKE. You have different types of firms respond to different types of shocks. It is also true that an individual industry with small firms might be subject to a broad shock, as we saw with the money market mutual funds, for example.

That being said, I think one of the sources of the crisis in 2008 was that there were very substantial gaps in the oversight of many large firms, like the AIG——

Senator SHELBY. Sure.

Mr. BERNANKE. ——which did not have strong consolidated oversight. And I think our task is to do the best we can to try to identify those firms which most likely pose a risk——

Senator SHELBY. What does "do the best we can" mean to us? What does that mean?

Mr. BERNANKE. Well, we do not want to be arbitrary, as you point out——

Senator SHELBY. OK.

Mr. BERNANKE. ——the FSOC, with the cooperation of all of the folks at this table, has already put out a request for input. But what we would like to do is provide relatively clear guidelines about the criteria that we will use to try to identify firms that are potentially systemic. Admittedly, those will not be exact numerical guidelines but I do think it is important that the fact that each agency at this table has a certain specific set of institutions for which it is responsible, that we do not allow that fact to create gaps where there are important firms that have no serious consolidated oversight. So I do think it is useful to do this, but I acknowledge your concerns that it will never be a perfect process.

Senator SHELBY. Chairwoman Bair, do you have a comment there?

Ms. BAIR. Yes, thank you. I do. I think it is perhaps easier to say what is not systemic. I think Congress said, at least for bank holding companies, if you are below $50 billion——

Senator SHELBY. Let us talk about banks, then.

Ms. BAIR. Right. So——

Senator SHELBY. And you are defending the fund, so to speak.

Ms. BAIR. We are defending the fund, and so I think our concern about this is to make sure if we have to use our resolution authority, that we are prepared and we have resolution plans and have had information that we need for an orderly wind-down.

So I think for me, Senator, the biggest—there are a number of factors that our NPR identifies. For me, it is interconnectedness more than anything. If you fail, what else happens? Who else gets hurt? And it may be that we need to do a type of a two-step process on some simple metrics based on size and counterparty exposures, take it to a second level, and ask those entities to do what is called

a Credit Exposure Report in Title 2 and basically do an analysis, do a scenario. If you fail, what happens?

So I think in terms of systemic, that is the most important factor to me. And there are some that will be obvious and that is why we need to know who they are in advance, to have prudential standards, to have them start reducing any concentrations they might have that would have broader collateral impact. There will be some gray areas. But at least in terms of resolution planning, I would err on the side of inclusiveness.

Senator SHELBY. Mr. Chairman—Chairman Bernanke—all of you are chairmen to a point. Do you believe that you are better positioned now than you were 2 years ago to deal with the failure of a large bank, for example, financial institution, or would that come as a shock to you still? In other words, would you be in a position to wind these institutions down?

Mr. BERNANKE. Well, of course——

Senator SHELBY. What about a manufacturing facility?

Mr. BERNANKE. As Chairman Bair discussed, the resolution regime and the other prudential requirements are aimed at financial firms which have the risk of bringing down the system. I think there is quite a bit more work to do to fully implement all that Dodd-Frank has put on the table in terms of living wills, resolution, prudential requirements, and so on.

I think we are better off today than we were 2 years ago, but I would say that it will still be some time before we have completely implemented not only all of the rules in the context of Dodd-Frank, but I think, very importantly, and Chairman Bair has taken leadership on this, we have to negotiate and coordinate with international regulators because so many large institutions are across borders. So we will need to work together with other institutions.

So we have not gotten to the point where this set of tools is fully implemented, but we are working very hard and it certainly is a focus of the Fed and the FDIC to get the resolution process up and running as effectively as possible.

Senator SHELBY. Do you believe the Fed as a regulator today is a lot more on top of things as to the capability of a bank to stand a lot of shocks as opposed to 2 years ago? In other words, are you more diligent than you were 2 years ago, the Fed as a regulator?

Mr. BERNANKE. Well, Senator, certainly we have all learned lessons from the crisis in terms of——

Senator SHELBY. What have you learned?

Mr. BERNANKE. Well, the importance of being very aggressive and not being willing to allow banks too much leeway when they are inadequate in areas like risk management, where it turned out to be such an important problem during the crisis. So we have done a lot to try to strengthen and improve our supervision from a day-to-day basis, but we have also done a good bit——

Senator SHELBY. It is important.

Mr. BERNANKE. ——to restructure the internal process so that we have a lot more interaction between the supervisors and economists and financial market specialists who have different skills they bring to the table to give us a broader perspective on what the bank or other institution is doing.

Senator SHELBY. How many banks today, just off the top of your head, still owe a lot of money because of TARP?

Mr. BERNANKE. Umm——

Senator SHELBY. I know a lot of them, but if you——

Mr. BERNANKE. Well, just a couple of larger banks. There still might be a couple hundred small banks. But the great majority of the money has been paid back, and in the end——

Senator SHELBY. I am getting to the point, the ones that have not paid back, is that a dangerous signal for you because the economy has picked up a little bit, or are you not worried about it?

Mr. BERNANKE. I do not think so, Senator. The relatively small banks have a relatively small number of smaller banks have not paid their dividends. But as you know, we have had a lot of failures of small institutions and a few of them had TARP money. But the great majority have either paid back or are on a track to pay back.

Senator SHELBY. Are we going to continue to lose a lot of banks, small banks, medium-sized banks, in this country? I see the decline. You can see the trend line down.

Mr. BERNANKE. Maybe Chairman Bair could take it.

Ms. BAIR. So, Senator, I think we peaked last year at 157 failures. There will be an elevated number of failures, but it will be lower, significantly lower, than 157.

Senator SHELBY. How many are on the watch list now, roughly?

Ms. BAIR. I think we have got, oh, about 700, close to 800 on the——

Senator SHELBY. Seven hundred banks on the watch list——

Ms. BAIR. ——and so—well, the troubled bank list is—most of those do not fail. Only about 23 percent ultimately fail, and that is cyclical. The economy is improving and I think our losses actually went down last year. It was about $22 billion last year. It was around $34 billion in 2009. So losses were down significantly last year. The banks that are failing are much smaller banks, which is why the losses are lower. So things are getting better. The banking sector is healing. At the community banks, that is very true of the community banks, as well.

Senator SHELBY. My last question, if I could direct it to Chairwoman Schapiro, on the importance of economic analysis. You have repeatedly stated that economic analysis is important to the SEC in its work, but it is my understanding that the SEC has about 4,000 employees but only has 25 Ph.D. financial economists. Considering the importance of economic analysis that you placed on what you are doing, how did you determine that 25 Ph.D. economists is the appropriate number, or have you done that, or are you trying to grow it or what?

Ms. SCHAPIRO. We are absolutely trying to grow it, Senator. And if I could also speak to your earlier comments, I think you know we are actively and aggressively recruiting for a Chief Economist at the SEC. But I want to note that we would like that person also to lead our Division of Risk, Strategy, and Financial Innovation, and the person who is acting head of that now is a Ph.D. economist. His Ph.D. is from the University of Chicago, from where he also has an MBA. So we are not without significant economic expertise within the agency. We have about 30 staff economists and

they are fully engaged, as you can imagine, on Dodd-Frank and other rules.

Senator SHELBY. But you do not feel like it is adequate yet, do you?

Ms. SCHAPIRO. No, I sure do not.

Senator SHELBY. OK.

Ms. SCHAPIRO. I think it is important for us to have more capacity in economic analysis. It is part of my view of how we have to shift the entire focus of the agency. We will always have lawyers. We are a law enforcement agency. That is important. But we also need—and have been very successful in recruiting—current market experience, new skill sets, new kinds of talent to the agency, and I view economic analysis and financial analysis to also be very key components of this. They are also very important to the support of our enforcement program, frankly, as well as our rule writing and the many studies we have to do. So my goal would be to try to significantly, if we have the resources, grow that area of our operations.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Bennet? Please abide by the 5-minute rule.

Senator BENNET. Thank you, Mr. Chairman. I will and——

Chairman JOHNSON. Do, as they say, not as I do.

Senator BENNET. I will.

[Laughter.]

Senator BENNET. Congratulations on your first hearing as Chairman. I also want to thank Senator Merkley for the amendment that he raised and withdrew and say that if it is any sign of things to come, we are delighted to have Senator Isakson on this side.

[Laughter.]

Senator BENNET. It is working out perfectly and we are enjoying it.

Chairman Bernanke, I wanted to just get some clarity from you on the interchange issue, again, because there were, I think, a lot of representations made when this vote came up and when this bill was passed that institutions $10 million or below would be exempt, and what I took you to say is that there appears to be, or you are starting to hear feedback that there may actually be a real—some practical problems with implementing that.

Mr. BERNANKE. Well, Senator, I should first say that our rule is out for comment and we are still gathering information. By the statute, the smaller institutions will be exempt from these restrictions, but there is the possibility that either because merchants would not accept the more expensive cards or because networks would not be willing to have a two-tier pricing system, it is possible that in practice they would not be exempt from the lower interchange fee.

Senator BENNET. And what would the result of that be if, in practice, they did not have the benefit of it?

Mr. BERNANKE. Well, the statute limits the interchange fee to the incremental cost associated with an individual transaction, which does not cover the full cost if you include some fixed costs associated with setting up a debit card program, for example. So it is certainly possible that some of those costs would get passed

on to consumers in some way, for example, a charge for a debit card or something like that, and that would just mean that if the small banks do not have an effective exemption, it would mean that whatever economic forces are impinging on the larger banks would affect them as well.

Senator BENNET. I wanted to follow up on some of the questions the Ranking Member was asking about the FSOC, asking it in a different way because it is both about the institutions themselves, which are the ones that are systemically risky, and it is also about the instruments, I would think. And I wonder if any of you would like to talk a little bit about what the priority setting looks like. How do you decide what the agenda is going to be for the Council and over what period of time? Is that something that the Treasury Secretary coordinates? How do you detect where you ought to be looking versus where you are not?

Mr. BERNANKE. Senator, if I may take it——

Senator BENNET. And to the extent that you actually have agenda items already, what those might be.

Mr. BERNANKE. Senator, first, our agenda has two parts, in a sense. As you know, FSOC has to write a financial stability report once a year, and for that purpose, it makes sense that there be an annual review of all the major financial sectors to try to identify any emerging problems or developments in those sectors, and so that is part of our process.

In addition, we want to remain flexible so that any ongoing problem, say the developments in Europe and the implications for U.S. banks or money markets, any developing event or situation can be brought quickly to the Council.

The Council has set up committees of staff and deputies who are covering different areas and who are presenting to the Council short summaries of areas where they have identified potential developments of interest and then the Council members are giving feedback about what they would like to hear most in the discussions.

Senator BENNET. Because I am under strict instructions from our Chairman, I am going to ask you, because you mentioned Europe, is our own domestic fiscal condition something that the Council is going to be taking up, and are you aware of any other systemic risks greater than our own debt and deficit?

Mr. BERNANKE. Well, that is a difficult question because obviously that falls somewhere between fiscal stability and financial stability, and so the question is whether that is more a Congressional responsibility or an FSOC responsibility. I do not think we have discussed anything related to that so far.

Senator BENNET. I would encourage it, just because I think our financial stability is so closely linked to our fiscal stability.

Thank you, Mr. Chairman. I have 3 seconds left. I yield back the balance of my time.

[Laughter.]

Chairman JOHNSON. Thank you. Senator Corker, we have a vote coming up at ten to 12 and I encourage you to abide by the 5-minute rule.

Senator CORKER. I have got it. Thank you. I appreciate it.

[Laughter.]

Senator CORKER. So I welcome all of you and I thank you for your service. We miss you. After Dodd-Frank, we have not heard from you and the phones quit ringing. We are glad to have you here today and appreciate the work each of you are doing. That is a sincere statement.

I know there is a lot of talk about the budget issues. There is no question that is going to probably get even tighter, so there will be more of a limitation in funding. And I know we did receive some calls during the CR period about what you were going to be able to do, and I guess I would ask this question. I am hearing that some of you are not being able to invest in technology and there are some positions that are open in other areas, examination and that kind of thing. Would it make any sense—I know that you all have been really pushing out rules and regulations and I know people have been concerned at the rapidity of that. Would it make any sense for us to slow you guys down a little bit so that you have time to both invest in technology and hire people and actually be slightly more thoughtful on the rulemaking? I will ask that to Chairman Schapiro.

Ms. SCHAPIRO. Thank you. I think, as I said earlier, the real impacts of the Continuing Resolution on the SEC are on, frankly, our core mission, our ability to hire examiners, to travel for enforcement cases, and most particularly, to build the technology we need to really do the job that is right in front of us at this moment, putting Dodd-Frank aside.

If you think back to May 6 and the flash crash and how long it took us after that to be able to generate the reports that gave the public an understanding of what happened on that day, that was largely because we lacked the technological capability to take in the kind of data we needed to take in and analyze it in a reasonable period of time. So for me, the budget impacts are really as much or more right now to core mission, than they are to Dodd-Frank implementation.

Once the rules are in effect—and we will be very careful with how we sequence and implement the actual rules. We will, as Chairman Gensler said, seek comment from the industry about what is the right order—what do they need 6 months to be able to do, because they have to build a system? What do we need time to do, because we might need to build a system? And that will require additional funding in order to both build those systems and bring in the people needed to, for example, do hedge fund examinations or examine swap dealers or major swap participants or whatever. But I think getting the rules written, it is a stress, for sure, and it is a challenge. It is affecting all of our capacities to do other things. But I think the real crunch comes after the rules are in place and we actually have to operationalize them, and we lack the resources to do that.

Senator CORKER. OK. Thank you very much.

Chairman Bernanke, I know that there are a lot of things that each of you sought and got, and then there were some things you did not ask for and got. I know one of the things you received was the interchange issue. I know you are being diplomatic, but it seems to me that it is an impossibility that if a rate is set for the larger institutions, it is not going to impact the smaller institutions

as it relates to interchange rules. I mean, it does not seem to me to be a possibility.

I know, again, you did not ask for this. It was an amendment that passed on the floor. But I was over the other day with Senator Kirk and we were watching a Fed auction take place at the Bureau of Debt. If you just looked at the cost of that transaction, the electronic auction itself, it is obviously very minimal. But there was a whole passel of folks paying attention and making sure that ethical guidelines were in place, and I am sure these—I know these institutions, these banking institutions, have those same things.

So would you please—I mean, the fairness of us price setting at some rate that only is a transmission cost seems to me to be incredibly in error. We also are going to be forcing people into credit cards over time. I mean, people that do not have credit are going to be forced into credit cards, which is a debt instrument, not something that is coming out of their account. It just seems like, to me, the whole issue is very perverse and something that was very short-sighted on our part and sort of a populus move, and I wonder if you would editorialize about that.

Mr. BERNANKE. I do not know if I can editorialize about it. As I said before, it is true that the statute requires us to look only at the incremental costs and not necessarily the full cost and that is going to have various implications. One would be probably that some costs on the banking side will be passed on to consumers or will affect product offerings and so on. On the other side, merchants will be paying less, and depending on the state of competition in that part of the market, they may be passing those savings on to consumers. So there will be some transfers on both sides and the issue really is what Congress intended, what objects you had. Again, this process will certainly lead to lower interchange fees which will benefit some and impose costs on others.

Senator CORKER. And Mr. Chairman, I know my time is up. I thank you. But there is no question, our smaller institutions are going to be impacted in a big way, and I think we all know that and I hope that we will endeavor somehow to fix that here in Congress. Thank you, and congratulations on chairing.

Chairman JOHNSON. Thank you.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Congratulations to your ascension to the Chairmanship. I look forward to working with you.

Since I have 5 minutes, let me try to get succinct questions and succinct answers. One is I marvel at people who 3 years after our financial crisis still do not have full regulation of the Wall Street derivatives and other key issues. I am always asked by New Jerseyans, why is it that no one has gone to jail? And so I marvel now that I hear that your response to the question of the funding ability to pursue what Congress passed and that the American people wanted to see is going to be sufficient to promote regulations but not sufficient to enforce them. Is that a fair statement of what you responded to the Chairman?

Ms. SCHAPIRO. I think that we will have a lot of responsibilities once the rules are written for examination and enforcement, registration, taking in massive amounts of data, particularly in the

swaps area where we will not be able to rely on a self-regulatory organization, and it will be very difficult for us to do any of that without additional resources. So it is broader than just enforcing the law.

Senator MENENDEZ. A cop on the beat without any bullets?

Mr. GENSLER. I——

Senator MENENDEZ. Well, it is a concern that I have because if we are going to promote regulations pursuant to the law but not to be able to enforce them, then it is a hollow promise to the American people of what we said we were going to do so that they would never face the risk again of collectively assuming risk for the decisions of others. And so I appreciate your honest answer to that because I think that will dictate part of the debate as to how we go forward in the budget process to at least, largely derived from the industry, have the resources so that you can do the enforcement that the American people want to see. Otherwise, I would not be surprised if they send everybody home.

Ms. SCHAPIRO. I agree with that, Senator. I was just trying to say that it is broader than just enforcement. It is market analysis and market surveillance and all of those things, but——

Senator MENENDEZ. The technology side, as well——

Ms. SCHAPIRO. Yes, absolutely.

Senator MENENDEZ. Absolutely. I am in agreement with you.

Second, I recently wrote to you, Madam Chair, about cyber security and attacks that have taken place against hacking at NASDAQ and what not. I hope you can give us some sense, because obviously market integrity is important in a variety of ways. One of the ways is that we are sure that we are not having markets being affected by those that are hacking it, and I hope you could give us some sense of where you are headed in that regard.

And let me get my third question and you can answer it, to both of them, and that is both for you, Chairlady Schapiro and Mr. Gensler, with reference to Title 7 of Dodd-Frank requires that all swaps, whether cleared or uncleared, are reported to a swap data repository. I would like to know what your agencies are doing to ensure that the information being reported to multiple repositories is not so fragmented and ultimately allows you an accurate and complete view of the market activity. One of the provisions of Dodd-Frank allows the CFTC to designate one repository to provide direct electronic access to the Commission for all swap data repository information and I am wondering if you considered that.

So if you can tell me what we are doing on cyber security and tell me what you are doing on that.

Ms. SCHAPIRO. Certainly. I do not want to comment specifically on the NASDAQ matter, which is obviously under scrutiny by regulators broadly. But let me just say that given the highly electronic nature of our markets and their highly fragmented nature, financial institutions broadly and exchanges are, I think, increasingly having to face cyber security threats.

We work very closely with the exchanges. We have something called the Automated Review Program, where our examiners evaluate with the exchanges the quality of their information security that is in place and what vulnerabilities they might have. We recently asked all of the exchanges to provide us with an audit of

their information security policies, practices, and systems so that we can have a baseline understanding of where the many different markets are with respect to that.

We are taking this extremely seriously. We are working closely with the FBI, the Secret Service, and the Department of Justice, to make sure that we are pursuing all of these threats as aggressively as we can. I can tell you that the exchanges are taking it extremely seriously, as well. This is their franchise.

With respect to the securities swap data repositories, we have asked questions in our proposing release on swap data repositories and their responsibilities and obligations and core principles about whether we should create some kind of a consolidated audit trail, so to the extent that multiple repositories are developed, we can link the data and have an adequate audit trail.

Our vision is that, ultimately, this should be part of the Consolidated Audit Trail System that we proposed last year and hope to make final later this year that would have all of the markets provide to a central repository all of the transactional information in the life of an order, from inception through execution, that would give us the ability to reconstruct trading in markets and look for violations of Federal securities laws.

Mr. GENSLER. With regard to data, which is so critical to regulators to get an aggregate picture, Congress did say that we could have a direct electronic feed from the data repositories, which we appreciate. We have put that in the proposed rules. We are looking for public comment.

One of the challenges is aggregating if there is more than one data repository in an asset class, more than one for interest rate swaps, for instance. And that is part of the reason why the CFTC, we believe, does need to be efficient and use technology. In the President's 2012 budget, it actually recommends doubling technology so we can be a more efficient agency and then aggregate that data with those direct electronic feeds that you referred to.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Johanns.

Senator JOHANNS. Mr. Chairman, thank you.

Chairman Bernanke, let me start with you, and I want to visit with you a little bit about the interchange rules that you put out. Let me just start out and offer an observation. I think you folks stunned everybody. I think you stunned the retailers. I think you stunned the banks. I do not think anyone ever expected something this dramatic, this Draconian.

Do you agree with me that 80 percent of the transactions, interchange transactions, are actually done by about a percent and a half of the merchants out there? Is that an accurate statistic?

Mr. BERNANKE. I know it is very concentrated. Obviously, large national firms account for a lot of the transactions, but I do not know the exact number.

Senator JOHANNS. I think that is the best available information I can find. Not only national firms, but multinational players are some of the biggest economic players in the world. This is not Joe's Hardware somewhere in Nebraska. Does it not occur to you that, really, what we have done there is we have taken money from this sector of the economy through Congressional price fixing and di-

rected you to transfer that money to this sector of the economy, impacting the biggest players, really, in the world on this side of the equation?

Mr. BERNANKE. Well, Senator, let me react first to your comment about Draconian. We tried very hard to follow the language of the statute, which is pretty clear——

Senator JOHANNS. Do not get me wrong. I am not beating up the messenger. If it feels that way, I am sorry about that. You are just trying to do what we told you to do. Now, not me. I voted against it, and I wish more of my colleagues would have. But the end result of this is that, really, what you are doing is moving money from here to here and it is the big players that are going to see the benefit of that, the big retailers. Would you agree with that?

Mr. BERNANKE. The retailers will benefit, as you say, according to the fraction of the total debit transactions that they have. A question is to what extent, those savings are passed on to customers, which is part of the objective.

Senator JOHANNS. But there is the problem with price fixing. We cannot guarantee that, can we? We cannot guarantee that a single consumer will get any benefit from that legislation. I mean, we hope we do. You might even be able to make an economic argument that they will. But the reality is, we do not know, do we?

Mr. BERNANKE. No, Senator. There is no guarantee, certainly.

Senator JOHANNS. Yes. Now, let me, if I might, just go a step further, because this sounds so preposterous to me. We are seeing commodity prices go up. There are a lot of complex reasons for that, just like the interchange fees. There is drought in China and *et cetera, et cetera.* But good economists are now saying, you are going to pay more at the grocery store for various products because the input costs are going up so dramatically. It is hard to argue against that at the moment.

You would not suggest that it would be good economic policy that we pass a law that the price of a porterhouse steak or the price of a gallon of milk could only go high, would you?

Mr. BERNANKE. No.

Senator JOHANNS. Yes. Mr. Gensler, let me go to you. You know, I have an interest in this end-user deal issue. We all do. One of the challenges I have, and I am guessing you probably have it, too, is how do we define end-user? I have got small community banks out there. They want to protect themselves, so they are in the derivatives market to protect themselves against the risks they are incurring. Are they end-users or are they financial institutions that should be regulated here?

Mr. GENSLER. The statute says that they are financial companies and so most of those community banks are not swap dealers. In fact, I am not aware of any small community bank that would be a swap dealer. They have not come knocking on the door. I do not think any, probably, are swap dealers. So they would not be regulated that way.

The question of the end-users is whether they are brought into clearing, whether they benefit and are brought into that clearinghouse, and Congress did give us authority to exempt them from that. We have asked the public a series of questions to help us on that. We are working with fellow regulators here, looking at that,

not only for those community banks but also Farm Credit institutions and national credit unions, as well.

Senator JOHANNS. Mr. Chairman, thank you.

Chairman JOHNSON. Senator Reed.

Senator REED. Thanks very much, Mr. Chairman. Thank you, ladies and gentlemen.

Chairman Bair, there has been a great deal of work over the last several months of trying to sort out the mortgage foreclosure issues. The State Attorneys General, the FSOC, everyone has been engaged. It seems from the reports that with respect to robosignings, liabilities have been established but penalties have not. Is that the crux of the debate at the moment?

Ms. BAIR. Well, I would defer to the Comptroller on this. They have been leading most of this. We are not the primary regulator of the large servicers. I think the way I envision this unfolding, I think all the agencies have been working hoping for some type of global settlement that would include robust enforcement actions as well as more appropriate remedial measures, including perhaps some type of very dramatically streamlined modification, not only to help borrowers get a fair shot at an affordable mortgage, but also to help clear the market, because there is such an increasing backlog here. So I would hope those would be key elements of any final package, but I think John might have something to add on that.

Senator REED. Mr. Walsh, what is your impression? Is this an issue of—what is holding up this settlement? Attorney General Miller was here months ago talking about how they were working and they were almost at the cusp, so could you elaborate briefly?

Mr. WALSH. We have been at work actually since the last time we appeared here in the Committee on a series of examinations—we, the Fed, the OTS, and with FDIC participating to some extent in the exams to identify the problems and develop both the facts on the ground and then also to develop what the appropriate remedies were. Those remedies include both remedial actions that the servicers will have to take to fix what is broken, and there are clearly some things broken, as I mentioned in my testimony. There is also the question of the penalty phase, if you will, of that process.

We have finished the work. We are getting to the point now where we will be delivering documents to the banks and talking about civil money penalties. But the comprehensive settlement that we are talking about is one that would also involve violations that are under the purview of other agencies. They are Department of Justice, the FTC, the State Attorneys General. And our effort has been to achieve a kind of comprehensive settlement that will put the problem to bed and let us get on with remediation. But the specific supervisory piece is kind of one piece of a broader effort.

Senator REED. Well, the *Wall Street Journal* has reported today that you are recommending rather modest fines in the penalty phase. Again, from following these revelations in the newspaper, it seems like there was some intentional activity and, in fact, I think if they are agreeing to some sort of penalty phase, there's some admission of something more than just negligence. Are you measuring these fines in terms of the overall impact on people who have

lost their homes through this process in terms of the benefits that banks have derived and are deriving from, at least prior to detection, this type of operation and will that factor into your consideration?

Mr. WALSH. Although one is amazed at what the *Wall Street Journal* finds out, in this case, we have not made decisions about the level of penalties. That is the next phase to come. We will be discussing that with the Federal Reserve and there will be penalties at the holding company and servicer levels. So that is a process that is still underway. But in terms of the sort of total penalties involved, they will include other things than just those we are looking at.

Senator REED. Well, I think you have to move with some expedition, because, again, the last time we were all here together visiting, we were talking about how much progress we were making in this global settlement. You have got to come to a conclusion very quickly, as Chairman Bair said, in terms of trying to settle the market and move forward.

Just a quick question, because I have only a few seconds left, Mr. Chairman. Dodd-Frank creates the position of a Vice Chairman of Supervision, or Vice Chairwoman of Supervision, for the Fed. How close are we to getting that person in place, and in the interim, who is taking the lead in terms of what you now have as extraordinarily more complicated and vast supervisory responsibilities?

Mr. BERNANKE. Well, the Administration has not yet nominated anyone, so we are still nowhere in that respect. But Governor Tarullo, in particular, who has headed our bank supervision area and has testified before this Committee a number of times is taking the lead on the supervisory and relevant rule writing issues.

Senator REED. Thank you. Thank you, Mr. Chairman.

Chairman JOHNSON. Welcome to the Committee, Senator Kirk.

Senator KIRK. Thank you, Mr. Chairman. Congratulations and I look forward to working with you on the VA–Mil Con Subcommittee.

Chairman Bernanke, I am an admirer of yours. I just finished Liaquat Ahamed's book, Lords of Finance, which is a very human story of what central bankers go through. A quick question on Dodd-Frank Titles 1 and 7, which creates the Oversight Council and talks about systemic risk, regulatory gap, and a key phrase, regardless of legal charter. So it is a broad authority to examine risk. You have now established this Office of Financial Security to look at any potential dangers out there. Would you be able to look at U.S. States as a source of systemic risk?

Mr. BERNANKE. Our Office of Financial Stability is a small office, which is just trying to look at different risks that might emerge. It does not have any examination authority.

The risks arising from States or the municipal market would be something that the Federal Reserve would pay attention to, but I think probably the appropriate venue for that would be the FSOC, the Council, where we would discuss mutually any complications or ramifications of the developments there.

Senator KIRK. I would just note that Illinois has the worst State-funded pension in the country, at 54 percent, but a new analysis could mean it is as low as 38. The *Chicago Tribune* reported this

morning that the State deficit is $160 billion. And we have concerns about California. I would just note that a young State Representative from New Salem, Illinois, wrestled with this issue in 1840, named Abraham Lincoln. The Senate passed a resolution in 1841 advising Treasury Secretary Webster not to guarantee State debt to preserve the full credit of the United States. So it would appear that this could be a source of systemic risk and something that is fully within your capability to examine.

One other question. The *Wall Street Journal* 2 days ago reported that our largest foreign creditor, China, had sold $11.2 billion in Treasuries in November and another $4 billion in December. A $15.2 billion unwinding is about a 1.7 percent reduction in their total holdings, now down to $892 billion. Do you see this movement by America's largest creditor abroad as a source of systemic risk?

Mr. BERNANKE. The international imbalances, the current account imbalances and reserve accumulations could in principle be a systemic risk and I think they contributed to the crisis. That being said, I would not make much of those data. First of all, they are actually incomplete data. And second, in the short run, the main determinant of Chinese accumulation of dollars is their need to keep the Renminbi pegged at the level that they choose, and so it is pretty much they take whatever they need to take in order to keep their currency at the desired level.

Senator KIRK. Thank you, Mr. Chairman. I have reached out to Chairman Warner on one of our subcommittees hoping that we will look at continued dangers in Spain and Portugal and the adequacy and size of the IMF, which I think this Committee really needs to work on.

Thank you, Mr. Chairman. I yield back.

Chairman JOHNSON. Senator Akaka.

Senator AKAKA. Thank you very much, Mr. Chairman, and congratulations on becoming Chairman.

Good morning to our witnesses. Your agencies have worked tirelessly on implementing this law. Your efforts have, I would say in large part, been prompt, thorough, and transparent, and we do appreciate that. Before I begin, I would like to thank each of you for your leadership and recognize your staffs for their extraordinary efforts.

Chairman Schapiro, I was pleased with the Commission's staff study on the obligations of broker-dealers and investment advisors. I am also encouraged by its recommendations in favor of a uniform fiduciary standard. I know this is an area that you have been interested in, so I have two questions for you.

First is how can confusion on the varying obligations of financial professionals harm investors seeking investment advice? And then second is how can a uniform fiduciary standard reduce investors' costs and improve portfolio performance?

Ms. SCHAPIRO. Thank you, Senator, and I know you share my great interest in financial literacy and investor protection and I have always appreciated your support. I think one of the things we learned, the SEC commissioned a study by the RAND Corporation several years ago that looked at this issue of whether investors understood the relationship that they had with a broker versus their relationship with an investment advisor and found that there was

actually significant confusion, and our current study references much of the work that was done by RAND Corporation.

The issue goes to whether the interests of the customer must be put ahead of the interests of the financial professional; whether the customer must come first, or whether the duty owed should be what is currently under the broker-dealer regime—the duty to only provide suitable recommendations, understanding the net worth, the investment goals, the risk tolerance, and so forth of the investor. So it currently is a suitability standard of care under broker-dealers, and a fiduciary duty to put the investor's interests first under the investment advisor regime.

We felt that it really was not fair to leave customers to guess which standard of care they were receiving when they were dealing with a financial professional. It is just not something that is transparent to investors. And so the staff study does recommend, and the Dodd-Frank Act authorizes the Commission to study, that a uniform fiduciary standard of care no less stringent than the one that applies to investment advisors be applied across financial professionals when giving advice to retail investors about securities.

I think that the standard will alleviate confusion for investors because it will become uniform, and I think while the costs are hard to quantify—the staff made attempts to do some of that, and we have asked for data in that context—I think the benefits to investors of having their interests put first are also hard to quantify but will be very real over time.

And so our next step is for the Commission to consider the report carefully and make a determination about whether to move forward with specific rules that would create this fiduciary standard of care.

Senator AKAKA. Chairman Schapiro, through the Dodd-Frank Act, we provided the Commission with the authority to require meaningful disclosures prior to the purchase of an investment product or services. More effective and timely disclosures can greatly improve investor financial decision making. What is the Commission's plan to implement this specific provision and to promote more responsible investor behavior in general?

Ms. SCHAPIRO. Well, this is an area of long-time interest to me, that investors get decision-useful, accessible information at the right moment in the process of making a decision about whether or not to invest. And what we often see is that they get information after they have made the decision to invest. So it would be my hope that we could, when our calendar is a little bit more open after getting through many of the Dodd-Frank rule-writing provisions, turn our attention back to a point of sale disclosure inquiry and see if the Commission can do something that helps investors get really useful information, not pages and pages and pages of boilerplate, and get it at the time that will help them make the right decisions. And so it would be my hope that at some point later this year we will be able to turn our attention back to those issues.

Senator AKAKA. Thank you very much for your responses. Thank you, Mr. Chairman.

Chairman JOHNSON. Welcome to the Committee, Senator Moran.

Senator MORAN. Mr. Chairman, thank you very much and congratulations to you. I want to be a good Member of this Committee.

This is my first hearing and I want to impress you. I assume that is done by speaking less than 5 minutes.

[Laughter.]

Chairman JOHNSON. It would.

Senator MORAN. I have read the audience.

I want to talk just a bit about a broad issue and then a very specific one. We have had lots of conversations about small community banks, credit unions, small financial institutions. They certainly dominate the economy in Kansas and communities across our State. And in all the responses to questions that have been given and in your testimony, you indicate an effort to treat differently, to recognize the difference between a community bank. I would assume that you would agree that they are not a cause of systemic risk to our economy. And yet the constant conversation with community bankers, with credit unions, is very much about the regulations that are coming our way. This conversation predates Dodd-Frank, but it is exacerbated by Dodd-Frank. And so while I hear the regulators saying, we understand the problem, we treat them differently, there does not seem to be a recognition on the part of bankers that that is the case.

My question, in a general sense, are my bankers just normally complaining types who have it wrong, or are my regulators wrong in which they say, we are taking care of this issue. We are not overly regulating community banks.

Mr. Shelby, in his question about the loss of small banks, the immediate response, Ms. Bair, by you was about the number of closures. That is a component, I suppose, of losing small banks, but what I have noticed in our economy is that it is happening by consolidation, and there are perhaps economic reasons that consolidation should occur, but my impression is that it is occurring because of the regulatory cost.

In fact, I had a conversation with one of our large regional bankers who tells me, for the first time in their bank's history, they are receiving calls from small community bankers saying, are you interested in buying our bank, because we no longer can afford the regulations. It is no longer fun to be a banker. And the cost of being a small community bank now exceeds our ability to generate the revenues necessary to get a return on investment.

So my question is, while we talk about treating differently community banks, the evidence, at least from my view, does not seem to be there. What are we missing? What needs to take place? I think there is great value in that community bank in making decisions and I would issue the caveat, I am not necessarily here advocating on behalf of the bankers, but I am here advocating on behalf of their customers, their borrowers, their clients who in a State like Kansas or like South Dakota, it is a place in which our farmers, ranchers, small businessmen and women have the opportunity to expand, and I think there is a tremendous consequence to our economy, including job creation, in the failure of our banks being comfortable in making loans.

And finally, in that regard, particularly real estate loans. I have had half-a-dozen bankers tell me, we no longer make real estate loans. You cannot come to our bank and borrow money to buy a house because of all the regulations and our fear of the next exam-

ination that we have missed something that is going to then get us written up. Making a real estate loan is no longer worth it. That is a terrible circumstance in small town Kansas, small town America, in which the local bank is now fearful of making a real estate loan, a mortgage on a house. Your response?

Ms. BAIR. Well, I would say a couple of things. I think you are right. There has been consolidation. There are still over 7,000 community banks out there, but there is consolidation. That is always a byproduct of a financial crisis. The stronger absorb the weak and that is what is happening here.

We are very concerned about making sure that we have a vibrant community banking sector. It is not our job to serve community banks. It is our job to serve the public. But I think the public interest is served by having diversity in their choice of banking institutions, and I think, and I have said this repeatedly throughout the crisis, we saw the community banks were doing a better job of lending than the larger institutions and that is just a fact.

We have very proactively tried to protect community banks from the brunt of the Dodd-Frank requirements, which I think are overwhelmingly targeted at large financial institutions. They, as I indicated earlier, are changing the assessment base. It has now reduced by 30 percent in aggregate, the premiums that community banks will be paying for their deposit insurance. They are, by and large, exempt from the compensation rules that we just put out. We have tried to insulate them from these QRM rules on securitizations, as you will see when those come out. So I think we have acted on a number of fronts to try to insulate them and strengthen their competitive position, and as I said, I think ending "too big to fail" and robust implementation of orderly liquidation authority will increase funding costs for many large institutions and provide better competitive parity.

The interchange fee issue, I think, is a very real one. We are very concerned. We will be writing a comment letter. I think the likelihood of this hurting community banks and requiring them to increase the fees they charge for accounts is much greater than any tiny benefit retail customers may get for that, any savings to be passed along. I think that is just obvious to me.

So we are very much hopeful that—I do not know if this could be dealt with by Congress, but what we are planning to do is work within the regulatory framework to see if there is greater discretion to provide better protection for community banks against discrimination and particularly by networks. But I do think this is a real issue and could have an adverse impact in a way that was clearly not intended by Congress in enacting Dodd-Frank.

Senator MORAN. I have set a standard for myself and the red light is on. I would like to follow up with you, Ms. Schapiro, about financial advisors, about community banks and lending to—or making perhaps advice to local units of Government. There is a new rule issued January 6 that has created great concern. And, Ms. Bair, I will be in your hometown a week from tomorrow. Thank you very much. Thank you, Mr. Chairman.

Ms. SCHAPIRO. I will make time to come and see you as soon as possible.

Chairman JOHNSON. Senator Tester.

Senator TESTER. Yes. Thank you, Mr. Chairman. I, too, want to congratulate you on your Chairmanship and I want to thank everybody for being here today. I appreciate your efforts in a difficult time.

Before I get to my questions on debit interchange rules directed at you, Chairman Bernanke, I just do want to say that the issues of regulation that Senator Moran brought up with community banks and credit unions is a big one. I brought it up with members of this panel at least on four different occasions. The inconsistencies with regulation and the "not on my watch" as it applies to community banks is a big concern to me and it continues to be a big concern to me and I do not know that consolidation in our financial system is a positive thing overall, especially for rural America.

That aside, I want to talk about the debit interchange rules, and Chairman Bernanke, it is an issue that I am very concerned about. I was wondering, is there any way to actually ensure that community banks and credit unions are exempted in practice from this provision?

Mr. BERNANKE. I hesitate to give a final answer on that because we are still getting comments and a lot of input——

Senator TESTER. In your opinion.

Mr. BERNANKE. I think it may not be the case. It may not be the case that they will be in practice exempt, but I do not know for sure. Of course, one way to address it, if Congress wants to, would be to require the networks to differentiate.

Senator TESTER. Let us talk about that for a second. I mean, with the routing provisions that are in this bill, first of all, it is illegal to turn down a credit card, correct, just to say, I do not want to use that credit card. Have you got another one?

Mr. BERNANKE. I do not think so.

Senator TESTER. That is not illegal? OK. So if you go into a retailer and you have a card and they look at it and say, we do not want that, we would rather have a different one, that is OK?

Mr. BERNANKE. You certainly have the right to accept different types, Visa, American Express, and so on——

Senator TESTER. Yes, yes, yes. But what I am talking about in this particular case is one that has a bigger fee involved to it as far as interchange——

Mr. BERNANKE. The restrictions are more a function of requirements imposed by the Visa company, for example, as opposed to legal restrictions.

Senator TESTER. Yes, but if we have a two-tiered system, the amount charged by interchange fees by the smaller banks and credit unions will be higher than those by the big banks, correct?

Mr. BERNANKE. Correct.

Senator TESTER. So what stops a retailer from saying, I do not want to use that card because that is one of the small bank ones. I would rather use one of the bigger ones. What stops them from doing that, anything?

Mr. BERNANKE. Not now, unless the company requires acceptance of all its cards, which in many cases they do.

Senator TESTER. OK. So it is—OK. So in practice, I cannot imagine Visa is out there checking out—I mean, if it is a Visa card, it

is a Visa card. They are going to do their thing anyway. It would seem to me that there is going to be undue harm done to smaller banks when the retailer looks at this and says, you know what? I am going with the smallest interchange possible because it is going to help my bottom line. Do you see it being that way?

Mr. BERNANKE. As I mentioned earlier, I think there are two reasons why this exemption might not work. One is exactly what you are saying, that merchants might turn down small bank cards, and the other is that the networks may not find it economical to have a two-tier system.

Senator TESTER. OK. Chairman Bair, from your point of view, how do you think it is going to impact the institutions that you supervise, particularly the small ones?

Ms. BAIR. Well, I think it remains to be seen whether they can be protected with this. I am skeptical for all the reasons Chairman Bernanke has articulated, and so I think if they are forced down to the 12-cent level, that is going to reduce the income that they get for debit cards, so I think they are going to have to make that up somewhere, probably by raising the fees that they have on transaction accounts.

It could also have the unintended consequence of pushing them into prepaid cards as opposed to debit cards, and prepaid cards do not have the same level of protection as debit cards, for instance, under Reg E. It is important—it is more difficult with deposit insurance. You have to be very careful about how you structure those accounts to get deposit insurance. So I think that might be—that would not be helpful for consumers and that might be an unintended consequence.

So we agree with you. This really needs to be fixed, and hopefully through the current regulatory authority, and that is what we are looking at right now.

Senator TESTER. Just let me ask this. You are not sitting on this side of the table and I am not sitting on your side of the table, but do you think it would be beneficial to delay this provision to take a look at unintended consequences?

Ms. BAIR. Yes, I—you know, it was—look, there are legitimate policy arguments on both sides of this, but it was done very quickly. I think the full policy ramifications, who is paying for what, who is going to pay more and who is going to pay less under this is something that maybe was not dealt with as thoroughly as it might have been.

Senator TESTER. Thank you all for being here. I wish we had another two or 3 hours just for my questions. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Wicker, welcome to the Committee.

Senator WICKER. Thank you, Mr. Chairman. I am delighted to be on the Committee and I have enjoyed the testimony, which I have watched on television from my office while trying to get a few other things done, so I am glad to be back in the room, and thank you all for your patience and for working with us today.

Let me ask Chairman Schapiro, Dodd-Frank is a familiar term. Less familiar is Franken-Wicker, but it was an amendment that Al Franken and I authored which passed, actually, in the Senate by a vote of 64 to 35 with regard to the rating agencies. Now, as you

know, there are many people, including me, who feel that the rating agencies were one of the principal reasons that we encountered the meltdown that we did in 2008. Our amendment would have required the securitized product to be assigned for rating by the SEC rather than having the companies themselves shop around for their favorite rating agency.

When we got to conference, this Franken-Wicker language was dropped, but in the final version, the law does require the SEC to implement a study on credit rating agencies and gives the SEC the authority to implement Franken-Wicker if it is deemed to be beneficial to the public's interest. So how is that study coming and what are your thoughts on this?

Ms. SCHAPIRO. That is right, Senator. We actually have many studies on rating agencies, but this is certainly an important one. We should be going out shortly with a request for comments from the public on ways to—alternative ways to both structure a system for the assignment of ratings as well as the specifics of having the SEC do it or having a self-regulatory organization do it or having another entity do it.

It has a 2-year time deadline, I believe, which is why we have not gotten it out the door yet in terms of seeking public comment, but the staff has worked on the notice and hopefully it will go very soon. That will kick off the study from our perspective and then we will be able, with the comments, begin to put together the different ideas.

Senator WICKER. Do you share my conclusion that defective and improper ratings were a large part of the problem in 2007–2008?

Ms. SCHAPIRO. I very much share that perspective and have spoken a lot over the last 2 years about the contribution of rating agencies to the financial crisis. And the SEC also gets much broader responsibility under Dodd-Frank with respect to rules and examinations of credit rating agencies, including a report to Congress on our annual examination findings and other issues, and we are well underway with all of those examinations.

Senator WICKER. But under the law now, a company wishing to be rated still has completely free reign to go out and shop around and pick the rating agency of their choice?

Ms. SCHAPIRO. We have proposed rules to require—to try to discourage rating shopping, which would require disclosure that you did shop around for ratings and you ultimately selected the agency that gave you the highest rating in the preliminary rating. So we have done some disclosure rules in that regard and we have done a number of other rules to try to limit the conflicts of interest that are really inherent in this issuer-pays model that is the predominant model among the rating agencies right now.

Senator WICKER. Well, thank you, and I hope you will be attentive to this issue.

Chairman Bernanke, I have a question about qualified residential mortgages and what the unintended consequences of the QRMs might be in actually forcing or directing housing finance toward the Government instead of toward the private sector. As you know, the Federal Government now dominates housing finance in this country, and I think it is the stated position of the Administration, and

certainly my position, that we want private sector capital to return to the market to replace taxpayer guaranteed mortgages.

Federal Housing Administration mortgages are exempt from the risk retention requirement, the 5 percent risk retention requirement, because they are considered by definition qualified residential mortgages. Might this cause FHA mortgages to grow and drive out the private sector and first-time homebuyer mortgages, and what steps might we take to ensure that the QRM rules do not artificially push even more borrowers into taxpayer guaranteed mortgages rather than the private market?

Mr. BERNANKE. Well, I believe part of the proposal that Treasury made was that FHA would become a smaller part of the housing market and be restricted to the appropriate group of people who are qualifying for that type of mortgage. Those mortgages are implicitly Government guaranteed and therefore, the securitization retention requirement is not necessarily relevant.

I think the main purpose of the QRM is just to provide some standardized underwriting criteria that are sufficiently strong that the securitizer can be exempt from the retention requirement. But they are entirely consistent with a private market in securitization and a housing market where the Government's role is quite limited, and if it is other than through FHA and other special programs, it becomes relevant only during periods of crisis.

Senator WICKER. Well, I know we are out of time, but have you received comments or has the Fed received comments from Americans expressing the view that this rule and the exemption of Federal Housing Administration mortgages might drive more and more mortgagors to the public rather than the private market? Is this something that has been brought to your——

Mr. BERNANKE. We have not issued a request yet for comments; so we will do that and then we will get the comments, but we have not gotten to that stage yet.

Senator WICKER. Thank you.

Chairman JOHNSON. Last but not least, Senator Isakson.

Senator ISAKSON. Mr. Chairman, thank you very much, and thank you for including me, allowing me to sit at the dais today, and thanks to all that have testified. I appreciate your time and I will be brief.

My question will be for Ms. Bair, but it really applies to all of you because all of you have some input on the qualified residential mortgage rule that is being written. Senator Wicker's comments could not be more appropriate.

In your testimony, your printed testimony, Ms. Bair, you say that we will continue to work to move these rules forward without delay. We are determined to get them right the first time. And it is to that subject I want to speak.

The QRM amendment which Senator Hagan, myself, and Senator Landrieu wrote, is very specific in what the theme of the requirements shall be in terms of underwriting—verified income, verified job, credit rating, ability to amortize the mortgage. On down payment, it did not specify an amount, but it specified that any amount of loan above 80 percent would have to be privately insured and carry private mortgage insurance.

I have seen a letter written to you all by a large institution recommending a down payment requirement for a loan to be a QRM loan at 30 percent. What that would, in effect, do would put a handful of people in control of the entire mortgage market privately and force even more people into FHA than are already there. Our markets from the VA loans of the post-World War II until the beginning of the collapse, which was lending practices in 2000, carried mortgage insurance on 90 and 95 percent loans that performed equally as well as larger down payment loans. Forty-one percent of all purchasers are first-time homebuyers, 95 percent of whom do not have 20 percent or 30 percent to put down.

So my request is, when you address this subject, because you could protract what is already a protracted real estate recession by denying liquidity in the private markets, to reasonable mortgages underwritten properly. With that said, I just hope you will follow the guidelines and the parameters that were issued in a QRM amendment by Ms. Landrieu, Ms. Hagan, and myself on the down payment subject and the private mortgage insurance, as well. I hope you will be willing to do that.

Ms. BAIR. Well, Senator, I do think it is important to emphasize that the QRM standards will not be the standards for all mortgages. They do not apply to portfolio lenders. They do not apply for those who will have the 5 percent risk retention. And I think the intention of the agencies is that there will be multiple funding mechanisms for mortgages and for portfolio lenders, those who retain all the risk as well as those that just opt for the 5 percent risk retention, because there is some skin in the game. There is some natural economic incentive to have stronger underwriting standards. You can provide more flexibility.

So the higher standards for QRMs are really just trying to compensate for the lack of skin in the game by the issuer, and so I do think we—I will have to be honest with you. I have talked a lot with my staff about this. We are very open. We want comment on this question. But we are unable to document that PMI lowers default risk. We just cannot find it. And if you have additional information, I would love to see it. We do have a lot of data that shows strong correlations between LTVs and loan performance.

So this is the framework we are trying to come up with. I think we are absolutely consistent with Dodd-Frank as it was written and we will seek comment on this and I will remain open-minded on this, I commit to you. But I do want to make sure everyone understands that we do not anticipate the QRM standards to be the standards for all mortgages and that, again, this is just to compensate for the lack of economic incentive because there is no skin in the game on the part of the issuer for portfolio lenders, and those securitizers who want to retain the 5 percent, they will have much more flexibility.

Senator ISAKSON. First of all, I will give you the historical data. I am old enough to have sold houses in 1968 when 90 percent loans came into practice with MGIC and later in 1972 when 95 percent loans came into effect and there is good historical data on the default rates being consistent with those with larger down payments if they are well underwritten, which is the whole intent of QRM.

But the other point that I would also make is, I understand the 5 percent risk retention, but if QRM's down payment requirement is so restrictive that it takes out most of the marketplace, then you are going to have a very small number of people controlling conventional lending to everybody else because they will be risk retention lenders and they will be able to price it and they will be able to control it, which will dramatically raise the potential costs of the loans to the borrowers, somewhat like B, C, and D credits and subprime did. They began to push the rates up and securitized to sell a premium rate, but in fact underwrote poorly on the loans.

So I want to—that is a very important decision you will all be making and I hope you will—I will get the data to you this afternoon, as a matter of fact. I have been working on it.

Thank you very much, and Mr. Chairman, thank you very much for your time.

Chairman JOHNSON. Thanks, Senator Isakson.

We have a tough road ahead of us on the Committee, but I believe we have a stronger financial system because of Dodd-Frank. Over the next weeks and months, we will continue to oversee the implementation of Dodd-Frank. I look forward to hearing more from my colleagues and the regulators. I am sure that we will continue to hear about numerous successes and challenges, and it is important for us to conduct thorough oversight.

Thanks again to my colleagues and our panelists for being here today. This hearing is adjourned.

[Whereupon, at 12:19 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF BEN S. BERNANKE

CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

FEBRUARY 17, 2011

Chairman Johnson, Ranking Member Shelby, and other Members of the Committee, thank you for the opportunity to testify about the Federal Reserve's implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). The Dodd-Frank Act addresses critical gaps and weaknesses in the U.S. regulatory framework, many of which were revealed by the recent financial crisis. The Federal Reserve is committed to working with the other U.S. financial regulatory agencies to implement the act effectively and expeditiously. We are also cooperating with our international counterparts to further strengthen financial regulation, to ensure a level playing field across countries, and to enhance international supervisory cooperation. And we have revamped the supervisory function at the Federal Reserve to allow us to better meet the objectives of the act.

The act gives the Federal Reserve important responsibilities both to make rules to implement the law and to apply the new rules. In particular, the act requires the Federal Reserve to complete more than 50 rulemakings and sets of formal guidelines, as well as a number of studies and reports. We have also been assigned formal responsibilities to consult and collaborate with other agencies on a substantial number of additional rules, provisions, and studies. So that we meet our obligations on time, we are drawing on expertise and resources from across the Federal Reserve System in banking supervision, economic research, financial markets, consumer protection, payments, and legal analysis. In all, more than 300 members of the Federal Reserve staff are working on Dodd-Frank implementation projects. We have created a senior staff position to coordinate our efforts and have developed project-reporting and tracking tools to facilitate management and oversight of all of our implementation responsibilities.

We have made considerable progress in carrying out our assigned responsibilities. We have been providing significant support to the Financial Stability Oversight Council, of which the Federal Reserve is a member. We are assisting the council in designing its systemic risk monitoring and evaluation process and in developing its analytical framework and procedures for identifying systemically important nonbank firms and financial market utilities. We also are helping the new Office of Financial Research at the Treasury Department develop potential data reporting standards to support the council's systemic risk monitoring and evaluation duties. We contributed significantly to the council's recent studies—one on the Volcker rule's restrictions on banking entities' proprietary trading and private fund activities and a second one on the act's financial-sector concentration limit. And we are now developing for public comment the necessary rules to implement these important restrictions and limits. Last week, the Board adopted a final rule to ensure that activities prohibited by the Volcker rule are divested or terminated in the time period required by the act.

We also have been moving forward rapidly in other areas. Last fall, we issued a study on the potential effect of the act's credit risk retention requirements on securitization markets, as well as an advance notice of proposed rulemaking on the use of credit ratings in the regulations of the Federal banking agencies. In addition, in December, the Board and the other Federal banking agencies requested comment on a proposed rule that would implement the capital floors required by the Collins Amendment. In December, we also requested comment on proposed rules that would establish standards for debit card interchange fees and implement the act's prohibition on network exclusivity arrangements and routing restrictions. In January, the Board, together with the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Office of Thrift Supervision (OTS), provided the Congress a comprehensive report on the agencies' progress and plans relating to the transfer of the supervisory authority of the OTS for thrifts and thrift holding companies. In addition, as provided by the act, we and the Federal Reserve Banks each established offices to consolidate and build on our existing equal opportunity programs to promote diversity in management, employment, and business activities.

We continue to work closely and cooperatively with other agencies to develop joint rules to implement the credit risk retention requirements for securitizations, resolution plans (or "living wills") for large bank holding companies and council-designated nonbank firms, and capital and margin requirements for swap dealers and major swap participants. We are consulting with the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) on a variety of rules to enhance the safety and efficiency of the derivatives markets, including rules that would require most standardized derivatives to be centrally traded

and cleared, require the registration and prudential regulation of swap dealers and major swap participants, and improve the transparency and reporting of derivatives transactions. We also are coordinating with the SEC and the CFTC on the agencies' respective rulemakings on risk-management standards for financial market utilities, and we are working with market regulators and central banks in other countries to update the international standards for these types of utilities.

The transfer of the Federal Reserve's consumer protection responsibilities specified in the act to the new Bureau of Consumer Financial Protection (CFPB) is well under way. A team at the Board, headed by Governor Duke, is working closely with the staff at the CFPB and at the Treasury to facilitate the transition. We have provided technical assistance as well as staff members to the CFPB to assist it in setting up its functions. We have finalized funding agreements and provided initial funding to the CFPB. Moreover, we have made substantial progress toward a framework for transferring Federal Reserve staff members to the CFPB and integrating CFPB employees into the relevant Federal Reserve benefit programs.

One of the Federal Reserve's most important Dodd-Frank implementation projects is to develop more-stringent prudential standards for all large banking organizations and nonbank firms designated by the council. Besides capital, liquidity, and resolution plans, these standards will include Federal Reserve- and firm-conducted stress tests, new counterparty credit limits, and risk-management requirements. We are working to produce a well-integrated set of rules that will significantly strengthen the prudential framework for large, complex financial firms and the financial system.

Complementing these efforts under Dodd-Frank, the Federal Reserve has been working for some time with other regulatory agencies and central banks around the world to design and implement a stronger set of prudential requirements for internationally active banking firms. These efforts resulted in the adoption in the summer of 2009 of more stringent regulatory capital standards for trading activities and securitization exposures. And, of course, it also includes the agreements reached in the past couple of months on the major elements of the new Basel III prudential framework for globally active banks. Basel III should make the financial system more stable and reduce the likelihood of future financial crises by requiring these banks to hold more and better-quality capital and more-robust liquidity buffers. We are committed to adopting the Basel III framework in a timely manner. In December 2010, we requested comment with the other U.S. banking agencies on proposed rules that would implement the 2009 trading book reforms, and we are already working to incorporate other aspects of the Basel III framework into U.S. regulations.

To be effective, regulation must be supported by strong supervision. The act expands the supervisory responsibilities of the Federal Reserve to include thrift holding companies and nonbank financial firms that the council designates as systemically important, along with certain payment, clearing, and settlement utilities that are similarly designated. Reflecting the expansion of our supervisory responsibilities, we are working to ensure that we have the necessary resources and expertise to oversee a broader range of financial firms and business models.

The act also requires supervisors to take a macroprudential approach; that is, the Federal Reserve and other financial regulatory agencies are expected to supervise financial institutions and critical infrastructures with an eye toward not only the safety and soundness of each individual firm, but also taking into account risks to overall financial stability.

We believe that a successful macroprudential approach to supervision requires both a multidisciplinary and wide-ranging perspective. Our experience in 2009 with the Supervisory Capital Assessment Program (popularly known as the bank stress tests) demonstrated the feasibility and benefits of employing such a perspective. Building on that experience and other lessons learned from the recent financial crisis, we have reoriented our supervision of the largest, most complex banking firms to include greater use of horizontal, or cross-firm, evaluations of the practices and portfolios of firms, improved quantitative surveillance mechanisms, and better use of the broad range of skills of the Federal Reserve staff. And we have created a new Office of Financial Stability within the Federal Reserve, which will monitor financial developments across a range of markets and firms and coordinate with the council and with other agencies to strengthen systemic oversight.

The Federal Reserve is committed to its long-standing practice of ensuring that all of its rulemakings are conducted in a fair, open, and transparent manner. Accordingly, we are disclosing on our public Web site summaries of all communications with members of the public—including banks, trade associations, consumer groups, and academics—regarding matters subject to a proposed or potential future rulemaking under the act. We also have implemented measures within the act to en-

hance the Federal Reserve's transparency. In December, we publicly released detailed information regarding individual transactions conducted between December 1, 2007, and July 20, 2010, across a wide range of Federal Reserve credit and liquidity programs, and we are developing the necessary processes to disclose information concerning transactions conducted after July 20, 2010, on a delayed basis as provided in the act.

To conclude, the Dodd-Frank Act is a major step forward for financial regulation in the United States. The Federal Reserve will work closely with our fellow regulators, the Congress, and the Administration to ensure that the law is implemented expeditiously and in a manner that best protects the stability of our financial system and our economy.

PREPARED STATEMENT OF SHEILA C. BAIR

CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

FEBRUARY 17, 2011

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today on the Federal Deposit Insurance Corporation's (FDIC) progress in implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

The recent financial crisis exposed grave shortcomings in our framework for regulating the financial system. Insufficient capital at many financial institutions, misaligned incentives in securitization markets, and the rise of a largely unregulated shadow banking system bred excess and instability in our financial system that led directly to the crisis of September 2008. When the crisis hit, regulatory options for responding to distress in large, nonbank financial companies left policy makers with a no-win dilemma: either prop up failing institutions with expensive bailouts or allow destabilizing liquidations through the normal bankruptcy process. The bankruptcy of Lehman Brothers Holdings Inc. (Lehman) in September 2008 triggered a liquidity crisis at AIG and other institutions that froze our system of intercompany finance and made the 2007–09 recession the most severe since the 1930s.

The landmark Dodd-Frank Act enacted last year created a comprehensive new regulatory and resolution regime that is designed to protect the American people from the severe economic consequences of financial instability. The Dodd-Frank Act gave regulators tools to limit risk in individual financial institutions and transactions, enhance the supervision of large nonbank financial companies, and facilitate the orderly closing and liquidation of large banking organizations and nonbank financial companies in the event of failure. Recognizing the urgent need for reform and the importance of a deliberative process, the Act directed the FDIC and the other regulatory agencies to promulgate implementing regulations under a notice and comment process and to do so within specified time frames. The FDIC is required or authorized to implement some 44 regulations, including 18 independent and 26 joint rulemakings. The Dodd-Frank Act also grants the FDIC new or enhanced enforcement authorities, new reporting requirements, and responsibility for numerous other actions.

We are now in the process of implementing the provisions of the Dodd-Frank Act as expeditiously and transparently as possible. The lessons of history—recent and distant—remind us that financial markets cannot function for long in an efficient and stable manner without strong, clear regulatory guidelines. We know all too well that the market structures in place prior to the crisis led to misaligned incentives, a lack of transparency, insufficient capital, and excessive risk taking. As a result, the U.S. and global economies suffered a grievous blow. Millions of Americans lost their jobs, their homes, or both, even as almost all of our largest financial institutions received assistance from the Government that enabled them to survive and recover. Memories of such events tend to be short once a crisis has passed, but we as regulators must never forget the enormous economic costs of the inadequate regulatory framework that allowed the crisis to occur in the first place. At the same time, our approach must also account for the potential high cost of needless or ill-conceived regulation—particularly to those in the vital community banking sector whose lending to creditworthy borrowers is necessary for a sustained economic recovery.

My testimony will review the FDIC's efforts to date to implement the provisions of Dodd-Frank and highlight what we see as issues of particular importance.

Implementing the Resolution Authority and Ending "Too Big To Fail"

A significant number of the FDIC's rulemakings stem from the Dodd-Frank Act's mandate to end "Too Big to Fail." This includes our Orderly Liquidation Authority

under Title II of the Act, our joint rulemaking with the Board of Governors of the Federal Reserve System (FRB) on requirements for resolution plans (or living wills) that will apply to systemically important financial institutions (SIFIs), and the development of criteria for determining which firms will be designated as SIFIs by the Financial Stability Oversight Council (FSOC).

Orderly Liquidation Authority

The Lehman bankruptcy in September 2008 demonstrated the confusion and chaos that can result when a large, highly complex financial institution collapses into bankruptcy. The Lehman bankruptcy had an immediate and negative effect on U.S. financial stability and has proven to be a disorderly, time-consuming, and expensive process. Unfortunately, bankruptcy cannot always provide the basis for an orderly resolution of a SIFI or preserve financial stability. To overcome these problems, the Dodd-Frank Act provides for an Orderly Liquidation Authority with the ability to: plan for a resolution and liquidation, provide liquidity to maintain key assets and operations, and conduct an open bidding process to sell a SIFI and its assets and operations to the private sector as quickly as possible.

While Title I of the Dodd-Frank Act significantly enhances regulators' ability to conduct advance resolution planning for SIFIs, Title II vests the FDIC with legal resolution authorities similar to those that it already applies to insured depository institutions (IDIs).

If the FDIC is appointed as receiver, it is required to carry out an orderly liquidation of the financial company. Title II also requires that creditors and shareholders "bear the losses of the financial company" and instructs the FDIC to liquidate a failing SIFI in a manner that maximizes the value of the company's assets, minimizes losses, mitigates risk, and minimizes moral hazard. Under this authority, common and preferred stockholders, debt holders and other unsecured creditors will know that they will bear the losses of any institution placed into receivership, and management will know that it could be replaced.

The new requirements will ensure that the largest financial companies can be wound down in an orderly fashion without taxpayer cost. Under Title II of the Dodd-Frank Act, there are no more bailouts. In implementing the Act's requirements, our explicit goal is that all market players should share this firm expectation and that financial institution credit ratings should, over time, fully reflect this fact. By developing a credible process for resolving a troubled SIFI, market discipline will be reinforced and moral hazard reduced.

From the FDIC's more than 75 years of bank resolution experience, we have found that clear legal authority and transparent rules on creditor priority are important elements of an orderly resolution regime. To that end, the FDIC issued an interim final rule implementing certain provisions of our Orderly Liquidation Authority on January 25, 2011. In the interim rule, the FDIC posed questions to solicit public comment on such issues as reducing moral hazard and increasing market discipline. We also asked for comment on guidelines that would create increased certainty in establishing fair market value of various types of collateral for secured claims. The rule makes clear that similarly situated creditors would never be treated in a disparate manner except to preserve essential operations or to maximize the value of the receivership as a whole. Importantly, this discretion will not be used to favor creditors based on their size or interconnectedness. In other words, there is no avenue for a backdoor bailout.

Comments on the interim rule and the accompanying questions will help us further refine the rule and bring more certainty to the industry as it navigates the recalibrated regulatory environment. This summer we expect to finalize other rules under our Title II authority that will govern the finer details of how the FDIC will wind down failed financial companies in receivership.

Resolution Plans

Even with the mechanism of the Orderly Liquidation Authority in place, ending "Too Big to Fail" requires that regulators obtain critical information and shape the structure and behavior of SIFIs before a crisis occurs. This is why the Dodd-Frank Act firms to maintain credible, actionable resolution plans that will facilitate their orderly resolution if they should fail. Without access to critical information contained in credible resolution plans, the FDIC's ability to implement an effective and orderly liquidation process could be significantly impaired.

As noted in my September testimony, the court-appointed trustee overseeing the liquidation of Lehman Brothers Inc. found that the lack of a disaster plan "contributed to the chaos" of the Lehman bankruptcy and the liquidation of its U.S. broker-dealer. Recognizing this, the Dodd-Frank Act created critical authorities designed to give the FDIC, the FRB, and the FSOC information from the largest potentially sys-

temic financial companies that will allow for extensive advance planning both by regulators and by the companies themselves.

The Dodd-Frank Act requires the FDIC and the FRB jointly to issue regulations within 18 months of enactment to implement new resolution planning and reporting requirements that apply to bank holding companies with total assets of $50 billion or more and nonbank financial companies designated for FRB supervision by the FSOC.

Importantly, the statute requires both periodic reporting of detailed information by these financial companies and the development and submission of resolution plans that allow "for rapid and orderly resolution in the event of material financial distress or failure." The resolution plan requirement in the Dodd-Frank Act appropriately places the responsibility on financial companies to develop their own resolution plans in coordination with the FDIC and the FRB.

The Dodd-Frank Act lays out steps that must be taken with regard to the resolution plans. First, the FRB and the FDIC must review each company's plan to determine whether it is both credible and useful for facilitating an orderly resolution under the Bankruptcy Code. Making these determinations will necessarily involve the agencies having access to the company and relevant information. This new resolution plan regulation will require financial companies to look critically at the often highly complex and interconnected corporate structures that have emerged within the financial sector.

If a plan is found to be deficient, the company will be asked to submit a revised plan to correct any identified deficiencies. The revised plan could include changes in business operations and corporate structure to facilitate implementation of the plan. If the company fails to resubmit a plan that corrects the identified deficiencies, the Dodd-Frank Act authorizes the FRB and the FDIC jointly to impose more stringent capital, leverage or liquidity requirements. In addition, the agencies may impose restrictions on growth, activities, or operations of the company or any subsidiary. In certain cases, divestiture of portions of the financial company may be required. Just last month, Neil Barofsky, the Special Inspector General for the Troubled Asset Relief Program, recognized that this regulatory authority, including the ability to require divestiture, provides an avenue to convincing the marketplace that SIFIs will not receive Government assistance in a future crisis. [1] The FDIC is working with the FRB to develop requirements for these resolution plans. It is essential that we complete this joint rule as soon as possible.

SIFI Designation

The Dodd-Frank Act created the FSOC to plug important gaps between existing regulatory jurisdictions where financial risks grew in the years leading up to the recent crisis. An important responsibility of the FSOC is to develop criteria for designating SIFIs that will be subject to enhanced FRB supervision and the requirement to maintain resolution plans. To protect the U.S. financial system, it is essential that we have the means to identify which firms in fact qualify as SIFIs so we do not find ourselves with a troubled firm that is placed into a Title II liquidation without having a resolution plan in place.

Since enactment of the Dodd-Frank Act, experienced and capable staff from each of the member agencies have been collaborating in implementing the FSOC's responsibilities, including establishing the criteria for identifying SIFIs. The Dodd-Frank Act specifies a number of factors that can be considered when designating a nonbank financial company for enhanced supervision, including: leverage; off-balance-sheet exposures; and the nature, scope, size, scale, concentration, interconnectedness, and mix of activities. The FSOC will develop a combination of qualitative and quantitative measures of potential risks posed by an individual nonbank institution to U.S. financial stability.

The nonbank financial sector encompasses a multitude of financial activities and business models, and potential systemic risks vary significantly across the sector. A staff committee working under the FSOC has segmented the nonbank sector into four broad categories: (1) the hedge fund, private equity firm, and asset management industries; (2) the insurance industry; (3) specialty lenders; and (4) broker-dealers and futures commission merchants. The Council has begun developing measures of potential risks posed by these firms. Once these measures are agreed upon, the FSOC may need to request data or information that is not currently collected or otherwise available in public filings.

Recognizing the need for accurate, clear, and high quality information, Congress granted the FSOC the authority to gather and review financial data and reports

[1] Transcript of interview with Neil Barofsky, National Public Radio, January 27, 2011. *http://www.npr.org/2011/01/27/133264711/Troubled-Asset-Relief-Program-Update*

from nonbank financial companies and bank holding companies, and if appropriate, request that the FRB conduct an exam of the company for purposes of making a systemic designation. By collecting more information in advance of designation, the FSOC can be much more judicious in determining which firms it designates as SIFIs. This will minimize both the threat of an unexpected systemic failure and the number of firms that will be subject to additional regulatory requirements under Title I.

Last October, the FSOC issued an Advance Notice of Proposed Rulemaking regarding the criteria that should inform the FSOC's designation of nonbank financial companies. The FSOC received approximately 50 comments from industry trade associations, individual firms, and individuals. On January 26, the FSOC issued a Notice of Proposed Rulemaking, with a 30-day comment period, describing the criteria that will inform—and the processes and procedures established under the Dodd-Frank Act—the FSOC's designation of nonbank financial companies. The FDIC would welcome comments particularly on whether the rule can offer more specificity on criteria for SIFI designation. The FSOC is committed to adopting a final rule on this issue later this year, with the first designations to occur shortly thereafter.

Strengthening and Reforming the Deposit Insurance Fund

Prior to 2006, statutory restrictions prevented the FDIC from building up the Deposit Insurance Fund (DIF) balance when conditions were favorable in order to withstand losses under adverse conditions without sharply increasing premiums. The FDIC was also largely unable to charge premiums according to risk. In fact, it was unable to charge most institutions any premium as long as the DIF balance exceeded $1.25 per $100 of insured deposits. Congress enacted reforms in 2006 that permitted the FDIC to charge all banks a risk-based premium and provided additional, but limited, flexibility to the FDIC to manage the size of the DIF. The FDIC changed its risk-based pricing rules to take advantage of the new law, but the onset of the recent crisis prevented the FDIC from increasing the DIF balance. In this crisis, as in the previous one, the balance of the DIF became negative, hitting a low of negative $20.9 billion in December 2009. The DIF balance has improved in each subsequent quarter, and stood at negative $8.0 billion as of last September. Through a special assessment and the prepayment of premiums, the FDIC took the necessary steps to ensure that it did not have to rely on taxpayer funds during the crisis to protect insured depositors.

In the Dodd-Frank Act, Congress revised the statutory authorities governing the FDIC's management of the DIF. The FDIC now has the ability to achieve goals for deposit insurance fund management that it has sought to achieve for decades but has lacked the tools to accomplish. The FDIC has increased flexibility to manage the DIF to maintain a positive fund balance even during a banking crisis while maintaining steady and predictable assessment rates throughout economic and credit cycles.

Specifically, the Dodd-Frank Act raised the minimum level for the Designated Reserve Ratio (DRR) from 1.15 percent to 1.35 percent and removed the requirement that the FDIC pay dividends of one-half of any amount in the DIF above a reserve ratio of 1.35 percent. The legislation allows the FDIC Board to suspend or limit dividends when the reserve ratio exceeds 1.50 percent.

FDIC analysis has shown that the dividend rule and the reserve ratio target are among the most important factors in maximizing the probability that the DIF will remain positive during a crisis, when losses are high, and in preventing sharp upswings in assessment rates, particularly during a crisis. This analysis has also shown that at a minimum the DIF reserve ratio (the ratio of the DIF balance to estimated insured deposits) should be about 2 percent in advance of a banking crisis in order to avoid high deposit insurance assessment rates when banking institutions are strained and least able to pay.

Consequently, the FDIC Board completed two rulemakings, one in December 2010, and one earlier this month, that together form the basis for a long-term strategy for DIF management and achievement of the statutorily required 1.35 percent DIF reserve ratio by September 30, 2020. The FDIC Board adopted assessment rates that will take effect on April 1, 2011. The Board also adopted lower rates that will take effect when the DIF reserve ratio reaches 1.15 percent, which we expect will approximate the long-term moderate, steady assessment rate that would have been needed to maintain a positive fund balance throughout past crises. The DRR was set at 2 percent, consistent with our analysis of a long-term strategy for the DIF, and dividends were suspended indefinitely. In lieu of dividends, the rules set forth progressively lower assessment rate schedules when the reserve ratio exceeds 2 percent and 2.5 percent.

These actions increase the probability that the fund reserve ratio will reach a level sufficient to withstand a future crisis, while maintaining moderate, steady, and predictable assessment rates. Indeed, banking industry participants at an FDIC Roundtable on deposit insurance last year emphasized the importance of stable, predictable assessments in their planning and budget processes. Moreover, actions taken by the FDIC's current Board of Directors as a result of the Dodd-Frank Act should make it easier for future Boards to resist inevitable calls to reduce assessment rates or pay larger dividends at the expense of prudent fund management and countercyclical assessment rates.

The Dodd-Frank Act also requires the FDIC to redefine the base used for deposit insurance assessments as average consolidated total assets minus average tangible equity. Earlier this month, the FDIC Board issued a final rule implementing this requirement. The rule establishes measures for average consolidated total assets and average tangible equity that draw on data currently reported by institutions in their Consolidated Report of Condition and Income or Thrift Financial Report. In this way, the FDIC has implemented rules that minimize the number of new reporting requirements needed to calculate deposit insurance assessments. As provided by the Dodd-Frank Act, the FDIC's rule adjusted the assessment base for banker's banks and custodial banks.

Using the lessons learned from the most recent crisis, our rule changed the large bank pricing system to better differentiate for risk and better take into account losses from large institution failures that the FDIC may incur. This new system goes a long way toward reducing the procyclicality of the risk-based assessment system by calculating assessment payments using more forward-looking measures. The system also removes reliance on long-term debt issuer ratings consistent with the Dodd-Frank Act.

The FDIC projects that the change to a new, expanded assessment base will not materially change the overall amount of assessment revenue that the FDIC would have collected prior to adoption of these rules. However, the change in the assessment base, in general, will result in shifting more of the overall assessment burden away from community banks and toward the largest institutions, which rely less on domestic deposits for their funding than do smaller institutions, as Congress intended.

Under the new assessment base and large bank pricing system, the share of the assessment base held by institutions with assets greater than $10 billion will increase from 70 percent to 78 percent, and their share of overall dollar assessments will increase commensurately from 70 percent to 79 percent. However, because of the combined effect of the change in the assessment base and increased risk differentiation among large banks in the new large bank pricing system, many large institutions will experience significant changes in their overall assessments. The combined effect of changes in this final rule will result in 59 large institutions paying lower dollar assessments and 51 large institutions paying higher dollar assessments (based upon September 30, 2010 data). In the aggregate, small institutions will pay 30 percent less, due primarily to the change in the assessment base, thus fewer than 100 of the 7,600 plus small institutions will pay higher assessments.

Strengthening Capital Requirements

One of the most important mandates of the Dodd-Frank Act is Section 171—the Collins Amendment—which we believe will do more to strengthen the capital of the U.S. banking industry than any other section of the Act.

Under Section 171 the capital requirements that apply to thousands of community banks will serve as a floor for the capital requirements of our largest banks, bank holding companies and nonbanks supervised by the FRB. This is important because in the years before the crisis, U.S. regulators were embarking down a path that would allow the largest banks to use their own internal models to set, in effect, their own risk-based capital requirements, commonly referred to as the "Basel II Advanced Approach."

The premise of the Advanced Approach was that the largest banks, because of their sophisticated internal-risk models and superior diversification, simply did not need as much capital in relative terms as smaller banks. The crisis demonstrated the fallacy of this thinking as the models produced results that proved to be grossly optimistic.

Policy makers from the Basel Committee to the U.S. Congress have determined that this must not happen again. Large banks need the capital strength to stand on their own. The Collins Amendment assures that whatever advances in risk modeling may come to pass, they will not be used to allow the largest banks to operate with less capital than our Nation's Main Street banks.

The Federal banking agencies currently have out for comment a Notice of Proposed Rulemaking to implement Section 171 by replacing the transitional floor provisions of the Advanced Approach with a permanent floor equal to the capital requirements computed under the agencies' general risk-based capital requirements. The proposed rule would also amend the general risk-based capital rules in way designed to give additional flexibility to the FRB in crafting capital requirements for designated nonbank SIFIs.

The Collins Amendment, moreover, does more than this. While providing significant grandfathering and exemptions for smaller banking organizations, the amendment also mandates that the holding company structure for larger organizations not be used to weaken consolidated capital below levels permitted for insured banks. That aspect of the Collins Amendment, which ensures that bank holding companies will serve as a source of strength for their insured banks, will be addressed in a subsequent rulemaking.

The Dodd-Frank Act also required regulators to eliminate reliance on credit ratings in our regulations. As you know, our regulatory capital rules and Basel II currently rely extensively on credit ratings. Last year, the banking agencies issued an Advance Notice of Proposed Rulemaking seeking industry comment on how we might design an alternative standard of credit worthiness. Unfortunately, the comments we received, for the most part, lacked substantive suggestions on how to approach this question. While we have removed any reliance on credit ratings in our assessment regulation, developing an alternative standard of creditworthiness for regulatory capital purposes is proving more challenging. The use of credit ratings for regulatory capital covers a much wider range of exposures; we cannot rely on nonpublic information, and the alternative standard should be usable by banks of all sizes. We are actively exploring a number of alternatives for dealing with this problem.

Separately and parallel to the Dodd-Frank Act rulemakings, the banking agencies are also developing rules to implement Basel III proposals for raising the quality and quantity of regulatory capital and setting new liquidity standards. The agencies issued a Notice of Proposed Rulemaking in January that proposes to implement the Basel Committee's 2009 revisions to the Market Risk Rule. We expect to issue a Notice of Proposed Rulemaking that will seek comment on our plans to implement Basel III later this year.

Reforming Asset-Backed Securitization

The housing bust and the financial crisis arose from a historic breakdown in U.S. mortgage markets. While emergency policies enacted at the height of the crisis have helped to stabilize the financial system and plant the seeds for recovery, mortgage markets remain deeply mired in credit distress and private securitization markets remain largely frozen. Moreover, serious weaknesses identified with mortgage servicing and foreclosure are now introducing further uncertainty into an already fragile market.

It is clear that the mortgage underwriting practices that led to the crisis, which frequently included loans with low or no documentation in addition to other risk factors such as impaired credit histories or high loan-to-value ratios, must be significantly strengthened. To this point, this has largely been accomplished through the heightened risk aversion of lenders, who have significantly tightened standards, and investors, who have largely shunned private securitization deals. Going forward, however, risk aversion will inevitably decline and there will be a need to ensure that lending standards do not revert to the risky practices that led to the last crisis.

In the case of portfolio lenders, underwriting policies are subject to scrutiny by Federal and State regulators. While regulators apply standards of safe and sound lending, they typically do not take the form of prespecified guidelines for the structure or underwriting of the loans. For these portfolio lenders, the full retention of credit risk by the originating institution tends to act as a check on the incentive to take risks. Provided that the institution is otherwise well capitalized, well run, and well regulated, the owners and managers of the institution will bear most of the consequences for risky lending practices. By contrast, the crisis has illustrated how the mortgage securitization process is somewhat more vulnerable to the misalignment of incentives for originators and securities issuers to limit risk taking, because so much of the credit risk is passed along to investors who may not exercise due diligence over loan quality.

The excessive risk-taking inherent in the originate-to-distribute model of lending and securitization was specifically addressed in the Dodd-Frank Act by two related provisions. One provision, under Section 941 of the Act, mandates that the FSOC agencies write rules that require the securitizers (and, in certain circumstances, originators) of asset-backed securities to retain not less than 5 percent of the credit

risk of those securities. The purpose of this provision is to encourage more careful lending behavior by preventing securitizers from avoiding the consequences of their risk-taking. Section 941 also mandates that the agencies define standards for Qualifying Residential Mortgages (QRMs) that will be exempt from risk retention when they are securitized. An interagency committee is working to define both the mechanism for risk retention and standards for QRMs.

Defining an effective risk retention mechanism and QRM requirements are somewhat complex tasks that have required extensive deliberation among the agencies. Because securitization structures and the compensation of securitizers can take many alternate forms, it is important that the rule be structured in a way that will minimize the ability of issuers to circumvent its intent. While we continue to work to move these rules forward without delay, we are also determined to get them right the first time. The confidence of the marketplace in these rules may well determine the extent to which private securitization will return in the wake of the crisis.

Long-term confidence in the securitization process cannot be restored unless the misalignment of servicing incentives that contributed to the present crisis is also addressed through these rules. There is ample research showing that servicing practices are critically important to mortgage performance and risk. [2] Regulators must use both their existing authorities and the new authorities granted under the Dodd-Frank Act to establish standards for future securitizations to help assure that, as the private securitization market returns, incentives for loss mitigation and value maximization in mortgage servicing are appropriately aligned.

The FDIC took a significant step in this regard when updating our rules for safe harbor protection with regard to the treatment of securitized assets in failed bank receiverships. Our final rule, approved in September, established standards for loan level disclosure, loan documentation, compensation, and oversight of servicers. It includes incentives to assure that loans are made and managed in a way that achieves sustainable lending and maximizes value for all investors. There is already evidence of market acceptance of these guidelines in the $1.2 billion securitization issue by Ally Bank earlier this month, which fully conformed to the FDIC safe harbor rules for risk retention.

In short, the desired effect of the risk retention and QRM rules will be to give both loan underwriting and Administration and loan servicing much larger roles in credit risk management. Lenders and regulators need to embrace the lessons learned from this crisis and establish a prudential framework for extending credit and servicing loans on a sounder basis. Servicing provisions that should be part of the QRM rule include disclosure of ownership interests in second-liens by servicers of a first mortgage and appropriate compensation incentives.

Better alignment of economic incentives in the securitization process will not only address key safety-and-soundness and investor concerns, but will also provide a stronger foundation for the new Consumer Financial Protection Bureau (CFPB) as it works to improve consumer protections for troubled borrowers in all products and by all servicers.

Additional Implementation Activities

While we have focused on the important ongoing reforms where the Dodd-Frank Act assigned a significant role to the FDIC, we have been pleased to work closely with the other regulators on several other critical aspects of the Act's implementation.

Earlier this month, the FDIC Board approved a draft interagency rule to implement Section 956 of the Dodd-Frank Act, which sets forth rules and procedures governing the awarding of incentive compensation in covered financial institutions. Implementing this section will help address a key safety-and-soundness issue that contributed to the recent financial crisis—namely, that poorly designed compensation structures and poor corporate governance can misalign incentives and induce excessive risk taking within financial organizations. The proposed rule is proportionate to the size and complexity of individual banks and does not apply to banks with less than $1 billion in assets. For the largest firms, those with over $50 billion in assets, the proposal requires deferral of a significant portion of the incentive compensation of identified executive officers for at least 3 years and board-level identification and approval of the incentive compensation of employees who can expose the firm to material loss.

[2] *For example, see,* Ashcraft, Adam B. and Til Schuermann, "Understanding the Securitization of Subprime Mortgage Credit", Staff Report No. 318, Federal Reserve Bank of New York, March 2008, p. 8. *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1071189* and "Global Rating Criteria for Structured Finance Servicers", Fitch Ratings/Structured Finance, August 16, 2010, p. 7.

Another important reform under the Dodd-Frank Act is the Volcker Rule, which prohibits proprietary trading and acquisition of an interest in hedge or private equity funds by IDIs. The FSOC issued its required study of proprietary trading in January of this year, and joint rules implementing the prohibition on such trading are due by October of this year. The Federal banking agencies will be working together, with the FSOC coordinating, to issue a final rule by the statutory deadline.

In addition to these rulemakings, the FDIC has a number of other implementation responsibilities, including new reporting requirements and mandated studies. Among the latter is a study to evaluate the definitions of core and brokered deposits. As part of this study, we are hosting a roundtable discussion next month to gather valuable input from bankers, deposit brokers, and other market participants.

Preparation for Additional Responsibilities

The FDIC Board of Directors has recently undertaken a number of organizational changes to ensure the effective implementation of our responsibilities pursuant to the Dodd-Frank Act.

As I previously described in my September testimony before this Committee, the FDIC has made organizational changes in order to enhance our ability to carry out the Dodd-Frank Act responsibilities, as well as our core responsibilities for risk management supervision of insured depository institutions and consumer protection. The new Office of Complex Financial Institutions (OCFI) will be responsible for orderly liquidation authority, resolution plans, and monitoring risks in the SIFIs. The Division of Depositor and Consumer Protection will focus on the FDIC's many responsibilities for depositor and consumer protection.

In response to the Committee's request for an update about the transfer of employees to the new CFPB, I can report that we continue to work with the Treasury Department and the other banking agencies on the transfer process of employees to ensure a smooth transition. The number of FDIC employees detailed to the CFPB will necessarily be limited since the FDIC retains the compliance examination and enforcement responsibilities for most FDIC-regulated institutions with $10 billion or less in assets. Nonetheless, there are currently seven FDIC employees being detailed to the Treasury Department and the CFPB to work on a wide range of examination and legal issues that will confront the CFPB at its inception. There are also several more employees who have expressed interest in assisting the CFPB and are being evaluated by the Treasury Department. Recognizing that FDIC employees have developed expertise, skills, and experience in a number of areas of benefit to the CFPB, our expectation has been that a number of employees would actively seek an opportunity to assist the CFPB in its earliest stages, or on a more permanent basis.

Finally, consistent with the requirements of Section 342, the FDIC in January established a new Office of Minority and Women Inclusion (OMWI). Transferring the existing responsibilities and employees of the FDIC's former Office of Diversity and Economic Opportunity into the new OMWI has allowed for a smooth transition and no disruption in the FDIC's ongoing diversity and outreach efforts. Our plans for the OMWI include the addition of a new Senior Deputy Director and other staff as needed to ensure that the new responsibilities under Section 342 are carried out, as well as an OMWI Steering Committee which will promote coordination and awareness of OMWI responsibilities across the FDIC and ensure that they are managed in the most effective manner.

Regulatory Effectiveness

The FDIC recognizes that while the changes required by the Dodd-Frank Act are necessary to establish clear rules that will ensure a stable financial system, these changes must be implemented in a targeted manner to avoid unnecessary regulatory burden. We are working on a number of fronts to achieve that necessary balance. An example is the recent rule to change the deposit insurance assessment system, which relied as much as possible on the current regulatory reporting structure. Although some additional reporting will be required for some institutions, most institutions should see their reporting burden unchanged or slightly reduced as some items that were previously required will no longer be reported.

At the January 20 meeting of the FDIC's Advisory Committee on Community Banking, we engaged the members—mostly bankers themselves—in a full and frank discussion of other ways to ease the regulatory burden on small institutions. Among the ideas discussed at that meeting were:

- Conduct a community bank impact analysis with respect to implementation of regulations under the Dodd-Frank Act,
- Identify which questionnaires and reports can be streamlined through automation,

- Review ways to reduce the total amount of reporting required of banks,
- Impose a moratorium on changes to reporting obligations until some level of regulatory burden reduction has been achieved,
- Develop an approach to bank reporting requirements that is meaningful and focuses on where the risks are increasing, and
- Ensure that community banks are aware that senior FDIC officials are available and interested in receiving their feedback regarding our regulatory and supervisory process.

The FDIC is particularly interested in finding ways to eliminate unnecessary regulatory burden on community banks, whose balance sheets are much less complicated than those of the larger banks. Our goal is to facilitate more effective and targeted regulatory compliance. To this end, we have established as a corporate performance goal for the first quarter of 2011 to modify the content of our Financial Institution Letters (FILs)—the vehicle used to alert banks to any regulatory changes or guidance—so that every FIL issued will include a section making clear the applicability to smaller institutions (under $1 billion). In addition, by June 30 we plan to complete a review of all of our recurring questionnaires and information requests to the industry and to develop recommendations to improve the efficiency and ease of use and a plan to implement these changes.

The FDIC has challenged its staff to find additional ways of translating some of these ideas into action. This includes launching an intensive review of existing reporting requirements to identify areas for streamlining. We have also initiated a process whereby, as part of every risk management examination, we will solicit the views of the institution on aspects of the regulatory and supervisory process that may be adversely affecting credit availability.

Above all, it is important to emphasize to small and midsized financial institutions that the Dodd-Frank reforms are not intended to impede their ability to compete in the marketplace. On the contrary, we expect that these reforms will do much to restore competitive balance to the marketplace by restoring market discipline and appropriate regulatory oversight to systemically important financial companies, many of which received direct Government assistance in the recent crisis.

Conclusion

In implementing the Dodd-Frank Act, it is important that we continue to move forward with dispatch to remove unnecessary regulatory uncertainties faced by the market and the industry. In passing the Act, the Congress clearly recognized the need for a sounder regulatory framework within which banks and other financial companies could operate under rules that would constrain the excessive risk taking that caused such catastrophic losses to our financial system and our economy during the financial crisis.

In the wake of the passage of the Act, it is essential that this implementation process move forward both promptly and deliberately, in a manner that resolves uncertainty as to what the new framework will be and that promotes long-term confidence in the transparency and stability of our financial system. Throughout this process, regulators must maintain a clear view of the costs of regulation—particularly to the vital community banking sector—while also never forgetting the enormous economic costs of the inadequate regulatory framework that allowed the crisis to occur in the first place. We have a clear obligation to members of the public who have suffered the greatest losses as a result of the crisis to prevent such an episode from ever recurring again.

Thank you for the opportunity to testify.

PREPARED STATEMENT OF MARY L. SCHAPIRO

CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

FEBRUARY 17, 2011

Chairman Johnson, Ranking Member Shelby, and Members of the Committee: Thank you for inviting me to testify today on behalf of the Securities and Exchange Commission regarding our implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act"). The Act includes over 100 rulemaking provisions applicable to the SEC, and also requires the SEC to conduct more than twenty studies and create five new offices.

Last September, I testified about our progress and plans for implementing the Act. Among other things, I described our new internal processes and cross-disciplinary working groups, the expanded opportunities for public comment we are pro-

viding, our emphasis on increased transparency in dealings with the public, the frequent and collaborative consultations we were undertaking with other financial regulators, and the priorities we created to assist us in complying in a timely manner with the Act's mandates. My prior testimony also provided an overview of the principal areas of Commission responsibility under the Act.

Since that time, the Commission has made significant progress. To date, in connection with the Dodd-Frank Act, the Commission has issued 25 proposed rule releases, seven final rule releases, and two interim final rule releases. We have received thousands of public comments, completed five studies, and hosted five roundtables. My testimony today will provide an overview of these activities.

OTC Derivatives

Among the key provisions of the Act are those that will establish a new oversight regime for the over-the-counter (OTC) derivatives marketplace. Title VII of the Act requires the SEC to work with other regulators—the Commodity Futures Trading Commission (CFTC) in particular—to write rules that address, among other things, capital and margin requirements, mandatory clearing, the operation of trade execution facilities and data repositories, business conduct standards for security-based swap dealers, and public transparency for transactional information. These rulemakings are intended to improve transparency and facilitate the centralized clearing of swaps, helping, among other things, to reduce counterparty risk. In addition, they should enhance investor protection by increasing disclosure regarding security-based swap transactions and helping to mitigate conflicts of interest involving security-based swaps. Finally, these rulemakings should serve our broader objective of providing a framework that allows the OTC derivatives market to continue to develop in a more transparent, efficient, accessible, and competitive manner.

Title VIII of the Act provides for increased regulation of financial market utilities and financial institutions that engage in payment, clearing and settlement activities that are designated as systemically important. The purpose of Title VIII is to mitigate systemic risk in the financial system and promote financial stability.

To date, the SEC has proposed nine rulemakings required by Title VII:

- Antifraud and antimanipulation rules for security-based swaps that would subject market conduct in connection with the offer, purchase, or sale of any security-based swap to the same general antifraud provisions that apply to all securities and would explicitly reach misconduct in connection with ongoing payments and deliveries under a security-based swap; [1]
- Rules regarding trade reporting, data elements, and real-time public dissemination of trade information for security-based swaps that would lay out who must report security-based swaps, what information must be reported, and where and when it must be reported; [2]
- Rules regarding the obligations of security-based swap data repositories that would require them to register with the SEC and specify other requirements with which they must comply; [3]
- Rules relating to mandatory clearing of security-based swaps that would set out the way in which clearing agencies provide information to the SEC about security-based swaps that the clearing agencies plan to accept for clearing; [4]
- Rules regarding the exception to the mandatory clearing requirement for hedging by end-users that would specify the steps that end-users must follow, as required under the Act, to notify the SEC of how they generally meet their financial obligations when engaging in security-based swap transactions exempt from the mandatory clearing requirement; [5]
- Rules regarding registration and regulation of security-based swap execution facilities that would define them, specify their registration requirements, and es-

[1] *See,* Release No. 34-63236, "Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps" (November 3, 2010), *http://www.sec.gov/rules/proposed/2010/34-63236.pdf.*

[2] *See,* Release No. 34-63346, "Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information" (November 19, 2010), *http://www.sec.gov/rules/proposed/2010/34-63346.pdf.*

[3] *See,* Release No. 34-63347, "Security-Based Swap Data Repository Registration, Duties, and Core Principles" (November 19, 2010), *http://www.sec.gov/rules/proposed/2010/34-63347.pdf.*

[4] *See,* Release No. 34-63557, "Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations" (December 15, 2010), *http://www.sec.gov/rules/proposed/2010/34-63557.pdf.*

[5] *See,* Release No. 34-63556, "End-User Exception of Mandatory Clearing of Security-Based Swaps" (December 15, 2010), *http://www.sec.gov/rules/proposed/2010/34-63556.pdf.*

tablish their duties and implement the core principles for security-based swap execution facilities laid out in the Act;[6]

- Joint rules with the CFTC regarding the definitions of swap and security-based swap dealers, and major swap and security-based swap participants;[7]
- Rules regarding the confirmation of security-based swap transactions that would govern the way in which certain of these transactions are acknowledged and verified by the parties who enter into them;[8] and
- Rules intended to address conflicts of interest at security-based swap clearing agencies, security-based swap execution facilities, and exchanges that trade security-based swaps.[9]

We also adopted interim final rules regarding the reporting of outstanding security-based swaps entered into prior to the date of enactment of the Dodd-Frank Act.[10] These interim final rules require certain security-based swap dealers and other parties to preserve and report to the SEC or a registered security-based swap data repository certain information pertaining to any security-based swap entered into prior to the July 21, 2010, passage of the Dodd-Frank Act and whose terms had not expired as of that date.

As required by Title VIII of the Act, our staff also is working closely with the Federal Reserve Board and CFTC to develop a common framework to supervise financial market utilities, such as clearing agencies registered with the SEC, that the Financial Stability Oversight Council (FSOC) designates as systemically important. For example, last December we coordinated with the other agencies to propose rules under Title VIII regarding the filing of notices of material changes to rules, procedures, or operations by systemically important financial market utilities. In addition, in December the FSOC issued an advance notice of proposed rulemaking regarding the criteria and analytical framework that should be applied in designating financial market utilities under the Dodd-Frank Act.[11]

Our staff also has been actively coordinating with the other agencies on the new authority granted to the SEC and CFTC to develop standards for these financial market utilities. Moreover, the SEC and CFTC staffs have begun working with staff from the Federal Reserve Board to develop a framework for consulting and working together on supervision and examination of systemically important financial market utilities consistent with Title VIII.

Private Fund Adviser Registration and Reporting

Under Title IV of the Dodd-Frank Act, large hedge fund advisers and private equity fund advisers will be required to register with the Commission beginning in July of this year. Under the Act, venture capital fund advisers and private fund advisers with less than $150 million in assets under management in the United States will be exempt from the new registration requirements. In addition, family offices will not be subject to registration. To implement these provisions, the Commission has proposed:

- Amendments to Form ADV, the investment adviser registration form, to facilitate the registration of advisers to hedge funds and other private funds and to gather information about these private funds, including identification of the private funds' auditors, custodians and other "gatekeepers;"[12]

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[6] *See,* Release No. 34-63825, "Registration and Regulation of Security-Based Swap Execution Facilities" (February 2, 2011), *http://www.sec.gov/rules/proposed/2011/34-63825.pdf.*

[7] *See,* Release No. 34-63452, "Further Definition of "Swap Dealer", "Security-Based Swap Dealer", "Major Swap Participant", "Major Security-Based Swap Participant", and "Eligible Contract Participant" (December 7, 2010), *http://www.sec.gov/rules/proposed/2010/34-63452.pdf.*

[8] *See,* Release No. 34-63727, "Trade Acknowledgment and Verification on Security-Based Swap Transactions" (January 14, 2011), *http://www.sec.gov/rules/proposed/2011/34-63727.pdf.*

[9] *See,* Release No. 34-63107, "Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC" (October 14, 2010), *http://www.sec.gov/rules/proposed/2010/34-63107.pdf.*

[10] *See,* Release No. 34-63094, "Reporting of Security-Based Swap Transaction Data" (October 13, 2010), *http://www.sec.gov/rules/interim-final-temp.shtml.*

[11] The FSOC's advance notice of proposed rulemaking can be found at *http://www.treasury.gov/initiatives/Documents/VIII%20-%20ANPR%20on%20FMU%20Designations%20111910.pdf.*

[12] See Release No. IA-3110, Rules Implementing Amendments to the Investment Advisers Act of 1940 (November 19, 2010), *http://www.sec.gov/rules/proposed/2010/ia-3110.pdf.*

- To implement the Act's mandate to exempt from registration advisers to private funds with less than $150 million in assets under management in the United States; [13]
- A definition of "venture capital fund" that distinguishes these funds from other types of private funds; [14] and
- A definition of "family office" that focuses on firms that provide investment advice only to family members (as defined by the rule), certain key employees, charities and trusts established by family members and entities wholly owned and controlled by family members. [15]

In addition, following consultation with staff of the FSOC member agencies, the Commission and CFTC jointly proposed rules to implement the Act's mandate to require advisers to hedge funds and other private funds to report information for use by the FSOC in monitoring for systemic risk to the U.S. financial system. [16] The proposal, which builds on coordinated work on hedge fund reporting conducted with international regulators, would institute a "tiered" approach to gathering the systemic risk data which would remain confidential. Thus, the largest private fund advisers—those with $1 billion or more in hedge fund, private equity fund, or "liquidity fund" assets—would provide more comprehensive and more frequent systemic risk information than other private fund advisers.

Asset-Backed Securities

Section 943 of the Dodd-Frank Act requires the Commission to adopt rules on the use of representations and warranties in the market for asset-backed securities (ABS). In January, the Commission adopted final rules [17] that require ABS issuers to disclose the history of repurchase requests received and repurchases made relating to their outstanding ABS. Issuers will be required to make their initial filing on February 14, 2012, disclosing the repurchase history for the 3 years ending December 31, 2011. The disclosure requirements will apply to issuers of registered and unregistered ABS, including municipal ABS, though the rules provide municipal ABS an additional 3-year phase-in period.

Section 945 requires the Commission to issue rules requiring an asset-backed issuer in a Securities Act registered transaction to perform a review of the assets underlying the ABS and disclose the nature of such review. In January, the Commission adopted final rules to implement Section 945. [18] Under the final rules, the type of review conducted may vary, but at a minimum must be designed and effected to provide reasonable assurance that the prospectus disclosure about the assets is accurate in all material respects. The final rule provides a phase-in period to allow market participants to adjust their practices to comply with the new requirements.

Section 942(a) of the Dodd-Frank Act eliminated the automatic suspension of the duty to file reports under Section 15(d) of the Exchange Act for ABS issuers and granted the Commission authority to issue rules providing for the suspension or termination of this duty to file reports. The Commission has proposed rules in connection with this provision of the Act which would permit suspension of the reporting obligations for ABS issuers when there are no longer asset-backed securities of the class sold in a registered transaction held by nonaffiliates of the depositor. [19]

We are working closely with other regulators to jointly create the risk retention rules required by Section 941 of the Act, which will address the appropriate amount, form and duration of required risk retention for ABS securitizers, and will define qualified residential mortgages. We expect that the Commission will consider proposed risk retention rules in the near future.

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[13] *See, id.*

[14] *See,* Release No. IA-3111, "Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management and Foreign Private Advisers" (November 19, 2010), *http://www.sec.gov/rules/proposed/2010/ia-3111.pdf.*

[15] *See,* Release No. IA-3098, "Family Offices" (October 12, 2010); *http://www.sec.gov/rules/proposed/2010/ia-3098.pdf.*

[16] *See,* Release No. IA-3145, "Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF" (January 26, 2011), *http://www.sec.gov/rules/proposed/2011/ia-3145.pdf.*

[17] *See,* Release No. 33-9175, "Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (January 20, 2011), *http://www.sec.gov/rules/final/2011/33-9175.pdf.*

[18] *See,* Release No. 33-9176, "Issuer Review of Assets in Offerings of Asset-Backed Securities" (January 20, 2011), *http://www.sec.gov/rules/final/2011/33-9176.pdf.*

[19] *See,* Release No. 34-63652, "Suspension of the Duty to File Reports for Classes of Asset-Backed Securities Under Section 15(d) of the Securities Exchange Act of 1934" (January 6, 2011), *http://www.sec.gov/rules/proposed/2011/34-63652.pdf.*

Credit Rating Agencies

Under the Dodd-Frank Act, the Commission is required to undertake approximately a dozen rulemakings related to nationally recognized statistical rating organizations (NRSROs). The Act requires the SEC to address, among other things, internal controls and procedures, conflicts of interest, credit rating methodologies, transparency, ratings performance, analyst training, credit rating symbology, and disclosures accompanying the publication of credit ratings. The staff plans to recommend rule proposals to the Commission on these matters in the near future.[20]

In addition, the Act requires every Federal agency to review its regulations that require use of credit ratings as an assessment of the credit worthiness of a security and undertake rulemakings to remove these references and replace them with other standards of credit worthiness that the agency determines are appropriate.[21] On February 9, 2011, the Commission proposed rule amendments that would remove credit ratings as conditions for companies seeking to use short-form registration when registering securities for public sale.[22] Under the proposed rules, the new test for eligibility to use Form S-3 or Form F-3 short-form registration would be tied to the amount of debt and other nonconvertible securities a particular company has sold in registered primary offerings within the previous 3 years. Additional rule proposals in response to Section 939A will be forthcoming.

The Act also requires the SEC to conduct three studies relating to credit rating agencies. In December, the Commission requested comment on the feasibility and desirability of standardizing credit rating terminology.[23] The additional NRSRO-related studies concern (1) alternative compensation models for rating structured finance products and (2) NRSRO independence. Given the complexity of the issues it raises, we likely will seek comment on the compensation study in the near future so as to provide commentators an extended period in which to communicate their views.

Corporate Governance and Executive Compensation

Section 951 of the Act requires public companies subject to the Federal proxy rules to provide a shareholder advisory "say-on-pay" vote on executive compensation at least once every 3 years and a separate advisory vote at least once every 6 years on whether the say-on-pay resolution will be presented for shareholder approval every 1, 2, or 3 years. In addition, Section 951 requires disclosure about—and a shareholder advisory vote to approve—compensation related to merger or similar transactions, known as "golden parachute" arrangements. In January, the Commission adopted rules to implement these provisions of Section 951.[24] The rules provide smaller reporting companies a 2-year delayed compliance period for the say-on-pay and "frequency" votes. Section 951 also requires that institutional investment managers report their votes on these matters at least annually. The Commission proposed rules to implement this requirement last October, and we expect that these rules will be finalized shortly.[25]

Section 957 of the Act requires the rules of each national securities exchange to be amended to prohibit brokers from voting uninstructed shares on the election of directors (other than uncontested elections of directors of registered investment companies), executive compensation matters, or any other significant matter, as determined by the Commission by rule. To date, the Commission has approved changes to the rules of the New York Stock Exchange, the Nasdaq Stock Market and the International Securities Exchange.[26] We anticipate that corresponding changes to

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[20] In addition, last September the Commission issued an amendment to Regulation FD that implements Section 939B of the Act, which requires that the SEC amend Regulation FD to remove the specific exemption from the rule for disclosures made to NRSROs and credit rating agencies for the purpose of determining or monitoring credit ratings. See Release No. 33-9146, Removal from Regulation FD of the Exemption for Credit Rating Agencies (September 29, 2010), *http://www.sec.gov/rules/final/2010/33-9146.pdf.*

[21] *See,* Section 939A of the Dodd-Frank Act.

[22] *See,* Release No. 33-9186, "Removing Security Ratings as Condition for Short-Form Registration" (February 9, 2011), *http://www.sec.gov/rules/proposed/2011/33-9186.pdf.*

[23] *See,* Release No. 34-63573, "Credit Rating Standardization Study" (December 17, 2010), *http://www.sec.gov/rules/other/2010/34-63573.pdf.*

[24] *See,* Release No. 33-9178, "Shareholder Approval of Executive Compensation and Golden Parachute Compensation" (January 25, 2011), *http://www.sec.gov/rules/final/2011/33-9178.pdf.*

[25] *See,* Release No. 34-63123, "Reporting of Proxy Votes on Executive Compensation and Other Matters" (October 18, 2010), *http://www.sec.gov/rules/proposed/2010/34-63123.pdf.*

[26] *See,* Release No. 34-62874 (September 9, 2010), *http://www.sec.gov/rules/sro/nyse/2010/34-62874.pdf;* Release No. 34-62992 (September 24, 2010), *http://www.sec.gov/rules/sro/nasdaq/2010/34-62992.pdf;* Release No. 34-63139 (October 20, 2010), *http://www.sec.gov/rules/sro/ise/2010/34-63139.pdf.*

the rules of other national securities exchanges will be considered by the Commission in the near future.

The Commission also is required by the Act to adopt several additional rules related to corporate governance and executive compensation. We anticipate that the staff will recommend proposed rules for the Commission's consideration in the near future, which will mandate new listing standards relating to the independence of compensation committees and establish new disclosure requirements and conflict of interest standards that boards must observe when retaining compensation consultants.[27] In addition, Section 956 requires the Commission, jointly with other financial regulators, to adopt incentive-based compensation regulations or guidelines that apply to covered financial institutions, including broker-dealers and investment advisers, with assets of $1 billion or more. The Commission staff has been working closely with the other regulators to prepare a proposal implementing this provision.

The Act also requires the Commission to adopt rules mandating new listing standards relating to specified "clawback" policies[28] and rules requiring new disclosures about executive compensation and company performance,[29] executive pay ratios,[30] and employee and director hedging.[31] These provisions of the Act do not contain rulemaking deadlines, but are being considered and assessed by the staff.

Investment Adviser Rulemaking and Investment Adviser Related Studies

In consultation with the State securities regulators, the Commission proposed rules and amendments to Form ADV (the adviser registration form) to implement the new threshold for registering advisers with the SEC rather than State regulators. Under the Act, the threshold increased from $25 million to $100 million in assets under management.[32] As a result of this change, we expect that approximately 4,100 investment advisers will switch from SEC to State registration. In addition, approximately 750 large private fund advisers will newly register with the Commission as a result of the Act's private fund adviser provisions.

In addition, the SEC recently released three Dodd-Frank-mandated staff studies related to improving the investment adviser and broker-dealer regulatory frameworks.

First, the Commission published a staff study on enhancing investment adviser examinations.[33] The study concludes that the Commission's investment adviser examination program requires a source of funding sufficiently stable to prevent examination resources from being outstripped by future growth in the number of registered advisers (*i.e.,* that the resources are scalable to any future increase—or decrease—in the number of registered investment advisers). The study identified three options for Congress to consider:

- Impose "user fees" on SEC-registered investment advisers that could be retained by the Commission to fund the investment adviser examination program;
- Authorize one or more SROs to examine, subject to SEC supervision, all SEC-registered investment advisers; or
- Authorize FINRA to examine dual registrants for compliance with the Advisers Act.

Second, we published a staff study on the obligations of investment advisers and broker-dealers.[34] That study made two primary recommendations: that the Commission (1) exercise its discretionary rulemaking authority under the Act to implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers when they are providing personalized investment advice about securities to

[27] *See,* Section 952 of the Dodd-Frank Act. Under the Act, these rules are to be adopted by the Commission within 360 days from the date of enactment of the Act.

[28] *See,* Section 954 of the Dodd-Frank Act.

[29] *See,* Section 953(a) of the Dodd-Frank Act.

[30] *See,* Section 953(b) of the Dodd-Frank Act.

[31] *See,* Section 955 of the Dodd-Frank Act.

[32] *See,* Release No. IA-3110, "Rules Implementing Amendments to the Investment Advisers Act of 1940" (November 19, 2010), *http://www.sec.gov/rules/proposed/2010/ia-3110.pdf.*

[33] "Staff Study on Enhancing Investment Adviser Examinations" (January 19, 2011), *http://www.sec.gov/news/studies/2011/914studyfinal.pdf; See also,* "Commissioner Elisse B. Walter, Statement on Study Enhancing Investment Adviser Examinations" (Required by Section 914 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act) (Jan. 2010), *http://www.sec.gov/news/speech/2011/spch011911ebw.pdf.* I did not participate in the study or the vote authorizing its publication.

[34] *See,* "Study on Investment Advisers and Broker-Dealers" (January 21, 2011), *http://www.sec.gov/news/studies/2011/913studyfinal.pdf; See also,* "Statement by SEC Commissioners Kathleen L. Casey and Troy A. Paredes Regarding Study on Investment Advisers and Broker-Dealers" (January 21, 2011), *http://www.sec.gov/news/speech/2011/spch012211klctap.htm.*

retail investors; and (2) consider harmonization of broker-dealer and investment adviser regulation when retail investors obtain the same or substantially similar services and when such harmonization adds meaningfully to investor protection. Under the Act, the uniform fiduciary standard to which broker-dealers and investment advisers would be subject would be "no less stringent" than the standard that applies to investment advisers today.

Third, we published a staff study on investor access to information about investment professionals. Today, investors must search two separate databases for information about broker-dealers and investment advisers. The primary recommendation was to centralize access to these two databases to enable investors to simultaneously search both databases and receive unified search results.[35]

Specialized Disclosure Provisions

Title XV of the Act contains specialized disclosure provisions related to conflict minerals, coal or other mine safety, and payments by resource extraction issuers to foreign or U.S. Government entities.

The conflict minerals provision of the Act, Section 1502, requires issuers to disclose annually whether any conflict minerals that are necessary to the functionality or production of a product originated in the Democratic Republic of the Congo or an adjoining country. If so, issuers are further required to provide a report describing, among other matters, the measures taken to exercise due diligence on the source and chain of custody of those minerals. The report must include an independent private sector audit that is certified by the person filing the report.

Section 1503 of the Act, which relates to mine safety, requires mining companies to disclose information about health and safety violations in their periodic reports filed with the Commission. It also requires issuers to file Form 8-K reports disclosing receipt of specified orders or notices from the Mine Safety and Health Administration. The disclosure requirement currently is in effect by operation of the Act.

Section 1504 of the Act requires resource extraction issuers that are required to file annual reports with the Commission and that engage in commercial development of oil, natural gas, and minerals to disclose annually information about any payment made by the issuer or its subsidiaries, or an entity under the control of the issuer, to the U.S. or a foreign Government for the purpose of the commercial development of oil, natural gas, or minerals.

The Commission published rule proposals relating to these three provisions of the Act in December.[36] The comment periods were scheduled to close on January 31, 2011, but the Commission recently extended the comment periods for all three rule proposals for 30 days, to March 2, 2011.[37] The nature of the proposed disclosure requirements differs from the disclosure traditionally required by the Exchange Act, and comments were requested on a variety of significant aspects of the proposed rules. After receiving requests for extensions of the public comment period for all three rule proposals, we determined that providing the public additional time to consider thoroughly the matters addressed by the releases and to submit comprehensive responses would benefit the Commission in its consideration of final rules.

Whistleblower

Section 922 of the Act requires the SEC, under regulations prescribed by the Commission, to pay awards to individuals who voluntarily provide the Commission with original information that leads to the successful enforcement of (1) an SEC action that results in monetary sanctions exceeding $1 million or (2) certain related actions. The Dodd-Frank Act substantially expands the agency's authority to compensate individuals who provide the SEC with information about violations of the Federal securities laws. Prior to the Act, the agency's bounty program was limited

[35] *See,* "Study and Recommendations on Improved Investor Access to Registration Information About Investment Advisers and Broker-Dealers" (January 26, 2011), *http://www.sec.gov/news/studies/2011/919bstudy.pdf.*

[36] *See,* Release No. 34-63547, "Conflict Minerals" (December 15, 2010), *http://www.sec.gov/rules/proposed/2010/34-63547.pdf;* Release No. 33-9164, "Mine Safety Disclosure" (December 15, 2010), *http://www.sec.gov/rules/proposed/2010/33-9164.pdf,* Release No. 34-63549, "Disclosure of Payments by Resource Extraction Issuers" (December 15, 2010), *http://www.sec.gov/rules/proposed/2010/34-63549.pdf.*

[37] *See,* Release No. 34-63793, "Conflict Minerals" (extension of comment period) (January 28, 2011), *http://www.sec.gov/rules/proposed/2011/34-63793.pdf;* Release No. 33-9179, "Mine Safety Disclosure" (extension of comment period) (January 28, 2011), *http://www.sec.gov/rules/proposed/2011/33-9179.pdf;* Release No. 34-63795, "Disclosure of Payments by Resource Extraction Issuers" (extension of comment period) (January 28, 2011), *http://www.sec.gov/rules/proposed/2011/34-63795.pdf.*

to insider trading cases, and the amount of an award was capped at 10 percent of the penalties collected in the action.

Last November, the Commission proposed rules mapping out the procedure for would-be whistleblowers to provide critical information to the agency.[38] The proposed rules convey how eligible whistleblowers can qualify for an award through a transparent process that provides them an opportunity to assert their claim to an award. We also have fully funded the SEC Investor Protection Fund, which will be used to pay awards to qualifying whistleblowers. Pending the adoption of final rules, Enforcement staff has been reviewing and tracking whistleblower complaints submitted to the Commission.

The Act requires the Commission to create a separate office within the SEC to administer and enforce whistleblower provisions of the Act. Soon, we plan to announce the selection of a Whistleblower Coordinator to oversee the whistleblower program.

Exempt Offerings

Section 413(a) of the Act requires the Commission to exclude the value of an individual's primary residence when determining if that individual's net worth exceeds the $1 million threshold required for "accredited investor" status. This change was effective upon enactment of the Act, but the Commission is also required to revise its rules to reflect the new standard. The Commission proposed rule amendments in January that would implement this provision, and would clarify the treatment of any indebtedness secured by the residence in the net worth calculation.[39]

In addition, under Section 926 of the Act, the Commission is required to adopt rules that disqualify securities offerings involving certain "felons and other 'bad actors'" from relying on the safe harbor from Securities Act registration provided by Rule 506 of Regulation D. We expect that the staff will recommend proposed rules for the Commission's consideration soon.

Volcker Rule

On January 18, 2011, the FSOC approved and released to the public a study formalizing its findings and recommendations for implementing section 619 of the Dodd-Frank Act, commonly referred to as the Volcker Rule.[40] Commission staff actively participated in the study. We recently solicited public comments in advance of our rule proposal concerning the SEC's implementation of the Volcker Rule.[41]

Procedural Rules for SRO Filings

Section 916 of the Act amended Section 19(b) of the Securities Exchange Act of 1934, which governs the handling of proposed rule changes submitted by SROs. Among other things, Section 916 required the Commission to promulgate rules setting forth the procedural requirements of proceedings to determine whether a proposed rule change should be disapproved. In satisfaction of this requirement, the Commission adopted new Rules of Practice to formalize the process it will use when conducting proceedings to determine whether an SRO's proposed rule change should be disapproved under Section 19(b)(2) of the Exchange Act.[42] The new rules are intended to add transparency to the Commission's conduct of those proceedings, to address the process the Commission will follow to institute proceedings and provide notice of the grounds for disapproval under consideration, and to provide interested parties with an opportunity to submit written materials to the Commission.

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[38] *See,* Release No. 34-63237, "Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934" (November 3, 2010), *http://www.sec.gov/rules/proposed/2010/34-63237.pdf.* In addition, last October, the Commission provided its first annual report to Congress on the Whistleblower Program as provided by the Act.

[39] *See,* Release No. 33-9177, "Net Worth Standard for Accredited Investors" (January 25, 2011), *http://www.sec.gov/rules/proposed/2011/33-9177.pdf.*

[40] The FSOC Volcker Rule study and recommendations can be found at *http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf.*

[41] *See, http://sec.gov/spotlight/dodd-frank/volckerrule.htm.*

[42] *See,* Release No. 34-63049, "Delegation of Authority to the Director of the Division of Trading and Markets" (Effective Date: October 12, 2010), *http://www.sec.gov/rules/final/2010/34-63049.pdf;* Release No. 34-63699, "Delegation of Authority to the Chief Accountant" (Effective Date: January 18, 2011), *http://www.sec.gov/rules/final/2011/34-63699.pdf;* and Release No. 34-63723, "Rules of Practice" (Effective Date: January 24, 2011), *http://www.sec.gov/rules/final/2011/34-63723.pdf.*

Creation of SEC Offices

Beyond the whistleblower office, the Act requires the Commission to create four new offices within the Commission, specifically, the Office of Credit Ratings,[43] Office of the Investor Advocate,[44] Office of Minority and Women Inclusion,[45] and Office of Municipal Securities.[46] As each of these offices is statutorily required to report directly to the Chairman, the creation of these offices is subject to approval by the Commission's appropriations subcommittees to reprogram funds for this purpose. Until approval is received, the initial functions of the offices are being performed on a limited basis by other divisions and offices. Below is a summary of our plans for each office, as well as the current status as to each.

- *Office of Credit Ratings*—The office will be responsible for administering the rules of the Commission with respect to the practices of NRSROs in determining ratings; promoting accuracy in credit ratings issued by NRSROs; ensuring that such ratings are not unduly influenced by conflicts of interest; and conducting examinations of each NRSRO at least annually. Currently, the NRSRO-related rulemaking functions remain with staff within the Commission's Division of Trading and Markets, and the examination functions continue to be performed by the existing Office of Compliance Inspections and Examination.
- *Office of the Investor Advocate*—The office will assist retail investors in resolving significant problems they may have with the Commission or with SROs; identify areas in which investors would benefit from changes in Commission regulations or SRO rules; identify problems that investors have with financial service providers and investment products; and analyze the potential impact on investors of proposed Commission regulations and SRO rules. The office will include an Ombudsman as required by the Act. Currently, activities regarding investor perspectives in rulemaking continue to be performed by staff in the existing Office of Investor Education and Advocacy.
- *Office of Minority and Women Inclusion*—The Office of Minority and Women Inclusion will be responsible for all matters of the agency relating to diversity in management, employment, and business activities. The director of this office will advise the Chairman on the impact of the policies and regulations of the SEC on minority-owned and women-owned businesses. The director also will develop and implement standards for: equal employment opportunity and the racial, ethnic, and gender diversity of the workforce and senior management of the SEC; increased participation of minority-owned and women-owned businesses in the programs and contracts of the agency, including standards for coordinating technical assistance to such businesses; and assessing the diversity policies and practices of entities regulated by the SEC. Currently, activities regarding diversity in hiring and small business contracting continue to be performed by staff in the existing EEO Office.
- *Office of Municipal Securities*—The office will administer the rules pertaining to broker-dealers, advisors, investors, and issuers of municipal securities,[47] as well as coordinate with the Municipal Securities Rulemaking Board on rulemaking and enforcement actions. Currently, those functions continue to be assigned to staff within the Division of Trading and Markets.

Internal Operations

In the past 2 years the SEC has taken significant and comprehensive steps to reform the way it operates. We have brought in new leadership and senior management, revitalized and restructured our enforcement, examination and corporation finance operations, revamped our handling of tips and complaints, taken steps to break down internal silos and create a culture of collaboration, improved our risk assessment capabilities, recruited more staff with specialized expertise and real world experience, and enhanced safeguards for investors' assets, among other

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[43] *See,* Section 932 of the Dodd-Frank Act.
[44] *See,* Section 915 of the Dodd-Frank Act.
[45] *See,* Section 342 of the Dodd-Frank Act.
[46] *See,* Section 979 of the Dodd-Frank Act.
[47] Section 975 of the Act also requires the registration of municipal advisors with the Commission. This new registration requirement became effective on October 1, 2010, making it unlawful for any municipal advisor to provide advice to a municipality unless registered with the Commission. Last September, the Commission adopted an interim final rule establishing a temporary means for municipal advisors to satisfy the registration requirement. In December, the Commission proposed a permanent rule creating a new process by which municipal advisors must register with the SEC.

things. Despite these changes, much work remains, and we continue to seek ways to improve our operations.

To assist the SEC in assessing its operational efficiency, Section 967 of the Dodd-Frank Act directed the agency to engage the services of an independent consultant to study a number of specific areas of SEC internal operations and of the SEC's relationship with SROs. On October 15, 2010, the Commission engaged Boston Consulting Group (BCG) to perform the organizational study. During the past four months, our staff has been fully engaged with BCG, participating in interviews, providing documentation, and responding to questions. BCG's report is due March 14, and we expect it will include recommendations that will identify additional efficiencies for SEC operations.

Funding for Implementation of the Dodd-Frank Act

The provisions of the Dodd-Frank Act represent a major expansion of the SEC's responsibilities and will require significant additional resources for full implementation. To date, the SEC has proceeded with the first stages of implementation of the Dodd-Frank Act without additional funding. As described above, implementation up to this point has largely involved performing studies, analysis, and the writing of rules. These tasks have taken staff time from other responsibilities, and have been done almost entirely with existing staff and without additional expenses in areas such as information technology.

The budget justification I recently submitted [48]—provided in connection with the President's fiscal year 2012 (FY2012) budget request—estimates that, over time, full implementation of the Dodd-Frank Act will require a total of approximately 770 new staff, of which many will need to be expert in derivatives, hedge funds, data analytics, credit ratings, or other new or expanded responsibility areas. The SEC also will need to invest in technology, to facilitate the registration of additional entities and capture and analyze data on these new markets.

Sixty percent, or 468, of the new staff positions requested are necessary initially to implement Dodd-Frank responsibilities. This number includes positions that I anticipate are needed to fully staff the five new offices at adequate levels. The agency also will need to invest in technology to facilitate the registration of additional entities and capture and analyze data on the new markets. It is estimated the costs of these new positions and technology investments will be approximately $123 million. The remaining positions requested in the budget will be used to strengthen and support core SEC operations and to continue reforming its operations and fostering stronger protections for investors.

In addition to the new positions requested in FY2012, I also anticipate that an additional 296 positions will be required in FY2013 for full implementation of the Dodd-Frank Act. It is important to note that the SEC's FY2012 funding will be fully offset by matching collections of fees on securities transactions. Currently, the transaction fees collected by the SEC are approximately 2 cents per $1,000 of transactions. Under the Dodd-Frank Act, beginning with FY2012, the SEC is required to adjust fee rates so that the amount collected will match the total amount appropriated for the agency by Congress. Under this mechanism, SEC funding will be deficit-neutral, as any increase or decrease in the SEC's budget would result in a corresponding rise or fall in offsetting fee collections.

Conclusion

Though the SEC's efforts to implement the Dodd-Frank Act have been extensive, our work is far from over. As we proceed with implementation, we look forward to continuing to work closely with Congress, our fellow regulators and members of the financial and investing public. Thank you for inviting me here today to share with you our progress on and plans for implementation. I look forward to answering your questions.

PREPARED STATEMENT OF GARY GENSLER

CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

FEBRUARY 17, 2011

Good morning Chairman Johnson, Ranking Member Shelby, and Members of the Committee. I thank you for inviting me to today's hearing on implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act. I am pleased to testify on behalf of the Commodity Futures Trading Commission (CFTC). I also thank

[48] In accordance with past practice, the budget justification of the agency was submitted by the Chairman of the Commission and was not voted on by the full Commission.

my fellow Commissioners and CFTC staff for their hard work and commitment on implementing the legislation.

I am honored to appear at today's hearing alongside fellow regulators with whom we are working so closely to implement the Dodd-Frank Act. We have consulted and coordinated closely with the Securities and Exchange Commission (SEC), Federal Reserve Board, Treasury Department, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency and other regulators on rulemakings to oversee the swaps markets. Throughout this process, interagency cooperation has been extraordinary and has improved our proposed rulemakings.

Before I move into the testimony, I want to congratulate Chairman Johnson on becoming Chairman of the Committee. I look forward to working with you and all Members of the Committee.

The Dodd-Frank Act

On July 21, 2010, President Obama signed the Dodd-Frank Act. The Act amended the Commodity Exchange Act (CEA) to establish a comprehensive new regulatory framework for swaps and security-based swaps. Title VII of the Act, which relates to swaps, was enacted to reduce risk, increase transparency and promote market integrity within the financial system by, among other things:

1. Providing for the registration and comprehensive regulation of swap dealers and major swap participants;
2. Imposing clearing and trade execution requirements on standardized derivatives products;
3. Creating robust record keeping and real-time reporting regimes; and
4. Enhancing the Commission's rulemaking and enforcement authorities with respect to, among others, all registered entities and intermediaries subject to the Commission's oversight.

The reforms mandated by Congress will reduce systemic risk to our financial system and bring sunshine and competition to the swaps markets. Markets work best when they are transparent, open and competitive. The American public has benefited from these attributes in the futures and securities markets since the great regulatory reforms of the 1930s. The reforms of Title VII will bring similar features to the swaps markets. Lowering risk and improving transparency will make the swaps markets safer and improve pricing for end-users.

Title VIII of the Dodd-Frank Act gives the Financial Stability Oversight Council (FSOC) and the Federal Reserve Board important roles in clearinghouse oversight by authorizing the Council to designate certain clearinghouses as systemically important and by permitting the Federal Reserve to recommend heightened prudential standards in certain circumstances. It also gives the CFTC heightened authorities with respect to those clearinghouses that are deemed systemically important by the FSOC.

Implementation

The Dodd-Frank Act is very detailed, addressing all of the key policy issues regarding regulation of the swaps marketplace. To implement these regulations, the Act requires the CFTC and SEC, working with our fellow regulators, to write rules generally within 360 days. At the CFTC, we initially organized our effort around 30 teams who have been actively at work. We have recently added another team. We had our first meeting with the 30 team leads the day before the President signed the law.

The CFTC is working deliberatively and efficiently to promulgate rules required by Congress. The talented and dedicated staff of the CFTC has stepped up to the challenge and has recommended thoughtful rules—with a great deal of input from each of the five Commissioners—that would implement the Act. Thus far, the CFTC has approved 39 notices of proposed rulemaking, two interim final rules, four advanced notices of proposed rulemaking and one final rule.

The CFTC's process to implement the rulemakings required by the Act includes enhancements over the agency's prior practices in five important areas. Our goal was to provide the public with additional opportunities to inform the Commission on rulemakings, even before official public comment periods. I will expand on each of these five points in my testimony.

1. We began soliciting views from the public immediately after the Act was signed and prior to approving proposed rulemakings. This allowed the agency to receive input before the pens hit the paper.
2. We hosted a series of public, staff-led roundtables to hear ideas from the public prior to considering proposed rulemakings.

3. We engaged in significant outreach with other regulators—both foreign and domestic—to seek input on each rulemaking.
4. Information on both staff's and Commissioners' meetings with members of the public to hear their views on rulemakings has been made publicly available at cftc.gov.
5. The Commission held public meetings to consider proposed rulemakings. The meetings were webcast so that the Commission's deliberations were available to the public. Archive webcasts are available on our Web site as well.

Two principles are guiding us throughout the rule-writing process. First is the statute itself. We intend to comply fully with the statute's provisions and Congressional intent to lower risk and bring transparency to these markets.

Second, we are consulting heavily with both other regulators and the broader public. We are working very closely with the SEC, the Federal Reserve, the FDIC, the OCC and other prudential regulators, which includes sharing many of our memos, term sheets and draft work product. We also are working closely with Treasury and the new Office of Financial Research. As of Tuesday, CFTC staff has had 422 meetings with other regulators on implementation of the Act.

In addition to working with our American counterparts, we have reached out to and are actively consulting and coordinating with international regulators to harmonize our approach to swaps oversight. As we are with domestic regulators, we are sharing many of our memos, term sheets and draft work product with international regulators as well. Our discussions have focused on clearing and trading requirements, clearinghouses more generally and swaps data reporting issues, among many other topics.

Specifically, we have been consulting directly and sharing documentation with the European Commission, the European Central Bank, the UK Financial Services Authority and the new European Securities and Markets Authority. We also have shared documents with the Japanese Financial Services Authority and consulted with Members of the European Parliament and regulators in Canada, France, Germany, and Switzerland.

Through this consultation, we are working to bring consistency to regulation of the swaps markets. In September of last year, the European Commission released its swaps proposal. As we had in the Dodd-Frank Act, the E.C.'s proposal covers the entire derivatives marketplace—both bilateral and cleared—and the entire product suite, including interest rate swaps, currency swaps, commodity swaps, equity swaps and credit default swaps. The proposal includes requirements for central clearing of swaps, robust oversight of central counterparties and reporting of all swaps to a trade repository. The E.C. also is considering revisions to its existing Markets in Financial Instruments Directive (MiFID), which includes a trade execution requirement, the creation of a report with aggregate data on the markets similar to the CFTC's Commitments of Traders reports and accountability levels or position limits on various commodity markets.

We also are soliciting broad public input into the rules. On July 21st, we listed the 30 rule-writing teams and set up mailboxes for the public to comment directly. We determined it would be best to engage the public as broadly as possible even before publishing proposed rules. As of Tuesday, we have received 2,856 submissions from the public through the e-mail inboxes as well as 1,258 official comments in response to notices of proposed rulemaking. The CFTC and the SEC in December proposed a joint rule to further define the terms "swap dealer" and "major swap participant." The comment period on this proposal is open until February 22. To the extent that members of the public have comments on other rules that apply to swap dealers and major swap participants and have not yet submitted them, they may include those comments within their submissions on this rule. The CFTC will use its discretion to include those in the comment files and consider them for the related rules.

We also have organized nine roundtables to hear specifically on particular subjects. We have coordinated the majority of our roundtables with the SEC and have joined with other regulators on several of them as well. These meetings have allowed us to hear directly from investors, market participants, end-users, academics, exchanges and clearinghouses on key topics including governance and conflicts of interest, real time reporting, swap data record keeping and swap execution facilities, among others. The roundtables have been open to the public, and we have established call-in numbers for each of them so that anyone can listen in.

Additionally, many individuals have asked for meetings with either our staff or Commissioners to discuss swaps regulation. As of Tuesday, we have had more than 540 such meetings. We are now posting on our Web site a list of all of the meetings CFTC staff and I have with outside organizations, as well as the participants, issues discussed and all materials given to us.

We began publishing proposed rulemakings at our first public meeting to implement the Act on October 1, 2010. We have sequenced our proposed rulemakings over 11 public meetings thus far. Our next meeting is scheduled for February 24.

Public meetings have allowed us to discuss proposed rules in the open. For the vast majority of proposed rulemakings, we have solicited public comments for a period of 60 days. On a few occasions, the public comment period lasted 30 days. As part of seeking public comment on each of the individual rules, we also have asked a question within many of the proposed rulemakings relating to the timing for the implementation of various requirements under these rules. In looking across the entire set of rules and taking into consideration the costs of cumulative regulations, public comments will help inform the Commission as to what requirements can be met sooner and which ones will take a bit more time.

We have thus far proposed rulemakings in 26 of the 30 areas established last July. We still must propose rules on capital and margin requirements, product definitions (jointly with the SEC) and the Volcker Rule. We also are considering comments received in response to advanced notices of proposed rulemaking with regard to disruptive trading practices and segregation of funds for cleared swaps.

A number of months ago we also set up a 31st rulemaking team tasked with developing conforming rules to update the CFTC's existing regulations to take into account the provisions of the Act.

End-User Margin

One of the rules on which the CFTC is working closely with the SEC, the Federal Reserve and other prudential regulators will address margin requirements for swap dealers and major swap participants.

Congress recognized the different levels of risk posed by transactions between financial entities and those that involve nonfinancial entities, as reflected in the nonfinancial end-user exception to clearing. Transactions involving nonfinancial entities do not present the same risk to the financial system as those solely between financial entities. The risk of a crisis spreading throughout the financial system is greater the more interconnected financial companies are to each other. Interconnectedness among financial entities allows one entity's failure to cause uncertainty and possible runs on the funding of other financial entities, which can spread risk and economic harm throughout the economy. Consistent with this, proposed rules on margin requirements should focus only on transactions between financial entities rather than those transactions that involve nonfinancial end-users.

Existing Derivatives Contracts

Congress provided for the legal certainty for swaps entered into prior to the date of enactment of the Dodd-Frank Act. Questions also have been raised regarding the clearing mandate and margin requirements. With respect to the clearing requirement and margin, I believe that the new rules should apply on a prospective basis only as to transactions entered into after the rules take effect.

Financial Stability Oversight Council

The Dodd-Frank Act established the FSOC to ensure protections for the American public. I am honored to serve on the Council. The financial system should allow people who want to hedge their risk to do so without concentrating risk. One of the challenges for this Council and for the American public is that like so many other industries, the financial industry has gotten very concentrated. Adding to our challenge is the perverse outcome of the financial crisis, which may be that some in the markets have come to believe that large financial firms will—if in trouble—have the backing of the taxpayers. As it is unlikely that we could ever ensure that no financial institution will fail—because surely, some will in the future—we must do our utmost to ensure that when those challenges arise, the taxpayers are not forced to stand behind those institutions and that these institutions are free to fail.

There are very important decisions that the Council will make, such as determinations about systemically important nonbank financial companies and systemically important financial market utilities and clearinghouses, resolving disputes between agencies and completing important studies as dictated by the Dodd-Frank Act. Though these specific decisions are significant, it is essential that we make sure that the American public doesn't bare the risk of the financial system and that the system works for the American public, investors, small businesses, retirees, and homeowners.

The Council's eight current voting members have coordinated closely. Treasury's leadership has been invaluable. To support the FSOC, the CFTC is providing both data and expertise relating to a variety of systemic risks, how those risks can spread through the financial system and the economy and potential ways to miti-

gate those risks. We also have had the opportunity to coordinate with Treasury and the Council on each of the studies and proposed rules issued by the FSOC.

Conclusion

Before I close, I will briefly address the resource needs of the CFTC. The futures marketplace that the CFTC currently oversees is approximately $40 trillion in notional amount. The swaps market that the Act tasks the CFTC with regulating has a notional amount roughly seven times the size of that of the futures market and is significantly more complex. Based upon figures compiled by the Office of the Comptroller of the Currency, the largest 25 bank holding companies currently have $277 trillion notional amount of swaps.

The CFTC's current funding is far less than what is required to properly fulfill our significantly expanded mission. Though we have an excellent, hardworking and talented staff, we just this past year got back to the staff levels that we had in the 1990s. To take on the challenges of our expanded mission, we will need significantly more staff resources and—very importantly—significantly more resources for technology. Technology is critical so that we can be as efficient as an agency as possible in overseeing these vast markets.

The CFTC currently is operating under a continuing resolution that provides funding at an annualized level of $169 million. The President requested $261 million for the CFTC in his proposed fiscal year (FY) 2011 budget. This included $216 million and 745 full-time equivalent employees for prereform authorities and $45 million to provide half of the staff estimated at that time needed to implement the Act. Under the continuing resolution, the Commission has operated in FY2011 at its FY2010 level. In the budget released on Monday, the President requested $308 million for the CFTC for FY2012 that would provide for 983 full-time equivalent employees.

Given the resource needs of the CFTC, we are working very closely with self regulatory organizations, including the National Futures Association, to determine what duties and roles they can take on in the swaps markets. Nevertheless, the CFTC has the ultimate statutory authority and responsibility for overseeing these markets. Therefore, it is essential that the CFTC have additional resources to reduce risk and promote transparency in the swaps markets.

Thank you, and I'd be happy to take questions.

PREPARED STATEMENT OF JOHN WALSH

ACTING COMPTROLLER OF THE CURRENCY, OFFICE OF THE COMPTROLLER OF THE CURRENCY

FEBRUARY 17, 2011

Statement Required by 12 U.S.C. §250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, I appreciate the opportunity to describe the initiatives the Office of the Comptroller of the Currency (OCC) has undertaken to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). My testimony reports on the OCC's work to date to implement Dodd-Frank in the following key areas:

- The OCC's progress integrating the staff and functions of the Office of Thrift Supervision (OTS) into the OCC, and identifying employees for transfer to the Consumer Financial Protection Bureau (CFPB);
- Highlights of our work to date in implementing important policy and rulemaking initiatives required by Dodd-Frank, including the OCC's participation on the Financial Stability Oversight Council (FSOC or Council), and the challenges of ensuring that these initiatives are appropriately coordinated with other participating agencies and with international efforts to reform capital and liquidity standards for financial institutions; and the Council's achievements thus far; and
- Provides an update on a significant issue that was just emerging at the time of the Committee's last hearing on Dodd-Frank implementation by reporting on the steps that the OCC, working with our fellow regulators, has taken to identify and address irregularities in institutions' foreclosure processes and our efforts to foster development and implementation of comprehensive and nationally applicable mortgage servicing standards.

I. Implementation of Agency Restructuring

A. OTS/OCC Integration

As the Committee is aware, the Dodd-Frank Act transfers from OTS to the OCC supervisory responsibilities for Federal savings associations, as well as rulemaking authority relating to all savings associations. Under the statute, all OTS employees will be transferred to either the OCC or the Federal Deposit Insurance Corporation (FDIC) no later than 90 days after the "transfer date," which is 1 year after enactment unless extended for an additional six months by the Secretary of the Treasury. The allocation is to be based generally on the proportion of Federal versus State savings associations regulated by the OTS.

When I testified before this Committee in September of last year, [1] I described the steps the OCC had begun to take to prepare for our expanded supervisory responsibilities and for the integration of OTS staff that is so essential to the success of that effort. Since then, we have continued to work closely with the OTS, the Board of Governors of the Federal Reserve System (FRB), and the FDIC to prepare for the smooth and effective transfer of OTS staff, authority and responsibilities, and property and other assets. Much remains to be done, but I am pleased to report that the agencies are on track to complete the transfer of functions and staff by the target date of July 21, 2011. The following summarizes key elements of this progress. A detailed description of all our activities is set forth in the interagency Joint Implementation Plan (Plan) submitted to the Committee on Banking, Housing, and Urban Affairs of the Senate, the Committee on Financial Services of the House of Representatives, and the Inspectors General of the Department of the Treasury, the FDIC, and the FRB on January 25, 2011. [2]

Because Dodd-Frank transfers the vast majority of OTS responsibilities to the OCC on the transfer date, most of the OTS's approximately 1,000 employees will transfer to the OCC. [3] The OCC recognizes that retaining the unique talent and experience of OTS staff is essential for the effective supervision of Federal savings associations going forward. Our work in preparing for the full integration of the OTS staff is focused on: ensuring that the protections afforded by the legislation are fully and equitably implemented; building a sustainable organizational structure that will successfully accomplish supervision and regulation of both national banks and Federal savings associations; fostering an environment that will maximize opportunities for staff; and promoting communication with all employees throughout the transition. Pursuant to section 314(b) of Dodd-Frank, on November 3, 2010, I designated Timothy T. Ward to be Deputy Comptroller for Thrift Supervision. Mr. Ward, who joined the OCC after 26 years at the OTS and its predecessor agency, reports to the Senior Deputy Comptroller for the OCC's Midsize/Community Bank Supervision (M/CBS) and is leading the planning process for integration of the OTS's examination and supervision functions and staff. He serves as a key senior management group member, and will coordinate the nationwide network of Senior Thrift Advisors and function as the key advisor to other Deputy Comptrollers on large and problem thrifts.

Realignment of Staffing To Prepare for Expanded Supervisory Responsibilities

The OCC will assign OTS employees, to the extent practicable, to OCC positions performing the same functions and duties that the OTS employees performed prior to the transfer. To assist in this effort, the OCC has reached out to OTS employees in a number of ways at the agency and business unit level. For example, because most OTS employees will transfer into the OCC's M/CBS organization, the Senior Deputy Comptroller for M/CBS has held four OTS-wide conference calls explaining its organizational structure and the decisions that are being made to accommodate the transfer of OTS staff. Similar conversations are occurring for other functional areas.

[1] Testimony of John Walsh, Acting Comptroller of the Currency, Before the Committee on Banking, Housing, and Urban Affairs of the United States Senate, September 30, 2010.

[2] The Plan was submitted pursuant to section 327 of the Dodd-Frank Act. *See,* "Interagency Joint Implementation Plan" at *www.occ.gov/publications/publications-by-type/other-publications/pub-other-jointimplementation-plan.pdf*. The Plan provides additional detail about the agencies' progress in implementing the employee protections that Dodd-Frank provides to transferring OTS employees, including retirement benefits; health, dental, vision, and long-term care; and life insurance. The Plan also discusses the integration of OTS employees into the OCC's pay structure.

[3] The final number of staff who transfer to the OCC will include those personnel who do not transfer to the FDIC to support functions transferred to that agency, those personnel who do not transfer to the CFPB, and those personnel who do not choose to leave the agency for other reasons prior to the transfer date.

Approximately 670 Federal savings associations will be transferred to the OCC on the transfer date. OCC's Community Bank Supervision staff will supervise the vast majority of them, while the Midsize and Large Bank Supervision programs will supervise Federal savings associations with profiles that align with those units. The Special Supervision portfolio will also expand to include certain troubled Federal savings associations. The OCC is working with the OTS to execute an orderly transfer of authority and responsibilities that will ensure the effective supervision of both national banks and Federal savings associations.

To provide thrift supervision leadership continuity and facilitate the integration of the OTS into the OCC, five senior OTS managers responsible for thrift supervision already have accepted positions in OCC's M/CBS organization. Although they will not officially assume these positions until the transfer date, they are actively participating in the OCC's planning activities. Their extensive knowledge of the OTS organization, the staff, and Federal savings associations is an invaluable resource as we prepare for the transition. The OCC is in the process of filling the remaining positions created by the OCC's structural changes through a competitive posting process open to both qualified OTS and OCC staff.

Training and Certification of Employees

Training will be critical to the combined success of the OCC and the OTS. Ultimately, the OCC's National Bank Examiner commission will expand to ensure that each commissioned examiner has the skill set and credentials to lead examinations of both national banks and Federal savings associations. Initially, the agencies are reviewing each of their training and certification programs to identify where OCC and OTS training programs overlap and where gaps need to be addressed.

Review and Continuation of OTS Regulations

Dodd-Frank requires the OCC, the FDIC, and the FRB to identify those continued OTS regulations that each agency will enforce. The OCC and the FDIC must consult with each other in identifying these regulations, and the OCC, the FRB, and the FDIC must publish a list of these identified regulations in the Federal Register not later than the transfer date. The agencies have begun the task of identifying these OTS regulations and will publish the lists required by the legislation on or before the transfer date.

Working together with OTS staff, the OCC is considering how to integrate the OTS's regulations with the OCC's regulations. This process is expected to include certain changes that would be effective as of the July 21, 2011, transfer date and to continue in phases after that date. Any substantive changes proposed to either the OCC's or the OTS's regulations affecting savings associations will be published in the *Federal Register*.

Thrift Industry Outreach

The OCC recognizes the importance of communicating regularly with the industry throughout this process to address concerns, clarify expectations, and promote effective supervision of Federal savings associations. The communication process began with a personal letter that I sent to the chief executive officer of each Federal savings association in September. Two additional letters have been sent since that time to share further information about the integration process. Senior OCC leaders have also accepted numerous invitations to participate in industry-sponsored events that provide an opportunity to speak directly with management representatives of Federal savings associations. Additionally, the OCC has developed a day-long program for thrift executives to provide information and perspective on the agency's approach to supervision and regulation. The OCC District Deputy Comptrollers and OTS Regional Directors are cohosting 17 of these sessions in locations around the country during the first quarter of 2011. More than 1,000 thrift industry representatives have registered to attend one of these sessions. The feedback received from attendees at the first seven sessions has been very positive.

B. Transfers of Specified Functions to the CFPB

OCC has continued to provide extensive assistance to Treasury and the CFPB to support the stand up of the CFPB. We have provided extensive information about our human resources policies and practices, compensation structure and OCC-unique benefits, and copies of all of our position descriptions. We have worked with Treasury and CFPB staff and our payroll provider, the National Finance Center, to enable the CFPB to replicate the OCC's NB pay plan and compensation system, accelerating its ability to hire employees under their own authorities and provide the compensation and benefits allowed for under the Dodd-Frank Act.

In the late fall, OCC established an Expression of Interest process for employees who may be interested in pursuing work with the CFPB, either on a temporary

basis (detail) or permanently. Having a cadre of interested employees has allowed us to respond to requests for assistance with targeted OCC resources with unique skill sets.

The OCC has met with the CFPB implementation team several times over the past few months to discuss a mutually agreeable transfer process for OCC employees who are interested in going to the CFPB and have the requisite skills and experience to perform the work. We are committed to following through on the development and execution of this process.

In addition to human resource related matters, the OCC has responded to numerous data requests, held informational meetings, and provided technical support to assist the CFPB as it develops processes to fulfill its consumer protection function. Informational meetings have been held to discuss OCC processes relating to the Equal Credit Opportunity Act (ECOA), the CARD Act, and general bank supervision as well as enforcement authorities and practices. Consumer compliance policies and training materials have been provided. Extensive meetings have been held with the OCC's Customer Assistance Group and a team leader from this group was detailed to help the CFPB develop its consumer complaints function. Most recently in response to a request for information on the CARD Act, the OCC agreed to make a presentation at the CFPB's seminar on the effects of the CARD Act.

II. Implementation of Dodd-Frank Policy and Rulemaking Initiatives

In my September 2010 testimony, I described the OCC's early postenactment efforts to support the organization and operation of the FSOC and our participation in the important interagency rulemaking projects that were just then starting up. The OCC now is actively working on approximately 85 Dodd-Frank projects ranging in scope from our extensive efforts to prepare to integrate the OTS's staff and supervisory responsibilities to consultation on a variety of rulemakings being undertaken by other agencies. While significant progress has occurred on a number of these policy and rulemaking initiatives, the OCC continues to face substantial challenges in the implementation of some of Dodd-Frank's provisions. This portion of my testimony provides highlights the progress we have made thus far in implementing key Dodd-Frank initiatives and describes the most significant challenges to implementation that we have identified.

A. Rulemaking and Policy Initiatives: Milestones Achieved

Financial Stability Oversight Council

The OCC actively participates in the FSOC. The FSOC's mission is to identify risks to financial stability that could arise from the activities, material financial distress, or failure of large, interconnected financial companies; to recommend standards for implementation by the agencies in specified areas; to promote market discipline; and to respond to emerging threats to the stability of the U.S. financial system.

The FSOC already has undertaken a number of significant actions. At its first meeting in October 2010, the FSOC approved publication of an advance notice of proposed rulemaking (ANPR) seeking public comments regarding the criteria and analytical framework for designation of nonbank financial firms for enhanced supervision by the FRB pursuant to section 113 of the Dodd-Frank Act. Based on a review of comments received and consideration by the members of the FSOC, at its January 2011 meeting the FSOC approved a notice of proposed rulemaking relating to section 113. The proposed rule lays out the framework that the FSOC proposes to use to determine whether a nonbank financial company could pose a threat to the financial stability of the United States. It also implements the process that the FSOC would use when considering whether to subject a firm to supervision by the FRB and heightened prudential standards.

The FSOC has also taken steps to implement the provisions of the Dodd-Frank Act known as the "Volcker Rule," which prohibit banking entities from engaging in proprietary trading and from maintaining certain relationships with hedge funds and private equity funds. The Volcker Rule requires the FSOC to study and make recommendations on implementing its restrictions. Under section 619, the OCC and other agencies must consider the recommendations of the FSOC study in developing and adopting regulations to implement the Volcker Rule. To assist the FSOC in conducting the study and formulating its recommendations, in October 2010 the FSOC issued a request for information through public comment. Based on a review of comments received and consideration by the members of the FSOC, the FSOC issued the Volcker Rule study and recommendations in January 2011. Informed by the study, the rulemaking agencies have begun the process of drafting regulations to implement the Volcker Rule. The statute sets a deadline of October 2011 for completion of that work.

Establishment of the Office of Minority and Women Inclusion

Pursuant to section 342 of the Dodd-Frank Act, the OCC has established an Office of Minority and Women Inclusion. On January 19, 2011, I named Joyce Cofield Director of this office. Ms. Cofield, who has 28 years of experience in human capital management, workforce diversity and business operations, will report to the Comptroller and provide executive direction, set policies, and oversee all matters of the OCC relating to diversity in management, employment, and business activities. The establishment of this office and the appointment of Ms. Cofield will ensure that the OCC will continue to be atop the list of "Best Places To Work" in the Federal Government for issues relating to the broadest definition of diversity.

Incentive Compensation Rulemaking

The OCC, FRB, FDIC, OTS, National Credit Union Administration (NCUA), Securities Exchange Commission (SEC), and Federal Housing Finance Agency (FHFA) (the Agencies) are in the process of issuing a proposal to implement the incentive-based compensation provisions in Section 956 of the Dodd-Frank Act. The proposed rule will require the reporting of certain incentive-based compensation arrangements by a covered financial institution[4] and prohibit incentive-based compensation arrangements at a covered financial institution that provide excessive compensation or that could expose the institution to inappropriate risks that could lead to a material financial loss.

The material financial loss provisions of the proposed rule establish general requirements applicable to all covered institutions and additional requirements applicable to larger covered financial institutions. The generally applicable requirements provide that an incentive-based compensation arrangement, or any feature of any such arrangement, established or maintained by any covered financial institution for one or more covered persons must balance risk and financial rewards and be compatible with effective controls and risk management and supported by strong corporate governance.

The proposed rule includes two additional requirements for "larger financial institutions," which for the Federal banking agencies, NCUA, and the SEC means those covered financial institutions with total consolidated assets of $50 billion or more. First, a larger financial institution must defer 50 percent of incentive-based compensation for its executive officers for a period of at least 3 years. Second, the board of directors (or committee thereof) of a larger financial institution also must identify, and approve the incentive-based compensation arrangements for, individuals (other than executive officers) who have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance. These individuals may include, for example, traders with large position limits relative to the institution's overall risk tolerance and other individuals that have the authority to place at risk a substantial part of the capital of the covered financial institution.

Credit Risk Retention

Section 941 of the Dodd-Frank Act requires the OCC, FRB, FDIC, and SEC to issue joint regulations requiring securitizers of asset-backed securities to retain an economic interest in a portion of the credit risk for assets that the securitizer packages into the securitization for sale to others. Where these regulations address the securitization of residential mortgage assets, the Department of Housing and Urban Development and the FHFA are also part of the joint rulemaking group. The Treasury Secretary, as Chairperson of FSOC, is directed to coordinate the joint rulemaking.

In order to correct adverse market incentive structures revealed by the crisis, section 941 requires the securitizer to retain a portion of the credit risk on assets it securitizes, unless those assets are originated in accordance with conservative underwriting standards established in regulation. This new regulatory regime will give securitizers direct financial disincentives against packaging loans that are underwritten poorly.

As the FRB has noted in its recent study of the securitization markets (also required by section 941), the securitization markets provide an important mechanism

[4] Section 956(e)(2) defines a "covered financial institution" to mean a depository institution or depository institution holding company; a registered broker-dealer; a credit union; an investment adviser; Fannie Mae; Freddie Mac; and "any other financial institution" that the regulators jointly determine, by rule, should be covered by section 956. Institutions with less than $1 billion in assets are not subject to section 956.

for making credit available for businesses, households, and governments.[5] In drafting the proposed rules mandated by section 941, the agencies are taking a number of priorities into account. These include incorporating appropriate incentives that encourage high-quality underwriting of loans included in securitizations; designing robust forms of risk retention that reflect the diversity of securitization structures used in the marketplace; and recognizing the diversity of asset classes commonly securitized. The statute requires the agencies not only to create low-risk underwriting standards for certain asset classes used in securitizations, but also to define the appropriate form and amount of risk retention interests, consider circumstances in which it might be appropriate to shift the retention obligation to the originator of the securitized assets, and create rules addressing complex securitizations backed by other asset-backed securities. Various exemptions from the risk retention requirements also must be implemented. In particular, the banking agencies, SEC, HUD and the FHFA are directed to define "qualified residential mortgages" with underwriting and product features that historical loan performance data indicate result in a lower risk of default. Securitizations of QRMs are specifically exempted from the credit risk retention requirements.

Work on the notice of proposed rulemaking is nearing completion and the agencies hope to be able to publish a proposal in the next month.

B. Implementation Challenges

Capital and Liquidity: Coordination of Dodd-Frank Initiatives With International Reforms

The Dodd-Frank Act focused considerable attention on enhancing the capital and liquidity standards of U.S. financial companies. The banking agencies and FSOC are called upon to develop and publish numerous studies and regulations that will materially affect the level and composition of capital and liquidity for both banks and certain nonbank financial companies. As I have indicated in previous testimony to this Committee[6] and reiterated in a recent speech,[7] one of the main challenges facing supervisors in this area is the need to coordinate Dodd-Frank implementation efforts with agency actions to adopt recent reforms announced by the Basel Committee on Banking Supervision (Basel Committee), the so-called Basel III reforms. While these two significant public policy initiatives are not identical in their design and standards, they share many common objectives and address many of the same underlying issues. It is incumbent on the agencies to consider these reforms in a coordinated, mutually reinforcing manner, so as to enhance the safety and soundness of the U.S. and global banking system, while not damaging competitive equity or restricting access to credit.

As noted above, various provisions of Dodd-Frank seek to enhance the capital and liquidity standards of U.S. financial companies. The U.S. agencies are making appropriate progress in drafting the required studies and regulations to effectuate Congressional intent in these areas. A summary of these efforts is provided below:

- Under sections 115(a) and 115(b) of Dodd-Frank, in order to prevent or mitigate risk to financial stability, the FSOC may make recommendations to the FRB[8] concerning the establishment of prudential standards applicable to nonbank financial companies supervised by the FRB and certain large bank holding companies. These prudential standards, which are to be more stringent than those applicable to other companies that do not pose similar risk to financial stability, are expected to address risk-based capital requirements, leverage limits, and liquidity requirements, among other provisions. The FSOC has commenced work on this project and expects to provide recommendations to the FRB shortly.
- Section 171(b) of Dodd-Frank requires the banking agencies to establish minimum risk-based capital requirements applicable to insured depository institutions, depository institution holding companies, and nonbank financial companies supervised by the FRB. On December 30, 2011, the banking agencies published a notice of proposed rulemaking addressing the requirements of section 171(b). Agencies continue to encourage public comment on this proposal through February 28, 2011.

[5] Board of Governors of the Federal Reserve System, *Report to Congress on Risk Retention,* (October 2010).

[6] *See, supra,* note 1.

[7] *See,* John Walsh, "Acting Comptroller of the Currency, Remarks at the Exchequer Club" (January 19, 2011).

[8] Under section 165 of Dodd-Frank, the FRB, on its initiative or pursuant to recommendations by FSOC under Sections 115(a) and 115(b), shall establish prudential standards applicable to nonbank financial companies supervised by the FRB and certain large bank holding companies.

- Section 115(c) of Dodd-Frank requires the FSOC to conduct a study of the feasibility, benefits, costs, and structure of a contingent capital requirement for certain nonbank financial companies and bank holding companies. FSOC has commenced work on this requirement earlier than initially projected in order to articulate a U.S. position on this important topic in advance of international deliberations at the Basel Committee, Financial Stability Board, and other organizations.
- Section 616(c) of Dodd-Frank amends the International Lending Supervision Act of 1983 by providing that each Federal banking agency shall seek to make capital standards countercyclical, so that the amount of required capital increases in times of economic expansion and decreases in times of economic contraction, consistent with safety and soundness. Consistent with this provision, the agencies are actively considering the establishment of countercyclical capital requirements in proposed regulations implementing the Basel III reforms.

As noted in my testimony before this Committee on September 30 of last year, the Basel III reforms focus on many of the same issues and concerns that the Dodd-Frank Act sought to address. These reforms of the Basel Committee are designed to strengthen global capital and liquidity standards governing large, internationally active banks and promote a more resilient banking sector. Like Dodd-Frank, the Basel III reforms tighten the definition of what counts as regulatory capital by placing greater reliance on higher quality capital instruments; expand the types of risk captured within the capital framework; establish more stringent capital requirements; provide a more balanced consideration of financial stability and systemic risks in bank supervision practices and capital rules; and call for leverage ratio requirement and global minimum liquidity standards. Since the Basel III enhancements can take effect in the U.S. only through formal rulemaking by the banking agencies, U.S. agencies have the opportunity to integrate certain Basel III implementation efforts with the heightened prudential standards required by Dodd-Frank. Such coordination in rulemaking will ensure consistency in the establishment of capital and liquidity standards for similarly situated organizations, appropriately differentiate relevant standards for less complex organizations, and consider broader economic impact assessments in the development of these standards.

Credit Ratings

The OCC recognizes that issues surrounding credit ratings were a significant factor in market overconfidence that contributed to losses in the markets for mortgage-backed securities in 2008–2009. The Dodd-Frank Act includes a number of important remedial measures to address this problem, including structural changes at the ratings agencies, greater SEC oversight of the ratings process, and loan-level disclosures to investors in asset-backed securities. In this context of enhanced regulation that Dodd-Frank provides, the absolute prohibition against any references to ratings under section 939A goes further than is reasonably necessary. Moreover, it has become clear, as we have tried to implement this requirement, that the disadvantages of the prohibition are substantial.

Section 939A of Dodd-Frank requires each Federal agency to review its regulations that refer to, or require the use of, credit ratings in connection with an assessment of the creditworthiness of a security or money market instrument. Each agency must then remove from its regulations any reference to or requirement for reliance on credit ratings and must develop alternative standards of creditworthiness to serve as a substitute for reliance on credit ratings.

In accordance with section 939A, the OCC reviewed its regulations and determined that credit ratings are referenced in two key areas: (1) regulations governing which investment securities banks may purchase and hold; and (2) regulations governing banking institutions' risk-based capital requirements. Together, these regulations prevent banks from making excessively speculative investments and help to assess the relative risk of securities holdings.

In an effort to modify its regulations pursuant to the requirements of section 939A, the OCC published an ANPR in August 2010 requesting comment on alternative creditworthiness measures for its investment securities regulations. Shortly thereafter, the OCC joined with the FDIC and FRB in publishing an ANPR requesting comment on alternatives for the agencies' risk-based capital regulations.

Additionally, the FRB, FDIC, and OCC hosted a forum on alternatives to credit ratings that included representatives from various sectors of the financial industry, including community, regional, and internationally active banking institutions, financial analysts and consultants, credit rating agencies, and insurance industry regulators, as well as members of academia.

The comments received in response to the ANPRs, as well as the discussion during the credit ratings forum, reinforced my concerns. Although the commenters generally concurred with the agencies' stated criteria for developing alternative creditworthiness standards, they failed to suggest practical alternatives that could be implemented across the banking industry.

In response to the OCC's requests for comment on how best to implement section 939A, regional and community banks noted that using internal risk assessment systems to measure credit worthiness for regulatory purposes would be costly and time consuming. These commenters noted that while cost and burden would be a factor for all banks, it is likely to be more pronounced for community and regional banks, and may therefore place them at a disadvantage compared to larger institutions that have advanced analytical capabilities and whose in-house systems and management capabilities could be converted to apply new standards. A number of commenters stated that the costs could be so great as to shut out smaller institutions from being able to purchase certain types of high quality investment securities.

These concerns could be addressed if section 939A is amended in a targeted manner that allows institutions to make limited use of credit ratings. Precluding undue or exclusive reliance on credit ratings, rather than imposing an absolute bar to their use, would strike a more appropriate balance between the need to address the problems created by overreliance on credit ratings with the need to enact sound regulations that do not adversely affect credit availability or impede economic recovery. With appropriate operational and due diligence requirements, credit ratings can be a valuable factor to consider when evaluating the creditworthiness of money market instruments and other securities.

Additionally, without amendment to allow the use of ratings as one of the factors taken into consideration in evaluating creditworthiness, the provision would prevent the Federal banking agencies from implementing internationally agreed capital, liquidity, and other prudential standards—including the strong new Basel III framework that is now being finalized. The banking agencies already have had to propose a limited implementation of an internationally negotiated framework applicable to traded assets. Because of section 939A, the Federal banking agencies' proposal to amend the risk-based capital rules for market risk, published on January 11, 2011, did not include ratings-based provisions that would have significantly increased the amount of capital required to be held against traded assets. The continued inability of the banking agencies to implement important portions of the international standards will adversely affect our ability to negotiate strong new global standards designed to prevent a recurrence of the recent financial crisis.

Inconsistent or Duplicative Supervisory Responsibilities

Other implementation difficulties arise outside the rulemaking context. One example concerns the respective roles of the banking agencies and the CFPB in dealing with consumer complaints. Under the Dodd-Frank Act, the function of handling consumer complaints is not a function that transfers to the CFPB, but the CFPB has various responsibilities concerning consumer complaints. At the same time, other provisions of the Dodd-Frank Act envision that the prudential regulators will also have responsibilities handling consumer complaints, and those responsibilities are not confined to complaints concerning banks of $10 billion or more in asset size. Absent clarification of the CFPB's role, it is difficult for the prudential regulators to determine how to staff their consumer complaint operations, and if we downsize those operations to handle only complaints involving institutions of less than $10 billion in size, it is not clear how complaints involving larger institutions will be handled.

Another area of concern is the confusing overlap of roles of the Federal banking agencies and the CFPB for supervising and enforcing fair lending provisions for insured depository institutions with total assets greater than $10 billion. The Federal banking agencies currently oversee depository institutions' compliance with the Fair Housing Act, the ECOA, and the Federal Reserve Board's Regulation B, using interagency examination guidelines issued by the Federal Financial Institutions Examination Council. Under the Dodd-Frank Act, the banking agencies will continue to perform this function for institutions under our supervision with $10 billion or less in total assets. For larger institutions, the legislation assigns exclusive supervisory responsibility for "Federal consumer financial laws" to the CFPB. The definition of "Federal consumer financial laws" includes the ECOA and Regulation B, but not the Fair Housing Act. Because conduct that violates the Fair Housing Act generally also violates the ECOA, the CFPB's examination for compliance with ECOA should suffice to address compliance with the Fair Housing Act.

However, if the intent of the legislation is for the CFPB to supervise larger institutions for compliance with the ECOA and Regulation B, but for the Federal bank-

ing agencies to supervise such institutions' compliance with the Fair Housing Act, this result risks significant inefficiency and potential confusion regarding accountability in this area.

Another provision presenting potential concerns are the particular requirements for how the prudential supervisors and the CFPB conduct examinations of institutions with $10 billion or more in size. We strongly favor efficient coordination of the activities of the prudential regulators and the CFPB, but the particular requirements set out in the Dodd-Frank Act would direct multistep activities that are inefficient, overbroad, and sufficiently time-consuming that safety and soundness based remedial actions that institutions should be required to take immediately could be delayed.

While we plan to work with the CFPB to ensure appropriate oversight of these activities without creating duplicative and potentially inconsistent supervision, we also believe these areas would benefit from Congressional clarification.

III. Other Developments

At the time of this Committee's Dodd-Frank implementation hearing in September, concerns about foreclosure processing at the largest mortgage servicers were just beginning to command wide attention. In the months since then, the OCC, together with the other Federal banking regulators, has taken unprecedented steps to investigate the problem. This section provides an overview of that work, and the related initiative to develop comprehensive national mortgage servicing standards.

A. Foreclosure Processing Irregularities

Following reports of irregularities in the foreclosure processes of several major mortgage servicers in the latter part of 2010, the OCC, together with the FRB, the FDIC, and the OTS, undertook an unprecedented project of coordinated horizontal examinations of foreclosure processing at the 14 largest [9] federally regulated mortgage servicers during fourth quarter 2010. In addition, the agencies conducted interagency examinations [10] of MERSCORP and its wholly owned subsidiary, Mortgage Electronic Registration Systems, Inc. (MERS), and Lender Processing Servicers (LPS), which provide significant services to support mortgage servicing and foreclosure processing across the industry. The primary objective of the examinations was to evaluate the adequacy of controls and governance over bank foreclosure processes, including compliance with applicable Federal and State law. Examiners also evaluated bank self assessments and remedial actions as part of this process, assessed foreclosure operating procedures and controls, interviewed bank staff involved in the preparation of foreclosure documents, and reviewed approximately 2,800 borrower foreclosure cases [11] in various stages of foreclosure. Examiners focused on foreclosure policies and procedures, organizational structure and staffing, vendor management including use of third parties, including foreclosure attorneys, quality control and audits, accuracy and appropriateness of foreclosure filings, and loan document control, endorsement, and assignment. When reviewing individual foreclosure files, examiners checked for evidence that servicers were in contact with borrowers and had considered alternate loss mitigation efforts, including loan modifications, in addition to foreclosure.

To ensure consistency in the examinations, the agencies used standardized work programs to guide the assessment and document findings of each institution's corporate governance process and the individual case review. Specifically, work programs were categorized into the following areas:

- *Policies and Procedures*—Examiners determined if the policies and procedures in place ensured adequate controls over the foreclosure process and that affidavits, assignments, and other legal documents were properly executed and notarized in accordance with applicable laws, regulations, and contractual requirements.

[9] Agencies conducted foreclosure-processing examinations at Aurora Bank, Bank of America, Citibank, EverBank, GMAC/Ally Bank, HSBC, OneWest, JPMC, MetLife, PNC, Sovereign Bank, SunTrust, U.S. Bank, and Wells Fargo.

[10] The interagency examination of MERS was led by the OCC with participation by the FHFA, FRB, FDIC, and OTS. The interagency examination of LPS was led by the FRB with participation by FDIC, OCC, and OTS.

[11] The foreclosure file sample was selected independently by examination teams based on preestablished criteria. Foreclosure files at each bank were selected from the population of in-process and completed foreclosures during 2010. In addition, the foreclosure file sample at each bank included foreclosures from both judicial States and nonjudicial States.

- *Organizational Structure and Staffing*—Examiners reviewed the functional unit(s) responsible for foreclosure processes, including staffing levels, qualifications, and training programs.
- *Management of Third-Party Service Providers*—Examiners reviewed the financial institutions' governance of key third parties used throughout the foreclosure process.
- *Quality Control and Internal Audits*—Examiners assessed foreclosure quality control processes. Examiners also reviewed internal and external audit reports, including Government-sponsored enterprise (GSE) and investor audits and reviews of foreclosure activities, and institutions' self-assessments to determine the adequacy of these compliance and risk management functions.
- *Compliance With Applicable Laws*—Examiners checked compliance with applicable State and local requirements as well as internal controls intended to ensure compliance.
- *Loss Mitigation*—Examiners determined if servicers were in direct communication with borrowers and whether loss mitigation actions, including loan modifications, were considered as alternatives to foreclosure.
- *Critical Documents*—Examiners determined whether servicers had control over the critical documents in the foreclosure process, including appropriately endorsed notes, assigned mortgages, and safeguarding of original loan documentation.
- *Risk Management*—Examiners determined whether institutions appropriately identified financial, reputation, and legal risks, and whether these risks were communicated to the board of directors and senior management.

In general, the examinations found critical deficiencies and shortcomings in foreclosure governance processes, foreclosure document preparation processes, and oversight and monitoring of third party law firms and vendors. These deficiencies have resulted in violations of State and local foreclosure laws, regulations, or rules and have had an adverse affect on the functioning of the mortgage markets and the U.S. economy as a whole. By emphasizing timeliness and cost efficiency over quality and accuracy, examined institutions fostered an operational environment that is not consistent with conducting foreclosure processes in a safe and sound manner.

Despite these deficiencies, the examination of specific cases and a review of servicers' custodial activities found that loans were seriously delinquent, and that servicers maintained documentation of ownership and had a perfected interest in the mortgage to support their legal standing to foreclose. In addition, case reviews evidenced that servicers were in contact with troubled borrowers and had considered loss mitigation alternatives, including loan modifications. A small number of foreclosure sales should not have proceeded because of an intervening event or condition, such as the borrower: (a) being covered by the Servicemembers Civil Relief Act; (b) filing bankruptcy shortly before the foreclosure action; or (c) being approved for a trial period modification.

While all servicers exhibited some deficiencies, the nature of the deficiencies and the severity of issues varied by servicer. The OCC and the other Federal banking agencies with relevant jurisdiction are in the process of finalizing actions that will incorporate appropriate remedial requirements and sanctions with respect to the servicers within their respective jurisdictions. We also continue to assess and monitor servicers' self-initiated corrective actions. We expect that our actions will comprehensively address servicers' identified deficiencies and will hold servicers to standards that require effective and proactive risk management of servicing operations, and appropriate remediation for customers who have been financially harmed by defects in servicers' standards and procedures.

We also intend to leverage our findings and lessons learned in this examination and enforcement process to contribute to the development of national mortgage servicing standards. This initiative is discussed in more detail below.

B. New National Mortgage Servicing Standards

The interagency foreclosure processing examinations revealed significant weaknesses in mortgage servicing related to foreclosure oversight and operations. Outside the scope of the foreclosure review, however, we have also seen servicing-related problems arise for borrowers seeking mortgage relief.

Two practices in particular are generally recognized to have adversely affected borrowers seeking to avoid foreclosure. For example, I have questioned the practice of continuing foreclosure proceedings even when a trial modification had been negotiated and is in force—the so-called "dual track" issue. Indeed, the OCC has directed national bank servicers to suspend foreclosure proceedings for borrowers in success-

fully performing trial modifications when they have the legal ability under the servicing contract to do so. Another significant issue relates to the sufficiency of staffing. Frequently, troubled borrowers find that there is no one individual or team who takes responsibility for monitoring and acting on their loan modification requests. This can lead to lost time, lost documents, and lost homes. These borrowers need to have a single point of contact that they can go to in these situations. And servicers need to have appropriately trained and dedicated staff, reporting to management, with the authority and responsibility to address the borrower's concerns so they cannot "fall through the cracks."

But the problems with servicing are not limited to the practices affecting delinquent loans, and recent experience highlights the need for uniform standards for mortgage servicing that apply to all facets of servicing the loan, from loan closing to payoff. The OCC believes that mortgage servicing standards should apply uniformly to all mortgage servicers and provide the same safeguards for consumers, regardless of whether a mortgage has been securitized. To be meaningful and effective, these standards should be directly enforceable by Federal and State agencies rather than rely on the actions of private parties to enforce the terms of servicing contracts affecting a limited class of mortgage loans. A key driver of servicing practices has been and continues to be secondary market requirements. We will not achieve improvements in mortgage servicing without corresponding changes in requirements imposed by the GSEs.

To further this effort and discussion, the OCC developed a framework for comprehensive mortgage servicing standards that we shared with other agencies, and we are now participating in an interagency effort to develop a set of comprehensive and robust, nationally applicable mortgage servicing standards. Our objective is to develop uniform standards that govern processes for:

- Handling borrower payments, including applying payments to principal and interest and taxes and insurance before they are applied to fees, and avoiding payment allocation processes designed primarily to increase fee income;
- Providing adequate borrower notices about their accounts and payment records, including a schedule of fees, periodic and annual statements, and notices of payment history, payoff amount, late payment, delinquency, and loss mitigation;
- Responding promptly to borrower inquiries and complaints, and promptly resolving disputes;
- Providing an avenue for escalation and appeal of unresolved disputes;
- Effective incentives to work with troubled borrowers, including early outreach and counseling;
- Making good faith efforts to engage in loss mitigation and foreclosure prevention for delinquent loans, including modifying loans to provide affordable and sustainable payments for eligible troubled borrowers;
- Implementing procedures to ensure that documents provided by borrowers and third parties are maintained and tracked so that borrowers generally will not be required to resubmit the same documented information;
- Providing an easily accessible single point of contact for borrower inquiries about loss mitigation and loan modifications;
- Notifying borrowers of the reasons for denial of a loan modification, including information on the NPV calculation;
- Implementing strong foreclosure governance processes that ensure compliance with all applicable legal standards and documentation requirements, and oversight and audit of third party vendors;
- Not taking steps to foreclose on a property or conduct a foreclosure sale when the borrower is in a trial or permanent modification and is not in default on the modification agreement; and
- Ensuring appropriate levels of trained staff to meet current and projected workloads.

We are still at a relatively early stage in this process, but the fact that we share these common objectives will help ensure that the agencies can achieve significant reforms in mortgage servicing practices across the board for all types of mortgage servicing firms.

IV. Conclusion

Let me close by assuring the Committee that, as we work to implement the initiatives required by the Dodd-Frank Act, the OCC remains fully engaged in its pri-

mary mission of ensuring the safety and soundness as well as the vibrancy of the national banking system.

We continue to closely monitor and evaluate developments in the system. The system is beginning to return to profitability—though revenue generation and margins are low compared to historical experience. In the large banks, we see a return to balance sheet strength as capital, reserve, and liquidity levels have been rebuilt over the past 3 years. Although credit risk remains elevated, we see steady improvements contributing to an overall lower risk profile in the largest banks. Conditions are also stabilizing for community banks. While embedded losses continue to produce bank failures among community banks, the vast majority of community banks continue to play a vibrant role in the Nation's financial system. But, going forward, banks of all sizes will face a business landscape that is significantly changed by postcrisis market developments and by new rules implementing Dodd-Frank. These developments affect both the ability of banks to generate revenue and the costs and viability of particular activities or lines of business. Their efficiency may be affected in the shorter term and their business models in the long run. The OCC is committed to supervising the effects of these changes to ensure the continuing safety and soundness of the national banks we supervise.

I appreciate this opportunity to update the Committee on the work we are doing to implement Dodd-Frank and I am happy to answer your questions.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM BEN S. BERNANKE

Q.1. Recently, some have voiced concerns that the timeframe for the rulemakings required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is too short to allow for adequate consideration of the various comments submitted or to review how the new rules may impact our financial markets. Does the current timeframe established by Dodd-Frank allow each rulemaking to be completed in a thoughtful and deliberative manner?

A.1. Response not provided.

Q.2. Please identify the key trends in the derivatives market that your agencies are currently monitoring to ensure systemic stability.

A.2. Response not provided.

Q.3. In defining the exemption for "qualified residential mortgages," are the regulators considering various measures of a lower risk of default, so that there will not just be one "bright line" factor to qualify a loan as a Q.R.M.?

A.3. Response not provided.

Q.4. What data are you using to help determine the definition of a Qualified Residential Mortgage?

A.4. Response not provided.

Q.5. Dodd-Frank (Sec 939A) required the regulators to remove any reference or requirement of reliance on credit ratings from its regulations. In his testimony, Acting Comptroller of the Currency John Walsh wrote: "[R]egional and community banks noted [in their comments] that using internal risk assessment systems to measure credit worthiness for regulatory purposes would be costly and time consuming . . . . These concerns could be addressed if section 939A is amended in a targeted manner that allows institutions to make limited use of credit ratings. Precluding undue or exclusive reliance on credit ratings, rather than imposing an absolute bar to their use, would strike a more appropriate balance between the need to address the problems created by overreliance on credit ratings with the need to enact sound regulations that do not adversely affect credit availability or impede economic recovery."

What is the status of this effort and what types of alternative measures are being considered? Do you share the concerns raised by community banks, and what is your reaction to Acting Comptroller Walsh's comments on this issue?

A.5. Response not provided.

Q.6. Please discuss the status of your efforts to implement the stress test provisions under Dodd-Frank? To what extent have you collaborated with the other banking regulators and how do you plan to leverage the Office of Financial Research?

A.6. Response not provided.

Q.7. Please discuss the current status and timeframe of implementing the Financial Stability Oversight Council's (FSOC) rulemaking on designating nonbank financial companies as being systemically important. As a voting member of FSOC, to what extent is the Council providing clarity and details to the financial market-

place regarding the criteria and metrics that will be used by FSOC to ensure such designations are administered fairly? Is the intent behind designation decisions to deter and curtail systemically risky activity in the financial marketplace? Are diverse business models, such as the business of insurance, being fully and fairly considered as compared with other financial business models in this rulemaking?

A.7. Response not provided.

Q.8. On February 1, the Fed decided to not move forward with three Regulation Z rulemakings, instead deferring to the CFPB to complete these rules. There are three additional Regulation Z rulemakings pending. Does the Fed intend to complete these rulemakings?

A.8. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM BEN S. BERNANKE

Q.1. The Dodd-Frank Act requires an unprecedented number of rulemakings over a short period of time. As a result, some deadlines have already been missed and some agencies expect to miss additional deadlines. It appears that many of the deadlines in Dodd-Frank are not realistic. Which Dodd-Frank deadlines do you anticipate not being able to meet? If Congress extended the deadlines, would you object? If your answer is yes, will you commit to meeting all of the statutory deadlines? If Congress affords additional time for rulemaking under the Dodd-Frank Act, will you be able to produce higher-quality, better coordinated rules?

A.1. The Board has made considerable progress in carrying out its assigned responsibilities for issuing final rules under the Dodd-Frank Act. In October, for example, the Board issued an interim final rule to ensure that real estate appraisers are free to use their independent professional judgment in assigning home values without influence or pressure from those with interests in the transactions. The rule also seeks to ensure that appraisers receive customary and reasonable payments for their services. In February, the Board announced its approval of a final rule to implement the provisions of the Act that give banking firms a period of time to conform their activities and investments to the prohibitions and restrictions of the so-called Volcker Rule. The Board recognizes the concern expressed by the Congress regarding agency delay in the rulemaking process and will work to ensure that the law is implemented in a manner that is timely, best protects the stability of our financial system, and strengthens the U.S. economy.

The Board maintains a projected schedule of rulemakings on its public Web site. While the Board generally has met the congressionally mandated schedule in the Dodd-Frank Act, the Board recently announced that final action on the implementation of the debit interchange fee standards and related rules under section 1075 of the Act will be delayed beyond the April 21, 2011, action date in the Act. The Board has devoted significant resources to timely completion of the rulemaking and expects that due to the complexity of this rulemaking, importance of the issues it raises,

and the significant amount of public comment received, the Board will act on the final rule before the July 21, 2011, effective date of the statutory requirement.

The provisions of the Dodd-Frank Act are important and grew out of the exigencies and difficulties experienced during the recent financial crisis. It is important that the steps taken by Dodd-Frank Act be implemented well and in a timely fashion. We will continue to work diligently to meet whatever schedule Congress determines is appropriate for effectively implementing and executing the policy objectives of the Act.

Q.2. Secretary Geithner recently talked about the difficulty of designating nonbank financial institutions as systemic. He said, "it depends too much on the state of the world at the time. You won't be able to make a judgment about what's systemic and what's not until you know the nature of the shock." [1] If it is impossible to know which firms are systemic until a crisis occurs, the Financial Stability Oversight Council will have a very difficult time objectively selecting systemic banks and nonbanks for heightened regulation. As a member of the Council, do you believe that firms can be designated *ex ante* as systemic in a manner that is not arbitrary? If your answer is yes, please explain how.

A.2. The Dodd-Frank Act requires the Council to designate nonbank financial firms for Federal Reserve supervision and regulation if material financial distress at the firm could pose a threat to U.S. financial stability. Making designation decisions will be challenging, but we are committed to assisting the Council in devising standards and processes for designations that are as consistent across firms as reasonably possible. Certain characteristics—such as a firm's size, its interconnectedness with other firms or markets, and the availability of substitutes for the financial services it provides—will affect the likelihood and the magnitude of spillovers from a firm's distress to the broader financial system and real economy in a variety of stress scenarios. The Council is also considering factors that are intended to account for different types of economic conditions in determining designations.

The Council has issued a notice of proposed rulemaking on the nonbank financial firm designation process that indicates the Council's intent to incorporate information on these characteristics into its designation process. The Council's decisions about the designation of nonbank financial firms will be based on substantial information and analysis about the characteristics of financial firms and markets and will provide significant due process to affected companies.

Q.3. Section 112 of the Dodd-Frank Act requires the Financial Stability Oversight Council to annually report to Congress on the Council's activities and determinations, significant financial market and regulatory developments, and emerging threats to the financial stability of the United States. Each voting member of the Council must submit a signed statement to the Congress affirming that

[1] *See,* Special Inspector General for the Troubled Asset Relief Program, "Extraordinary Assistance Provided to Citigroup, Inc." (SIGTARP 11-002) (Jan. 13, 2011) (available at: *http://www.sigtarp.gov/reports/audit/2011/Extraordinary%20Financial%20Assistance%20Provided%20to%20Citigroup,%20Inc.pdf*), at 43.

such member believes the Council, the Government, and the private sector are taking all reasonable steps to ensure financial stability and mitigate systemic risk. Alternatively, the voting member shall submit a dissenting statement. When does the Council expect to supply the initial report to Congress?

A.3. Section 112 requires the Council to make an annual report to Congress. The Council has been working diligently to implement its statutory authorities and responsibilities outlined under section 112 of the Dodd-Frank Act. For example, the Council has begun to develop a framework and infrastructure to evaluate potential systemic risks to the financial stability of the United States and to monitor financial market and regulatory developments. As a member agency of the Council, the Board is providing assistance to the Council in these efforts. The Board is committed to continuing to work with the Council and the other member agencies to assist the Council in implementing all of its responsibilities and duties under section 112 within the timeframe provided under the Act. The Board expects the Council will submit its report to Congress by July 21, 2011.

Q.4. Which provisions of Dodd-Frank create the most incentives for market participants to conduct business activities outside the United States? Have you done any empirical analysis on whether Dodd-Frank will impact the competitiveness of U.S. financial markets? If so, please provide that analysis.

A.4. The extent to which the Dodd-Frank Act creates incentives for market participants to conduct business activities outside the United States will depend importantly on (i) the extent to which other major jurisdictions adopt similar regulatory frameworks and (ii) the manner in which the Federal financial regulatory agencies implement the provisions of the Act. The outcomes of both of these processes are far from over. As a result, assessing the extent to which the Dodd-Frank Act might provide incentives for financial firms to move businesses overseas is difficult at this time.

International coordination of financial reform is essential for achieving global financial stability. Fortunately, from the U.S. perspective, the international agenda to date has been well aligned with the Dodd-Frank Act and the complementary endeavors of the U.S. financial regulatory agencies. We have worked hard in the Basel Committee and Financial Stability Board over the past few years to achieve international regulatory outcomes that are consistent with U.S. reform goals, and there are a few areas where we in the United States are continuing to work particularly hard to keep our reforms well aligned with international efforts. These areas include, among others, our efforts as part of the Financial Stability Oversight Council to establish criteria for measuring the systemic importance of nonbank financial firms, our ongoing work to determine how to apply the stricter prudential standards for systemically important financial firms under the Dodd-Frank Act to foreign banks, and the implementation of Dodd-Frank reforms for over-the-counter derivatives and incentive compensation. We hope that all countries will similarly strive to harmonize domestic rules with international standards.

Of course, some parts of the Dodd-Frank Act are unlikely to become part of the international financial regulatory framework. For example, the Volcker Rule in section 619 limits the authority of banks to engage in proprietary trading of securities and derivatives and to sponsor and invest in private funds. The derivatives push-out rule in section 716 forces U.S. banks to push certain derivatives activities into affiliates. Section 622 of the Act also contains a financial sector concentration limit. We understand that other countries are unlikely to adopt these sorts of restrictions.

Although not all aspects of financial reform will be perfectly consistent across countries, our challenge is nevertheless to achieve global consistency on the core reforms necessary to protect financial stability while providing a playing field that is as level as possible. Achieving these objectives will require a continued commitment to international collaboration and a resolve to continue to push reforms forward, even as the pressures for reform generated by the financial crisis begin to ease.

To the extent consistent with its statutory obligations, the Board will consider competitive considerations as we work to implement the provisions of the Act and will monitor the competitive and other effects of the Act as part of our ongoing efforts to protect U.S. financial stability and the safety and soundness of U.S. financial institutions.

Q.5. More than 6 months have passed since the passage of the Dodd-Frank Act, and you are deeply involved in implementing the Act's approximately 2,400 pages. Which provisions of the Dodd-Frank Act are proving particularly difficult to implement? Have you discovered any technical or substantive errors in the Dodd-Frank legislation? If so, please describe them.

A.5. The Board has made considerable progress in completing its assigned responsibilities under the Act. As we continue to work through our rulemaking and other implementation projects, we will communicate challenges, including technical or substantive errors we encounter in the legislation, to you in response to this inquiry.

Q.6. What steps are you taking to understand the impact that your agency's rules under Dodd-Frank will have on the U.S. economy and its competitiveness? What are the key ways in which you anticipate that requirements under the Dodd-Frank Act will affect the U.S. economy and its competitiveness? What are your estimates of the effect that the Dodd-Frank Act requirements will have on the jobless rate in the United States?

A.6. Since the Dodd-Frank Act was enacted, the Federal Reserve, both independently and in conjunction with other agencies, has made considerable progress towards adopting regulations designed to promote financial market stability, strengthen financial institutions, and reduce systemic risk to the financial system and the economy. Measuring the impact of these regulations on the overall economy, however, is exceptionally challenging, especially given that many significant Government regulations aimed at strengthening the financial system and financial institutions are still in development. And even after the various provisions of the act are implemented, any estimate of their economic effects would be inherently quite uncertain. Nevertheless, the effects of the act are likely

to be much less important than those of other factors now influencing unemployment and economic growth. In particular, the current slow pace of the recovery appears to be primarily driven by ongoing problems in the housing market and the commercial construction sector, the extremely tight budget conditions facing State and local governments, and a general need for many households and firms to repair their balance sheets in the wake of falling real estate values and a deep recession.

As noted in the study issued by the Secretary of the Treasury pursuant to section 123 of the Dodd-Frank Act, financial regulation can affect the economy through two main channels. First, financial regulation can affect the supply and cost of credit by promoting or inhibiting allocative efficiency, which in turn can have implications for the overall economy. Financial regulation also can affect the riskiness of individual financial institutions and the financial system as a whole. For example, financial regulations that reduce default risk will help lower the expected cost of resolutions, thereby benefiting the economy by making systemic financial crises less likely. Thus, regulations that increase efficiency and reduce excessive risk-taking can bring substantial long-run benefits to American households and firms. As the experience of the last few years amply demonstrates, financial instability can be extremely costly in terms of unemployment and overall economic well-being.

The Federal Reserve is cognizant of the fact that poorly designed rules can adversely affect the supply and cost of credit, or unintentionally increase risk. Accordingly, examining proposed rules for their possible unintended consequences is a key part of Federal Reserve rulemaking. In exercising its rulemaking authority under the act, the Federal Reserve strives to avoid any disruption to the functioning of the financial system and the broader economy that might be caused by its rules.

With respect to global competitiveness, the Federal Reserve (together with other U.S. Government regulatory agencies) seeks to preserve a level playing field that will continue to allow U.S. companies to compete effectively and fairly in the global economy through ongoing discussions with foreign supervisory authorities on possible changes to bank capital standards and other international rules affecting financial markets and firms.

Q.7. What steps are you taking to assess the aggregate costs of compliance with each Dodd-Frank rulemaking? What steps are you taking to assess the aggregate costs of compliance with all Dodd-Frank rulemakings, which may be greater than the sum of all of the individual rules' compliance costs? Please describe all relevant reports or studies you have undertaken to quantify compliance costs for each rule you have proposed or adopted. Please provide an aggregate estimate of the compliance costs of the Dodd-Frank rules that you have proposed or adopted to date.

A.7. The Board complies with its obligation under the Paperwork Reduction Act (PRA) (44 U.S.C. 3501, *et seq.*) to estimate the paperwork burden (specifically record keeping, reporting, and disclosure requirements) imposed by the Board's rules and to keep this burden as low as possible. As required under the PRA, the Board seeks public comment on the paperwork burden imposed by its

rules by providing notice in the *Federal Register*. The level of burden estimated under the PRA is then described, in detail, in the *Federal Register* notice for each final rule adopted by the Board, after taking account of the comments received during the public comment process. These *Federal Register* notices and final burden estimates are best evaluated in the context of each statutorily required rule and can be found on the Board's public Web site.

Q.8. The Fed, the SEC, the FDIC, and the CFTC are all structured as boards or commissions. This means that before they can implement a rule they must obtain the support of a majority of their board members. How has your board or commission functioned as you have been tackling the difficult job of implementing Dodd-Frank? Have you found that the other members of your board or commission have made positive contributions to the process?

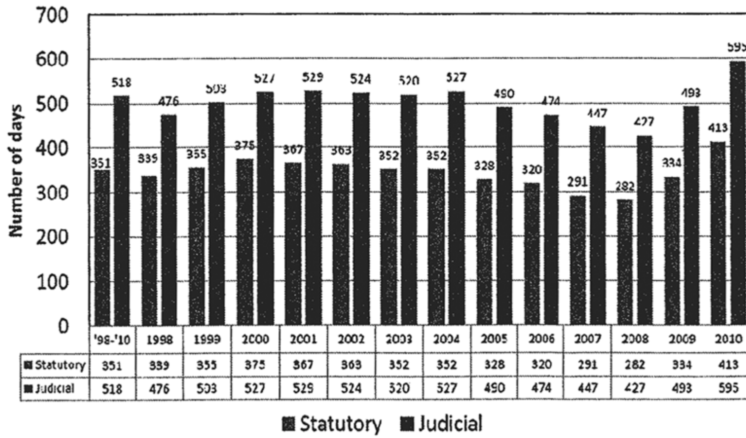
A.8. The members of the Board of Governors are working cooperatively and constructively to implement the provision of the Dodd-Frank Act. The Board has established a series of committees that allow for direct input by Board members into, and supervision of staff working on, each Dodd-Frank rulemaking. This approach has allowed the Board to draw on the expertise of its members and, at the same time, work in an efficient and collaborative way. All rules are then reviewed by the full Board before being published for comment and then again before final adoption.

To aid the Board in these efforts, since the enactment of the Dodd-Frank Act, the Board has approved a number of staffing and organizational changes, drawing on resources from across the Federal Reserve System in areas such as banking supervision, economic research, financial markets, consumer protection, payments, and legal analysis. In all, more than 300 staff are working to assist in completing the Dodd-Frank Act rulemakings and related provisions. The Board also has created a senior staff position to coordinate our efforts and developed project reporting and tracking tools to facilitate management and oversight of all of our implementation responsibilities. The Board's Senior Advisor for Regulatory Reform Implementation provides updates to the Board on progress and ensures that important issues are put before the Board and other system leaders for resolution.

Q.9. Numerous calls have arisen for a mandatory "pause" in foreclosure proceedings during the consideration of a mortgage modification. Currently, what is the average number of days that customers of the institutions that you regulate are delinquent at the time of the completed foreclosure? If servicers were required to stop foreclosure proceedings while they evaluated a customer for mortgage modification, what would be the effect on the foreclosure process in terms of time and cost. What effect would these costs have on the safety and soundness of institutions within your regulatory jurisdiction. Please differentiate between judicial and nonjudicial States in your answers and describe the data that you used to make these estimates.

A.9. As of year-end 2010, the average number of days between a delinquency start and foreclosure completion had grown to 474 days from 378 days at year-end 2009. For the period from 1998 through 2010, the number of days from delinquency to foreclosure

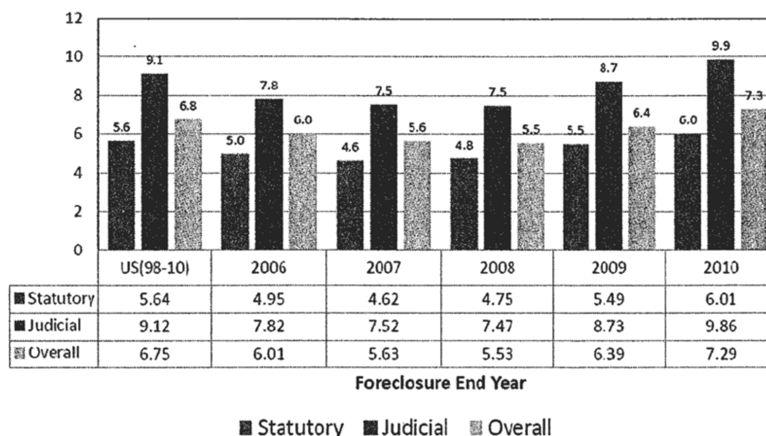
was, on average, 404 days. The number of days required to complete a foreclosure is higher in judicial States as the first table below demonstrates.



The second table shows the average amount of lost expense as a percent of a foreclosure balance.[1] The data indicate that lengthening the number of days required to complete a foreclosure adds to the relative cost of the overall process, and the cost is higher in judicial States. Although it is difficult to quantify the incremental effect of further procedural delays in foreclosures, delays and uncertainty resulting from flaws in the foreclosure process have the potential to delay recovery in housing markets and to undermine confidence in our financial and legal systems. For this reason, the Federal Reserve has emphasized the importance of using loan modifications as a means to prevent avoidable foreclosures and continues to encourage effective loan modifications as the most beneficial outcome from both consumers and the banking industry.

[1] Lost interest expense is computed by first multiplying one-twelfth of the annual interest rate on the loan by the number of months between the start of delinquency and the foreclosure. This product is then divided by the loan balance at foreclosure end to get costs as a percent of loan balance.

Average Lost Interest Expense as Percent of Foreclosure Balance
By Year of Completed Foreclosure
National Average, First Liens, Statutory, Judicial versus overall US



Source: LPS (Lender Processing Services Inc.) and Federal Reserve Bank of Philadelphia RADAR Group

Q.10. The burden of complying with Dodd-Frank will not affect all banks equally. Which new Dodd-Frank Act rules will have the most significant adverse impact on small and community banks? Which provisions of Dodd-Frank will have a disparate impact on small banks as compared to large banks? Do you expect that the number of small banks will continue to decline over the next decade? If so, is the reason for this decline the Dodd-Frank Act? Have you conducted any studies on the costs Dodd-Frank will impose on small and community banks? If so, please describe the results and provide copies of the studies.

A.10. The reforms contained within the Dodd-Frank Act are principally directed at constraining the activities and risks of the largest, most interconnected financial institutions, not at small or community banks. Moreover, small and community banks are exempted from many of the Act's restrictions. Accordingly, the Act as a whole should help level the competitive playing field between large and small banks. However, many community banks are concerned about an expected increase in overall regulatory burden as a result of the Act's implementation.

For example, many community banks are concerned about potential future regulatory burden from new consumer protection rules they expect to be promulgated by the Consumer Financial Protection Bureau (CFPB) established under Dodd-Frank. Many community banks are also concerned about Dodd-Frank's regulation of debit card interchange fees, noting that proposed requirements will raise their operating costs and that caps imposed on the amount that large banks may charge for interchange could result in a significant decline in revenues for smaller banks, a substantial concern given the relatively limited options small banks have for earn-

ing noninterest income. Other provisions of the Act that raise concerns for community banks include the provision that prohibits Federal agencies from using credit ratings in their regulations, and provisions that could apply central clearing and trading requirements or swap dealer regulation to the OTC derivatives activities of small banks.

The number of small banks has been declining steadily for a number of decades. This trend reflects a highly competitive market for financial products and services, as well as significant demographic and technological changes. Legislation has also affected the number of small banks in the United States by, for example, allowing interstate banking and eliminating the requirement for a bank holding company to own a separate bank in each of the states in which it was operating. While many community banks have argued that the costs of complying with new regulatory burdens arising from the Dodd-Frank Act will accelerate the decline in the number of small banks, relatively few of the major provisions of Dodd-Frank apply in a meaningful way to small banks. As a result, it is not clear that Dodd-Frank will be a material driver of future declines in the numbers of small banks in the United States. To date, we have not conducted a study on the costs Dodd-Frank will impose on small and community banks.

The Federal Reserve is committed to working with the other U.S. financial regulatory agencies to implement the Dodd-Frank Act and related reforms in a manner that both achieves the law's key financial stability objectives and appropriately takes into account the risk profiles and business models of small and community banks.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM BEN S. BERNANKE

Q.1. It is my understanding that the Federal Reserve has a 1,887 page supervision manual for Bank Holding Companies, a 1,767 page supervision manual for commercial banks, and a 675 page manual for trading and capital markets activities, and several other supervision manuals that apply to your covered institutions. I appreciate that there is a lot of ground for the Federal Reserve staff examiners to cover. For the largest financial institutions, what is the process for ensuring that your examiners cover all of the applicable materials from these manuals on a regular basis at each institution?

A.1. The Federal Reserve's risk-focused program for supervising the largest banking organizations on a consolidated basis entails developing a comprehensive understanding of each organization and assessing the risks to which each organization is exposed. A supervisory plan is tailored to each organization based on this institutional understanding and risk assessment and typically includes a combination of continuous onsite and offsite monitoring, targeted examination/inspection activities, and detailed reviews of operations and internal controls. In addition to extensive supervision at the individual firm level, these organizations are grouped into a portfolio of firms which facilitates cross-portfolio peer perspectives. The findings from the supervisory activities conducted

throughout the year are combined into a comprehensive assessment that leads to the assignment of supervisory ratings.

In conducting these activities, examiners are expected to utilize sufficient examination procedures to reach informed judgments on the factors included in the rating systems for State member banks and bank holding companies, as appropriate. The Federal Reserve ensures the integrity of this process through oversight by senior Board and System officials and through a quality assurance process that includes horizontal reviews of activities across organizations and reviews of Reserve Bank operations. The Federal Reserve's supervisory manuals are intended to serve as reference documents for staff as they engage in supervisory activities. Staff is not expected to review each element contained in these manuals because the supervision of the largest institutions is tailored to an institution's unique business activities and risk profile.

Q.2. Do you believe that the Federal Reserve needs to conduct routine, full-scale examinations of the largest firms in order to identify risks and concerns that may not be identified by the firms themselves?

A.2. As noted above, Federal Reserve staff develops and executes a comprehensive supervisory plan tailored to the areas of primary risk for each banking organization, with the depth and breadth of the plan typically being greater for the largest and most complex organizations, as well as those with the most dynamic risk profiles. A primary objective of these supervisory activities is to understand and assess an organization's ability to identify, measure, monitor, and control primary risks to the consolidated organization, and examination and other activities are undertaken to maintain this understanding and assessment across risk management and control functions (credit, legal, and compliance, liquidity, market, operational, and reputational risks) for the consolidated organization. These activities result in supervisory assessments that are comparable to those generated under a routine, full scope examination.

For each banking organization there are selected portfolios and business lines that are primary drivers of risk or revenue, or that otherwise materially contribute to understanding inherent risk or assessing controls for a broader corporate function. Independent from each firm's internal efforts to identify risks and concerns, Federal Reserve staff analyze external factors and internal trends in the firm's strategic initiatives—as evidenced by budget and internal capital allocations and other factors—to identity significant activities and areas vulnerable to volatility in revenue, earnings, capital, or liquidity that represent material risks for the organization. This determination of material portfolios and business lines considers all associated risk elements, including legal and compliance risks.

A wide variety of examination and other supervisory activities are utilized by Federal Reserve staff to identify, understand, and assess primary firmwide risk management or control mechanisms, and the underlying material portfolios and business lines. These activities may identify certain functions that require more intensive supervisory focus due to significant change in inherent risk, control processes, or key personnel; potential concerns regarding

the adequacy of controls; or the absence of sufficiently recent examination activities for a primary firmwide risk management or control function, either by the Federal Reserve or another primary supervisor or functional regulator.

It is important to add that with passage of the Dodd-Frank Act, the Federal Reserve and other agencies are expected to supervise financial institutions and critical infrastructures with an eye toward not only the safety and soundness of each individual firm, but also taking into account risks to overall financial stability. In response, the Federal Reserve is developing a macroprudential approach to supervision with explicit focus on identifying risks and concerns, strengthening systemic oversight and addressing stability concerns.

Q.3. Can you provide your view on the Basel III framework and also the extent, if any, that Basel III may conflict with the requirements of the Dodd-Frank Act and how are you responding to these conflicts?

A.3. The Board of Governors of the Federal Reserve System (Board) actively participates on and contributes to the work of the Basel Committee on Banking Supervision (BCBS) to advance sound supervisory policies for internationally active banking organizations and improve the stability of the international banking system. On December 16, 2010, the BCBS published, "Basel III: A global regulatory framework for more resilient banks and banking systems." The Basel III framework, as part of the BCBS's ongoing efforts to improve the resilience of the banking sector, increases the quality, quantity, consistency, and transparency of capital, introduces new global liquidity standards, and strengthens capital requirements for certain risk exposures. The Board generally supports the Basel III framework and will continue working collaboratively with the BCBS and the Financial Stability Board in the ongoing efforts to develop an appropriate approach to ensure that systemically important financial institutions have a sufficient degree of loss-absorbing capacity.

The Board has identified key areas where the requirements of the Basel III framework and Dodd-Frank Act conflict. For instance, the Dodd-Frank Act's requirement under Section 939A to remove any reference to or requirement of reliance on ratings in Federal regulations conflicts with, or significantly complicates, the implementation of the Basel III framework, which requires the use of credit ratings for determining the risk-based capital requirements of certain exposures. To address the requirements of Section 939A, the U.S. Federal banking agencies issued an advanced notice of proposed rulemaking August 25, 2010, seeking comments on alternatives to the use of credit ratings in risk-based capital rules and are in the process of developing alternative approaches.

In addition, Section 171 of the Dodd-Frank Act (commonly referred to as the "Collins Amendment") establishes certain requirements for U.S. leverage and risk-based capital requirements that are not included in the Basel III framework. To address certain requirements of Section 171, the agencies requested comment on December 15, 2010, on a proposed rulemaking that would require a banking organization operating under the advanced approaches.

(Basel II-based) capital standards to meet, on an ongoing basis, the higher of the generally applicable (Basel I-based) and the advanced approaches minimum risk-based capital requirements. Also, under the Basel III framework, certain capital instruments that will no longer qualify for inclusion in regulatory capital will be phased out over a period of 10 years. Under Section 171, however, such instruments would be subject to a more rapid phase out period of 3 years. The agencies will address this and other provisions of Section 171 in subsequent rulemakings.

The Board is analyzing several other sections of Dodd-Frank Act that pose potential conflicts with the Basel III framework. We expect to have a more comprehensive list of such conflicts in the next few months as we work through the elements of the domestic rulemaking related to the Basel III framework.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM BEN S. BERNANKE

Q.1. One of the most important reforms in Dodd-Frank was requiring systemically significant firms to hold more capital and have better liquidity to prevent another crisis. The crisis would not have happened had we not allowed big banks and some nonbanks to acquire so much debt and leverage. What steps are being taken to ensure that these capital, leverage, and liquidity requirements are implemented robustly?

A.1. The Federal Reserve Board is in the process of strengthening capital, leverage and liquidity requirements for systemically important institutions through a number of international and domestic initiatives. As part of its response to the financial crisis, the Basel Committee approved the final Basel 3 Accord in December 2010. The Accord will make the global financial system more stable and reduce the likelihood of future devastating financial crises by requiring internationally active banks to hold more and better quality capital and more robust liquidity buffers against the risks they run. The Accord will increase the capacity of banks to absorb losses and withstand funding pressures without relying on public support, and reduce the likelihood that stresses in the financial system would result in damaging spillovers to the real economy. The Accord will also reduce the incentives for banks to take excessive risks in the first place. National jurisdictions are required to issue legislation or regulations to implement the Accord by the end of 2013. The Board, in conjunction with the other U.S. banking agencies, is currently working on proposed rules to implement the Accord in the United States consistent with that timetable. The Federal Reserve System is also engaged in a capital planning review exercise that, by design, assesses the firms' capital planning processes, including the outcome of their internal stress tests. Part of the capital planning review includes an assessment of the largest BHCs' plans to meet the increased capital requirements associated with the Basel 3 Accord.

While the Basel Accord is directed at banks and bank holding companies, additional efforts are underway to increase the regulation and supervision of systemically important nonbank financial institutions. As you are aware, some of the most destabilizing

events of the recent financial crisis involved the collapses of large, nonbank financial firms. The Dodd-Frank Act usefully includes provisions that enable the Federal Government to expand the perimeter of regulation and help ensure that any nonbank financial firm with an outsized systemic footprint is subject to strong Federal oversight on a consolidated basis. The Financial Stability Oversight Council (FSOC) recently issued a notice of proposed rulemaking on the designation process for systemically important nonbank financial institutions (nonbank SIFIs) and is expected to finalize those rules later this year, paving the way for possible future designations. Nonbank firms designated by the FSOC will be subject to consolidated supervision by the Federal Reserve Board, including consolidated capital, leverage, and liquidity requirements.

The Board is also in the process of developing the enhanced prudential standards contained in sections 165 and 166 of the Dodd-Frank Act for both bank holding companies with consolidated assets greater than $50 billion as well as nonbank SIFIs designated by the FSOC. The enhanced prudential standards include risk-based capital, leverage and liquidity requirements, as well as single-counterparty credit exposure limits and requirements to produce resolution plans, run stress tests, and comply with enhanced risk management standards. The enhanced prudential standards generally must increase in stringency as the firm's systemic footprint increases and not result in sharp, discontinuous changes for firms with a similar systemic footprint. Final rules implementing sections 165 and 166 are due in January 2012, and the Board expects to issue proposed rules in the coming months. Our goal is to produce a well-integrated set of rules that meaningfully reduces the probability of failure of our largest, most complex financial firms and the losses to the financial system in the event of their failure.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM BEN S. BERNANKE

Q.1. *Banks, Capital, and Losses.* The ongoing foreclosure crisis and the foreclosure fraud scandal are issues of great national importance, and of particular importance in my home State.

And right now the four largest banks are the most exposed to the shaky real estate market—they have over 40 percent of the mortgage servicing contracts and second lien mortgages.

Despite this exposure to potential housing-related losses, as well as looming new capital rules from Dodd-Frank and the Basel Committee, the Federal Reserve is conducting stress tests that will pave the way for 19 of the largest banks to once again buy back their stock and issue dividends.

The three largest banks also have about $121 billion in debt guaranteed by the FDIC which costs taxpayers, gives this debt a funding advantage, and is not being counted by the stress tests.

- By easing dividend and stock restrictions on big banks, are we adding to the advantage that they have over their smaller competitors?
- Everyone agrees that lending has contracted but bonuses are booming. Won't paving the way for dividend payments to inves-

tors—including their own executives—limit the banks' ability to deploy their capital to support the recovery?

- There is a lot of uncertainty about the future of the housing market and new capital requirements, and each dollar paid out to shareholders is a dollar less in equity for the bank. How can we ensure that allowing big banks to issue dividends now won't damage their capital levels and future stability?
- Should one of these 19 companies encounter issues with their capital base, are the Fed and FDIC ready to use their new authorities under Dodd-Frank right now—the "Grave Threat Divestiture" and "Orderly Liquidation Authority," respectively?

If not now, when will those authorities be ready?

A.1. Response not provided.

Q.2. *Capital Rules and Foreign Banks.* A recent report in the *Wall Street Journal* raised concerns about foreign banks shedding their Bank Holding Company designations in an effort to evade new capital requirements imposed by the Dodd-Frank Act. There appear to be concerns about the level of capital at some of these institutions. And though Dodd-Frank contains several anti-evasion provisions, including Section 113 and Section 117, those provisions apply, respectively, to Nonbank Financial Companies and Bank Holding Companies that received TARP funding.

- Is it your interpretation that Dodd-Frank does not contain anti-evasion authority that would apply to this situation? Please explain any authority that the Board does have.
- Would such anti-evasion authority be useful for the Board to carry out its mission of Bank Holding Company supervision and systemic risk mitigation?

A.2. Response not provided.

Q.3. *Mortgage Servicing and Examinations.* In November, the GAO released a study on abandoned foreclosures, also known as "bank walkaways." With respect to mortgage servicing, the report found:

> According to our interviews with Federal banking regulators, mortgage servicers' practices . . . have not been a major focus covered in their supervisory guidance in the past. The primary focus in these regulators' guidance is on activities undertaken by the institutions they oversee that create the significant risk of financial loss for the institutions. Because a mortgage servicer is generally managing loans that are actually owned or held by other entities, the servicer is not exposed to losses if the loans become delinquent or if no foreclosure is completed. As a result, the extent to which servicers' management of the foreclosure process is addressed in regulatory guidance and consumer protection laws has been limited and uneven. For example, guidance in the mortgage banking examination handbook that OCC examiners follow when conducting examinations of banks' servicing activities notes that examiners should review the banks' handling of investor-owned loans in foreclosure, including whether servicers have a sound rationale for not completing foreclosures in time or meeting in-

vestor guidelines. In contrast, the guidance included in the manual Federal Reserve examiners use to oversee bank holding companies only contained a few pages related to mortgage servicing activities, including directing examiners to review the income earned from the servicing fee for such operations, but did not otherwise address in detail foreclosure practices.

In addition, until recently, the extent to which these regulators included mortgage servicing activities in their examinations of institutions was also limited. According to OCC and Federal Reserve staff, they conduct risk-based examinations that focus on areas of greatest risk to their institutions' financial positions as well as some other areas of potential concern, such as consumer complaints. Because the risks from mortgage servicing generally did not indicate the need to conduct more detailed reviews of these operations, federal banking regulators had not regularly examined servicers' foreclosure practices on a loan-level basis, including whether foreclosures are completed. For example, OCC officials told us their examinations of servicing activities were generally limited to reviews of income that banks earn from servicing loans for others and did not generally include reviewing foreclosure practices.

Please describe your agencies' views of the risks related the banks' servicing divisions, including:

- The losses stemming from the servicing divisions of the banks that you regulate.
- What further losses, if any, you expect.
- How your agencies have changed your examination procedures relating to banks' servicing divisions.
- Whether there will be uniform standards for servicing examination across all Federal banking agencies.

A.3. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TESTER FROM BEN S. BERNANKE

Q.1. The "routing" provisions included in the Fed's proposed debit interchange rules would seem to provide merchants with an opportunity to discriminate against purchases made with cards from "exempt" small issuers which would hear larger interchange rates. What responsibility and authority does the Fed have to ensure that small issuers aren't discriminated against through subtle "steering" by merchants or more explicit discrimination against transactions made with cards from small issuers?

A.1. Response not provided.

Q.2. In drafting your proposed debit interchange rules, to what extent did the Fed evaluate the impact of those proposed rules on consumers?

A.2. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARNER FROM BEN S. BERNANKE

Q.1. For each of the witnesses, though the Office of Financial Research does not have a Director, what are each of you doing to assist OFR in harmonizing data collection, compatibility, and analysis?

A.1. Response not provided.

Q.2. Chairman Bernanke, I understand the FSOC has organized and released proposed rules on how it will designate systemically significant nonbank financial companies for regulation.

A.2. Response not provided.

Q.3. As you know, I worked quite extensively on Title 1 and Title 2, and I worked very hard to include this authority and specifically, to make sure that this authority was not restricted by exempting any class of institution. But the bill did specifically include a list of 10 factors that together, were intended to paint a thorough picture of the systemic risks that threatened our economy during the last few years. One of the things financial institutions asked for, and I thought was reasonable and the Congress thought reasonable, was that the Council provide some specificity around those factors so that if a company wanted to manage the risks it posed and avoid designation, it could.

I am concerned that your draft rule merely restates the criteria without providing any quantitative guidance for companies. This is not about evasion—the Council has authority to react to attempts at evasion. And this is not about rigid rules that must be triggered before the council can act, because the Council can also look at qualitative issues and the whole picture.

I also feel that there is a benefit to including specifics that companies can manage to as long as the specifics really get at systemic risk, companies managing within the parameters you set will by definition reduce the systemic risk present in the financial system. There is nothing wrong with teaching to the test if the test is well designed and there shouldn't be anything wrong with companies managing to the Council's parameters if they are well designed.

Why did the draft rule fail to provide any specifics, unlike, banking regulators do when it comes to Tier 1 capital, or leverage ratios, or core deposits? Will you reconsider the rule to give companies more specific measures so that they can manage the risk they pose?

A.3. Response not provided.

Q.4. Chairman Bernanke, your agency was charged with working together to develop orderly liquidation plans for systemically significant financial institutions so that they can avoid needing resolution under Title 2 if they fail. Where are we in that process and when can we expect companies to start submitting plans to you for review and approval?

A.4. Response not provided.

Q.5. Chairman Bernanke, most of the companies subject to the requirement for an orderly liquidation plan are multinational in at least some respect. What cross border issues have you uncovered

and how are you working to address those issues? Are there any legal barriers to resolving those issues in a way that ensures the plans work?

A.5. Response not provided.

Q.6. Chairman Bernanke, many of my colleagues have brought up concerns about how the proposed interchange rule will affect small financial institutions and, ultimately, consumers. Specifically the rule does not address how merchants make routing choices, which could significantly affect volume for small institutions. So I want to ask you, how do you anticipate that this proposed cap will affect consumers and their access to banking services?

If banks raise account fees, limit access to certain services, and banking generally becomes more expensive for consumers, will that push people out of the regulated banking space that many people have worked hard to bring them into?

A.6. Response not provided.

Q.7. Chairman Bernanke, I believe that the Qualified Residential Mortgage is a significant effort towards repairing our underwriting problems and lack of private sector investment in the housing market right now. I understand there is concern that because these qualified mortgages will be exempted from risk retention standards, we want this type of mortgage to be affordable and available. Can you tell us how you are weighing the construct of a QRM—including down payment, income, LTV, and the use of private insurance?

A.7. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MERKLEY FROM BEN S. BERNANKE

Q.1. *Federal Reserve Supervision of Largest Financial Firms.* The rulemaking for Dodd-Frank is a critical part of ensuring financial reform and protecting the economy and taxpayers. Equally important, though, is the manner in which the Federal Reserve, as the supervisor of the largest financial firms, conducts its supervisory responsibilities. Could you please update the Committee on improvements to the supervisory process put in place over the past 2 years. In addition, can you please describe improvements to the examination process, including what types of full-scope examinations (including but not limited to stress tests) that the largest bank holding companies are subjected to on an annual basis. In addition, what processes does the Federal Reserve use to ensure that its staff conducting examinations identify risks or compliance problems that are not identified by the bank holding companies themselves.

A.1. Response not provided.

Q.2. *Financial Crisis and Economic Growth.* Please provide your best estimate of (1) how much U.S. gross domestic product was lost during the period of 2009 through the present as a result of the 2007–08 financial crisis and (2) how much of the U.S. debt added during the period of 2009 through the present was as a result of

the 2007–08 financial crisis (for example, lost tax revenue and increased mandatory payments)?

Do you agree that failure to speedily implement necessary financial reforms represents a very serious fiscal risk to the United States?

A.2. Response not provided.

Q.3. *Community Banks and Economic Growth.* I have heard from some of my local community banks that certain capital, accounting, and examination rules may be working at cross purposes with the ability of community banks to serve the economic growth needs of the families and small businesses they serve in their communities, especially when compared to standards applied to the largest national banks. I wish to bring several to your attention and ask that you comment:

- The Financial Accounting Standards Board's proposed exposure draft on "Troubled Debt Restructurings" (TDRs) has been pointed out as possibly creating a capital disincentive for banks to engage in work-outs and modifications with their business borrowers because of the effect of immediately having to declare those loans "impaired." In addition, for banks over $10 billion in asset size, there may be additional direct costs for FDIC premiums based on a formula that considers TDR activity.
- The disallowance to Risk-Based Capital of the amount of Allowance for Loan Losses (ALLL) in excess of 1.25 percent of Risk Weighted Assets has been flagged as a challenge in this environment, where some firms have ALLL that significantly exceeds that threshold. This may serve to understate the risk-based capital strength of the bank, adding to costs and negatively impacting customer and investor perceptions of the bank's strength.
- It has been reported that examiners have rejected appraisals that are less than 9 months old when regulatory guidance calls for accepting appraisals of up to 12 months.
- Community banks are subject to examination in some cases as frequently as every 3 months. In contrast, some suggest that our largest national banks may not ever undergo an examination as thorough, with the challenges surrounding loan documentation, foreclosure, and MERS as a glaring example of the results.

Are there regulatory or supervisory adjustments in these or related areas that need to be made to facilitate community banks' abilities to serve their communities?

In addition, have you considered ways in which capital charges, accounting rules, and examination rules for community banks in particular can be adapted to be less procyclical, such that they do not become stricter into an economic downturn and lighter at the top of an upturn?

Finally, what procedures do you have in place to ensure that our community banks and our largest national banks are not subject to differing examination standards, even when they are examined by different regulators?

A.3. Response not provided.

Q.4. *International Coordination Regarding Resolution.* Our largest financial firms today operate across many national boundaries. Some firms are aiming to conduct 50 percent or more of their business internationally. Can you update the Committee on the status and any challenges regarding the establishment of mechanisms, plans, and other aspects of coordination between international regulatory bodies to ensure that financial firms operating internationally can be effectively placed into the Dodd-Frank resolution regime and are not otherwise able to attain "too big to fail" status through international regulatory arbitrage?

Please also update the Committee on the status of the regulation of international payments systems and other internal systemic financial market utilities so that the entities that manage or participate in them are not able to avoid the resolution regime through international regulatory arbitrage.

A.4. Response not provided.

Q.5. *Repo and Prime Brokerage.* During the financial crisis, the instability of the triparty repurchase agreement (repo) markets and prime brokerage relationships played critical roles in the collapse of several major financial firms. As the quality of the repo collateral began to decline and as both repo and prime brokerage "depositors" began to doubt the stability of their counterparties (because of the toxic positions in the trading accounts of the counterparties), a classic bank run emerged, only this time it was at the wholesale level. Please provide an update on rulemaking and other policy changes designed to reduce risks to our financial system in the repo markets and in prime brokerage.

A.5. Response not provided.

Q.6. *Derivatives Oversight.* Counterparty risk and other risks associated with derivatives played a central role in the financial crisis, especially in fueling the argument that firms such as AIG were too big or too interconnected to fail. What oversight systems do you plan to have in place to ensure that any accommodations made in the course of rulemaking for nonfinancial commercial parties do not create holes in the regulatory structure that permit the accumulation of hidden or outsized risk to the U.S. financial system and economy.

A.6. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM BEN S. BERNANKE

Q.1. Regarding the FSOC's recently proposed Notice of Proposed Rulemaking on the authority to require Federal Reserve supervision and regulation of certain nonbank financial companies, will the Council propose metrics adapted for the risks presented by particular industry sectors for notice and comment, and does the Council intend to designate nonbank financial companies before those industry-specific metrics are published?

A.1. Response not provided.

Q.2. Dodd-Frank requires that risk retention be jointly considered by the regulators for each different type of asset and includes a specific statutory mandate related to any potential reforms of the commercial mortgage-backed securities to limit disruptions. Given the importance of rigorous cost-benefit and economic impact analyses and the need for due consideration of public comments, do your agencies need more time than is provided by the looming April deadline?

A.2. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORKER FROM BEN S. BERNANKE

Q.1. Chairman Bernanke, the Federal Reserve has issued proposed changes to disclosures under Regulation Z and the Truth in Lending Act with the comment period having ended in December 2010. It has been brought to my attention that the model disclosure forms included in the proposed rule related to certain credit insurance products steer customers away from those products with claims that may not be relevant to a particular customer's situation—*i.e.,* "This product will cost up to $118.00 per month." (Model Form H-17(B)). While I am aware of the risks associated with certain credit insurance products, the experience in Tennessee has been that many consumers have benefited from this type of insurance coverage. Model disclosures containing strong warnings against purchasing this type of protection may leave consumers unprotected and in a worse financial situation than currently today with credit protection in place. Can you discuss the Federal Reserve model disclosure testing methodologies to determine the impact of certain terms and phrases used in model disclosures and customer responses to those terms and phrases?

A.1. The Federal Reserve Board has recently issued proposals to revise Regulation Z, which implements the Truth in Lending Act (TILA). Among other things, the proposals published in August 2009 and September 2010 would revise the disclosures provided to consumers in connection with the purchase of credit insurance and similar products, such as debt cancellation coverage or debt suspension coverage (credit protection products). These new disclosure requirements would apply to credit protection products purchased in connection with any consumer credit transaction. The Board used consumer testing to develop the model disclosures in both the August 2009 and September 2010 proposed rules for credit protection products.

On February 1, 2011, the Board announced that it does not expect to finalize three pending Regulation Z proposals prior to the transfer of authority for such rulemakings to the Consumer Financial Protection Bureau (CFPB). Those rulemakings include the proposed disclosures for "credit protection" products. The Board will transfer the record of these rulemakings to the CFPB for its consideration before any final rules are issued. Thus, the CFPB also would be the agency to determine whether further study is needed, including whether additional consumer testing would be appropriate.

You express concern about the Board's proposed model disclosures for these products. You state that the proposed disclosures would steer consumers away from credit protection products with claims that might not be relevant to a particular customer's situation. The Board believes that in order for consumers to benefit from the disclosures, the disclosures must be clear and meaningful. Accordingly, the proposed disclosures that were published for comment were based, in part, on consumer testing to ensure that consumers understand the product. The model disclosures seek to provide consumers with timely information regarding the costs and risks of credit protection products in addition to the benefits promoted by creditors or other vendors. Even if a particular risk may not affect every consumer, there can be benefit in alerting all consumers who potentially may be affected. However, in weighing whether the benefits of the added disclosure outweigh its costs, it would be appropriate also to consider the likelihood that the risk will occur.

You also ask about the consumer testing methodologies used by the Board to determine the impact of the language used in the proposed model disclosures, and about consumers' responses to this language. The Board conducted consumer testing for the proposed model forms with the assistance of a consulting firm, ICF Macro (Macro) that specializes in designing and testing such documents. Consumer testing was conducted in connection with both the August 2009 and September 2010 proposals. Macro conducted six rounds of testing in various locations around the country, with a total of 60 individual interviews with consumers of varying demographic backgrounds. Four rounds of testing were conducted before the Board issued the August 2009 proposals; two rounds were conducted in connection with the September 2010 proposal.

In connection with the September 2010 proposed rules, testing of the disclosures and notices related to credit insurance was carried out through two rounds of interviews. Before each round of interviews, Macro developed model disclosures. In some cases, multiple versions of each type of disclosure were developed so that the impact of varying language or format could be studied. Board staff attended all rounds of testing. After each round, Macro briefed Board staff on key findings, as well as their implications for disclosure design and layout.

Individual interviews with consumers were approximately 75 minutes long. While the interview guide varied between rounds, the general structure of these interviews was very similar. Participants were given a disclosure and asked to "think aloud" while they reviewed the document, indicating whenever they found something surprising, interesting, or confusing. Following this "think aloud" process, participants were asked specific questions about the information on the disclosure to determine how well they could find and interpret the content. The participants were then given a new disclosure to review and the interviewer took them through the same process.

The consumer testing results generally demonstrated that that the proposed model forms communicate important information in a clear and effective way, which should enable consumers to comprehend complex information and make informed financial deci-

sions. In addition, findings from the last round of testing showed that comprehension of the disclosure was high when the information was presented in tabular question-and-answer format. As a result, the proposed model forms use this format. Comprehension of the content of this disclosure was also high. However, because of concerns about "information overload," some of the information on the tested disclosure form was not included in the proposed model forms published for comment. The following three reports prepared by Macro describe the results of the 2009 and 2010 testing, and are available on the Board's public Web site at: *http://www.federalreserve.gov/boarddocs/meetings/2009/20090723/Full%20HELOC_Macro%20Report.pdf* (August 2009 Proposed Rules for Home-Equity Lines of Credit); *http://www.federalreserve.gov/boarddocs/meetings/2009/20090723/Full%20Macro%20CE%20Report.pdf* (August 2009 Proposed Rules for Closed-end Mortgage Loans); *http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20100816_MacroBOGReportOtherDisclosures(7-10)(FINAL).pdf* (September 2010 Proposal).

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM BEN S. BERNANKE

Q.1. A Bloomberg news story, citing a Financial Stability Oversight Council (FSOC) staff report marked "confidential," indicates that there is a parallel regulatory track with respect to the designation of systemically significant nonbank financial companies. The Bloomberg story mentions FSOC staff are moving forward with "confidential" criteria that will be used to designate systemically important nonbank financial institutions. However, unlike the proposed rule, which merely restates the statutory language, these confidential criteria are not subject to public comment and has yet to be reviewed by anyone outside of the council aside from this news report. This raises serious questions about the transparency of FSOC's rulemaking process.

From what has been reported, portions of the leaked report conclude that an insurer failure could create adverse macroeconomic impact. This conclusion appears to have been reached without the required insurance expertise, which has yet to be appointed. A similar conclusion was made with respect to hedge funds.

Unfortunately, there has been no public disclosure of the criteria or metrics that were used to arrive at this conclusion. As such, could you explain what metrics were applied and by whom in reaching this conclusion? What basis did the FSOC staff use to select these criteria?

Chairwoman Bair's written testimony to this Committee states: "The nonbank financial sector encompasses a multitude of financial activities and business models, and potential systemic risks vary significantly across the sector. A staff committee working under the FSOC has segmented the nonbank sector into four broad categories: (1) the hedge fund, private equity firm, and asset management industries; (2) the insurance industry; (3) specialty lenders, and (4) broker-dealers and futures commission merchants. The

council has begun developing measures of potential risks posted by these firms."

"The FSOC is committed to adopting a final rule on this issue later this year, with the first designations to occur shortly thereafter." Since the rulemaking process is already underway, do you know if the administration is planning to make this report public?

Will there be an opportunity for public comment on it before any final rules are promulgated?

What is your logic behind identifying these four categories?

Will you publish and seek comment on the industry-specific metrics that will applied, before such assessments begin, so that Congress can have confidence that FSOC is exercising its authority appropriately and impacted financial companies can be assured that they are not being treated arbitrarily?

A.1. The Council is working to develop a framework to help it identify systemically important nonbank firms. On January 26, 2011, the Council issued a notice of proposed rulemaking (NPR)[1] seeking public comment on a proposed framework that the Council could use to determine whether a nonbank financial company may pose a threat to the financial stability of the United States. In developing the proposed framework set forth in the NPR, the Council considered the comments received on its earlier advance notice of proposed rulemaking (ANPR).[2] Issuing the NPR continued the Council's commitment to solicit input from the public as the Council works to develop a robust and disciplined framework to support any designation decisions that it makes.

The preamble to the NPR sets forth a framework for assessing the threat a nonbank financial company may pose to the financial stability of the United States. The proposed framework groups the statutory factors that the Council must consider into the following six categories: size, lack of substitutes, interconnectedness, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. The Council has begun to gather and analyze data to develop metrics to evaluate each of the six categories. The Council also intends to tailor the metrics to the principal business lines and business models of a nonbank financial company as appropriate.

The Council has received many comments on the NPR and is in the process of reviewing these comments. Many commenters suggested that the Council provide more detail regarding the framework and criteria it will use as it considers possible designations. As it moves forward with developing its framework to support designation, the Council is considering how best to reflect these comments in its final rule. The Council also is considering how to continue to allow for transparency and public input in its process.

As a member agency of the Council, the Board is providing assistance to the Council as it works to establish its framework.

[1] 76 FR 4555 (2011).
[2] 75 FR 61653 (2010).

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM SHEILA C. BAIR

Q.1. Recently, some have voiced concerns that the timeframe for the rulemakings required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is too short to allow for adequate consideration of the various comments submitted or to review how the new rules may impact our financial markets. Does the current timeframe established by Dodd-Frank allow each rulemaking to be completed in a thoughtful and deliberative manner?

A.1. The FDIC recognizes the importance of providing sufficient time for interested parties to comment on all proposed rules and studies required by the Dodd-Frank Act. We are committed to providing adequate time for that process. It is critical, therefore, that we try to strike an appropriate balance in our efforts to implement the Dodd-Frank Act between timely and efficient rulemaking and careful review and consideration of public comment. As stated in my testimony, "regulators must maintain a clear view of the costs of regulation—particularly to the vital community banking sector—while also never forgetting the enormous economic costs of the inadequate regulatory framework that allowed the crisis to occur in the first place." Moreover, "it is essential that this implementation process move forward both promptly and deliberately, in a manner that resolves uncertainty as to what the new framework will be and that promotes long-term confidence in the transparency and stability of our financial system," On the other hand, we do recognize that the industry is adjusting to significant changes in banking laws and regulation, and there is cost associated with that.

The FDIC establishes comment periods consistent with the timeframes dictated by the statute. As a general matter, the FDIC tries to provide a 60-day comment period for each significant proposed rule, and for some rules we have provided comment periods as long as 90 days. As a matter of practice, the FDIC often accepts and considers comments filed after the established deadlines but before the rulemakings are finalized.

Q.2. In defining the exemption for "qualified residential mortgages," are the regulators considering various measures of a lower risk of default, so that there will not just be one "bright line" factor to qualify a loan as a Q.R.M.?

A.2. Section 941 of the Dodd-Frank Act, titled, Regulation of Credit Risk Retention, requires the FDIC (together with the Federal Reserve Board, Offce of the Comptroller of the Currency, Securities and Exchange Commission, Department of Housing and Urban Development, and the Federal Housing Finance Agency—collectively, the "agencies") to require securitizers to retain no less than 5 percent of the credit of any assets transferred to investors through the issuance of an asset-backed security (ABS). Section 941 exempts certain ABS issuances from the general risk retention requirement, including ABS issuances collateralized exclusively by "qualified residential mortgages" (QRM), as jointly defined by the agencies.

An interagency working group is near completion of a notice of proposed rulemaking to implement section 941. I anticipate the proposed rule will solicit public comment on various options for satisfying the credit risk retention requirements of section 941, as well

as the appropriateness of certain exemptions. I believe that, based on the data and other information described in the response to Question 3 (below), the underwriting and product features for QRM loans should include standards related to the borrower's ability and willingness to repay the mortgage (as measured by the borrower's debt-to-income (DTI) ratio); the borrower's credit history; the borrower's down payment amount and sources; the loan-to-value (LTV) ratio for the loan; the form of valuation used in underwriting the loan; the type of mortgage involved; and the owner-occupancy status of the property securing the mortgage.

Q.3. What data are you using to help determine the definition of a Qualified Residential Mortgage?

A.3. In considering how to determine whether a mortgage is a QRM, the agencies are examining data from multiple sources. For example, the agencies are reviewing data on mortgage performance supplied by the Applied Analytics division (formerly McDash Analytics) of Lender Processing Services (LPS). To minimize performance differences arising from unobservable changes across products, and to focus on loan performance through stressful environments, for the most part, the agencies are considering data for prime fixed-rate loans originated from 2005 to 2008. This data set includes underwriting and performance information on approximately 8.9 million mortgages.

As is typical among data provided by mortgage servicers, the LPS data do not include detailed information on borrower income and on other debts the borrower may have in addition to the mortgage. For this reason, the agencies are also examining data from the 1992 to 2007 waves of the triennial Survey of Consumer Finances (SCF). Because families' financial conditions will change following the origination of a mortgage, the analysis of SCF data focused on respondents who had purchased their homes in either the survey year or the previous year. This data set included information on approximately 1,500 families. In addition, it is my understanding that the agencies are examining a combined data set of loans purchased or securitized by a Government-sponsored enterprise from 1997 to 2009. This data set consists of more than 78 million mortgages, and includes data on loan products and terms, borrower characteristics (for example, income and credit score), and performance data through the third quarter of 2010.

Q.4. Dodd-Frank (Sec 939A) required the regulators to remove any reference or requirement of reliance on credit ratings from its regulations. In his testimony, Acting Comptroller of the Currency John Walsh wrote: "(R)egional and community banks noted (in their comments) that using internal risk assessment systems to measure credit worthiness for regulatory purposes would be costly and time consuming . . . . These concerns could be addressed if section 939A is amended in a targeted manner that allows institutions to make limited use of credit ratings. Precluding undue or exclusive reliance on credit ratings, rather than imposing an absolute bar to their use, would strike a more appropriate balance between the need to address the problems created by overreliance on credit ratings with the need to enact sound regulations that do not adversely affect credit availability or impede economic recovery."

What is the status of this effort and what types of alternative measures are being considered? Do you share the concerns raised by community banks, and what is your reaction to Acting Comptroller Walsh's comments on this issue?

A.4. The Federal banking agencies continue to work toward developing alternatives to credit ratings. On August 25, 2010, the banking agencies issued an Advance Notice of Proposed Rulemaking (ANPR) seeking industry comment on how we might design an alternative standard of creditworthiness, For the most part, the comments we received lacked substantive suggestions on how to answer this question, Although we have removed any reliance on credit ratings in our assessment regulation, developing an alternative standard of creditworthiness for regulatory capital purposes is proving more challenging, The use of credit ratings for regulatory capital covers a much wider range of exposures; we cannot rely on nonpublic information, and the alternative standard should be usable by banks of all sizes. We are actively exploring a number of alternatives for dealing with this problem.

We agree with the concerns raised by Acting Comptroller Walsh, which stem from the difficult nature of designing alternative standards of creditworthiness that are appropriately risk sensitive and can be consistently applied across banking organizations of all sizes. We also agree with the concerns of community banks that internal risk assessments would place a significant burden on smaller banks, as would some of the other alternatives discussed in the NPR. Notwithstanding these concerns, the agencies will continue to work toward the development of a pragmatic solution for all banks.

Q.5. You have said that the resolution plans are a critical component of ending "too big to fail." What is the status of that rulemaking?

A.5. Section 165 of the Dodd-Frank Act requires the FDIC to promulgate joint rules with the Federal Reserve setting forth the regulatory standards and filing requirements for resolution plans. The plans are to be jointly reviewed and enforced by the FDIC and Federal Reserve. The FDIC is working closely with the Federal Reserve to jointly promulgate rules under Section 165 of Title I. It is the FDIC's publicly expressed desire to issue a proposed rulemaking in the very near term. The standards would establish a time line and process for firms to submit resolution plans.

Q.6. Please discuss the current status and timeframe of implementing the Financial Stabilty Oversight Council's (FSOC) rulemaking on designating nonbank financial companies as being systemically important. As a voting member of FSOC, to what extent is the Council providing clarity and details to the financial marketplace regarding the criteria and metrics that will be used by FSOC to ensure such designations are administered fairly? Is the intent behind designation decisions to deter and curtail systemically risky activity in the financial marketplace? Are diverse business models, such as the business of insurance, being fully and fairly considered as compared with other financial business models in this rulemaking?

A.6. The FSOC has issued a notice of proposed rulemaking regarding the designation of nonbank financial firms under Title I of the

Dodd-Frank Act. The notice of proposed rulemaking seeks public comment on the best methods to approach the designation of firms, and the application of systemic determination criteria on an institution-specific basis. The proposal suggests using a framework to analyze the firms, and applying metrics that would be tailored to that firm's business model and industry sector. As provided in the proposed rule: "The Council would evaluate nonbank financial companies in each of the (six categories of the framework as proposed under the rule) using quantitative metrics where possible. The Council expects to use its judgment, informed by data on the six categories, to determine whether a firm should be designated as systemically important and supervised by the Board of Governors. This approach incorporates both quantitative measures and qualitative judgments." The six broad categories are size, suitability, interconnectedness, leverage, liquidity risk, and existing regulatory scrutiny. Designated firms will be subjected to heightened prudential standards developed to reduce the risk the firms may pose to U.S. financial stability. As an important element of the analysis, diverse business models and industry specific considerations are being taken into account.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM SHEILA C. BAIR

Q.1. The Dodd-Frank Act requires an unprecedented number of rulemakings over a short period of time. As a result, some deadlines have already been missed and some agencies expect to miss additional deadlines. It appears that many of the deadlines in Dodd-Frank are not realistic. Which Dodd-Frank deadlines do you anticipate not being able to meet? If Congress extended the deadlines, would you object? If your answer is yes, will you commit to meeting all of the statutory deadlines? If Congress affords additional time for rulemaking under the Dodd-Frank Act, will you be able to produce higher-quality, better coordinated rules?

A.1. The FDIC is committed to meeting any statutory deadlines on rulemakings for which it has sole rule writing authority. Joint rules and rules written in consultation with other agencies generally take more time, but to date these deadlines have been met as well.

While the FDIC might not object to an extension of the Dodd-Frank Act deadlines, we believe the statutory timeframes are appropriate and serve a useful purpose. On the one hand, as I stated in my recent written testimony before the Committee, "in implementing the Dodd-Frank Act, it is important that we continue to move forward with dispatch to remove unnecessary regulatory uncertainties faced by the market and the industry." Moreover, "it is essential that this implementation process move forward both promptly and deliberately, in a manner that resolves uncertainty as to what the new framework will be and that promotes long-term confidence in the transparency and stability of our financial system." On the other hand, we do recognize that the industry is adjusting to significant changes in banking laws and regulation, and there is cost associated with that.

In addition, the FDIC recognizes the importance of providing sufficient time for interested parties to comment on all proposed rules and studies required by the Dodd-Frank Act. We are committed to providing adequate time for that process. It is critical, therefore, that we try to strike an appropriate balance in our efforts to implement the Dodd-Frank Act between timely and efficient rulemaking and careful review and consideration of public comment. As stated in my testimony, "regulators must maintain a clear view of the costs of regulation—particularly to the vital community banking sector—while also never forgetting the enormous economic costs of the inadequate regulatory framework that allowed the crisis to occur in the first place."

Q.2. Secretary Geithner recently talked about the difficulty of designating nonbank financial institutions as systemic. He said, "it depends too much on the state of the world at the time. You won't be able to make a judgment about what's systemic and what's not until you know the nature of the shock." [1] If it is impossible to know which firms are systemic until a crisis occurs, the Financial Stabilty Oversight Council will have a very difficult time objectively selecting systemic banks and nonbanks for heightened regulation. As a member of the Council, do you believe that firms can be designated *ex ante* as systemic in a manner that is not arbitrary? If your answer is yes, please explain how.

A.2. Yes, we believe it is possible and necessary to designate firms as systemically significant prior to an actual crisis. The designation process can be established using a defined framework and criteria, together with clear and understandable procedures.

There is an important distinction to be made between a systemic risk determination that is made under Title II to authorize appointment of the FDIC as receiver for a financial company, and the designation of firms as systemically important under Title I of the Dodd-Frank Act. The systemic risk determination under Title II is made at the time of financial distress, and requires a finding that the firm is in default or in danger of default and that its insolvency would pose a threat to the financial stability of the U.S., among other findings. That determination will depend upon the circumstances at the moment. On the other hand, the determination of systemic significance under Title I, while addressing similar analysis regarding potential threat to U.S. financial stability, is focused on the need to develop and apply—prior to crisis—heightened supervisory standards applicable to such firms, including a requirement that the firm develop resolution plans. It is vital that those firms which may possibly threaten U.S. financial stability be identified and subject to these heightened standards, and submit resolution plans as mandated by Congress prior to the actual occurrence of financial distress.

To provide a defined framework and explain the process, the FSOC has issued a notice of proposed rulemaking regarding the designation of nonbank financial firms under Title I of the Dodd-

[1] *See,* "Special Inspector General for the Troubled Asset Relief Program, Extraordinary Assistance Provided to Citigroup, Inc." (SIGTARP 11-002) (Jan. 13, 2011) (available at: *http://www.sigtarp.gov/reports/auditl2011/Extraordinary%20Financia1%20Assistance%20Provided%20to%20Citigroup,%20Inc.pdf*), at 43.

Frank Act. The notice of proposed rulemaking seeks public comment on the best methods to approach the designation of firms, and the application of systemic determination criteria on an institution-specific basis, The proposal suggests using a framework to analyze the firms and applying metrics that would be tailored to that firm's business model and industry sector. As provided in the proposed rule: "The Council would evaluate nonbank financial companies in each of the [six categories of the framework as proposed under the rule] using quantitative metrics where possible. The Council expects to use its judgment, informed by data on the six categories, to determine whether a firm should be designated as systemically important and supervised by the Board of Governors. This approach incorporates both quantitative measures and qualitative judgments."

Q.3. Section 112 of the Dodd-Frank Act requires the Financial Stabilty Oversight Council to annually report to Congress on the Council's activities and determinations, significant financial market and regulatory developments, and emerging threats to the financial stability of the United States. Each voting member of the Council must submit a signed statement to the Congress affirming that such member believes the Council, the Government, and the private sector are taking all reasonable steps to ensure financial stability and mitigate systemic risk. Alternatively, the voting member shall submit a dissenting statement. When does the Council expect to supply the initial report to Congress?

A.3. The report is required on an annual basis, and we expect that the report will be submitted in a timely fashion this July.

Q.4. Which provisions of Dodd-Frank create the most incentives for market participants to conduct business activities outside the United States? Have you done any empirical analysis on whether Dodd-Frank will impact the competitiveness of U.S. financial markets? If so, please provide that analysis.

A.4. The Dodd-Frank Act contains no provisions that specifically encourage the conduct of business outside of the U.S. The FDIC has not conducted an empirical analysis of the potential impact of the Act on the decision making of financial firms in locating their operations internationally. However, these decisions will likely continue to be based on a large number of considerations. Foremost among them will continue to be the location of their customers. The U.S. economy is the world's largest, encompassing about a quarter of global economic activity. Its capital markets also remain the world's largest and most sophisticated. This leading global position not only makes the U.S. a preferred venue for conducting banking and other financial activities, but it also necessitates a strong regulatory framework for ensuring financial stability and safe and sound banking practices.

It is true that short-term international competitive imbalances could arise if there were a failure to coordinate capital requirements, resolution procedures, and other regulatory practices designed to promote financial stability. However, as we have seen in the aftermath of the recent global financial crisis, some of the countries where financial practices were allowed to weaken the most saw their financial institutions experience large losses that ulti-

mately undermined their sovereign balance sheets and macroeconomic stability. Clearly, winning such a race to the bottom is no recipe for long-term competitive advantage in finance or in overall economic performance.

The Dodd-Frank Act mandates more than 70 studies, many of which relate to the effects of the Act's provisions on the economy and the functioning of financial markets. As described in our testimony, the FDIC is working on a number of fronts, both on our own and in concert with our regulatory counterparts, to complete these assigned studies and carry out rulemakings as mandated by the Act as expeditiously, as carefully, and as transparently as possible.

Q.5. More than 6 months have passed since the passage of the Dodd-Frank Act, and you are deeply involved in implementing the Act's approximately 2,400 pages. Which provisions of the Dodd-Frank Act are proving particularly difficult to implement? Have you discovered any technical or substantive errors in the Dodd-Frank legislation? If so, please describe them.

A.5. It is still relatively early in the implementation process. As you know, the Act charges the FDIC and other regulators with interpreting a number of new statutory provisions through rulemakings with differing time lines. While some final rules are in place (such as the FDIC's initial orderly liquidation authority interim final rule and the final rule changing the Deposit Insurance Fund assessment base), much still needs to be done.

Agency rulemaking typically involves notice and opportunity for comment. One benefit of that process is that it helps identify the more difficult interpretive issues and flesh out reasonable options for addressing them.

So far, the most difficult practical issue has been identifying substitutes for credit ratings in some particular contexts. Section 939A of the statute requires the elimination of credit ratings rather than supplementing their use. While the FDIC's final large bank pricing rule adopted earlier this month has eliminated reliance on long-term debt issuer ratings, we are still in the process of developing substitute measures for creditworthiness in other areas, such as the capital rules.

Q.6. What steps are you taking to understand the impact that (the) your agency's rules under Dodd-Frank will have on the U.S. economy and its competitiveness? What are the key ways in which you anticipate that requirements under the Dodd-Frank Act will affect the U.S. economy and its competitiveness? What are your estimates of the effect that the Dodd-Frank Act requirements will have on the jobless rate in the United States?

A.6. As you know, the FDIC is required or authorized by Congress to implement some 44 regulations, including 18 independent and 26 joint rulemakings. As we proceed with implementing the provisions of the Dodd-Frank Act as expeditiously and transparently as possible, we undertake the same steps that we follow in any regulatory process, from providing a comment period through meeting requirements of the Paperwork Reduction Act, Regulatory Flexibility Act, the Riegle Community Development and Regulatory Improvement Act of 1992, and the FDIC's own Statement of Policy for

rulemaking (all discussed in further detail in response to Question 7).

The FDIC has not conducted an empirical analysis of the potential impact of Dodd-Frank Act on the economy and market competitiveness. However, we remain mindful of the devastating effects that the 2008 financial crisis visited on the U.S. economy, and the lingering consequences of the crisis on the functioning of the U.S. financial system. For example, in the 6-month period following the failure of Lehman Brothers in September of 2008, the U.S. economy lost some 3.9 million payroll jobs, and the monthly volume of domestically produced steel declined by approximately one-half. As you know, it was with these types of economic consequences in mind that the FDIC, Federal Reserve, and U.S. Department of Treasury undertook the programs of extraordinary assistance that helped to stabilize U.S. financial markets and institutions. Without those programs, the economic consequences would surely have been much worse.

Although these stabilization programs have mostly been wound down, U.S. financial markets and institutions have been slow in recovering from the crisis. FDIC-insured institutions have seen their total loan balances shrink for 9 of the past 10 quarters, with the only quarter of growth resulting from accounting changes in early 2010 that resulted in billions of dollars in securitized assets returning to bank balance sheets. Meanwhile, the volume of private asset-backed securitization remains at just a small fraction of its precrisis level, as investors continue to be reluctant to purchase the types of securities that were the result of hundreds of billions of dollars of losses during the crisis.

Proper implementation of the provisions of the Dodd-Frank Act can do much to improve the functioning of U.S. financial markets and restore their ability to support economic activity. For example, the forthcoming risk retention rule requiring issuers of asset-backed securities to retain at least 5 percent of the credit risk should help to reassure investors that newly issued securities will be much more likely to perform over the long-term than the mortgage-related securities issued in the middle of the last decade.

Financial stability is not an end in itself. It is a means to an end, which is to support economic activity and put Americans back to work. As we have seen, the economic costs of financial instability are high and long-lasting. The FDIC is committed to fulfilling its responsibilities under the Dodd-Frank Act, restoring investor confidence, and laying the foundation for a stronger U.S. economy.

Q.7. What steps are you taking to assess the aggregate costs of compliance with each Dodd-Frank rulemaking? What steps are you taking to assess the aggregate costs of compliance with all Dodd-Frank rulemakings, which may be greater than the sum of all of the individual rules' compliance costs? Please describe all relevant reports or studies you have undertaken to quantify compliance costs for each rule you have proposed or adopted.

Please provide an aggregate estimate of the compliance costs of the Dodd-Frank rules that you have proposed or adopted to date.

A.7. As we have described, the Dodd-Frank Act mandates more than 70 studies, many of which relate to the effects of its provisions

on the economy and the functioning of financial markets. In addition, there also are a number of preexisting statutory provisions requiring the FDIC to consider costs imposed on insured depository institutions by new regulations, both as a general matter and through specific provisions. For example:

- Section (7)(b)(2)(B)(iii) of the FDI Act requires the FDIC Board, when setting assessments, to consider the "projected effects of the payment of assessments on the capital and earnings of insured depository institutions" among other factors.
- Section 302 of the Riegle Community Development and Regulatory Improvement Act of 1994 requires the FDIC and the other banking agencies to consider—consistent with the principles of safety and soundness and the public interest—(1) any administrative burdens that such regulations place on depository institutions, including small depository institutions and customers of depository institutions; and (2) the benefit of such regulations.
- The Paperwork Reduction Act, 44 U.S.C. 3501 *et seq.,* requires OMB approval of any "information collection," including review of whether any paperwork burden imposed by the proposed regulation is warranted by the benefits to be accrued.
- The Regulatory Flexibility Act, 5 U.S.C. 601 *et seq.,* generally requires a Federal agency to provide a regulatory flexibility analysis for a proposed rule describing the impact on small entities, as defined by the Small Business Administration.

Further, the FDIC's Statement of Policy for rulemaking expressly states, "Prior to issuance, the potential benefits associated with the regulation or statement of policy are weighed against the potential costs." The FDIC remains committed to fulfilling all of these statutory requirements to study the economic impact of its rulemaking as it also fulfills its extensive rulemaking mandate under the Dodd-Frank Act.

Q.8. Section 115 of the Dodd-Frank Act asks the Financial Stabilty Oversight Council to make recommendations to the Federal Reserve on establishing more stringent capital standards for large financial institutions. In addition, Section 165 requires the Fed to adopt more stringent standards for large financial institutions relative to smaller financial institutions. Chairman Bernanke's testimony for this hearing implied that the Basel III framework satisfies the Fed's obligation to impose more stringent capital on large financial institutions. As a member of the Financial Stabilty Oversight Council, do you agree with Chairman Bernanke that the Basel III standards are sufficient to meet the Dodd-Frank Act requirement for more stringent capital standards? Please explain the basis for your answer.

A.8. The Basel III agreement stated that heightened capital standards would be developed for the largest banks. To the extent such standards are developed and require additional loss-absorbing capital, there is a potential that such standards could meet the requirements of Section 165.

Q.9. The Fed, the SEC, the FDIC, and the CFTC are all structured as boards or commissions. This means that before they can imple-

ment a rule they must obtain the support of a majority of their board members. How has your board or commission functioned as you have been tackling the difficult job of implementing Dodd-Frank? Have you found that the other members of your board or commission have made positive contributions to the process?

A.9. As you know, section 2 of the Federal Deposit Insurance Act provides that the FDIC is to be managed by a five-member Board of Directors. Our existing Board structure and governance procedures have functioned well as we work to fulfill our responsibilities under the Dodd-Frank Act. The expertise and perspective the Board members have brought to each stage of the Act's implementation to date has been very valuable. Board members have provided constructive feedback and candid comments, demonstrating their understanding of both the challenges and opportunities that the Act presents for the FDIC and the other regulatory agencies. In addition, Board members have supported the FDIC's numerous and continuing efforts to make implementation of the Act and the Board's deliberative process as open and transparent as possible. As Chairman, I have appreciated their ongoing support and guidance as we continue to move forward through the rulemaking and functional implementation process.

Q.10. Numerous calls have arisen for a mandatory "pause" in foreclosure proceedings during the consideration of a mortgage modification. Currently, what is the average number of days that customers of the institutions that you regulate are delinquent at the time of the completed foreclosure? If servicers were required to stop foreclosure proceedings while they evaluated a customer for mortgage modification, what would be the effect on the foreclosure process in terms of time and cost. What effect would these costs have on the safety and soundness of institutions within your regulatory jurisdiction. Please differentiate between judicial and nonjudicial States in your answers and describe the data that you used to make these estimates.

A.10. FDIC-supervised banks are not required to report the number of days customers are delinquent at the time of a completed foreclosure. However, there is evidence that the time needed to complete foreclosure has been rising. Industry data as of August 2010 suggests that the number of consecutive missed payments prior to foreclosure had risen to 5.5, up from 2.9 missed payments at year-end 2007, The length of a foreclosure proceeding (judicial and nonjudicial) would vary widely by State based on rules and standards governing notice of default, mandatory mediation or counseling, and cure or redemption periods, as well as backlogs that have resulted from the rapid rise in foreclosure filings during the past 2 years.

The FDIC believes loss mitigation is essential to stabilize the housing market and minimize losses to insured banks and thrifts. Far from being simply a socially desirable practice to preserve home ownership, effective loss mitigation is consistent with safe-and-sound banking practice and has positive macroeconomic consequences. Modification may improve the value of distressed mortgages by achieving long-term sustainable cash flows for lenders and investors that exceed the value that can be gained through

foreclosure. A net present value test is typically used to confirm that a modification would minimize losses to financial institutions and investors. In cases where the borrower cannot afford the lowest payment allowed, foreclosure should proceed expeditiously to minimize the financial impact on institutions, communities, and the housing market. In some cases it may be reasonable to begin conducting preliminary filings for seriously past-due loans in States with long foreclosure time lines. Nonetheless, it is vitally important that the modification process be brought to conclusion before a foreclosure sale is scheduled. Failure to coordinate the foreclosure and modification processes could confuse and frustrate homeowners and could result in unnecessary foreclosures. Servicers should identify a single point of contact to work with homeowners once it becomes evident the homeowner is in distress. This single point of contact must be appropriately authorized to provide current, accurate information about the status of the borrower's loan or loan modification application, as well as provide a sign-off that all loan modification efforts have failed before a foreclosure sale. This approach will go a long way toward eliminating the potential conflict and miscommunication between loan modifications and foreclosures and providing borrowers assurance that their modification application is being considered in good faith.

Q.11. The burden of complying with Dodd-Frank will not affect all banks equally. Which new Dodd-Frank Act rules will have the most significant adverse impact on small and community banks? Which provisions of Dodd-Frank will have a disparate impact on small banks as compared to large banks? Do you expect that the number of small banks will continue to decline over the next decade? If so, is the reason for this decline the Dodd-Frank Act? Have you conducted any studies on the costs Dodd-Frank will impose on small and community banks? If so, please describe the results and provide copies of the studies.

A.11. The FDIC believes the Dodd-Frank Act financial reform legislation will not cause undue burden or costs on community banks. The legislation's primary focus is on large financial institutions. Provisions that specifically apply to large institutions include new rules on proprietary trading, the composition of capital, and risk retention by asset-backed securities issuers, as well the provisions in Title I and Title II that, together, will establish an orderly liquidation process for systemically important institutions and end the perception that a large institution are "too big to fail." We believe there are tangible benefits for community banks in the Dodd-Frank Act, such as and end to "too big to fail," increased oversight of their nonbanks competitors (which will help level the financial services playing field), an increase in the coverage limit and an expansion of the assessment base for Federal deposit insurance, and community bank exemptions from certain other new requirements. The change in the deposit insurance assessment base alone, one based on domestic deposits to one focused on assets, will effectively reduce community bank premiums by about 30 percent.

Further, the FDIC believes that certain aspects of the Dodd-Frank Act will have a significant positive impact on small and community banks, particularly regarding the development of a more

level playing field with respect to regulatory capital requirements. For instance, the Collins Amendment will place a floor under the so-called advanced approached to risk-based capital rules, which will ensure the resulting capital requirements for large banks and bank holding companies are no lower than the capital requirements required of small and community banks that hold similar exposures. In addition, the Dodd-Frank Act will require large bank holding companies to hold additional capital beyond that required of smaller institutions to account for the greater risk that large bank holding companies pose to the financial system.

As I discussed during the Committee's hearing, new rules on interchange fees may present an issue for community banks, and we are discussing this with the Federal Reserve. There is some concern about the interchange rule's effectiveness and whether community banks can continue to charge higher fees, particularly if networks are not required to have a two-tiered pricing structure.

We have seen significant consolidation in the number of U.S. banks in recent decades, as a result of both economic forces and statutory changes that facilitate branching. This process of consolidation tends to accelerate during periods of industry distress, But there is no regulatory policy, intention, or goal to reduce the number of banks. The FDIC has long supported the community bank model, and believes that community banks play an essential role in a U.S. economy where more than two thirds of all new jobs are created by small businesses. Ultimately, we need healthy banks that can provide credit in their communities.

We have not performed a study on the costs of the Dodd-Frank Act for small community banks; however, we believe that any costs will be relatively low as the legislation primarily impacts large institutions. Further, any major rulemaking will require that we conduct an impact analysis on community banks, The FDIC shares the public's concern about unnecessary regulatory burden, and we are engaging in dialogue with the banking industry through the FDIC Advisory Committee on Community Banking and our examination process to ensure the supervisory process is not burdensome and the potential effect on credit availability is mitigated.

Q.12. When the Dodd-Frank Act passed, President Obama said "There will be no more tax-funded bailouts—period." Nevertheless, Secretary Geithner recently said: "In the future we may have to do exceptional things again if we face (another financial crisis)."[2] Presumably, Secretary Geithner means more taxpayer bailouts when he talks about the need to do "exceptional things." Can you envision any situation in which the FDIC could use the new resolution authority to bail out creditors, regardless of whether they are long-term bondholders or short-term commercial paper lenders? Which types of creditors will fall within the "essential services" exception to the mandatory clawback provision under Title II of Dodd-Frank? Trade creditors? Commercial paper lenders? Repurchase agreement lenders?

[2] *See,* "Special Inspector General for the Troubled Asset Relief Program, Extraordinwy Assistance Provided to Citigroup, Inc." (SIGTARP 11-002) (Jan. 13, 2011) (available at: *http://www.sigtarp.gov/reports/audit/2011/Extraordinary%20Financia1%20Assistance%20Provided%20to%20Citigroup,%20Inc.pdf*), at 44.

A.12. Irrespective of how creditors are treated in a Title II resolution, there can be no taxpayer bailout. The Dodd-Frank Act permits the FDIC as receiver for a systemically significant financial company to borrow funds from the U.S. Treasury to ensure an orderly liquidation. The Act makes very clear, however, that in the event that the assets of the receivership estate are not sufficient to repay the Treasury borrowings in full, the FDIC must assess the industry in an amount sufficient to repay all borrowings from the Treasury. As a result, no taxpayer funds will ever be at risk.

With respect to the ability of the FDIC as receiver to transfer the operations of a failed systemically significant financial company to a third party or to operate the business through a bridge financial company after the receiver has been appointed and shareholders and creditors have taken appropriate losses, it is possible in such a resolution that certain creditors could be paid more than their liquidation share. The receiver may do so in the event that it would result in lower losses to the entire operation of the company since the receiver would be able to transfer the intangible franchise value of the company to a third party. It is possible that commercial paper lenders or unsecured derivative counterparties could fall into this category. If either of those types of creditors received additional payments from the receiver in order to benefit all creditors, they would be subject to the clawback provision. The Act requires the FDIC to clawback any additional funds paid to creditors (other than those deemed essential) prior to assessing the industry in the event the assets of the receivership estate are insufficient to repay the Treasury for funds borrowed.

As noted above, commercial paper lenders would not be considered essential and exempt from the clawback requirement. Instead, creditors deemed essential are more likely to be service providers that cannot be easily replaced. Our experience is that if a service provider is not paid for its prefailure work, then it typically will not want to continue to provide services after the failure, In most cases, the receiver would simply replace the service provider. In limited instances, the receiver may determine that it can not replace the service provider and so make payment on prefailure expenses. The simplest example is the local utility. If the receiver does not pay the prefailure electric bill, the lights will be turned off. The receiver would not be able to find another provider of electricity and obviously could not fulfill its mission without electrical power. Similarly, if unique software were provided by a small company and such company would go out of business if its prefailure bills were not paid, the receiver may also determine that such a service is essential.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM SHEILA C. BAIR

Q.1. *Capital Rules for Systemically Important Financial Institutions*—The Basel Committee on Banking Supervision set the so-called "Basel III" minimum capital requirements for banks at 8 percent, with an additional 2.5 percent buffer. But a study by the Bank for International Settlements suggests that the optimal capital ratio would actually be about 13 percent. A Government-spon-

sored panel in Switzerland has said that massive banks UBS and Credit Suisse should hold 19 percent capital.

The Financial Stabilty Oversight Council, or FSOC, will recommend capital requirements for the largest financial institutions—the so-called "Systemically Important Financial Institutions."

Do you favor increasing capital for systemically important financial companies above the 10.5 percent Basel III ratio? If so, what is the right number?

A.1. The Basel Committee agreed that systemically important banks would be required to have additional loss-absorbing capacity over and above the requirements announced for smaller banks. We continue to support these heightened expectations. Given the unique risk to the financial system posed by these organizations, it is important that these organizations are more resilient to stress. We are working closely with the other Federal banking agencies to determine the appropriate capital surcharge.

Q.2. Wall Street often argues that increased capital and equity requirements will lead to decline in lending. However, a recent paper by professors at the Stanford Business School argues that large banks with access to diverse sources of funding can both continue lending and meet higher equity requirements, either by replacing some liabilities with equity or by expanding their balance sheets. Do you agree with this conclusion?

Wall Street often argues that higher capital means higher costs for borrowers. Do you believe that banks could adapt to new capital requirements in ways that do not pass costs on to customers and borrowers, for example, by cutting outsized salaries and bonuses?

A.2. Although it will not be cost free to move to a stronger capital regime, we do not agree that the new requirements will reduce the availability of credit or significantly raise borrowing costs. Furthermore, the new standards allow a substantial phase-in period that will provide banks with ample time to raise capital through retained earnings. In addition, the new standards will help to level the playing field between large and small banks in the U.S. as well as between U.S. banks and their overseas competitors.

In addition to the Stanford Business School paper, studies by economists at Harvard, the University of Chicago, and the Bank for International Settlements argue persuasively that the impact on the cost of credit will be modest, and that these costs will be far outweighed by the benefits of a more stable financial system.

Q.3. *Banks, Capital, and Losses*—The ongoing foreclosure crisis and the foreclosure fraud scandal are issues of great national importance, and of particular importance in my home State.

And right now the four largest banks are the most exposed to the shaky real estate market—they have over 40 percent of the mortgage servicing contracts and second lien mortgages.

Despite this exposure to potential housing-related losses, as well as looming new capital rules from Dodd-Frank and the Basel Committee, the Federal Reserve is conducting stress tests that will pave the way for 19 of the largest banks to once again buy back their stock and issue dividends.

The three largest banks also have about $121 billion in debt guaranteed by the FDIC which costs taxpayers, gives this debt a funding advantage, and is not being counted by the stress tests.

By easing dividend and stock restrictions on big banks, are we adding to the advantage that they have over their smaller competitors?

A.3. We believe large banks should hold more capital than their smaller competitors commensurate with their heightened risk profile and any potential systemic implications of financial distress. With respect to your question on easing dividend and stock restrictions on large banks, we do not believe that dividend and capital repurchases, which involve significant cash outlays, should be allowed until we are fully confident that these firms will have the financial resources to remain strong under a stressed scenario and to repay debt guaranteed by the FDIC.

Q.4. Everyone agrees that lending has contracted but bonuses are booming. Won't paving the way for dividend payments to investors—including their own executives—limit the banks' ability to deploy their capital to support the recovery?

A.4. We are in favor of a strong earnings retention policy to ensure banks continue prudent lending to support the economic recovery. We would be concerned about prematurely resuming or increasing capital distributions without first determining that the capital and liquidity position of a bank would remain strong under a stressed scenario.

Q.5. There is a lot of uncertainty about the future of the housing market and new capital requirements, and each dollar paid out to shareholders is a dollar less in equity for the bank. How can we ensure that allowing big banks to issue dividends now won't damage their capital levels and future stability?

A.5. Banks must plan for the heightened capital requirements under Basel III, capital surcharges needed for banks that are systemically important, and any potential changes to business models that might result from the Dodd-Frank Act. Furthermore, the banking agencies historically have expected banks to operate with capital positions well above the minimum requirements to account for risks that are not adequately captured by the risk-based capital framework. Banks need to be prudent with their capital positions, especially in uncertain economic times.

Finally, banks need to have adequate liquidity reserves in place to repay TLGP debt guaranteed by the FDIC. Regulators should not approve dividend and capital repurchases, which involve significant cash outlays by financial firms, until we are all fully confident that these firms will have the financial resources to repay debt guaranteed by the FDIC.

Q.6. Should one of these 19 companies encounter issues with their capital base, are the Fed and FDIC ready to use their new authorities under Dodd-Frank right now—the "Grave Threat Divestiture" and "Orderly Liquidation Authority," respectively?

If not now, when will those authorities be ready?

A.6. Yes, the FDIC stands ready to serve as receiver should it be appointed under the authorities established under Title II of the Dodd-Frank Act.

With regard to the orderly liquidation authority, the FDIC issued a notice of proposed rulemaking (published October 19, 2010) to implement certain orderly liquidation provisions of Title II. The FDIC approved an Interim Final Rule on January 18, 2011, which addressed the payment of similarly situated creditors, the honoring of personal services contracts, the recognition of contingent claims, the treatment of any remaining shareholder value in the case of a covered financial company that is a subsidiary of an insurance company, and limitations on liens that the FDIC may take on assets of a covered financial company that is an insurance company or covered subsidiary.

A second notice of proposed rulemaking was approved by our Board on March 15 and included the orderly additional questions for public comment. The proposed rule provides details of the orderly liquidation process including additional details on the role of the FDIC as receiver for a covered financial company, claims processes and priorities, recoupment of compensation from certain senior executive officers of covered financial companies, criteria to be applied by the FDIC in determining if a company is "predominantly engaged in activities that are financial in nature or incidental thereto" (and therefore a financial company subject to the Title II orderly liquidation authority), and insights regarding preferential and fraudulent transfers. The FDIC will issue additional rules to address receivership termination, receivership purchaser eligibility requirements, and records retention requirements.

With regard to the Title I provisions granting authority to the FDIC to issue orders compelling divestiture, the authority is confined to those firms properly subject to the resolution planning requirement of section 165 of the Dodd-Frank Act. Section 165 provides authority to the FDIC to act jointly with the Federal Reserve to issue an order to correct deficiencies identified in a firm's resolution plan. The standards for review, and the process by which firms will be found deficient and curative actions taken, will be the subject of joint rulemaking by the FDIC and the Federal Reserve, as required by section 165(d) of the Act. The FDIC is working closely with the Federal Reserve to implement section 165, and we expect to issue a proposed rulemaking in the very near term.

Q.7. *Mortgage Servicing and Examinations*—In November, the GAO released a study on abandoned foreclosures, also known as "bank walkaways." With respect to mortgage servicing, the report found:

According to our interviews with Federal banking regulators, mortgage servicers' practices . . . have not been a major focus covered in their supervisory guidance in the past. The primary focus in these regulators' guidance is on activities undertaken by the institutions they oversee that create the significant risk of financial loss for the institutions. Because a mortgage servicer is generally managing loans that are actually owned or held by other entities, the servicer is not exposed to losses if the loans become delinquent or if no foreclosure is completed. As a result, the extent to which servicers' management of the foreclosure process is addressed in

regulatory guidance and consumer protection laws has been limited and uneven. For example, guidance in the mortgage banking examination handbook that OCC examiners follow when conducting examinations of banks' servicing activities notes that examiners should review the banks' handling of investor-owned loans in foreclosure, including whether servicers have a sound rationale for not completing foreclosures in time or meeting investor guidelines. In contrast, the guidance included in the manual Federal Reserve examiners use to oversee bank holding companies only contained a few pages related to mortgage servicing activities, including directing examiners to review the income earned from the servicing fee for such operations, but did not otherwise address in detail foreclosure practices.

In addition, until recently, the extent to which these regulators included mortgage servicing activities in their examinations of institutions was also limited. According to OCC and Federal Reserve staff, they conduct risk-based examinations that focus on areas of greatest risk to their institutions' financial positions as well as some other areas of potential concern, such as consumer complaints. Because the risks from mortgage servicing generally did not indicate the need to conduct more detailed reviews of these operations, Federal banking regulators had not regularly examined servicers' foreclosure practices on a loan-level basis, including whether foreclosures are completed. For example, OCC officials told us their examinations of servicing activities were generally limited to reviews of income that banks earn from servicing loans for others and did not generally include reviewing foreclosure practices.

Please describe your agencies' views of the risks related (to) the banks' servicing divisions, including:

- The losses stemming from the servicing divisions of the banks that you regulate.
- What further losses, if any, you expect.
- How your agencies have changed your examination procedures relating to banks' servicing divisions.
- Whether there will be uniform standards for servicing examination across all Federal banking agencies.

A.7. To date, there is no evidence of serious mortgage servicing deficiencies or losses related to such deficiencies at State nonmember banks supervised by the FDIC. Overall, FDIC-supervised banks tend to be less involved in mortgage servicing activities than larger institutions. Mortgage servicing is significantly concentrated in a handful of large financial institutions regulated by the OCC or Federal Reserve. For example, according to data in the September 30, 2010, Reports of Condition and Income, the top six servicers in the U.S. are national banks and account for almost 84 percent of all loans serviced by federally insured institutions. As noted in the GAO report excerpted above, the FDIC is the primary regulator for servicers that represent only 1.2 percent of the market.

When the FDIC is the primary Federal regulator for a bank with mortgage banking activities, our examiners follow an examination process that includes a core review of the institution's mortgage banking policies and procedures, origination and underwriting standards, internal controls, audit, and information systems.

The FDIC participated in an interagency review of certain financial institutions' mortgage servicing departments in late 2010 and early 2011. Based on the results of this review, we see opportunities to strengthen standards governing mortgage servicing, foreclosure processes, and loss mitigation. This may require more stringent oversight of servicers' risk management and operational controls as well as ensuring internal and external audits are designed to identify weaknesses and report them to management. It may also require that more attention be paid to the reputational risks associated with servicing failures. In addition, the FDIC is working with other bank regulatory agencies to develop national mortgage servicing standards. Once these standards are finalized, the agencies will consider what revisions may need to be made to existing examination procedures to ensure servicing operations meet specified requirements.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARNER FROM SHEILA C. BAIR

Q.1. For each of the witnesses, though the Offce of Financial Research does not have a Director, what are each of you doing to assist OFR in harmonizing data collection, compatibility, and analysis?

A.1. The FDIC has ongoing discussions with the Office of Financial Research (OFR) staff. We look forward to sharing our considerable experience in obtaining, aggregating, analyzing and reporting financial data and information, and expect to contribute significant support to the OFR.

Q.2. Chairman Bair, each of your agencies was charged with working together to develop orderly liquidation plans for systemically significant financial institutions so that they can avoid needing resolution under Title 2 if they fail. Where are we in that process and when can we expect companies to start submitting plans to you for review and approval?

A.2. Section 165 of the Dodd-Frank Act requires the FDIC to promulgate joint rules with the Federal Reserve that set forth the regulatory standards and filing requirements for resolution plans. The plans are to be jointly reviewed and enforced by the FDIC and Federal Reserve. The FDIC is working closely with the Federal Reserve to jointly promulgate rules under section 165 of Title I. It is the FDIC's publicly expressed desire to issue these standards in the very near term. The standards would establish a time line and process for firms to submit resolution plans.

Q.3. Chairman Bair, most of the companies subject to the requirement for an orderly liquidation plan are multinational in at least some respect. What cross border issues have you uncovered and how are you working to address those issues? Are there any legal barriers to resolving those issues in a way that ensures the plans work?

A.3. A primary challenge the FDIC is addressing in the area of international coordination is conforming resolution regimes and the adoption of consistent resolution and receivership mechanisms, standards and policies in order to more effectively conduct an or-

derly resolution of internationally active firms. In coordination with the Financial Stability Board (FSB) Cross-Border Crisis Management Group and as Chair of the Basel Committee on Banking Supervision (BCBS) Cross-Border Resolutions Group, the FDIC has led a number of meetings during 2010 with international resolution authorities and supervisors to address these challenges and identify obstacles to overcoming them.

In order to address the challenges presented by cross-border resolutions, the Financial Stability Board (FSB) has made various recommendations to be adopted by participating jurisdictions. In its recently published paper titled, "Reducing the Moral Hazard Posed by Systemically Important Financial Institutions (SIFIs)," the FSB outlines recommendations to assist in resolving a systemically important international financial institution. The paper recommends that comprehensive resolution regimes and tools must be established in order for SIFIs to be resolved properly. The various recommendations are:

- All jurisdictions should undertake the necessary legal reforms to ensure that they have in place a resolution regime which would make feasible the resolution of any financial institution without taxpayer exposure to loss from solvency support while protecting vital economic functions through mechanisms which make it possible for shareholders and unsecured and uninsured creditors to absorb losses in their order of seniority.
- Each country should have a designated resolution authority responsible for exercising resolution powers over financial institutions. The resolution authority should have the powers and tools proposed in the FSB note on Key Attributes of Effective Resolution Regimes and in the BCBS Cross-Border Bank Resolution Group Recommendations and the flexibility to tailor resolution measures to the specific nature of financial institutions' domestic and international business activities.
- National authorities should consider restructuring mechanisms to allow recapitalization of a financial institution as a going concern by way of contractual and/or statutory (*i.e.,* within-resolution) debt-equity conversion and write-down tools, as appropriate to their legal frameworks and market capacity. Such mechanisms require that a robust resolution regime be in place.

The FSB's program has built on work undertaken by the BCBS Cross-Border Bank Resolution Group, cochaired by the FDIC since 2007. In support of these efforts, the FDIC is participating in multiple international working groups that are analyzing resolution challenges associated with derivatives booking practices, business line management and legal entity operations, global payment systems, intragroup guarantees and interconnectedness, resolvability, contingent capital, and similar issues. Also, to inform decision making and assist in the conformance of resolution regimes, the FSB is conducting a stock-taking of the resolution regimes and approaches in multiple jurisdictions. The FDIC has been an active participant in these efforts. There are ongoing institution-specific Crisis Management Group meetings involving relevant inter-

national supervisors and resolution authorities relative to firm-specific recovery and resolution planning.

Q.4. Chairman Bair, I believe that the Qualified Residential Mortgage is a significant effort towards repairing our underwriting problems and lack of private sector investment in the housing market right now. I understand there is concern that because these qualified mortgages will be exempted from risk retention standards, we want this type of mortgage to be affordable and available. Can you tell us how you are weighing the construct of a QRM—including down payment, income, LTV, and the use of private insurance?

A.4. Section 941 of the Dodd-Frank Act, titled, Regulation of Credit Risk Retention, requires the FDIC (together with the Federal Reserve Board, Office of the Comptroller of the Currency, Securities and Exchange Commission, Department of Housing and Urban Development, and the Federal Housing Finance Agency) to require securitizers to retain no less than 5 percent of the credit of any assets transferred to investors through the issuance of an asset-backed security (ABS). Section 941 exempts certain ABS issuances from the general risk retention requirement, including ABS issuances collateralized exclusively by "qualified residential mortgages" (QRMs), as jointly defined by the agencies.

An interagency working group is near completion of a notice of proposed rulemaking to implement section 941. I anticipate the proposed rule will solicit public comment on various options for satisfying the credit risk retention requirements of section 941, as well as the appropriateness of certain exemptions. In considering how to determine whether a mortgage qualifies for the QRM exemption, the agencies are examining data from several sources. One data set consists of 10 years of performance information on more than 78 million mortgage loans, and includes data on loan products and terms, borrower characteristics (for example, income and credit score), and performance data through the third quarter of 2010.

I believe the underwriting and product features for QRM loans should include standards related to the borrower's ability and willingness to repay the mortgage (as measured by the borrower's debt-to-income (DTI) ratio); the borrower's credit history; the borrower's down payment amount and sources; the loan-to-value (LTV) ratio for the loan; the form of valuation used in underwriting the loan; the type of mortgage involved; the owner-occupancy status of the property securing the mortgage; and whether the loan documents include mortgage servicing standards that require the servicer to work with the borrower if the borrower is past due or in default.

The proposed QRM standards should be transparent to, and verifiable by, originators, securitizers, investors, and supervisors. This approach should assist originators of all sizes in determining whether residential mortgages will qualify for the QRM exemption, and assist ABS issuers and investors in assessing whether a pool of mortgages will meet the requirements of the QRM exemption. In addition, I believe the approach taken by the proposal should allow individual QRM loans to be modified after securitization without

the loan ceasing to be a QRM in order to avoid creating a disincentive to engaging in appropriate loan modifications.

As required by section 941, the agencies will also consider information regarding the credit risk mitigation effects of mortgage guarantee insurance or other credit enhancements obtained at the time of origination. If such guarantees are backed by sufficient capital, they likely lower the credit risk faced by lenders or purchasers of securities because they typically payout when borrowers default. However, the agencies have not identified studies or historical loan performance data adequately demonstrating that mortgages with such credit enhancements are less likely to default than other mortgages, after adequately controlling for loan underwriting or other factors known to influence credit performance—especially LTV ratios. Therefore, at this time I do not believe the proposal should include any criteria regarding mortgage guarantee insurance or other types of insurance or credit enhancements. The proposal should, however, solicit public comment on the appropriateness of recognizing such insurance or credit enhancements, and the appropriate definition, characteristics, and requirements for QRM loans for purposes of the final rule.

Again, the proposed rule will be open to public comment and the FDIC and the other agencies will take such comments into account in their deliberations.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MERKLEY FROM SHEILA C. BAIR

Q.1. *Community Banks and Economic Growth*—I have heard from some of my local community banks that certain capital, accounting, and examination rules may be working at cross purposes with the ability of community banks to serve the economic growth needs of the families and small businesses they serve in their communities, especially when compared to standards applied to the largest national banks. I wish to bring several to your attention and ask that you comment:

The Financial Accounting Standards Board's proposed exposure draft on "Troubled Debt Restructurings" (TDRs) has been pointed out as possibly creating a capital disincentive for banks to engage in work-outs and modifications with their business borrowers because of the effect of immediately having to declare those loans "impaired." In addition, for banks over $10 billion in asset size, there may be additional direct costs for FDIC premiums based on a formula that considers TDR activity.

The disallowance to Risk-Based Capital of the amount of Allowance for Loan Losses (ALLL) in excess of 1.25 percent of Risk Weighted Assets has been flagged as a challenge in this environment, where some firms have ALLL that significantly exceeds that threshold. This may serve to understate the risk-based capital strength of the bank, adding to costs and negatively impacting customer and investor perceptions of the bank's strength.

It has been reported that examiners have rejected appraisals that are less than 9 months old when regulatory guidance calls for accepting appraisals of up to 12 months.

Community banks are subject to examination in some cases as frequently as every 3 months. In contrast, some suggest that our largest national banks may not ever undergo an examination as thorough, with the challenges surrounding loan documentation, foreclosure, and MERS as a glaring example of the results.

Are there regulatory or supervisory adjustments in these or related areas that need to be made to facilitate community banks' abilities to serve their communities?

In addition, have you considered ways in which capital charges, accounting rules, and examination rules for community banks in particular can be adapted to be less procyclical, such that they do not become stricter into an economic downturn and lighter at the top of an upturn?

Finally, what procedures do you have in place to ensure that our community banks and our largest national banks are not subject to differing examination standards, even when they are examined by different regulators?

A.1. The FDIC reviews its supervisory programs regularly to ensure they are effective, consistent, and applied equitably. We agree that the past several years have been very difficult for financial institutions as they have experienced the effects of weakness in economic and real estate markets. As you point out, loan accounting and related financial reporting standards can significantly impact financial institutions during economic downturns as the volume of problem credits increases. As banks work with borrowers to prudently restructure loans—an activity that has been encouraged by the banking regulators to help troubled borrowers—U.S. generally accepted accounting principles (GAAP) require certain modified loans to be designated as Troubled Debt Restructurings (TDRs). This is not a regulatory directive but rather a longstanding accounting requirement. The FDIC believes that accurate and timely financial and regulatory reporting in conformity with GAAP, which is required by statute, fosters transparency and provides decision-useful information for financial institution stakeholders.

The Financial Accounting Standards Board (FASB) October 2010 proposal on TDRs is intended to clarify the existing accounting standards on TDRs by providing additional guidance on aspects of these standards for which diversity in practice has developed. We presume the proposal is not designed to change existing criteria for determining when a loan modification constitutes a TDR, *i.e.,* when a borrower is experiencing financial difficulties and a concession has been granted by the lender. For the most part, the proposed clarifications would provide useful guidance to institutions. However, we urged the FASB to revise one portion of the proposal to ensure a restructuring is not automatically a TDR simply because a borrower does not have access to funds at a market rate for debt with similar risk characteristics as the restructured note. In an environment where some otherwise creditworthy borrowers have found it difficult to obtain or renew credit, we are concerned this proposed clarification may be interpreted in a manner that would result in many modifications, extensions, and renewals of loans being mischaracterized as TDRs. In its redeliberations on this proposal to address issues raised by commenters, the FASB has decided to modify the provision that concerned us.

The FDIC Board approved a final rule revising the risk-based assessment system for large insured depository institutions on February 7, 2011. Large institutions generally are those with at least $10 billion in total assets. Under the final rule, assessment rates for these institutions will be calculated using scorecards that combine CAMELS ratings and certain forward-looking financial measures to assess the risk a large institution poses to the Deposit Insurance Fund. The multiple quantitative measures in these scorecards are intended to differentiate risk based on how large institutions would fare during periods of economic stress. One of these measures considers the volume of underperforming loans—a component of which is loans that are TORs—as a percentage of capital and reserves. In developing the revised large institution assessment system, computations of the scorecards' new measures using financial data from 2005 through 2008 were found to be predictive of the performance of large institutions in 2009. Therefore, we believe it is appropriate to consider TORs as one of many data inputs to this assessment system.

The Allowance for Loan and Lease Losses (ALLL) covers estimated credit losses on individually evaluated loans determined to be impaired, as well as estimated credit losses inherent in the remainder of the loan and lease portfolio. As such, the ALLL is set aside to absorb specific losses that have yet to be recognized for accounting purposes. Therefore, the ALLL's loss absorbing capacity is limited to certain credit losses and is unavailable to absorb losses in the same manner as other capital instruments. To recognize this limited loss-absorbing capability, the current risk-based capital rules provide that ALLL is only included in tier 2 capital up to 1.25 percent of risk-weighted assets. This view of the limited loss-absorbing capacity of ALLL was reinforced by the recent Basel II agreement released by the Basel Committee for Banking Supervision which retained the existing treatment.

Real estate appraisals are also a significant issue during real estate downturns, and this economic cycle has been no exception. Many institutions have been prudently updating appraisals to better understand collateral position and, as you point out, examiners review appraisal reports as part of their loan review process. There have been some misconceptions about regulatory expectations for appraisals, and we believe recent guidance has helped clarify requirements. On December 2, 2010, the Federal banking agencies issued the Interagency Appraisal and Evaluation Guidelines. These guidelines provide banks with the regulators' perspective on how valuations should be used in the loan modification process, clarifies criteria for inspecting mortgaged properties' physical condition, eliminates confusing terminology, provides explanations on the use of automated valuation models, and strengthens the independence of the collateral valuation function. Overall, we believe this guidance will enhance banks' understanding of regulatory expectations and flexibilities related to collateral valuation.

We agree that there are differences in the examination approach for large and community financial institutions. Large banks are typically supervised by examiners stationed at the institution on a resident basis and perform continuous supervisory activities during the year. In such cases, one annual Report of Examination is gen-

erated under statutory examination timeframes as well as "targeted" examinations at various intervals. Targeted reviews delve into a financial institution's specific business lines and are used to examine the safety and soundness of certain activities through transaction testing and reviews of policies and procedures. For example, targeted reviews recently have been completed at several large institutions to investigate internal foreclosure processes. On the other hand, community bank supervision relies on point-in-time annual on-site examinations and off-site surveillance during interim periods. We also conduct visitations at certain community institutions to determine their success in achieving the goals of corrective programs or look into any areas of emerging risk. The on-site component of these visitations typically lasts a week or less. Although there is a different approach for supervising large and small institutions, both rely on a risk-focused methodology customized to each institution's size, business lines, and inherent risk.

The Federal banking agencies recognize the importance of consistent examinations for all institution sizes, and we take steps to ensure the supervisory process is applied fairly for large banks and community institutions. The Federal Financial Institutions Examination Council (FFIEC) was created, in part, to ensure that financial institutions are subject to appropriate examination standards. Accordingly, the FFIEC sponsors a variety of collaborative workstreams among the Federal banking agencies relating to examination procedures, data collection efforts, and training processes that help ensure financial institutions are supervised consistently.

Q.2. *International Coordination Regarding Resolution*—Our largest financial firms today operate across many national boundaries. Some firms are aiming to conduct 50 percent or more of their business internationally. Can you update the Committee on the status and any challenges regarding the establishment of mechanisms, plans, and other aspects of coordination between international regulatory bodies to ensure that financial firms operating internationally can be effectively placed into the Dodd-Frank resolution regime and are not otherwise able to attain "too big to fail" status through international regulatory arbitrage?

A.2. Given the complexity and complications of resolving internationally active institutions, the FDIC continues to engage counterparts in other countries to develop greater understanding and coordination to improve the ability of achieving an orderly liquidation in the event of the failure of such an institution. While some of this work involves working toward Memorandums of Understanding (MOUs) with other countries, much of the focus of bilateral and multilateral efforts (through the Basel Committee on Bank Supervision and the Financial Stability Board (FSB)) are on reforming foreign laws to allow better coordination with U.S. law, and identifying and addressing potential conflicts.

With respect to MOUs, for example, the FDIC entered into an MOU with the Bank of England in January 2010 to expand cooperation when we act as resolution authorities in resolving troubled deposit-taking financial institutions with activities in the U.S. and the United Kingdom. In addition, the FDIC and the China

Banking Regulatory Commission signed an agreement in May 2010 to expand cooperation on contingency planning, coordination and information sharing related to crisis management and the potential resolution of banks active in the two countries.

Further, in coordination with the FSB Cross-Border Crisis Management Group, and as Chair of the Basel Committee on Banking Supervision (BCBS) Cross-Border Resolutions Group, the FDIC has led a number of meetings during 2010 with international resolution authorities and supervisors to address the challenges in the area of international coordination and identify obstacles to overcoming them.

In order to address the challenges presented by cross-border resolutions, the FSB has made various recommendations to be adopted by participating jurisdictions. In its October 2010 paper titled, "Reducing the Moral Hazard Posed by Systemically Important Financial Institutions (SIFIs)," the FSB outlines recommendations to assist in resolving a systemically important international financial institution. The paper recommends that comprehensive resolution regimes and tools must be established in order for SIFIs to be resolved properly. The various recommendations are:

- All jurisdictions should undertake the necessary legal reforms to ensure that they have in place a resolution regime which would make feasible the resolution of any financial institution without taxpayer exposure to loss from solvency support while protecting vital economic functions through mechanisms which make it possible for shareholders and unsecured and uninsured creditors to absorb losses in their order of seniority.
- Each country should have a designated resolution authority responsible for exercising resolution powers over financial institutions. The resolution authority should have the powers and tools proposed in the FSB note on Key Attributes of Effective Resolution Regimes and in the BCBS Cross-border Bank Resolution Group Recommendations and the flexibility to tailor resolution measures to the specific nature of financial institutions' domestic and international business activities.
- National authorities should consider restructuring mechanisms to allow recapitalization of a financial institution as a going concern by way of contractual and/or statutory (*i.e.,* within-resolution) debt-equity conversion and write-down tools, as appropriate to their legal frameworks and market capacity. However, to be effective, such mechanisms require that a robust resolution regime already be in place.

In support of these efforts, the FDIC is participating in multiple international working groups that are analyzing resolution challenges associated with derivatives booking practices, business line management and legal entity operations, global payment systems, intragroup guarantees and interconnectedness, resolvability, contingent capital, and similar issues.

Another important aspect of the FDIC's efforts to promote cooperative efforts with international regulators is through the FDIC's work with the Federal Reserve to formalize the structure and content of resolution plans (living wills). For an internationally active institution, one function of a resolution plan will be to identify

business lines that operate in international jurisdictions and delineate how such operations could be addressed in the event of a failure, recognizing that such operations may be subject to the laws of other countries.

Q.3. Please also update the Committee on the status of the regulation of international payments systems and other internal systemic financial market utilities so that the entities that manage or participate in them are not able to avoid the resolution regime through international regulatory arbitrage.

A.3. The Financial Stability Oversight Council (FSOC) has issued an advance notice of proposed rulemaking addressing the designation of financial market utilities (FMUs) as systemically significant and subject to heightened supervision under Title VIII of the Dodd-Frank Act. A notice of proposed rulemaking is expected to be issued by the FSOC sometime later this month. While these entities are not subject to heightened prudential standards under Title I of the Act, they will be subject to further rulemaking and prudential standards under Title VII. Furthermore, to the extent that such activities are carried out through a bank holding company or nonbank financial company designated under Title I for heightened supervision, the entity and the activities it engages in will be subject to supervision by the Federal Reserve.

An FMU typically would be resolved under applicable State or Federal insolvency law, including liquidation or reorganization under the Bankruptcy Code. One of these entities could potentially be subject to resolution under title II of the Dodd-Frank Act if it is a financial company predominantly engaged in financial activities and a systemic risk determination were to be made under section 203 of the Dodd-Frank Act. However, such a determination would be made at the time an FMU were to become troubled. While U.S. entities may be subject to resolution under Title II of the Dodd-Frank Act, Title II orderly liquidation authority does not extend to foreign-based corporate entities. International bodies, such as the FSB, International Organization of Securities Commissions (IOSCO) and the Basel Committee on Banking Supervision provide a forum to monitor the nature and extent of any differences in the implementation of supervisory standards on an international basis. These international bodies are working to address issues associated with international payment systems and the potential destabilizing effects that could occur if a major payment system were to fail or suffer severe disruptions due to the failure of a large member. In particular, the FSB Cross-Border Crisis Management Group has established a work stream relating to global payments operations and is developing recommendations related to global payments operations in the context of a cross-border resolution. This work also is being conducted on a firm-specific basis through the FSB Crisis Management Group.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM SHEILA C. BAIR

Q.1. Dodd-Frank requires that risk retention be jointly considered by the regulators for each different type of asset and includes a specific statutory mandate related to any potential reforms of the

commercial mortgage-backed securities to limit disruptions. Given the importance of rigorous cost-benefit and economic impact analyses and the need for due consideration of public comments, do your agencies need more time than is provided by the looming April deadline?

A.1. Section 941 of the Dodd-Frank Act, titled, *Regulation of Credit Risk Retention,* requires the FDIC (together with the Federal Reserve Board, Office of the Comptroller of the Currency, Securities and Exchange Commission, Department of Housing and Urban Development, and the Federal Housing Finance Agency) to require securitizers to retain no less than 5 percent of the credit of any assets transferred to investors through the issuance of an asset-backed security (ABS). Section 941 exempts certain ABS issuances from the general risk retention requirement, including ABS issuances collateralized exclusively by assets insured or guaranteed by the U.S. Government or an agency thereof, or "qualified residential mortgages" (QRMs), as jointly defined by the agencies.

An interagency working group has convened well over 50 times since the enactment of the Dodd-Frank Act for purposes of developing a proposal to implement section 941. All implementation issues have been analyzed and vetted thoroughly and we expect to reach an appropriate consensus informed by the unique supervisory expertise of the respective agencies.

The interagency working group is near completion of a notice of proposed rulemaking. It is my expectation that the proposed rule would solicit public comment on various options for satisfying the credit risk retention requirements of section 941, including an option that recognizes widely used industry practices in structuring commercial mortgage-backed securities, as well as the appropriateness of certain exemptions. The proposed rule also will set forth and solicit public comment on the economic and cost-benefit analyses required under the Administrative Procedure Act, the Regulatory Flexibility Act, and Unfunded Mandates Reform Act of 1995.

I believe that the many options included in the proposed rules with respect to the risk retention requirements should ensure that securitizers retain a meaningful amount of credit risk in a way that minimizes the potential adverse impact of the proposed rule on the availability and costs of credit to consumers and businesses. At the same time, the proposed rules should be consistent with the stated objectives of section 941 and foster sound underwriting and prudent risk management practices with respect to loans that are originated for securitization. The FDIC Board is expected to approve and adopt the proposed rule in advance of the statutory deadline.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM SHEILA C. BAIR

Q.1. A Bloomberg news story, citing a Financial Stabilty Oversight Council (FSOC) staff report marked "confidential," indicates that there is a parallel regulatory track with respect to the designation of systemically significant nonbank financial companies. The Bloomberg story mentions FSOC staff are moving forward with "confidential" criteria that will be used to designate systemically

important nonbank financial institutions. However, unlike the proposed rule, which merely restates the statutory language, these confidential criteria are not subject to public comment and has yet to be reviewed by anyone outside of the council aside from this news report. This raises serious questions about the transparency of FSOC's rulemaking process.

From what has been reported, portions of the leaked report conclude that an insurer failure could create adverse macroeconomic impact. This conclusion appears to have been reached without the required insurance expertise, which has yet to be appointed. A similar conclusion was made with respect to hedge funds.

Unfortunately, there has been no public disclosure of the criteria or metrics that were used to arrive at this conclusion. As such, could you explain what metrics were applied and by whom in reaching this conclusion? What basis did the FSOC staff use to select these criteria?

A.1. The FSOC continues to develop the criteria and metrics that will be used in identifying firms as systemic, drawing upon relevant information from both public and supervisory sources. We also believe that we will likely need to gather information from firms given their complexity and the lack of readily available information that is necessary to measure their potential systemic impact. The FDIC believes that it is important to identify firms that could possibly need to be resolved under Title II authority since all firms designated as systemically significant are required to provide the FDIC and FRB with resolution plans. Resolution plans will significantly aid in our preparation efforts, resulting in a more orderly resolution. The FSOC has issued a notice of proposed rulemaking regarding the designation of nonbank financial firms under Title I of the Dodd-Frank Act. The notice of proposed rulemaking seeks public comment on the best methods to approach the designation of firms, and the application of systemic determination criteria on an institution-specific basis. The FDIC believes that the FSOC rulemaking on this issue should include significant detail on the process to be used by the FSOC in making designations, but also the criteria that the FSOC will employ when making designations.

The FDIC has been a strong advocate for transparency and public engagement in the regulatory processes surrounding the implementation of Act, adopting an "open door" policy under which the public has and will continue to have a larger role in the process than ever before. Under the policy, public disclosure of meetings between senior FDIC officials and private sector individuals is required to enhance openness and accountability. In addition, the FDIC has conducted various public forums and roundtables, seeking public engagement and feedback regarding related issues in the Dodd-Frank Act.

Q.2. Chairwoman Bair's written testimony to this Committee states:

> The nonbank financial sector encompasses a multitude of financial activities and business models, and potential systemic risks vary significantly across the sector. A staff committee working under the FSOC has segmented the nonbank sector into four broad categories: (1) the hedge

> fund, private equity firm, and asset management industries; (2) the insurance industry; (3) specialty lenders; and (4) broker-dealers and futures commission merchants. The council has begun developing measures of potential risks posed by these firms.
>
> The FSOC is committed to adopting a final rule on this issue later this year, with the first designations to occur shortly thereafter.

Since the rulemaking process is already underway, do you know if the Administration is planning to make this report public?

A.2. We are not aware of any plans to make this report public; however, we believe it is important that any final rule should include significant detail on the process to be used by the FSOC in making designations and the criteria that the FSOC will employ when making designations.

Q.3. Will there be an opportunity for public comment on it before any final rules are promulgated?

A.3. The FSOC issued a notice of proposed rulemaking regarding the designation of nonbank financial firms under Title I of the Dodd-Frank Act on January 26, 2011, and the comment period closed on February 25, 2011. The FSOC received 39 comments. The notice of proposed rulemaking sought public comment on the application of systemic determination criteria on an institution-specific basis. This is important from the FDIC's perspective, since all firms designated as systemic will be required to provide us and the FRB with resolution plans, that detail their assets, liabilities, counterparty exposures, and other key structural aspects of their organization on a legal entity and consolidated basis. The proposal suggests using a framework to analyze the firms and applying metrics that would be tailored to that firm's business model and industry sector. As provided in the proposed rule: "The Council would evaluate nonbank financial companies in each of the (six categories of the framework as proposed under the rule) using quantitative metrics where possible. The Council expects to use its judgment, informed by data on the six categories, to determine whether a firm should be designated as systemically important and supervised by the Board of Governors. This approach incorporates both quantitative measures and qualitative judgments."

As stated, the FDIC believes that the rule should include significant detail on the process to be used by the FSOC in making designations and the criteria that the FSOC will employ when making designations.

Q.4. What is your logic behind identifying these four categories?

A.4. These four broad categories of nonbank financial firms are considered reflective of the nonbank financial services industry generally. These broad groupings need to be established for purposes of creating appropriate analytic tools, and allows for thoughtful analysis and judgment by the FSOC. The broad delineations characterize groups as firms that invest assets for themselves or others and seek an equity-like return (asset managers), firms that primarily underwrite risks other than credit risk, such as life or casualty risks (insurers), firms that create or trade financial instru-

ments as market-makers or for the account of others (broker/dealers), and other nonbank firms that extend credit (specialty lenders). There will be firms that do not clearly fit within a particular category, and for this reason these categories are not being suggested as fixed elements of the FSOC proposed analytic framework. The proposed framework addresses factors that analyze the firm's possible impact to U.S. financial stability in the event of financial distress, analyzes characteristics of the firm in six broad categories (size, substitutability, interconnectedness, leverage, liquidity risk, existing regulatory scrutiny) in order to assess the impact of spillover effects in the event of insolvency and the firm's vulnerability to financial distress. These standards are being proposed for public comment and are designed to be consistent with congressional mandate as set forth in the Dodd-Frank Act.

Q.5. Will you publish and seek comment on the industry-specific metrics that will (be) applied, before such assessments begin, so that Congress can have confidence that FSOC is exercising its authority appropriately and impacted financial companies can be assured that they are not being treated arbitrarily?

A.5. The FSOC is responsible for making such a determination in conformance with the law and its transparency policy. As a voting member of the FSOC, the FDIC believes that these transparency and public openness standards should be vigorously applied. The FDIC believes that any rule should include significant detail on the process to be used by the FSOC in making designations and the criteria that the FSOC will employ when making designations.

Q.6. In 2004, the FDIC issued a report assessing the banking industry's exposure to an implicit Government guarantee of the GSEs. The report indicated that, "As of September 30, 2003, the initial effect of eliminating the implicit guarantee would reduce the value of banking industry GSE-related securities by $12 billion, or 1.1 percent. This initial loss of market value of securities would not severely harm overall liquidity of the banking industry. Individual institutions could be affected more depending on the amount, maturity structure, and mix of their GSE-related holdings." As you know Basel III and Dodd-Frank both continue the favored treatment of GSE debt. What are you and other regulators doing to reduce the exposure of the banking industry to Fannie Mae and Freddie Mac?

A.6. Basel III liquidity standards would require banks to hold unencumbered liquid assets sufficient to meet 30 days of a predefined stressed outflow. The published standard limits the amount of GSE exposures in this pool of liquid assets to not more than 40 percent of the total pool. The standards further limit the reliance on GSEs by requiring a 15 percent "haircut" on their balances prior to the calculation of the pool.

Additionally, from a supervisory perspective, the FDIC and the other banking agencies review banks' fixed income portfolios and attendant policies at each supervisory examination, and analyze the institution's investment decision-making process. The FDIC will continue to monitor GSE debt investments at State nonmember institutions and will ensure that banks have effective investment portfolio management processes to mitigate risk.

Q.7. Do you believe that our banking industry would be more stable if the favored treatment of GSE debt was removed?

A.7. When the recent financial crisis was in full swing, the activities of the GSEs supported financial stability. Without the ability of GSEs to support prudently underwritten mortgage credit during the last few years, the cyclical downturn in housing markets we have experienced would doubtless have been far worse. The more difficult question is, what is the effect of GSE activities during the upward phase of the business cycle: whether explicit and implicit Federal support for the housing sector encouraged the formation of the housing price bubble in the years leading to the crisis. It is difficult to disentangle all the factors that contributed to that bubble. To the extent GSEs can maintain and promote prudent credit underwriting standards for the loans they guarantee, they may be a force to constrain speculative excess during "boom" periods.

We also would note that policy changes in the treatment of GSE obligations could have implications for the ability of banks to meet capital and liquidity requirements. Removing the preferential treatment GSEs receive would make compliance with the new Basel III requirements more costly for U.S. banks. Moreover, such a change also could adversely affect the liquidity of GSE obligations. For example, at present GSE's obligations frequently serve as collateral in a debt repurchase agreement market that enhances the liquidity of banks that hold these obligations even as they hold assets with higher returns that could be earned by holding liquid U.S. Treasury securities.

Q.8. Has the FDIC done any follow up of this 2004 study so that it has a clear understanding of the exposure of our banking system to GSE debt given the fact that the GSE's are in conservatorship? If so, can you provide those details to this Committee? If not, why not?

A.8. No, the FDIC has not published a follow-up to our 2004 study. We do, however, continue to monitor closely GSE debt investments at all institutions through our internal supervisory processes. These efforts enable us to understand, analyze, and monitor the exposure of the banking system to GSE debt.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WICKER FROM SHEILA C. BAIR

Q.1. Chairman Bair, I am concerned that in our haste to identify institutions that pose a systemic risk, we may rely too heavily on the top line amount of assets a company may hold or manage and overlook the fact that many of these assets may be in individual smaller funds.

Can you please tell me how you will determine a way to look at individual investment funds and not the aggregate amount of assets under a manager in determining if a fund is systemically important?

A.1. In order to make a determination regarding systemic importance, it will be crucial for the FSOC to have a robust set of metrics that can be used to appropriately measure the factors that contribute to systemic risk. While total assets under management

is one important measure, it is only one of many different quantitative and qualitative metrics that must be viewed together in order to develop a complete picture of systemic importance. Since any measure is only as good as the data that is used to calculate it, it is vitally important that the FSOC have a robust set of detailed data at its disposal. The FSOC has taken the SIFI designation process seriously and has sought public input into the development of robust metrics. On October 2, 2010, the FSOC issued an Advance Notice of Proposed Rulemaking (ANPR), followed up a Notice of Proposed Rulemaking on January 26, 2011. The ANPR sought public comment on a host of issues, particularly the metrics that should be used to make SIFI determinations. In light of public comments received, the FSOC is considering issuing a revised notice of proposed rulemaking in the coming months to provide the public with an opportunity to comment on a more refined set of metrics.

Q.2. I am wondering if we should be worried more about funds collapsing rather than managers collapsing. If the funds are independent of each other's liabilities, what is our responsibility or concern about an individual manager?

A.2. We should be concerned about systemic risk associated with both the fund and the fund manager. From the fund perspective, it is possible that the interconnectedness of the fund with the broader financial market could cause systemic instability in the event that the fund suffered financial distress. It is also possible that a particular fund or group of funds are highly interconnected with their fund managers, such that financial distress at the fund manager could lead to systemic instability either through the interactions of the fund manager with the financial markets or out of market concern that the fund manager may be unable to provide liquidity or capital support to a particular fund in a time of distress. As one example, during the recent financial crisis, money market mutual funds with financially weaker managers were more susceptible to investment withdrawals and much more likely to "break the buck" than similar funds that were managed by more financially secure managers.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM MARY L. SCHAPIRO

Q.1. Recently, some have voiced concerns that the timeframe for the rulemakings required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is too short to allow for adequate consideration of the various comments submitted or to review how the new rules may impact our financial markets. Does the current timeframe established by Dodd-Frank allow each rulemaking to be completed in a thoughtful and deliberative manner?

A.1. Implementation of the Dodd-Frank Act is a substantial undertaking. The Act's requirement that a significant number of Commission rulemakings be completed within 1 year of the date of enactment poses significant challenges to the Commission. Throughout, the staff and Commission have been diligent in working to meet the deadlines imposed by the Dodd-Frank Act while also tak-

ing the time necessary to thoughtfully consider the issues raised by the various rulemakings.

We recognize that many of our new rules may have substantial market implications. As a result, we must be sure we have assessed those implications and provide market participants sufficient time to understand the obligations that may apply to them. We are considering how to sequence the implementation of rules so that market participants have sufficient time to develop the infrastructure needed to comply, and we also anticipate that many final rules will include implementation periods that will provide additional time for market participants to take necessary steps to achieve compliance. We also are taking steps to gather additional input on our implementation process where appropriate, such as the joint roundtable held on May 2–3 with the CFTC regarding the adoption of derivatives rules under Title VII.

Given the significant issues involved in many of the Dodd-Frank rules, it will not always be possible to meet the statutory deadlines imposed under the Act. Indeed, we have missed certain of the deadlines set forth in that Act and expect we similarly will miss others in the future. While we obviously are desirous of meeting the Act's deadlines, it is critical that we get the rules right.

Q.2. In carrying out the required rulemaking under Title VII, the SEC and the CFTC are instructed under Dodd-Frank to "treat functionally or economically similar products or entities . . . in a similar manner." However, some of the rules defining the key infrastructure for the new derivatives regime that have been proposed by the SEC and CFTC contain some significant and important differences, as is demonstrated by the different definitions for rules governing Swap Execution Facilities. How do your two agencies plan to reconcile these differences before the final rules are adopted later this year?

A.2. Since the Dodd-Frank Act was passed last July, the Commission staff has been engaged in ongoing discussions with CFTC staff regarding our respective approaches to implementing the statutory provisions for SEFs and security-based SEFs. In many cases, these discussions have led to a common approach—for example, both proposals have similar registration programs, as well as similar filing processes for rule changes and new products. As you note, however, there are differences in certain areas, such as the treatment of requests for quotes, block trades, and voice brokerage.

Our proposal reflects the Commission's preliminary views as to how the Dodd-Frank Act would best be applied to the trading of security-based swaps, which differ in certain ways from the swaps that will be regulated by the CFTC. We look forward to input from the public as to whether these differences are adequately supported by functional distinctions in the trading and liquidity characteristics of swaps and security-based swaps, as well as comments as to how the agencies' rules may be further harmonized. Based on this feedback, we plan to work with the CFTC to achieve greater harmonization of the rules for SEFs and security-based SEFs to the extent practicable.

Throughout this process, we are particularly mindful of the potential burdens on entities that will be dually registered with the

Commission and the CFTC. To this end, we have specifically requested comment in our proposal on the impact of the overall regulatory regime for such registrants, such as areas where differences in the Commission and the CFTC approaches may be particularly burdensome. We are also sensitive to the opportunity for regulatory arbitrage with respect to non-U.S. markets, and my staff has been working closely with their international colleagues to find common ground with respect to the regulation of SEFs. We expect to benefit from significant public input on both of these issues, and we will carefully consider such input in crafting our final rule.

Q.3. Please identify the key trends in the derivatives market that your agencies are currently monitoring to ensure systemic stability.

A.3. Although the Commission will not have direct electronic access to detailed swap and security-based swap data until the Dodd-Frank Act's requirements are fully implemented, the Commission currently receives periodic updates of available trade information that covers substantially all single-name and index credit default swap transactions. Commission staff currently is using this data to develop better information regarding net exposures of U.S-based market participants (or market participants trading in a U.S.-based reference entity). Commission staff intends to assess and monitor how these net exposures vary by market participant, time, and instruments to better understand when or if concentrations of risk develop.

Commission staff also is supporting an ongoing effort to classify the more than 1,400 market participants and 8,000 trading accounts managed by these participants to develop a better understanding of how swap and security-based swap transactions are being used. Because there is no standard formatting for the reporting of such transactions or the details of the relevant counterparties, considerable effort is required to assemble and verify the underlying data. Based on this experience, Commission staff has been meeting regularly with representatives of potential data repositories to discuss specifications for the Commission's direct electronic access to data in order to make such data as useful as possible to the Commission.

Though these efforts have been somewhat limited in scope (*e.g.,* equity swaps and debts swaps have not yet been covered), we expect that the data-related requirements of the Dodd-Frank Act will assist the Commission in developing better resources for identifying key trends in the security-based swap market.

Q.4. In defining the exemption for "qualified residential mortgages," are the regulators considering various measures of a lower risk of default, so that there will not just be one "bright line" factor to qualify a loan as a Q.R.M.?

A.4. The definition of "qualified residential mortgage" in the proposed rule issued jointly by the Commission and other regulators at the end of March 2011 takes into account underwriting and product features that historical loan performance data indicate result in a lower risk of default as required by the statute. Specifically, the underwriting and product features established by the Commission and other regulators for qualified residential mortgages include standards related to the borrower's ability and will-

ingness to repay the mortgage (as measured by the borrower's debt-to-income ratio); the borrower's credit history; the borrower's down payment amount; the loan-to-value ratio for the loan; the form of valuation used in underwriting the loan; the type of mortgage involved; and the owner-occupancy status of the property securing the mortgage. As stated in the Agencies' Notice of Proposed Rulemaking, a substantial body of evidence, both in academic literature and developed for rulemaking, supports the view that loans that meet the minimum standards established by the agencies have low credit risk even in stressful economic environments that combine high unemployment with sharp drops in house prices.

Q.5. What data are you using to help determine the definition of a Qualified Residential Mortgage?

A.5. In considering how to determine the definition of "qualified residential mortgage," the relevant agencies examined data from several sources. For example, the agencies reviewed data on mortgage performance supplied by the Applied Analytics division (formerly McDash Analytics) of Lender Processing Services (LPS). To minimize performance differences arising from unobservable changes across products, and to focus on loan performance through stressful environments, the agencies for the most part considered data from prime fixed-rate loans originated from 2005 to 2008. This data set included underwriting and performance information on approximately 8.9 million mortgages. As is typical among data provided by mortgage servicers, the LPS data do not include detailed information on borrower income and on other debts the borrower may have had in addition to the mortgage. For this reason, the agencies also examined data from the 1992 to 2007 waves of the triennial Survey of Consumer Finances (SCF).[1] Because families' financial conditions will change following the origination of a mortgage, the analysis of SCF data focused on respondents who had purchased their homes either in the survey year or the previous year. This data set included information on approximately 1,500 families. The agencies also examined a combined data set of loans purchased or securitized by Federal National Mortgage Association and Federal Home Loan Mortgage Corporation (the "Enterprises") from 1997 to 2009. The Enterprises' data set consisted of more than 75 million mortgages, and include data on loan products and terms, borrower characteristics (*e.g.,* income and credit score), and performance data through the third quarter of 2010.

Q.6. The Congress considered that a significant contributor to the crisis were compensation systems that encouraged management to take excessive risks. What is the experience so far with the new "say on pay" rules for public companies?

A.6. Public companies subject to the federal proxy rules are required to conduct "say-on-pay" votes at annual meetings beginning

[1] The SCF is conducted every three years by the Board of Governors of the Federal Reserve System, in cooperation with the Department of the Treasury, to provide detailed information on the finances of U.S. families. The SCF collects information on the balance sheet, pension, income, and other demographic characteristics of U.S. families. To ensure the representativeness of the study, respondents are selected randomly using a scientific sampling methodology that allows a relatively small number of families to represent all types of families in the Nation. Additional information on the SCF is available at *http://www.federalreserve.gov/pubs/oss/oss2/method.html.*

on January 21, 2011. The Commission's rules on the say-on-pay vote became effective on April 4, 2011. Although many companies have begun to conduct these votes, it is too early to gauge how these votes will be received and how shareholders will react to the opportunity to cast an advisory vote on executive compensation.

Q.7. Dodd-Frank required the SEC to conduct a 6-month study on investor protection and the duty of care observed by broker-dealers and by investment advisers who provide personalized investment advice to retail investors and gave it new rulemaking authority. In January, the majority of the Commission voted to issue a staff report on this subject. The Report recommended rulemaking to create a new uniform fiduciary duty standard and harmonize the regulation of broker-dealers and investment advisors. Two Commissioners said that additional study is needed, and called for more analysis of the existing problems and justification that the study's recommendations would improve investor protection.

Does the Commission or staff plan to further study all Commissioners' questions? How do you plan to proceed in this area to assure that such significant questions are addressed prior to making new rules?

A.7. In the study required under Section 913 of the Dodd-Frank Act, Commission staff recommended implementing a uniform fiduciary standard that would accommodate different existing business models and fee structures, preserve investor choice, and not decrease investors' access to existing products, services, or service providers. In preparing the study, the staff considered the comment letters received in response to the Commission's solicitation of comment and considered the potential costs and other burdens associated with implementing the recommended fiduciary standard. We will continue to be mindful of the potential economic impact going forward. In light of this ongoing focus, I have asked a core team of economists from the Commission's Division of Risk, Strategy and Financial Innovation (Risk Fin) to study among other things, data pertaining to the standards of conduct in place under the existing broker-dealer and investment adviser regulatory regimes to further inform the Commission.

Ultimately, if the Commission does engage in rulemaking under Section 913, as with any proposed rulemaking, the Commission would conduct an economic analysis regarding the impact of any proposed rules. Such analysis would include the views of Risk Fin, which has broad experience analyzing economic and empirical data. The Commission would then consider public comment on any such proposal, including public comment on the Commission's analysis of costs and benefits. Any final rulemaking would also take into account not only the views of all interested parties, but also the potential impact of such rules on the financial marketplace, including the impact on retail investors and the advice they receive from financial professionals.

Q.8. Please discuss the current status and timeframe of implementing the Financial Stability Oversight Council's (FSOC) rulemaking on designating nonbank financial companies as being systemically important. As a voting member of FSOC, to what extent is the Council providing clarity and details to the financial market-

place regarding the criteria and metrics that will be used by FSOC to ensure such designations are administered fairly? Is the intent behind designation decisions to deter and curtail systemically risky activity in the financial marketplace? Are diverse business models, such as the business of insurance, being fully and fairly considered as compared with other financial business models in this rulemaking?

A.8. The process of designating institutions as systemically important financial institutions, or SIFIs, is designed to identify large, nonbank financials that might pose a risk to the financial system and provide heightened prudential regulation of such firms by the Federal Reserve, and to reduce the moral hazard risks of "too big to fail."

The Council published a Notice of Proposed Rulemaking (NPR) early this year concerning the SIFI designation process, but has not yet made determinations regarding the application specific criteria for greater review or designation. In general, I think differences in industries and business models need to be closely considered and that an identical set of quantitative criteria may not be equally helpful to different types of institutions. For example, the factors that would be relevant in looking at insurance companies may differ from those that should be considered for hedge funds.

Given the important public interest in this exercise, and the inevitable judgment that will be required, I believe it is important to establish an FSOC decision-making framework that (1) is built to the maximum extent possible on the use of objective criteria; (2) provides a fair and transparent process; and (3) provides for the regular review and revisiting of determinations to ensure they are current and meaningful. I also think it is vital to try to identify the objective factors that the Council will consider with as much specificity as possible, and to make the process generally as transparent and responsive to public input as possible. As a member of the Council, I will be especially focused on providing transparency in the process in considering the adoption of final rules. The Council plans to provide additional guidance regarding its approach to designations and will seek public comment on it.

Q.9. The Dodd-Frank Act created an important program to help the SEC identify major violations of the securities laws by motivating persons with original information about such violations to come forward and act as whistleblowers, subject to very limited statutory exceptions.

Please describe the experience thus far with the program.

The National Whistleblower Center has recently reported that the existence of a whistleblower rewards program does not negatively impact the willingness of employees to use internal corporate compliance program, based on its analysis of cases filed under the False Claims Act in recent years and other data. What is your appraisal of the study by the National Whistleblower Center? Do you intend to consider such statistical analysis and data in arriving at final rules for the SEC Whistleblower Program?

A.9. Since the passage of the Dodd-Frank Act, we have been working hard to establish our new whistleblower program. Last Novem-

ber, we proposed rules to implement the statute. To date, the Commission has received hundreds of comments from a wide variety of interested persons and entities. Staff is in the process of reviewing and analyzing those comments, which will be considered in connection with the adoption of final Commission rules. We recently have seen an uptick in high quality, detailed complaints from whistleblowers, and we expect this trend to grow once the Commission's rules are finalized.

In February, we announced the hiring of Sean McKessy, the first Chief of our new Office of the Whistleblower, to oversee the program. In addition, the whistleblower fund that will be used to pay awards to qualifying whistleblowers is fully funded.

Not surprisingly, the issue of the rules' possible impact on internal compliance programs was among the most common of the comments we received in response to our proposed rules. Any staff recommendation on final rules will take into consideration the National Whistleblowers Center study and any additional empirical data provided to us.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM MARY L. SCHAPIRO

Q.1. The Dodd-Frank Act requires an unprecedented number of rulemakings over a short period of time. As a result, some deadlines have already been missed and some agencies expect to miss additional deadlines. It appears that many of the deadlines in Dodd-Frank are not realistic. Which Dodd-Frank deadlines do you anticipate not being able to meet? If Congress extended the deadlines, would you object? If your answer is yes, will you commit to meeting all of the statutory deadlines? If Congress affords additional time for rulemaking under the Dodd-Frank Act, will you be able to produce higher-quality, better coordinated rules?

A.1. As your question suggests, implementation of the Dodd-Frank Act is a substantial undertaking. The Act's requirements that a significant number of Commission rulemakings be completed within 1 year of the date of enactment poses significant challenges to the Commission. Throughout, the staff and Commission have been diligent in working to meet the deadlines imposed by the Dodd-Frank Act while also taking the time necessary to thoughtfully consider the issues raised by the various rulemakings.

We recognize that many of our new rules may have substantial market implications. As a result, we must be sure we have assessed those implications and provide market participants sufficient time to understand the obligations that may apply to them.

Given the significant issues involved in many of the Dodd-Frank rules, it will not always be possible to meet the statutory deadlines imposed under the Act. Indeed, we have missed certain of the deadlines set forth in that Act and expect we similarly will miss others in the future. While we obviously are desirous of meeting the Act's deadlines, it is critical that we get the rules right.

To help keep the public informed, we have created a new section on our Web site that provides detail about the Commission's implementation of the Act. We also are taking steps to gather additional input on our implementation process where appropriate, such as

the joint roundtable held on May 2 and 3 with the CFTC regarding the adoption of derivatives rules under Title VII. We value, and are committed to seeking, the broad public input and consultation needed to promulgate these important rules.

Q.2. Secretary Geithner recently talked about the difficulty of designating nonbank financial institutions as systemic. He said, "it depends too much on the state of the world at the time. You won't be able to make a judgment about what's systemic and what's not until you know the nature of the shock." If it is impossible to know which firms are systemic until a crisis occurs, the Financial Stability Oversight Council will have a very difficult time objectively selecting systemic banks and nonbanks for heightened regulation. As a member of the Council, do you believe that firms can be designated *ex ante* as systemic in a manner that is not arbitrary? If your answer is yes, please explain how.

A.2. It is important to begin by distinguishing between designations made pursuant to Title I of the Dodd-Frank Act (*i.e.,* as a systemically important financial institutions, or SIFIs, subject to heightened prudential oversight by the Federal Reserve) and "systemic risk determinations" for special resolution of financial companies made pursuant to Title II.

Regarding Title II systemic risk determinations for special resolution of financial companies, I agree that regulators would not normally make such determinations without first understanding the nature of the shock that gave rise to risk and the potential need for the determination.

The SIFI designation, however, is separate and apart from the Title II designation. Although it is not likely possible to identify all potential causes of, and conditions leading to, systemic risk, it should be possible to identify firms that engage in levels of activity sufficient to warrant further oversight. The purpose of SIFI, then, is to examine a broader range of firms so that large, interconnected and potentially systemic firms do not "fall through the regulatory cracks."

Furthermore, through additional consolidated Federal Reserve oversight, the goal of SIFI designations should be to proactively address the risks in such firms so that they do not become "too big to fail" institutions. It is important to note that large interconnected firms exist whether or not SIFI designations are made. The purpose of SIFI is not to create a new type of entity, but rather to acknowledge that such large entities may exist, identify them when possible, and to bring them under the fold of prudential oversight in a way that may enable a bankruptcy—or orderly wind down—for firms that might otherwise have posed "too big to fail risks" on the market and the Government. There is always the possibility that new risks will develop that were not considered systemic, or even well-understood, as designations are made. But that should not deter regulators from identifying firms that are susceptible to the risk that are presently well understood. For these designations, FSOC will seek to determine whether the "material financial distress; or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of [a] U.S. nonbank financial company, could pose a threat to the financial stability of

the United States." This will require a deep understanding of the ongoing characteristics of a nonbank financial company (for example, its size and leverage, among other things) rather than the nature of particular "shocks" that might give rise to a specific near term systemic risk.

Accordingly, I do believe SIFI designations can be made *ex ante* without being arbitrary. Given the inevitable judgment involved, however, I believe it is important to establish an FSOC decision-making framework that (1) is built, to the maximum extent possible, on the use of objective criteria; (2) provides a fair and transparent process; and (3) provides for the regular review and revisiting of determinations to ensure they are both current and meaningful.

Q.3. Section 112 of the Dodd-Frank Act requires the Financial Stability Oversight Council to annually report to Congress on the Council's activities and determinations, significant financial market and regulatory developments, and emerging threats to the financial stability of the United States. Each voting member of the Council must submit a signed statement to the Congress affirming that such member believes the Council, the Government, and the private sector are taking all reasonable steps to ensure financial stability and mitigate systemic risk. Alternatively, the voting member shall submit a dissenting statement. When does the Council expect to supply the initial report to Congress?

A.3. I expect the Council will supply its initial report to Congress at some point later this year.

Q.4. Which provisions of Dodd-Frank create the most incentives for market participants to conduct business activities outside the United States? Have you done any empirical analysis on whether Dodd-Frank will impact the competitiveness of U.S. financial markets? If so, please provide that analysis.

A.4. There are a number of provisions in the Federal securities laws that require the Commission to consider the competitive effects of its rules. Many of those provisions further require the Commission, before approving a rule, to determine that the rule is necessary and appropriate in the public interest, and for the protection of investors. Section 3(f) of the Exchange Act generally requires the Commission to consider whether the rules will promote efficiency, competition, and capital formation. In addition, the Commission must consider the impact these rules would have on competition under Section 23(a) of the Exchange Act.

The releases that accompany our rules include our analysis of these issues. To the extent that the Commission believes that a proposed rule would create an incentive for market participants to conduct business activities outside the United States, that effect would be discussed in the analysis contained in the release. We also seek comment on the competitive impact of our rules, both to elicit this information as well as to better inform us of the potential effects of our rules.

In addition, the Commission is consulting bilaterally and through multilateral organizations with counterparts abroad regarding the international consequences of implementation of the Dodd-Frank Act. The Commission, for example, together with the CFTC, is di-

rected by the Dodd-Frank Act to consult and coordinate with foreign regulators on the establishment of consistent international standards with respect to the regulation of swaps, security-based swaps, swap entities and security-based swap entities. We believe that the recently formed IOSCO Task Force on OTC Derivatives Regulation, which the Commission cochairs, as well as other international fora, will help this effort.

Q.5. More than 6 months have passed since the passage of the Dodd-Frank Act, and you are deeply involved in implementing the Act's approximately 2,400 pages. Which provisions of the Dodd-Frank Act are proving particularly difficult to implement? Have you discovered any technical or substantive errors in the Dodd-Frank legislation? If so, please describe them.

A.5. The Dodd-Frank Act includes over 100 rulemaking provisions applicable to the SEC. As discussed above, we recognize that many of the rules that result may have substantial market implications. Accordingly, we are taking the time to thoughtfully consider how to sequence the implementation of rules so that market participants have sufficient time to develop the infrastructure needed to comply. We also anticipate that certain final rules will include implementation periods that will provide additional time for market participants to take the necessary steps to achieve compliance.

In the course of our efforts to implement the Dodd-Frank Act, we have discovered technical errors or inconsistencies in some of the provisions of the statute. To date, we have been able to work around these errors in our rulemaking. If we find that we cannot do so in a particular circumstance, we will reach out to Congress with potential legislative fixes.

Q.6. What steps are you taking to understand the impact that your agency's rules under Dodd-Frank will have on the U.S. economy and its competitiveness? What are the key ways in which you anticipate that requirements under the Dodd-Frank Act will affect the U.S. economy and its competitiveness? What are your estimates of the effect that the Dodd-Frank Act requirements will have on the jobless rate in the United States?

A.6. As with all of the Commission's rulemaking, we are carefully analyzing the costs and benefits of the rules we are implementing under the Dodd-Frank Act. In its proposing releases, the Commission includes a cost-benefit analysis and invites public comment. In adopting releases, the Commission responds to those comments and revises its analysis as appropriate.

In addition, as set forth in various administrative law provisions, the Commission undertakes other types of analyses in its rulemaking. For example, the Commission estimates the information collection burdens under the Paperwork Reduction Act, and also assesses the potential effects on small entities under the Regulatory Flexibility Act.

The Commission also is subject to particular provisions in the federal securities laws that require it generally to consider the effects of its rules on competition, efficiency and capital formation (*e.g.,* Section 3(f) of the Securities Exchange Act of 1934 and similar provisions in the Securities Act of 1933, Investment Company Act of 1940, and Investment Advisers Act of 1940). Moreover,

under Section 23(a) of the Exchange Act, the Commission must consider the impact any rule would have on competition. The Commission has included these analyses in its rulemaking releases under the Dodd-Frank Act and solicited comment on the analyses.

Q.7. What steps are you taking to assess the aggregate costs of compliance with each Dodd-Frank rulemaking? What steps are you taking to assess the aggregate costs of compliance with all Dodd-Frank rulemakings, which may be greater than the sum of all of the individual rules' compliance costs? Please describe all relevant reports or studies you have undertaken to quantify compliance costs for each rule you have proposed or adopted. Please provide an aggregate estimate of the compliance costs of the Dodd-Frank rules that you have proposed or adopted to date.

A.7. As noted, the Commission undertakes various types of analyses to determine the costs and impacts of its rules. In its cost-benefit analyses, the rulemaking staff from the responsible Division works closely with the economists from our Division of Risk, Strategy, and Financial Innovation (Risk Fin) to identify the proposed rule's possible costs and benefits (including the compliance costs and other economic impacts of rules) and to develop an analysis that takes into account the relevant data and economic literature. Once senior members of the division primarily responsible for the rule and Risk Fin have reviewed this information, each of the Commissioners review and comment extensively on the draft proposing release. Ultimately, the proposing release, including the economic and cost-benefit analyses, is voted on by the Commission for release to the public.

Specifically with respect to compliance costs resulting from paperwork burdens, the Commission in each proposed rulemaking seeks comment from the public on the estimated paperwork burden associated with each rule. It analyzes the comments received, makes appropriate changes based on these comments, and includes a discussion of the comments received and any changes made in the adopting release.

To better inform the Commission of the aggregate cost of its rules, in several proposing releases related to Dodd-Frank, the Commission has specifically asked commenters about the interaction of a particular rulemaking with other provisions of the Dodd-Frank Act or rules adopted thereunder. In the proposing release regarding the process for review of security-based swaps for mandatory clearing, for example, the Commission requested comment in its cost-benefit analysis on whether other provisions of the Dodd-Frank Act for which Commission rulemaking was required were likely to have an effect on the costs and benefits of the proposed rules.

Q.8. Section 115 of the Dodd-Frank Act asks the Financial Stability Oversight Council to make recommendations to the Federal Reserve on establishing more stringent capital standards for large financial institutions. In addition, Section 165 requires the Fed to adopt more stringent standards for large financial institutions relative to smaller financial institutions. Chairman Bernanke's testimony for this hearing implied that the Basel III framework satisfies the Fed's obligation to impose more stringent capital on large

financial institutions. As a member of the Financial Stability Oversight Council, do you agree with Chairman Bernanke that the Basel III standards are sufficient to meet the Dodd-Frank Act requirement for more stringent capital standards? Please explain the basis for your answer.

A.8. While the Commission is not a member of the Basel Committee, I understand that the Basel III standards will be phased in gradually and that the Committee will use that transition period to assess whether the proposed design and calibration of the standards is appropriate over a full credit cycle and for different types of business models. The capital requirements in the Basel III standards also will be subject to an observation period and will include a review clause to address any unintended consequences. I look forward to reviewing these standards with other members of the Financial Stability Oversight Council to determine whether they fulfill the Dodd-Frank Act requirement for increased capital standards.

Q.9. The Fed, the SEC, the FDIC, and the CFTC are all structured as boards or commissions. This means that before they can implement a rule they must obtain the support of a majority of their board members. How has your board or commission functioned as you have been tackling the difficult job of implementing Dodd-Frank? Have you found that the other members of your board or commission have made positive contributions to the process?

A.9. The Commission has begun implementing the Dodd-Frank Act in the same manner as it performs its other responsibilities—with dedication and the benefits that each Commissioner's insights, experience and expertise provide. To assist Commissioners in handling the significantly increased workload represented by the Dodd-Frank rulemaking, each has been authorized to hire an additional counsel. I feel strongly that our rulemaking—be it Dodd-Frank or otherwise—is better informed, considers a wider array of potential outcomes, and is articulated more clearly because of the combined contributions of each Commissioner.

Q.10. The SEC and CFTC are both spending many resources on writing rules and initiating the oversight programs for over-the-counter derivatives. These parallel efforts are in many respects redundant, costly, and potentially damaging to the market. Would a combined SEC–CFTC unit to deal with swaps and security-based swaps reduce implementation costs, eliminate the redundancy of having two sets of rules, and provide for a more certain and effective regulatory regime?

A.10. There are important similarities between swaps and security-based swaps that warrant close coordination between the SEC and the CFTC—just as there are similarities between other products for which jurisdiction is divided between the two agencies. A combined SEC–CFTC unit to deal with swaps and security-based swaps would be one way of addressing the challenges of parallel oversight of these two categories of products. Even with a combined effort, however, differing approaches to regulation and oversight may be warranted for different types of swaps and security-based swaps. For example, differing approaches to regulating security-based swaps that are economic substitutes for securities (such as total re-

turn swaps on single equity securities, where the total return swap provides economic exposure equivalent to owning a single security) may be warranted to avoid arbitrage opportunities between the securities markets and these security-based swaps. Such regulatory arbitrage could, among other things, lead to further fragmentation in U.S. equity markets and reduce investor confidence in these markets.

Q.11. Title VIII of Dodd-Frank deals with more than systemically important financial market utilities. Under Title VIII, the SEC and CFTC are authorized to prescribe and enforce regulations containing risk management standards for financial institutions engaged in payment, clearance, and settlement activities designated by the Financial Stability Oversight Council as systemically important. Should the Council designate any activities under Title VIII? If the Council designates any activities as systemically important, what are the limits to your authority under Title VIII with respect to your regulated entities that engage in designated activities? What specific actions are beyond the authority of the CFTC and SEC?

A.11. The Financial Stability Oversight Council has the authority to apply the same standards used for designating financial market utilities (FMUs) to financial institutions' payment, clearing and settlement (PCS) activity that is—or is likely to become—systemically important. This approach reflects a view that financial institutions may, in some circumstances, perform PCS activities that pose risks to the financial system broadly comparable to those posed by certain FMUs. Accordingly, additional supervision that may be warranted in such cases should not be limited simply because of the organizational structure of the entity performing the activity. That said, such organizational differences do require that appropriate additional supervisory controls be implemented differently. This is reflected in the differing powers provided to the Council with respect to PCS activity—versus FMU activity—under Title VIII of the Dodd-Frank Act. To date the Council has focused its attention on rulemaking concerning FMUs and financial institutions themselves, but I look forward to working with my colleagues on the Council to develop an approach for reviewing PCS activity.

Q.12. One of the purposes of joint rulemaking was to bring the best minds of both agencies together to design a uniform regulatory approach for OTC derivatives. In one recent joint proposal, the SEC and CFTC took two different approaches to further defining "swap dealer" and "security-based swap dealer." Specifically, the release applied the dealer-trader distinction that has been used to interpret the term "dealer" under the 1934 Act only to security-based swap dealers, not to swap dealers. Does this violate the Dodd-Frank mandate that you work together?

A.12. The Commission and CFTC have worked closely in developing rules and related interpretations regarding the definitions of "swap dealer" and "security-based swap dealer." In so doing, we have been mindful of practical differences between how "swaps" and "security-based swaps" are used and traded. These differences include the use of swaps for hedging purposes by "natural long" en-

tities in the agricultural, energy and resource sectors, as well as the use of aggregators in the swaps markets.

I believe that the proposed interpretations of the "swap dealer" and the "security-based swap dealer" definitions are generally parallel, while appropriately accounting for those differences between swaps and security-based swaps and reflecting the Commission's historic use of the "dealer-trader" distinction.

I expect the staff and Commission will carefully consider commenters' views on the rules and interpretations regarding the dealer definitions prior to promulgating a final rule.

Q.13. One of the concerns of foreign regulators and foreign market participants is a lack of clarity about the application of your derivatives regulation. What are the limits of your ability to regulate foreign swap participants and foreign transactions in the swap market? Do you think that the CFTC and SEC should define the bounds of their regulatory authority in a formal rulemaking? If not, why not?

A.13. The Commission has been actively considering how the mandates in the Dodd-Frank Act should interact with the global derivatives market and its participants, particularly those entities and transactions that may be subject to regulation by a foreign regulatory authority. We are keenly aware that the existing derivatives market is global in nature, and that cross-border issues abound, as derivatives transactions often involve counterparties and products from around the world.

The application of Title VII provisions to foreign market participants raises difficult issues regarding competition, arbitrage and international comity, among others. We believe that providing guidance on the reach of Title VII to the market either through rulemaking or other means is important. Given the complicated, interwoven nature of these matters, we have sought to avoid a piecemeal approach through the rules we have proposed thus far.

As we have been working through the implementation of each of the provisions in Title VII, we have been meeting with foreign and domestic market participants to understand their views. Additionally, the Commission continues to be actively engaged in ongoing bilateral and multilateral discussions with foreign regulators regarding the direction of international derivatives regulation generally, and the Commission's efforts to implement Title VII's requirements.

Q.14. So far, the SEC's Dodd-Frank rulemakings total more than 4,300 pages. Even if the SEC gets the additional staff it believes it needs to implement Dodd-Frank, the Commissioners still have to review every rule under consideration. Chairman Schapiro, how much of your own time is taken up reviewing all these rules? Have you personally read each proposed and final rule release? To which areas are you devoting less time than you otherwise would because you must devote so much of your time to Dodd-Frank implementation?

A.14. On average, I am spending close to two-thirds of my time on Dodd-Frank rulemaking. By the time that each proposing and adopting release is voted on by the Commission, I have (a) met with staff in multiple meetings to discuss policy options, pros and

cons (including the costs and benefits), and Commission views; (b) read and commented upon a term sheet and multiple drafts of each release, and (c) had numerous meetings with outside parties on the rules. Because of the responsibility to implement Dodd-Frank, I am spending less time on other non-Dodd-Frank rulemaking, and am accepting fewer public speaking requests that require travel, than was the case prior to Dodd-Frank's adoption.

Q.15. The Dodd-Frank Act established a reserve fund for the SEC, which was intended to enable the SEC to respond quickly to unexpected events, like the flash crash, and to help the SEC through an extended Continuing Resolution. The President's budget, however, includes $20 million in direct obligations from the reserve fund to pay for routine information technology needs. If the SEC uses its emergency reserve fund to cover routine expenses that should be on budget, what will the SEC do when it faces a true emergency?

A.15. In establishing the Reserve Fund for the SEC starting in FY2012, the Dodd-Frank Act gives the agency authority to use the Fund for expenses the Commission determines are necessary to carry out the agency's functions. The Reserve Fund will be helpful in addressing three main kinds of funding issues: multiyear technology initiatives, extended Continuing Resolutions (CR), and emergencies such as the "flash crash" that may require the quick expenditure of funds to address issues that arise.

The SEC is required to deposit into the Fund $50 million a year in registration fees, and the balance of the Fund cannot exceed $100 million. Under the Act, the SEC can cover salaries and expenses from this Fund, and then must notify Congress of each expense.

Since the provision takes effect in FY2012, the President's Budget contains an estimate of how much will be obligated from the Reserve Fund in that year. The estimate is $20 million, and it assumes that those funds will be spent primarily on technology. Potential projects include an e-Discovery system for the enforcement, examination, and other programs; knowledge management; and security improvements.

This estimate would leave $30 million available in the Reserve Fund for FY2012, which could be used for emergency needs should they arise.

Q.16. The SEC staff recently completed a study on whether a fiduciary duty should be imposed on broker-dealers, many of whom serve small towns. The study, however, failed to conduct an empirical analysis of the costs of imposing such a legal obligation. Before moving forward on any rulemaking in this area, do you believe that it is important for the SEC to conduct an empirical analysis of both the compliance costs and the impact on the availability of financial services, especially in rural communities?

A.16. The Commission solicited comments and data as part of the study required by Section 913 of the Dodd-Frank Act and received over 3,500 comment letters. Commission staff reviewed all of the comment letters and considered the many complex issues raised in them. In conjunction with drafting the study, Commission staff also met with interested parties representing investors, broker-dealers,

investment advisers, other representatives of the financial services industry, academics, state securities regulators, the North American Securities Administrator Association, and the Financial Industry Regulatory Authority.

As part of the Section 913 study, Commission staff did consider the impact of the study's recommendation of a uniform fiduciary duty on rural broker-dealers—most directly in connection with the staff's consideration of potential loss of investor choice, as mandated by the study. [1]

Commission staff considered whether potentially underserved portions of the retail investor population, including those located in rural areas, might be adversely affected by any of the options considered under Section 913. The staff concluded that the recommended uniform fiduciary standard would, in and of itself, not adversely impact such populations' access to financial products and services. In fact, the staff concluded that retail investors generally would benefit from the uniform fiduciary standard because it would better assure the integrity of the advice they receive, while continuing to allow for various compensation schemes (commissions and flat fees) and product offerings.

The staff does not expect the uniform fiduciary standard to have a disproportionate impact in rural areas. Many financial planners and other investment advisers operate in small towns today, subject to a fiduciary standard of conduct. The staff's recommendations were designed to be flexible and to accommodate different existing business models and fee structures.

In preparing the study, the staff considered the potential costs and other burdens associated with implementing the recommended fiduciary standard. We will continue to be mindful of the potential economic impact going forward. In light of this ongoing focus, I have asked a core team of economists from the Commission's Division of Risk, Strategy and Financial Innovation (Risk Fin) to review, among other things, data pertaining to the standards of conduct in place under the existing broker-dealer and investment adviser regulatory regimes to further inform the Commission.

Ultimately, if the Commission does engage in rulemaking under Section 913, as with any proposed rulemaking, the Commission would conduct an economic analysis regarding the impact of any proposed rules. Such analysis would include the views of Risk Fin, which has broad experience analyzing economic and empirical data. The Commission would then consider public comment on any such proposal, including public comment on the Commission's analysis of costs and benefits. Any final rulemaking would also take into account not only the views of all interested parties, but also the potential impact of such rules on the financial marketplace, including the impact on retail investors and the advice they receive from financial professionals. Like you, I want our regulations to promote retail investor access to affordable investment products, including those investors in rural communities.

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[1] Staff of the U.S. Securities and Exchange Commission, Study on Investment Advisers and Broker-Dealers as required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 162 (January 2011).

Q.17. The Department of Labor recently proposed to broaden the definition of "fiduciary" under ERISA. This proposal may have substantial effects on retail investors and SEC registrants. Phyllis Borzi of the Department of Labor mentioned last week that the Department has been working closely with the SEC on the issue.[2] Which members of the SEC staff and which Commissioners have consulted with the Department of Labor on its fiduciary rulemaking and what has the nature of those consultations been?

A.17. Since the Commission issued its Section 913 study, Commission staff has received and reviewed additional comments on the study, has continued to meet with interested parties to discuss their reactions to the study, and has discussed with staff of the Department of Labor its proposed rulemaking on fiduciary status. For example, with respect to developing business conduct standards for swap and security-based swap dealers and major participants, senior staff of the Division of Trading and Markets and Commodity Futures Trading Commission are coordinating with staff of the Department of Labor regarding the relationship between these business conduct standards and rules (both existing and proposed) under ERISA. Senior members of Commission staff, including Douglas J. Scheidt, Chief Counsel and Associate Director of the Division of Investment Management, and Lourdes Gonzalez, Acting Co-Chief Counsel of the Division of Trading and Markets, together with the staff from the CFTC and the Department of Labor, have participated in joint briefings with Congressional staff on these issues. Commission staff also attended the hearings held by the Department of Labor on March 1 and 2 to hear the concerns raised by affected parties. Commission staff is committed to continuing this consultative process. Similarly, if the Commission engages in rulemaking to address the recommendations in the Section 913 study, we would do so in consultation with the staff of the Department of Labor, recognizing, of course, the different mandates of the statutes that the agencies administer.

Q.18. The SEC describes its treatment of small companies under the say-on-pay rule as an exemption, but it is more appropriately described as delayed implementation. Why did the SEC choose not to exempt small companies from the say-on-pay requirements as permitted by Section 951 of the Dodd-Frank Act? More generally, what efforts are you making to assess and address the unique burdens faced by smaller public companies under Dodd-Frank Act requirements?

A.18. After reviewing and considering comments received from the public on the say-on-pay proposing release, the Commission adopted a temporary exemption for smaller reporting companies so that these issuers will not be required to conduct either a shareholder advisory vote on executive compensation or a shareholder advisory vote on the frequency of say-on-pay votes until their first annual

[2] Meredith Z. Maresca, "Borzi Says DOL Focusing on Initiatives For Disclosures, Exchanges, Lifetime Income", BNA Daily Report for Executives (Feb. 23, 2011) (available at: *http://news.bna.com/drln/display/no__alpha.adp?mode=si&frag__id=19639762&item=9DA7A4B5F927841A448E47A7E5934B24*) ("Borzi added that the Labor Department has been working closely with the Securities and Exchange Commission on the fiduciary regulations to make sure that the definition of fiduciary is 'compatible and harmonized' for both agencies.").

or other meeting of shareholders occurring on or after January 21, 2013. Based on the comments received, the Commission believes investors in smaller reporting companies have the same interest as investors in larger reporting companies in voting on executive compensation and in clear and simple disclosure of golden parachute compensation in connection with mergers and similar transactions. However, after reviewing comments on the potential burdens on smaller reporting companies, the Commission determined it was appropriate to provide additional time before smaller reporting companies are required to conduct the shareholder advisory votes on executive compensation and the frequency of say-on-pay votes.

In providing a delayed effective date for the say-on-pay and frequency votes for smaller reporting companies, the Commission noted that the delay should allow those companies to observe how the rules operate for other companies and permit them to better prepare for implementation of the rules. The Commission also noted that delayed implementation for smaller reporting companies will allow us to evaluate the implementation of the adopted rules by larger companies and provide us an additional opportunity to consider whether adjustments to the rules would be appropriate for smaller reporting companies before the rules become applicable to them.

The Dodd-Frank Act authorizes the Commission to exempt an issuer or class of issuers from the requirements, but only after considering, among other things, whether the requirements disproportionately burden small issuers. The 2-year deferral period is designed to assist the Commission in its consideration of these factors and will enable us to adjust the rule, if appropriate, before it applies to smaller issuers.

More generally, in implementing the Dodd-Frank Act, the Commission is carefully considering the unique burdens faced by smaller public companies. For example, the Commission recently issued a rule proposal to modify the calculation of "net worth" for purposes of the "accredited investor" definition to exclude the value of an individual's primary residence when calculating net worth. In developing the proposal, the Commission was mindful of the potential burden on small businesses and drafted the proposal to balance concerns relating to the impact on small businesses and the regulatory purpose of the proposal by specifying that debt secured by an individual's primary residence, up to the value of such primary residence, is excluded from the net worth calculation, thereby deducting only the equity value in the primary residence in the net worth calculation. Before we adopt the final rule, the Commission and staff will carefully weigh the public comments to ensure we strike the right balance.

As we continue to implement the provisions of the Dodd-Frank Act, we will continue to consider how the rules will impact smaller public companies, with particular focus on public comments we receive regarding the burdens they face and ways we can reduce those burdens.

Q.19. Recent SEC failures like Stanford and Madoff illustrate that even when resources are dedicated to inspecting a particular firm, fraud may go unchecked. If the SEC receives the resources it asks

for, what will it do to ensure that those resources are used productively?

A.19. The SEC already has taken significant action over the past 2 years to ensure resources are used productively. We have new management across the major divisions and offices, and we created a new Division of Risk, Strategy, and Financial Innovation to refocus the agency's attention on—and response to—new products, trading practices, and risks. We also created new Chief Operating Officer and Chief Compliance Officer positions, and have moved to modernize our information technology, including a centralized system for tips and complaints, enforcement and examination management systems, risk analysis tools, and financial management systems.

To better ensure effective performance in detecting and addressing fraud, the agency has carried out a comprehensive restructuring of its two largest programs—enforcement and examinations. These reforms are intended to maximize our use of resources and permit the agency to move more swiftly and strategically.

Specifically, the Division of Enforcement has streamlined its procedures to bring cases more quickly; removed a layer of management to permit more staff to be allocated to front-line investigations; created five national specialized investigative groups dedicated to high-priority areas of enforcement; and created a new Office of Market Intelligence to serve as the hub for the effective handling of tips, complaints, and referrals. The Office of Compliance Inspections and Examinations (OCIE) reorganized the agency's national examination program in response to rapidly changing Wall Street practices and lessons learned from the Madoff and Stanford frauds. The changes provide greater consistency and efficiencies across our 11 regions and sharpen the staff's focus on identifying the higher risk firms that it targets for examination. OCIE also implemented new policies requiring examiners to routinely verify the existence of client assets with third party custodians, counterparties, and customers. Going forward, the national exam program will continue to conduct sweeps in critical areas from trading practices to market manipulation to structured products.

Q.20. You have made a number of structural changes in the Division of Enforcement and Office of Compliance Inspections and Examinations. What performance metrics is the SEC using to assess the effectiveness of those changes? Does the SEC track the number of hours that a compliance examination or enforcement action takes?

A.20. The structural reforms implemented within the Division of Enforcement are composed of several initiatives with the overarching goal of increasing the speed, efficiency, and expertise with which the division investigates potential violations of the Federal securities laws and makes enforcement recommendations to the Commission. The Enforcement Division tracks the number of investigations opened and closed, the number of enforcement actions filed, the timeliness in which actions are filed, and the relative efficiency of various investigative groups (including the handling of programmatically significant matters by those groups). Much of this information is broken down by office as well as by senior man-

agers (Associate Directors) who supervise investigative groups nationwide. In addition, in annual publications (either its Performance and Accountability Report or Select SEC and Market Data publication) the Commission provides the following performance information relating to the work of the Enforcement Division:

- Percentage of enforcement actions successfully resolved ("successfully resolved" means a favorable outcome for the SEC whether through a settlement, litigation, or the issuance of a default judgment). In fiscal year 2010, 92 percent of enforcement actions were successfully resolved.
- Percentage of first enforcement actions filed within 2 years of an investigation commencing. In fiscal year 2010, 67 percent of first enforcement actions were filed within 2 years.
- Amount of disgorgement and penalties ordered. In fiscal year 2010, SEC obtained orders in judicial and administrative proceedings requiring securities law violators to disgorge illegal profits of approximately $1.82 billion and to pay penalties of approximately $1.03 billion.
- Trading halts where inadequate public disclosure. In fiscal year 2010, SEC halted trading in securities of 254 issuers about which there was inadequate public disclosure.
- Orders barring service as officer or director of public companies. In fiscal year 2010, SEC sought orders barring 71 defendants and respondents from serving as officers and directors of public companies.

While the number of enforcement actions that we bring each year and the speed with which we bring them are important performance factors, we also recognize that meaningful and effective investor protection requires that significant, complex, and difficult cases be investigated and filed. For this reason, Enforcement, as part of its recent structural reforms, generates a national priority case report that identifies and tracks cases deemed programmatically significant. Matters are designated as high priority based on criteria, such as the deterrent impact of a case, the egregiousness of the conduct, the nature of the parties involved, and the extent of investor harm. Enforcement tracks the number of pending national priority investigations as well as the number of national priority investigations that have resulted in enforcement actions. In addition to the national priority case report, the division is in the pilot stage of establishing qualitative metrics for all of its enforcement actions. Under the new qualitative metrics, enforcement actions will be rated qualitatively in the following four areas: (1) the deterrent message of the case; (2) the seriousness and scope of the misconduct; (3) the nature of the parties involved in the misconduct; and (4) the priority of the subject matter. Once implemented, Enforcement believes that these qualitative metrics will assist in ensuring that programmatic priorities are being met and that the measurement of the Division's performance is fair and consistent.

The Enforcement Division does not track the number of hours that an enforcement action takes. As noted above, the division tracks—and the Commission reports on—the percentage of actions filed within 2 years after an investigation commenced.

The mission of OCIE's National Exam Program is to improve compliance with Federal securities laws, prevent fraud, monitor risks, and inform Commission policy. OCIE has established key performance indicators (KPIs) to help assess the efficiency and effectiveness of its National Exam Program. Currently, OCIE monitors—or is in the process of establishing processes to monitor—the following KPIs related to each of these four objectives:

- *Improve compliance*
  - Number of exams completed;
  - Percentage of exams completed within 180 days;
  - Percentage of firms receiving deficiency letters asserting that they have taken corrective action in response to findings; and
  - Number of industry outreach and education programs targeted to areas identified as raising particular compliance risk.
- *Prevent fraud*
  - Percentage of exams receiving deficiency letters and/or referred to Enforcement;
  - Percentage of Enforcement investigations arising from National Exam Program referrals, as well as the frequency with which enforcement investigations arise from such referrals;
  - Percentage of completed examinations identifying significant findings; and
  - Recoveries to investors from examinations.
- *Monitor risk*
  - Percentage of examinations that are conducted for cause; and
  - Number of cause exams that result from tips.
- *Inform Commission policy*
  - Number of exams that inform policy;
  - Number of consultations, coordinated events, reports or initiatives with other divisions; and
  - Coordinated exams and other efforts with SROs and other regulators.

OCIE does not monitor the number of hours that a compliance exam takes.

Q.21. Section 965 of the Dodd-Frank Act directed the Commission to set up staffs to conduct examinations of investment advisers, investment companies, and broker-dealers within the Division of Investment Management and Division of Trading and Markets. Instead of eliminating OCIE and moving OCIE examiners back into the divisions, the SEC is preserving OCIE and creating a redundant examination staff within the divisions. In light of SEC budget concerns, wouldn't it make sense to comply with the Dodd-Frank directive by moving existing examiners back into the relevant divisions rather than creating a duplicative set of examiners?

A.21. In seeking to comply with Section 965 of the Dodd-Frank Act, we are sensitive to the need to maximize the use of limited resources and avoid ineffective or duplicative examinations. While I believe it will be helpful to have experienced and well-trained examiners operating in the policy divisions (for example, to help ensure "real world" examination findings inform our rule writing and to assist in integrating the expertise of our policy divisions into our examinations), I do not believe that all OCIE examiners should be placed into these two divisions.

The convergence of the financial services industry over the past several decades has made it increasingly important to have significant interdisciplinary skills available for any given examination. Housing all of the Commission's examiners in two different policy divisions would result in an examination program divided along statutory lines that does not generally reflect business realities. Moreover, a centralized examination program is better positioned to look for risks across entire markets, effectively examine the integrated operations of today's financial service providers, internally share information and examination skills, procedures and practices and ensure that examinations are conducted and managed in a consistent and cohesive manner. Splitting the OCIE staff into two divisions may therefore create inefficiencies and weaken the effectiveness of the examination program.

Q.22. The SEC recently proposed rules to implement the venture capital exemption adviser in Section 407 of the Dodd-Frank Act. Nevertheless, the SEC subjected venture capital advisers to significant reporting obligations, thereby seemingly violating the exemption's purpose of treating venture capital fund advisers differently than other private fund advisers. Could the SEC take an alternative approach that would respect the spirit as well as the letter of the Congressionally mandated exemption for venture capital advisers?

A.22. The Dodd-Frank Act provides that the Commission shall require venture capital fund advisers pursuant to Section 407 of the Act to submit such reports as the Commission determines necessary or appropriate in the public interest or for the protection of investors. To implement this Congressional requirement, the Commission proposed those reporting requirements for public comment in November 2010. Those proposed requirements are a subset of the information required of registered private fund advisers, specifically, basic information about the adviser in a check-box or short answer format. The Commission did not propose, for example, to require exempt venture capital fund advisers to complete and file the narrative disclosure brochure required of registered advisers. We have received numerous comments from industry and the public about the proposed reporting requirements, and the Commission will take those comments into account when considering changes to the proposals before adopting these reporting requirements. In January, the Commission proposed for public comments systemic risk reporting requirements (*i.e.,* new Form PF). As proposed, the requirement to file Form PF would apply only to registered advisers and therefore would not apply to exempt venture capital fund advisers.

Q.23. One of the frequently cited concerns about the SEC's proposed approach to implementing the whistleblower provisions of the Dodd-Frank Act is that it will undermine companies' existing compliance programs. How is the SEC taking these concerns into account?

A.23. On November 3, 2010, the Commission proposed rules to reward individuals who provide the agency with high-quality tips that lead to successful enforcement actions. To date, the Commission has received hundreds of comments from a wide variety of interested persons and entities concerning the proposed rules. Staff is in the process of reviewing and analyzing those comments, which will be considered in connection with the adoption of final Commission rules.

Whistleblowers can be an invaluable source of information to uncover securities fraud and better protect investors. I believe it is important—consistent with the statute's language and our mission to protect investors—to ensure that whistleblowers can bring us their evidence of securities violations expeditiously. Although there is great value in whistleblowers reporting matters internally when appropriate, there may be numerous instances when such reporting is not appropriate.

When the Commission proposed its rules, we attempted to achieve a balance that preserved the important role that internal compliance programs play while remaining true to the statute's purpose of encouraging whistleblowers to come forward. With that in mind, we included provisions in the proposed rules intended to encourage, but not require, employees to continue to report potential violations through existing company processes in addition to making whistleblower submissions. For example, the proposed rules provide that an employee who reports information through appropriate company procedures would be treated as a whistleblower under the SEC's program as of the date the employee reported internally so long as the employee provides the same information to the SEC within 90 days. By taking advantage of this provision, employees would be able to report internally first while preserving their "place in line" for a possible award from the SEC. Additionally, the proposed rules provide that the Commission can consider, as a basis for paying a higher percentage award, whether a whistleblower first reported the violation through effective company compliance programs. Additional ideas in this area have been raised during the public comment process which will be considered before adoption of final rules.

In sum, I believe we can adopt rules which achieve a balance that preserves the important role that internal compliance programs can play while remaining consistent with the statute's purpose of encouraging whistleblowers to come forward.

Q.24. In response to one of my questions at the hearing, you stated "We are actively and aggressively recruiting for a Chief Economist at the SEC." Yet, the SEC Chief Economist position has remained unfilled since last summer. Why have your recruiting efforts been unsuccessful for so long? How has your new Division of Risk, Strategy, and Financial Innovation changed the role that economic analysis plays in informing the SEC's formulation, proposal, and adop-

tion of rules? Please give an example of a Dodd-Frank rulemaking or study in which the Division played a particularly important role. Given that you noted at the hearing that you are trying to grow the number of economists at the SEC, how many of the 780 new positions (612 FTE) that the SEC is requesting for FY2012 does the SEC intend to fill with Ph.D. economists?

A.24. As I noted in my testimony, our search for a new Chief Economist was active and aggressive. We interviewed a number of highly qualified candidates from a distinguished field comprised of individuals suggested by a wide variety of sources, including our former Chief Economists. In connection with this process, I made clear that the Chief Economist will report directly to me with respect to all economic matters. In addition, as I testified, the Chief Economist also will serve as Director of Risk Fin.

On May 20, 2011, Dr. Craig M. Lewis, the Madison S. Wigginton Professor of Finance at Vanderbilt University's Owen Graduate School of Management, was named the Commission's Chief Economist and Director of Risk Fin. Professor Lewis is a distinguished economist with a clear understanding of the complexities of financial markets. As the head of the Division, he will not only lead our qualified team of expert economists, but will also help to inject strong data-driven analysis into the SEC's decision-making process.

In creating Risk Fin, we made economic analysis a core function within the broader Risk Fin mission. In so doing, I believe we have created conditions in which economic analysis at the SEC can flourish. Putting our economists together with mathematicians and financial engineers will enhance the Division's ability to provide timely and reliable empirical analysis of current market phenomena and their implications. Risk Fin had also begun to tap the deep pool of talent experienced market professionals offer, until recent budgetary constraints temporarily curtailed those efforts. Bringing a broad range of analytic disciplines and experienced practitioners into a single division that has economic analysis of rule proposals as a core responsibility will, in my view, generate synergies that can only assist the Commission in fulfilling its responsibilities.

Risk Fin assists and supports the rulemaking initiatives of other divisions, and does not itself write rules. Risk Fin continues to be actively involved in all SEC rulemaking initiatives, including those stemming from Dodd-Frank. Moreover, examples of Dodd-Frank-related studies for which Risk Fin has taken the lead SEC role include the recent joint SEC–CFTC staff Study on the Feasibility of Requiring Use of Standardized Algorithmic Descriptions for Financial Derivatives (April 7, 2011, pursuant to Dodd-Frank sec. 719(b)) and the Security-Based Swap Block Trade Definition Analysis (Jan. 13, 2011) appended to Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information (Release No. 34-63346 (Nov. 19, 2019)), both posted on the SEC's Web site. The Division also made a significant contribution to the joint SEC–CFTC staff Report on the Market Events of May 6, 2010 (Sept. 30, 2010).

The SEC's request for 780 new positions in FY2012 incorporates approximately 21 economists—10 in the Division of Trading and Markets and 11 in Risk Fin. The agency hopes to fill most, if not all, of those 21 positions with Ph.D. economists. If that is not pos-

sible, other factors (including analytical expertise and practical experience in key areas of focus) would determine which individuals are selected for the positions.

The SEC has a history of employing Ph.D. economists, and we continue to believe that the breadth of training and depth of experience entailed in earning a Ph.D. degree prepares an economist particularly well for the range of work and complex data sets at the SEC. The market for top quality Ph.D. economists is, however, very competitive. The SEC is just one of many entities, public and private, that compete in the market for high quality Ph.D. economists each year. Given our desire to strengthen the role and quality of economic analysis at the SEC, as well as the additional demands placed on our economists in connection with Dodd-Frank Act mandates, if we could not fill all positions with Ph.D. economists, we would have to consider whether we could meet our unmet staffing needs by hiring at least some non-Ph.D. economists.

Q.25. The SEC has historically suffered from a culture of poor management. If you get additional staff to help with your increased workload under Dodd-Frank, what steps will you take to ensure that the new staff are managed effectively? What are you doing to monitor relative workloads of employees and to redeploy those who are underworked to assist those who are overworked?

A.25. The SEC has moved aggressively in recent years to develop management tools and techniques to build a stronger management culture. New leadership development programs have been put in place at all levels of our leadership structure and a new performance management system is being implemented agency-wide that should be significantly more robust then previous systems used at the agency. This system requires more effective feedback and coaching for improvement where necessary at all levels of the organization. It also proactively identifies career growth and developmental needs, allowing the agency to create flexibilities regarding job assignments when needed. The current funding environment has limited the agency's ability to fully execute these programs on an ongoing basis.

Q.26. The Dodd-Frank Act gave the SEC a number of new enforcement powers. Which of these Dodd-Frank provisions do you believe applies retroactively and why?

A.26. Because the Dodd-Frank Act contains many different types of enforcement provisions that have different effects on prior law, no single approach applies uniformly. In addition, the Commission has not yet had occasion to address all of the potential retroactivity issues that may arise. In general, however, the Commission's approach is to follow case law guidance concerning whether application of a statute would be impermissibly retroactive.

With respect to provisions that change the legal standards governing liability, we have not applied them to conduct that occurred before the effective date of the statute absent a clearly expressed Congressional intention for retroactive application.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM MARY L. SCHAPIRO

Q.1. A serious topic of discussion in the financial markets these past few days is the announcement of a proposed merger between the NYSE-Euronext and the Deutsche Börse.

If this merger takes place, what will be the potential impact on the implementation of the provisions of the Dodd-Frank Act, particularly in respect to the trading and clearing of derivatives?

Is there a potential that this merger will enhance the availability of regulatory arbitrage by allowing market participants the ability to circumvent the requirements of Dodd-Frank by providing easier access to foreign trading and clearing venues?

Should we be concerned with any anticompetitive implications of this further consolidation of trading and clearing platforms?

A.1. I do not anticipate that this proposed business combination alone would have a significant impact on our implementation of the Dodd-Frank Act. In developing rules that would govern the trading and clearing of security-based swaps, the Commission has sought to consider issues regarding the derivatives markets broadly and without limiting its focus to any specific entity's role in those markets.

Requirements regarding access to foreign trading and clearing venues, including those under the Dodd-Frank Act, are generally not determined or applied based on which entity owns the trading or clearing venue. Accordingly, although the Commission is sensitive to the issue, such proposed changes in ownership alone would not typically increase the potential for circumvention of the requirements of the Dodd-Frank Act. More broadly, in connection with these cross-border combinations of exchanges, each market has continued to operate as a separate liquidity pool in its respective jurisdiction and has continued to be regulated subject to its home country's requirements—that is, European exchanges continue to be overseen by the relevant European regulator, and the Commission continues to oversee the U.S. exchanges. Currently, U.S. Federal securities laws generally require all exchanges operating in the United States, and all securities traded on those exchanges, to be registered with—and regulated by—the Commission. However, as U.S. and non-U.S. exchanges continue to seek increased integration of their markets and foreign markets seek greater direct access to U.S. investors, the potential regulatory considerations increase. Accordingly, such direct access by foreign markets to U.S. investors generally is not currently permitted without registering with the Commission.

Competition is an important issue that the Commission will be considering carefully as we proceed in our review of the proposed business combination.

Q.2. To what extent is your agency working with your relevant domestic and foreign counterparts in respect to the possible merger between the New York Stock Exchange and the Deutsche Börse? Are you working to ensure that arrangements will be in place for cooperation in supervision and enforcement and for information sharing, all of which will be required as a result of this potential

merger? Should we expect formal MOUs on supervisory cooperation to precede a cross-border merger?

A.2. The Commission has existing Memoranda of Understanding (MOUs) for consultation, cooperation, and the exchange of information related to supervisory matters with both the College of Euronext Regulators and the German federal securities authority (German BaFin). The Commission also has multilateral and bilateral arrangements in place for enforcement cooperation with all five of the European authorities that comprise the College, as well as with the German BaFin. *See, http://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml.*

The Commission staff has been consulting regularly with its European counterparts in relation to the possible merger between NYSE Euronext and Deutsche Börse. The staff anticipates that, if the merger goes through, cooperation between the Commission and the relevant European regulators will continue pursuant to existing or similar arrangements.

Q.3. The Securities, Insurance, and Investment Subcommittee held a hearing in December that focused, in part, on the increasing interconnectedness of today's modern markets and the need for effective oversight of trading across products and venues. Today's traders buy and sell options, futures, and equities interchangeably in dozens of marketplaces around the world. Yet, our regulatory oversight mechanism largely relies on a model where each marketplace is primarily responsible for policing the activities on its platform. Given the recently announced potential merger of NYSE Euronext with Deutsche Börse Group, it seems as though the trading marketplaces are only becoming more interconnected. What are your thoughts regarding how to implement an effective regulatory oversight infrastructure to police trading done both by Americans around the world and by traders around the world in our increasingly interconnected and international marketplaces?

A.3. In recent years, several U.S. exchanges have combined with non-U.S. exchanges, including NYSE's combination with Euronext, Eurex's acquisition of ISE, and Nasdaq's combination with OMX. In connection with these cross-border combinations of exchanges, each market has continued to operate as a separate liquidity pool in its respective jurisdiction and has continued to be regulated subject to its home country's requirements—that is, European exchanges continue to be overseen by the relevant European regulator, and the Commission continues to oversee the U.S. exchanges. In addition, the Commission seeks to cooperate fully with the non-U.S. exchange's home regulator.

Currently, U.S. Federal securities laws generally require all exchanges operating in the United States, and all securities traded on those exchanges, to be registered with—and regulated by—the Commission. However, as U.S. and non-U.S. exchanges continue to seek increased integration of their markets and foreign markets seek greater direct access to U.S. investors, the potential regulatory considerations increase. Accordingly, such direct access by foreign markets to U.S. investors generally is not currently permitted without registering with the Commission. Through our ongoing dialogue with the EU and other foreign jurisdictions, we have sought to im-

prove our understanding of the differences and similarities in the regulation of exchanges as practiced in the United States and in foreign jurisdictions. In addition, we are committed to developing globally consistent standards that reduce the possibilities of regulatory arbitrage.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM MARY L. SCHAPIRO

Q.1. *Exchanges and Clearinghouses*—I'm concerned that the exchanges or clearinghouses, both for derivatives and securities, could themselves become "too big to fail" and systemically significant. What steps are you taking to ensure that their size and risks are properly managed so that they do not become "too big to fail"?

A.1. *Clearing Agencies*—When structured and operated appropriately, clearing agencies can provide benefits to the markets such as improving the management of counterparty risk and reducing outstanding exposures through multilateral netting of trades. It is clear, however, that while playing a critical role in the markets, clearing agencies need to appropriately manage risk. To support its oversight of clearing agencies, including their risk management practices, the Commission recently began taking several actions, including:

- Developing a clearing agency monitoring group within our Division of Trading and Markets, which is an effort in the early stages to more closely monitor and evaluate clearing agency risk management and operational systems;
- Enhancing our examination program for clearing agencies, including by developing dedicated staff for the clearing agency exam program; and
- Engaging in rulemaking, including proposing new risk management, governance, and operational standards for clearing agencies.

Specifically, in March, the Commission proposed rules that seek to establish standards for the operation and governance of clearing agencies, as well as appropriate standards for risk management. We also are actively contributing to the work of the Financial Stability Oversight Council, which has the authority to recognize financial market utilities (FMUs) such as clearing agencies that are determined to be, or are likely to become, systemically important. Designated FMUs will be subject to such additional risk management standards as may be prescribed by the Federal Reserve Board, in consultation with supervisory agencies like the Commission, as well as enhanced examination and enforcement standards.

These new rules and standards are designed to help ensure that risks at clearing agencies are properly managed. Our ability to implement any such proposed rules or standards—as well as implement other new initiatives and sustain our oversight functions—depends heavily on adequate staffing and resources.

Exchanges—Exchanges and similar trading platforms are situated somewhat differently from clearing agencies with respect to the risks they may pose. Structurally, the exchange business in the United States is highly competitive and interconnected. The vast

majority of equity securities can trade on multiple venues. As a result, if an exchange were to fail, other exchanges would likely be available to pick up the volume in securities previously traded in the failed exchange. With respect to the relatively few equity securities that are available to trade on only one exchange (for example, many index options), the Commission has encouraged exchanges to enter into reciprocal trading arrangements to enable those securities to trade in other venues if the exchange trading such a security were unable to trade following a disruption.

In addition, staff from the Division of Trading and Market's Automation Review Policy program works regularly with exchanges and certain other markets to review the capacity, resiliency and security of their market-related systems. A similar "ARP" program also is in place for clearing agencies.

Q.2. *CEO to Median Worker Pay Disclosure*—A provision I successfully included in Dodd-Frank would require publicly listed companies to disclose in their SEC filings the amount of CEO pay, the median company worker pay at that company, and the ratio of the two. Do you believe this information would be useful for investors who want to know about a company's pay practices and their effect on performance? Also for employees or potential employees who want to know about their company's pay practices relative to others in the industry?

A.2. As you know, we have a number of disclosure requirements regarding executive compensation which have been updated from time to time. Our rules do not currently require information of the nature required by the provision I believe you were referring to, Section 953(b) of the Dodd-Frank Act. Although the Commission has not yet proposed a rule to implement Section 953(b), the staff currently is considering how this requirement could be implemented in a manner consistent with the statutory language. When we issue our proposed rule to implement this provision, we expect to hear from issuers, investors and other interested parties regarding the utility of the disclosure and the costs of preparing it.

To facilitate public input on the Dodd-Frank Act, the Commission has provided a series of e-mail links, organized by topic, on its Web site at *http://www.sec.gov/spotlight/regreformcomments.shtml.* The Commission already has received many comments from the public on Section 953(b), available at *http://www.sec.gov/comments/df-title-ix/executive-compensation/executive-compensation.shtml.*

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TESTER FROM MARY L. SCHAPIRO

Q.1. The Department of Labor recently announced new regulations redefining fiduciary duty which would seem to have the potential to undermine the thoughtful work that the SEC has done to look at actually harmonizing standards of care for different types of advisors. Have you been in conversations with the Department of Labor on these issues or raised concerns about potential inconsistencies and conflicts between your efforts? Will the SEC take steps to address any further inconsistency and uncertainty that could arise from the Department of Labor's rulemaking for advisors?

A.1. The Commission and its staff are working hard to avoid inconsistent regulatory standards among Government agencies. If the Commission engages in rulemaking to address the recommendations in its Dodd-Frank Act section 913 study to implement a uniform fiduciary duty for broker-dealers and investment advisers providing personalized investment advice about securities to retail customers, we would do so in consultation with the Department of Labor and other interested regulators. In addition, since the Commission issued the Section 913 study, Commission staff has received and reviewed additional comments on the study and has continued to meet with interested parties to discuss their reactions to it. As such, the Commission's process leading up to any potential rulemaking under Section 913 would take into account, with deliberation, the views of all interested parties, and the potential impact of such rules on the financial marketplace, as well as the existing regulations and proposed actions of our fellow regulators.

In addition, staff of the Department of Labor has consulted with Commission staff regarding the Department of Labor's proposed rulemaking on fiduciary status, and those discussions and consultations are ongoing. Ultimately, however, the definition of fiduciary under ERISA is for the Department of Labor to decide.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARNER FROM MARY L. SCHAPIRO

Q.1. For each of the witnesses, though the Office of Financial Research does not have a Director, what are each of you doing to assist OFR in harmonizing data collection, compatibility, and analysis?

A.1. Over the past few months, Commission staff has participated in the cross-agency meetings that Treasury has organized related to OFR and data collection initiatives. The staff also has worked on cataloguing existing Commission databases and presented current and anticipated data capabilities at such meetings, laying the foundations for potential harmonization of data collection, compatibility, and analysis. Commission staff also has worked directly with their colleagues at the CFTC and staff at Treasury/OFR on harmonizing published requirements for the production of legal entity identifiers to be used by industry market participants that identify counterparties to derivative transactions, with potential applicability for the universal identification of all legal entities engaging in financial transactions.

Q.2. Chairman Schapiro, can each of you explain what budget cuts will mean for the ability of your agencies to ensure markets are safe, protected from abuse, and don't create the types of risks that nearly destroyed our economy?

A.2. For the first six and a half months of FY2011, the agency already had curtailed its core program activities such as technology, staff hiring, travel, and litigation support, to name a few, to operate under its previous continuing resolution level. Additionally, the SEC had begun to implement the Dodd-Frank Act without additional funding, taking on significant new rulemaking and other re-

sponsibilities almost entirely with existing staff. This has taken staff time from base program operations.

The SEC's budget for FY2011 contained within the broader budget compromise would permit the SEC to continue reforms to our operations and implement much-needed improvements to our technology. However, if this budget were to be followed by significant budget cuts, then such cuts would have a profound impact on the SEC's ability to oversee the securities markets. Depending on their magnitude, budget cuts could leave the SEC further behind in its efforts to close the existing gap with the rapidly growing markets. The SEC only now is returning to the staffing levels of 2005, while during that time the securities markets have grown significantly in size and complexity. For example, in 2005, the SEC had 19 examiners for each trillion dollars in investment advisor assets, and today there are only 12 examiners per trillion dollars. Significant budget cuts could also stymie efforts to modernize the SEC's technology infrastructure, which continue to need significant investments to improve risk assessment and operational efficiency, support enforcement and examination processes, and modernize EDGAR.

As you know, the SEC also has received sizable new responsibilities in areas such as the oversight of the over-the-counter derivatives market and hedge fund advisers; registration of municipal advisors and security-based swap market participants; enhanced supervision of nationally recognized statistical rating organizations and clearing agencies; heightened regulation of asset-backed securities; and creation of a new whistleblower program. In acknowledgement of this substantially increased workload, the Dodd-Frank Act includes increased budget authorization levels for the SEC of $1.3 billion in FY2011 and $1.5 billion in FY2012. If budget cuts were enacted, then the SEC would be unable to add the resources necessary to conduct enforcement, examine for compliance, and analyze trends and risks in these new markets.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MERKLEY FROM MARY L. SCHAPIRO

Q.1. *Repo and Prime Brokerage*—During the financial crisis, the instability of the triparty repurchase agreement (repo) markets and prime brokerage relationships played critical roles in the collapse of several major financial firms. As the quality of the repo collateral began to decline and as both repo and prime brokerage "depositors" began to doubt the stability of their counterparties (because of the toxic positions in the trading accounts of the counterparties), a classic bank run emerged, only this time it was at the wholesale level. Please provide an update on rulemaking and other policy changes designed to reduce risks to our financial system in the repo markets and in prime brokerage.

A.1. In the area of repos, the Commission is involved in a number of initiatives that are designed to reduce risks to the financial system. Commission staff has provided assistance to the Tri-Party Repo Infrastructure Reform Task Force that was formed at the request of the Federal Reserve Bank of New York to address weaknesses that became visible over the course of the 2008 financial cri-

sis. This initiative is aimed at reducing the intraday credit exposure of the clearing banks who act as intermediaries in the triparty repo market, creating efficiencies for both lenders and borrowers, and increasing confidence in the use of this financing method. Further, in connection with its ongoing monitoring of the risk management processes of the largest broker-dealers, the Commission's staff is focused on the potential liquidity needs of these firms in times of market stress, as well as the adequacy of existing and backstop liquidity arrangements.

In the prime brokerage area, the Commission is engaged in additional initiatives designed to help reduce risks to the financial system. Commission staff is undertaking a review of prime brokerage margin practices at the largest broker-dealers. This review is focused on the ability of the prime broker to fund collateral in the repo market, and the prime broker's reliance on that collateral to fund its business. It also includes understanding the different collateral requirements for liquid and illiquid assets, and reviewing the process for entering into and managing margin agreements.

Finally, as you are aware, the Commission is no longer engaged in consolidated supervision. The liquidity issues you raise can impact an entire financial institution, however, and the Commission coordinates regularly with the Federal Reserve to facilitate cooperative approaches to addressing these issues.

Q.2. *Derivatives Oversight*—Counterparty risk and other risks associated with derivatives played a central role in the financial crisis, especially in fueling the argument that firms such as AIG were too big or too interconnected to fail. What oversight systems do plan to have in place to ensure that any accommodations made in the course of rulemaking for nonfinancial commercial parties do not create holes in the regulatory structure that permit the accumulation of hidden or outsized risk to the U.S. financial system and economy.

A.2. The Dodd-Frank Act, through a variety of mechanisms, provides regulators with authority to limit systemic risks posed by activities of previously unregulated entities. In particular, the Act provides the Commission, CFTC, and banking regulators with authority to impose prudential limits on so-called "major security-based swap participants" and "major swap participants"—a category that, broadly speaking, can encompass otherwise unregulated entities that hold large unhedged derivatives positions (such as AIG did). Such entities would be subject to capital and margin requirements established by regulators, which should help mitigate the accumulation of hidden or outsized risks. The Commission and the CFTC proposed joint rules last December to further define the scope of entities that would fall under this regime, and I expect that the Commission will propose rules in the near future concerning the capital and margin requirements for major participants and other intermediaries in the security-based swap market.

In addition, the Commission has proposed rules for the reporting of security-based swap transactions to registered data repositories, and the CFTC has proposed similar rules with respect to the reporting of swap transactions. Assuming that the agencies have adequate resources to analyze and monitor this information, such re-

porting should increase the transparency of these markets to regulators and help prevent the accumulation of hidden risks.

Q.3. *Derivatives Disclosure*—One of the key exacerbating factors in the financial crisis was that firms were hesitant to do business with one another because they feared a potential counterparty may be unable to fulfill its obligations. In particular, they feared that their potential counterparty might be financially constrained by liabilities from undisclosed and/or uncleared derivatives transactions. Similarly, as the bankruptcy examiner of Lehman Brothers reported, investors and regulators are often also similarly unaware of the risks from firms' derivatives positions.

Given what we have seen, do you believe that public disclosure to shareholders and other market participants regarding a company's derivatives positions should be improved? If so, how do you plan to incorporate in that enhanced disclosure regime the theme from the Dodd-Frank Act that uncleared derivatives should be subject to additional obligations?

A.3. Clear and transparent disclosure is critically important to an investor's understanding of a company's financial position. In this regard, we have a number of requirements in our rules designed to elicit disclosure about a company's ability to fulfill its commitments and obligations. For example, Item 303 of Regulation S–K requires a company to discuss, in its Management's Discussion and Analysis, any known trends, demands, commitments, events or uncertainties it reasonably expects to have a material favorable or unfavorable impact on its results of operations, liquidity, and capital resources. In effect, we require companies to allow investors to see the company "though the eyes of management." The rule also requires a company to disclose its contractual obligations in tabular format. In addition, Item 303 requires a company to disclose off-balance sheet arrangements that have, or are reasonably likely to have, a current or future effect on the company's financial condition, revenues or expenses, results of operations, liquidity, and capital expenditures. In doing so, a company must disclose information necessary to an understanding of the arrangements, including information about the nature and business purpose of the arrangement and the importance of the arrangement to the company. Additionally, Item 305 of Regulation S–K requires a company to provide qualitative and quantitative information about market risk.

In addition to these SEC rules, U.S. GAAP requires extensive disclosures about a company's derivatives portfolio. For example, companies must provide disclosures about:

- how and why an entity uses derivative instruments;
- how derivative instruments and related hedged items are accounted for; and
- how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows.

The disclosures provided are distinguished by derivative instruments that are used for risk management purposes and derivative instruments that are used for other purposes. Information also is separately disclosed in the context of each instrument's primary

risk exposure, such as interest rate, credit, foreign exchange, and overall price risk. While we believe companies generally understand and comply with these requirements, we will continue to monitor this area and consider whether additional guidance is necessary, particularly as we see how changes to the derivatives regulatory structure may affect reporting companies.

Q.4. *Markets Oversight*—As you may know, Korean securities regulators recently imposed a six month ban on a large European bank from engaging in proprietary trading in Korean markets after it came to light that the bank manipulated the Seoul stock market. With the proposed acquisition of the New York Stock Exchange by a European börse, markets are becoming more international and interconnected than ever before. Do you feel you have the tools you need to monitor trading across multiple markets and across multiple products? If not, what steps do you need to take and what additional tools do you need from Congress to assist you in accomplishing your critical mission of ensuring our markets operate with integrity?

A.4. Commission staff currently has access to a limited set of tools to monitor trading in the United States, including the ability to obtain and utilize information about trading from the audit trails of the exchanges and FINRA. However, these audit trails are limited in their scope, required data elements, and format. Accordingly, the Commission proposed in May 2010 to require the exchanges and FINRA to create and implement a consolidated audit trail that captures customer and order event information for all equities and options orders across all markets—from the time of order inception through routing, cancellation, modification, or execution. This consolidated audit trail would create a single, comprehensive, and readily accessible database of information about orders and executions in the United States for regulators. If adopted, I believe the consolidated audit trail would become a critical tool and a significant first step toward more effectively detecting and deterring illegal trading.

However, as you note, securities markets are becoming more international and interconnected than ever before. To address the issues arising from cross-border securities transactions, the Commission pursues international regulatory and enforcement cooperation, promotes the adoption of high regulatory standards worldwide, and formulates technical assistance programs to strengthen the regulatory infrastructure in global securities markets. The Commission also works within our global network of securities regulators and law enforcement authorities to facilitate cross-border regulatory compliance and to ensure that international borders are not used to escape detection and prosecution of fraudulent securities activities.

In terms of Congressional support, the SEC is at an especially critical juncture in its history. Not only does the Dodd-Frank Act create significant additional work for the SEC, both in the short and long term, but the agency also must continue to carry out its longstanding core responsibilities to prevent securities fraud, review public company disclosures and financial statements, inspect the activities of investment advisers and broker-dealers, and en-

sure fair and efficient markets. The Commission must have adequate resources so that it can fulfill these responsibilities and promote investor confidence and trust in our financial institutions and markets.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM MARY L. SCHAPIRO

Q.1. SEC Commissioners Kathleen Casey and Troy Paredes issued a statement calling for more rigorous analysis on the SEC staff study on Investment Advisers and Broker-dealers required by Dodd-Frank. The two commissioners stated: "Indeed, the Study does not identify whether retail investors are systematically being harmed or disadvantaged under one regulatory regime as compared to the other and, therefore, the Study lacks a basis to reasonably conclude that uniform standard or harmonization would enhance investor protection." Do you intend to gather this type of economic analysis so that these kinds of questions can be answered before proposing any new rule?

A.1. In the study required by Section 913 of the Dodd-Frank Act, Commission staff recommended implementing a uniform fiduciary standard that would accommodate different existing business models and fee structures, preserve investor choice, and not decrease investors' access to existing products, services, or service providers. In preparing the study, the staff considered the comment letters received in response to the Commission's solicitation of comment and considered the potential costs and other burdens associated with implementing the recommended fiduciary standard. We will continue to be mindful of the potential economic impact going forward. In light of this ongoing focus, I have asked a core team of economists from the Commission's Division of Risk, Strategy and Financial Innovation (Risk Fin) to study, among other things, data pertaining to the standards of conduct in place under the existing broker-dealer and investment adviser regulatory regimes to further inform the Commission.

Ultimately, if the Commission does engage in rulemaking under Section 913, as with any proposed rulemaking, the Commission would conduct an economic analysis regarding the impact of any proposed rules. Such analysis would include the views of Risk Fin, which has broad experience analyzing economic and empirical data. The Commission would then consider public comment on any such proposal, including public comment on the Commission's analysis of costs and benefits. Any final rulemaking would also take into account not only the views of all interested parties, but also the potential impact of such rules on the financial marketplace, including the impact on retail investors and the advice they receive from financial professionals.

Q.2. I understand that you and your staff are working very hard and talking to each other during the proposal stage, but from the outside it looks like too often the agencies are proposing inconsistent approaches to the same rule sets. For instance, on the Swap Execution Facility rules, the SEC seems to be taking a more flexible approach relative to what you've developed. And their approach seems to be more consistent with what the Europeans are looking

at so it will minimize the risk of regulatory arbitrage. Rather than one agency jumping out in front of the other agency the point of coordination should be to propose consistent approaches to the same rule sets. How do you intend to achieve great harmonization, timing, minimize inconsistent rules and avoid regulatory arbitrage—specifically with respect to the SEF?

A.2. Since the Dodd-Frank Act was passed last July, the Commission staff has been engaged in ongoing discussions with CFTC staff regarding our respective approaches to implementing the statutory provisions for SEFs and security-based SEFs. In many cases, these discussions have led to a common approach—for example, both proposals have similar registration programs, as well as similar filing processes for rule changes and new products. As you note, however, there are differences in certain areas, such as the treatment of requests for quotes, block trades, and voice brokerage.

Our proposal reflects the Commission's preliminary views as to how the Dodd-Frank Act would best be applied to the trading of security-based swaps, which differ in certain ways from the swaps that will be regulated by the CFTC. We look forward to input from the public as to whether these differences are adequately supported by functional distinctions in the trading and liquidity characteristics of swaps and security-based swaps, as well as comments as to how the agencies' rules may be further harmonized. Based on this feedback, we plan to work with the CFTC to achieve greater harmonization of the rules for SEFs and security-based SEFs to the extent practicable.

Throughout this process, we are particularly mindful of the potential burdens on entities that will be dually registered with the Commission and the CFTC. To this end, we have specifically requested comment in our proposal on the impact of the overall regulatory regime for such registrants, such as areas where differences in the Commission and the CFTC approaches may be particularly burdensome. We are also sensitive to the opportunity for regulatory arbitrage with respect to non-U.S. markets, and my staff has been working closely with their international colleagues to find common ground with respect to the regulation of SEFs. We expect to benefit from significant public input on both of these issues, and we will carefully consider such input in crafting our final rule.

Q.3. Dodd-Frank requires that risk retention be jointly considered by the regulators for each different type of asset and includes a specific statutory mandate related to any potential reforms of the commercial mortgage-backed securities to limit disruptions. Given the importance of rigorous cost-benefit and economic impact analyses and the need for due consideration of public comments, do your agencies need more time than is provided by the looming April deadline?

A.3. As you note, the statute is fairly complex. The staff of the agencies have worked together to develop a joint recommendation, meeting multiple times a week for many months in order to consider all the various issues and implications. The agencies proposed rules at the end of March and the comment period will close on June 10, 2011. The staff of the agencies will then begin another deliberative process to consider the comments received and to work

to a consensus recommendation for adoption of final rules. I recognize the importance of getting these rules right and expect that we will take the time needed to do that.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM MARY L. SCHAPIRO

Q.1. In 2010 the SEC issued proposed revisions to Regulation AB (asset backed) that had several requirements that could impact regulations required in Dodd-Frank. Are those regulations on hold?

A.1. The April 2010 ABS proposals sought to address a number of issues, some of which were subsequently referenced in the Dodd-Frank Act, but others that were not.

Issues addressed in the ABS proposals also referenced in the Dodd-Frank Act include:

- repealing the current credit rating references in shelf eligibility criteria for asset-backed issuers and establishing new shelf eligibility criteria, including a requirement that the sponsor of a shelf-eligible offering retain five percent of the risk; and
- requiring that, with some exceptions, prospectuses for public offerings of ABS and ongoing Exchange Act reports contain specified asset-level information (*i.e.,* loan level data) about each asset in the pool. Under the Commission's proposal, the asset-level information would be provided according to proposed standards and in a tagged data format using eXtensible Markup Language, or XML.

Issues addressed in the ABS proposals *not* referenced in the Dodd-Frank Act include:

- revising filing deadlines for ABS offerings to provide investors with more time to consider transaction-specific information, including information about the pool assets;
- requiring the filing of a computer program of the contractual cash flow (*i.e.,* the "waterfall") provisions along with any prospectus filing; and
- new information requirements for the safe harbors for exempt offerings and resales of asset-backed securities.

The staff of our Division of Corporation Finance is reviewing all of the comments received on the April 2010 ABS proposals and is in the process of developing recommendations for the Commission. Those recommendations will necessarily take into consideration the ABS provisions in Dodd-Frank.

Q.2. Will you commit to having your staff brief this committee prior to issuing Regulation AB?

A.2. Yes. I would be happy to have our staff brief the committee on the proposal, the comments we receive, and the possible approaches to addressing the outstanding issues.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM GARY GENSLER

Q.1. Recently, some have voiced concerns that the timeframe for the rulemakings required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is too short to allow for adequate consideration of the various comments submitted or to review how the new rules may impact our financial markets. Does the current timeframe established by Dodd-Frank allow each rulemaking to be completed in a thoughtful and deliberative manner?

A.1. The Dodd-Frank Act has a deadline of 360 days after enactment for completion of the bulk of our rulemakings—July 16, 2011. Both the Dodd-Frank Act and the Commodity Exchange Act (CEA) give the CFTC the flexibility and authority to address the issues relating to the effective dates of Title VII. We have coordinated closely with the SEC on these issues and issued a proposed order on June 14 to provide clarity.

First, a substantial portion of provisions only go into effect once we finalize our rules and based on any implementation phasing that we set.

Second, for many provisions that are not dependent upon a final rule or are self-executing, we proposed exemptive relief until no later than December 31, 2011.

This will provide relief for most of Title VII. We look forward to hearing from the public and finalizing this exemptive relief before July 16.

Q.2. In carrying out the required rulemaking under Title VII, the SEC and the CFTC are instructed under Dodd-Frank to "treat functionally or economically similar products or entities . . . in a similar manner." However, some of the rules defining the key infrastructure for the new derivatives regime that have been proposed by the SEC and CFTC contain some significant and important differences, as is demonstrated by the different definitions for rules governing Swap Execution Facilities. How do your two agencies plan to reconcile these differences before the final rules are adopted later this year?

A.2. The CFTC and SEC consult and coordinate extensively to harmonize our rules to the greatest extent possible. These continuing efforts began with the enactment of the Dodd-Frank Act. This close coordination will benefit the rulemaking process.

With regard to the SEF rulemakings, the CFTC's proposed rule will provide all market participants with the ability to execute or trade with other market participants. It will afford market participants with the ability to make firm bids or offers to all other market participants. It also will allow them to make indications of interest—or what is often referred to as "indicative quotes"—to other participants. Furthermore, it will allow participants to request quotes from other market participants. These methods will provide hedgers, investors, and Main Street businesses the flexibility to trade using a number of methods, but also the benefits of transparency and more market competition. The proposed rule's approach is designed to implement Congress' mandates for a competitive and transparent price discovery process.

The proposal also allows participants to issue requests for quotes, with requests distributed to a minimum number of other market participants. It also allows that, for block transactions, swap transactions involving nonfinancial end-users, swaps that are not "made available for trading" and bilateral transactions, market participants can get the benefits of the swap execution facilities' greater transparency or, if they wish, could be executed by voice or other means of trading.

In the futures world, the law and historical precedent is that all transactions are conducted on exchanges, yet in the swaps world many contracts are transacted bilaterally. While the CFTC will continue to coordinate with the SEC to harmonize approaches, the CFTC also will consider matters associated with regulatory arbitrage between futures and swaps. The Commission has received public comments on its SEF rule and will move forward to consider a final rule only after staff has had the opportunity to summarize them for consideration and after Commissioners are able to discuss them and provide feedback to staff.

Q.3. Please identify the key trends in the derivatives market that your agencies are currently monitoring to ensure systemic stability.

A.3. The Dodd-Frank Act lowers risk in the swaps marketplace by directly regulating dealers for their swaps activities and by moving standardized swaps into central clearing. The Act also brings transparency to the swaps marketplace. The more transparent a marketplace is the more liquid it is, the more competitive it is and the lower costs will be for hedgers, borrowers, and their customers. Increased transparency also lowers risk by improving the reliability of the valuations of open positions. With more swaps being cleared through derivatives clearing organizations regulated by the CFTC, the Commission also is working to ensure that clearinghouses have robust risk management standards.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM GARY GENSLER

Q.1. The Dodd-Frank Act requires an unprecedented number of rulemakings over a short period of time. As a result, some deadlines have already been missed and some agencies expect to miss additional deadlines. It appears that many of the deadlines in Dodd-Frank are not realistic. Which Dodd-Frank deadlines do you anticipate not being able to meet? If Congress extended the deadlines, would you object? If your answer is yes, will you commit to meeting all of the statutory deadlines? If Congress affords additional time for rulemaking under the Dodd-Frank Act, will you be able to produce higher-quality, better coordinated rules?

A.1. The Dodd-Frank Act has a deadline of 360 days after enactment for completion of the bulk of our rulemakings—July 16, 2011. Both the Dodd-Frank Act and the Commodity Exchange Act (CEA) give the CFTC the flexibility and authority to address the issues relating to the effective dates of Title VII. The CFTC has coordinated closely with the SEC on these issues.

Section 754 of the Dodd-Frank Act states that Subtitle A of Title VII—the Subtitle that provides for the regulation of swaps—"shall

take effect on the later of 360 days after the date of the enactment of this subtitle or, to the extent a provision of this subtitle requires a rulemaking, not less than 60 days after publication of the final rule or regulation implementing such provisions of this subtitle."

Thus, those provisions that require rulemakings will not go into effect until the CFTC finalizes the respective rules. This is a substantial portion of the derivatives provisions under Dodd-Frank. Furthermore, they will only go into effect based on the phased implementation dates included in the final rules. The CFTC has posted a list of the provisions of the swaps subtitle that require rulemakings to the agency's Web site.

There are other provisions of Title VII that do not require rulemaking and will take effect on July 16. On June 14, 2011, the CFTC issued a proposed order that would provide relief until December 31, 2011, or when the definitional rulemakings become effective, whichever is sooner, from certain provisions that would otherwise apply to swaps or swap dealers on July 16. This includes provisions that do not directly rely on a rule to be promulgated, but do refer to terms that must be further defined by the CFTC and SEC, such as "swap" and "swap dealer."

The proposed order also would provide relief through no later than December 31, 2011, from certain CEA requirements that may result from the repeal, effective on July 16, 2011, of some of sections 2(d), 2(e), 2(g), 2(h), and 5d. The proposed order was published with a 14-day public comment period.

The CFTC will begin considering final rules only after staff can analyze, summarize and consider public comments, after the Commissioners are able to discuss the comments and provide direction to staff, and after we consult with fellow regulators on the rules.

Q.2. Secretary Geithner recently talked about the difficulty of designating nonbank financial institutions as systemic. He said, "it depends too much on the state of the world at the time. You won't be able to make a judgment about what's systemic and what's not until you know the nature of the shock." [1] If it is impossible to know which firms are systemic until a crisis occurs, the Financial Stability Oversight Council will have a very difficult time objectively selecting systemic banks and nonbanks for heightened regulation. As a member of the Council, do you believe that firms can be designated *ex ante* as systemic in a manner that is not arbitrary? If your answer is yes, please explain how.

A.2. The FSOC's proposed rulemaking on Authority to Require Supervision of Certain Nonbank Financial Companies would fulfill Congress' mandate by laying out a set of designation criteria that the Council would use to determine whether nonbank financial companies are systemically significant. Effective regulation of systemically important nonbank financial entities is essential to preventing the next AIG from threatening the financial system.

The Dodd-Frank Act includes a specific list of factors to consider in the designation process. These include: the extent of the leverage

[1] *See,* Special Inspector General for the Troubled Asset Relief Program, "Extraordinary Assistance Provided to Citigroup, Inc." (SIGTARP 11-002) (Jan. 13, 2011) (available at: *http://www.sigtarp.gov/reports/audit/2011/Extraordinary%20Financial%20Assistance%20Provided%20to%20Citigroup,%20Inc.pdf*), at 43.

of the company; the extent and nature of the off balance sheet exposures of the company; transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies; the extent to which assets are managed rather than owned by the company; the extent to which ownership of assets under management is diffuse; and other factors. I look forward to working with fellow Council members to ensure that designations are made according to these criteria and not arbitrarily.

Q.3. Section 112 of the Dodd-Frank Act requires the Financial Stability Oversight Council to annually report to Congress on the Council's activities and determinations, significant financial market and regulatory developments, and emerging threats to the financial stability of the United States. Each voting member of the Council must submit a signed statement to the Congress affirming that such member believes the Council, the Government, and the private sector are taking all reasonable steps to ensure financial stability and mitigate systemic risk. Alternatively, the voting member shall submit a dissenting statement. When does the Council expect to supply the initial report to Congress?

A.3. The Council is expected to deliver the report sometime later this year.

Q.4. Which provisions of Dodd-Frank create the most incentives for market participants to conduct business activities outside the United States? Have you done any empirical analysis on whether Dodd-Frank will impact the competitiveness of U.S. financial markets? If so, please provide that analysis.

A.4. As we work to implement the derivatives reforms in the Dodd-Frank Act, we are actively coordinating with international regulators to promote robust and consistent standards and avoid conflicting requirements in swaps oversight. The Commission participates in numerous international working groups regarding swaps, including the International Organization of Securities Commissions Task Force on OTC Derivatives, which the CFTC cochairs with the Securities and Exchange Commission (SEC). The CFTC, SEC, European Commission, and European Securities Market Authority are coordinating through a technical working group.

The Dodd-Frank Act recognizes that the swaps market is global and interconnected. It gives the CFTC the flexibility to recognize foreign regulatory frameworks that are comprehensive and comparable to U.S. oversight of the swaps markets in certain areas. In addition, we have a long history of recognition regarding foreign participants that are comparably regulated by a home country regulator. The CFTC enters into arrangements with international counterparts for access to information and cooperative oversight. The Commission has signed memoranda of understanding with regulators in Europe, North America, and Asia.

Q.5. More than 6 months have passed since the passage of the Dodd-Frank Act, and you are deeply involved in implementing the Act's approximately 2,400 pages. Which provisions of the Dodd-Frank Act are proving particularly difficult to implement? Have

you discovered any technical or substantive errors in the Dodd-Frank legislation? If so, please describe them.

A.5. The CFTC is working deliberatively, efficiently, and transparently to write rules to implement the Dodd-Frank Act. At this point, the Commission has substantially completed the proposal phase of rule writing. The public has had an opportunity to comment on the entire mosaic of proposed rules in a supplemental comment period of 30 days, which closed on June 3.

We will begin considering final rules only after staff can analyze, summarize, and consider comments, after the Commissioners are able to discuss the comments and provide feedback to staff, and after the Commission consults with fellow regulators on the rules.

The Commission has scheduled public meetings in July, August, and September to begin considering final rules under Dodd-Frank. We envision having more meetings into the fall to take up final rules.

Q.6. What steps are you taking to understand the impact that your agency's rules under Dodd-Frank will have on the U.S. economy and its competitiveness? What are the key ways in which you anticipate that requirements under the Dodd-Frank Act will affect the U.S. economy and its competitiveness? What are your estimates of the effect that the Dodd-Frank Act requirements will have on the jobless rate in the United States?

A.6. The 2008 financial crisis was very real. Millions more Americans are out of work today than if not for the financial crisis. Millions of homeowners now have homes worth less than their mortgages. Millions of people have had to dig into their savings; millions more haven't seen their investments regain the value they had before the crisis. There remains significant uncertainty in the economy.

Though there were many causes to the crisis, it is clear that swaps played a central role. They added leverage to the financial system with more risk being backed up by less capital. They contributed, particularly through credit default swaps, to the bubble in the housing market and helped to accelerate the financial crisis. They contributed to a system where large financial institutions were thought to be not only too big to fail, but too interconnected to fail. Swaps—initially developed to help manage and lower risk—actually concentrated and heightened risk in the economy and to the public.

The Dodd-Frank Act's derivatives reforms will increase transparency, lower risk, and promote integrity in the swaps markets. This will benefit derivatives users and the broader economy.

Q.7. What steps are you taking to assess the aggregate costs of compliance with each Dodd-Frank rulemaking? What steps are you taking to assess the aggregate costs of compliance with all Dodd-Frank rulemakings, which may be greater than the sum of all of the individual rules' compliance costs? Please describe all relevant reports or studies you have undertaken to quantify compliance costs for each rule you have proposed or adopted. Please provide an aggregate estimate of the compliance costs of the Dodd-Frank rules that you have proposed or adopted to date.

A.7. The CFTC strives to include well-developed considerations of costs and benefits in each of its proposed rulemakings. Relevant considerations are presented not only in the cost-benefit analysis section of the CFTC's rulemaking releases, but also throughout the releases.

In addition, Commissioners and staff have met extensively with market participants and other interested members of the public to hear, consider and address their concerns regarding each rulemaking. CFTC staff hosted a number of public roundtables so that rules could be proposed in line with industry practices and address compliance costs consistent with the Dodd-Frank Act's regulatory requirements. Information about each of these meetings, as well as full transcripts of the roundtables, is available on the CFTC's Web site and has been factored into each applicable rulemaking.

With each proposed rule, the Commission has sought public comment regarding costs and benefits to better inform the rulemaking process.

Q.8. Section 115 of the Dodd-Frank Act asks the Financial Stability Oversight Council to make recommendations to the Federal Reserve on establishing more stringent capital standards for large financial institutions. In addition, Section 165 requires the Fed to adopt more stringent standards for large financial institutions relative to smaller financial institutions. Chairman Bernanke's testimony for this hearing implied that the Basel III framework satisfies the Fed's obligation to impose more stringent capital on large financial institutions. As a member of the Financial Stability Oversight Council, do you agree with Chairman Bernanke that the Basel III standards are sufficient to meet the Dodd-Frank Act requirement for more stringent capital standards? Please explain the basis for your answer.

A.8. On January 19, 2011, the Council issued a notice of proposed rulemaking concerning the criteria that will inform, and the processes and procedures established under the Dodd-Frank Act for, the Council's designation of nonbank financial companies that may be subject to more stringent capital standards pursuant to Section 165. FSOC staff currently is summarizing comments concerning that notice of proposed rulemaking, and I look forward to reviewing the comments that are submitted.

Q.9. The Fed, the SEC, the FDIC, and the CFTC are all structured as boards or commissions. This means that before they can implement a rule they must obtain the support of a majority of their board members. How has your board or commission functioned as you have been tackling the difficult job of implementing Dodd-Frank? Have you found that the other members of your board or commission have made positive contributions to the process?

A.9. Each of the CFTC's commissioners, as well as their staffs, has put in a great deal of hard work to implement the Dodd-Frank Act. I believe that our rules, the markets and the American public benefit from the CFTC's collaborative and inclusive process of writing rules to oversee the swaps markets.

Q.10. The SEC and CFTC are both spending many resources on writing rules and initiating the oversight programs for over-the-

counter derivatives. These parallel efforts are in many respects redundant, costly, and potentially damaging to the market. Would a combined SEC–CFTC unit to deal with swaps and security-based swaps reduce implementation costs, eliminate the redundancy of having two sets of rules, and provide for a more certain and effective regulatory regime?

A.10. The CFTC and the SEC are coordinating closely in writing rules to implement the derivatives provisions of the Dodd-Frank Act. We have jointly proposed rulemakings and coordinated and consulted on each of the other rulemakings. This includes sharing many of our memos, term sheets and draft work product. This close working relationship has benefited the rulemaking process.

Q.11. Title VIII of Dodd-Frank deals with more than systemically important financial market utilities. Under Title VIII, the SEC and CFTC are authorized to prescribe and enforce regulations containing risk management standards for financial institutions engaged in payment, clearance, and settlement activities designated by the Financial Stability Oversight Council as systemically important. Should the Council designate any activities under Title VIII? If the Council designates any activities as systemically important, what are the limits to your authority under Title VIII with respect to your regulated entities that engage in designated activities? What specific actions are beyond the authority of the CFTC and SEC?

A.11. The CFTC has proposed several rules relating to clearing organizations. One proposed rule regarding financial resources for derivatives clearing organizations (DCOs) is an important first step in fulfilling the requirements of the Dodd-Frank Act to have robust oversight and risk management of clearinghouses. The proposed rulemaking will reduce the potential for systemic risk in the financial markets. The CFTC consulted with the Securities and Exchange Commission (SEC) and the Federal Reserve Board on this proposed rule. The Commission also has worked to ensure that these proposed financial resource rules are consistent with international standards in the newest draft CPSS–IOSCO standards.

The Commission also has proposed regulations related to compliance with DCO core principles regarding participant and product eligibility, risk management, settlement procedures, treatment of funds, default rules and procedures, and system safeguards.

For DCOs that are designated by the FSOC as systemically important DCOs (SIDCOs), the Commission proposed heightened standards in the area of system safeguards supporting business continuity and disaster recovery and a provision that would implement the Commission's special enforcement authority over SIDCOs.

Q.12. One of the purposes of joint rulemaking was to bring the best minds of both agencies together to design a uniform regulatory approach for OTC derivatives. In one recent joint proposal, the SEC and CFTC took two different approaches to further defining "swap dealer" and "security-based swap dealer." Specifically, the release applied the dealertrader distinction that has been used to interpret the term "dealer" under the 1934 Act only to security-based swap

dealers, not to swap dealers. Does this violate the Dodd-Frank mandate that you work together?

A.12. The Dodd-Frank Act provides that in adopting rules, the CFTC and SEC shall treat functionally or economically similar products or entities in a similar manner, but are not required to treat them in an identical manner. In December 2010, the CFTC and the SEC jointly issued a proposed rulemaking to further define the terms "swap dealer" and "security-based swap dealer." Under the joint proposal, the CFTC and the SEC recognize that the principles relevant to identifying dealing activity involving swaps can differ from comparable principles associated with security-based swaps. "These differences are due, in part, to differences in how those instruments are used. For example, because security-based swaps may be used to hedge or gain economic exposure to underlying securities, there is a basis to build upon the same principles that are presently used to identify dealers for other types of securities."

Because security-based swaps are related to securities, the CFTC and SEC joint reflects the understanding that the dealer-trader distinction (which refers to the SEC's interpretation of aspects of the Securities Exchange Act of 1934) is "an important analytical tool to assist in determining whether a person is a 'security-based swap dealer.'" Swaps, unlike security-based swaps, are related to financial and nonfinancial commodities such as interest rates, currencies and agricultural, energy, and metals commodities.

The joint proposed rule also reflects the understanding that it would not necessarily be appropriate to use principles developed to determine if a person is a securities dealer to determine if a person is a dealer in commodity swaps. The proposal requested comment on this interpretive approach. The use of the dealer-trader distinction will be addressed in the final rules relating to the swap dealer and security-based swap dealer definitions, after taking the comments into account.

Q.13. One of the concerns of foreign regulators and foreign market participants is a lack of clarity about the application of your derivatives regulation. What are the limits of your ability to regulate foreign swap participants and foreign transactions in the swap market? Do you think that the CFTC and SEC should define the bounds of their regulatory authority in a formal rulemaking? If not, why not?

A.13. The derivatives provisions of the Dodd-Frank Act apply to activities outside the U.S. if they have a "direct and significant connection with activities, or effect on, commerce" of the U.S. or contravene regulations the Commission may promulgate as necessary to prevent evasion of the Act. In particular proposed rules, the Commission provided guidance with respect to treatment of activities outside of the United States and sought public comment.

Q.14. In your written testimony, you noted that you "are working very closely with the SEC, the Federal Reserve, the FDIC, the OCC, and other prudential regulators, which includes sharing many of our memos, term sheets and draft work product." Please give a specific example in which the CFTC has changed its regulatory approach in response to input from each of these agencies.

A.14. The CFTC's 31 Dodd-Frank staff rulemaking teams and the Commissioners are all working closely with fellow regulators. It is difficult to provide discrete examples of changes in this regard because the effort has been so closely integrated on each of the more than 50 proposed rules promulgated by the Commission. CFTC staff have had more than 600 meetings with their counterparts at other agencies and have hosted numerous public roundtables with staff from other regulators to benefit from the open exchange of ideas. Commission staff will continue to engage with their colleagues at the other agencies as we proceed to develop and consider final rules.

Q.15. The CFTC's proposals are routinely focused more on highlighting anticipated societal benefits than rigorously assessing potential compliance costs to market participants. For example, in a recent proposal with respect to risk management requirements for derivatives clearing organizations, the CFTC estimated that it would cost DCOs $500 a year to comply with these new requirements. It is hard to understand how a DCO could "maintain records of all activities related to its business as a DCO" for a mere $500 a year, even at the bargain $10 hourly rate estimated by the CFTC. The CFTC, however, concluded that even the $500 estimate might be too high; it opined that "the actual costs to many DCOs may be far less" than the CFTC's $500 estimate. Please explain how this is a credible estimate and describe the basis for the estimate.

A.15. The proposed rule regarding risk management requirements for DCOs specifically identified the record-keeping costs associated with one discrete, new reporting requirement to be $500 annually. This estimate references the same figure estimated under Paperwork Reduction Act (PRA) computations. As noted in the proposal, the $500 figure was not intended to be an estimate of the total costs associated with compliance with all the proposed risk management rules. Rather, the PRA costs are a subset of overall costs. The Commission noted that the estimate may be less because DCOs already may have in place certain record-keeping procedures that would meet the proposed requirements. In addition, public comment was specifically requested with respect to costs and benefits to be considered in connection with the proposed rule.

Q.16. The CFTC recently filled its Chief Economist position, which had remained vacant for several months. Please describe the Chief Economist's experience in conducting cost-benefit analyses and the role that experience played in his being selected for the position. During the time when the CFTC Chief Economist position remained unfilled, how many regulatory actions did the CFTC undertake without the benefit of a Chief Economist to direct the required cost-benefit analyses? During the time when the CFTC Chief Economist position was unfilled, how many enforcement actions did the CFTC undertake without the benefit of a Chief Economist to direct analytic support, such as calculations of ill-gotten gains and investor harm? How has the quality of regulatory cost-benefit analysis improved since the hiring of a new Chief Economist? Please provide specific examples. Given that much of the cost-benefit work is done by members of the rulemaking teams, please describe the cost-ben-

efit analysis qualifications of the relevant staff members charged with conducting cost-benefit analyses with respect to the Dodd-Frank rulemakings.

A.16. On December 21, 2010, the CFTC announced the appointment of Dr. Andrei Kirilenko as the Chief Economist. The Office of the Chief Economist (OCE) is responsible for providing expert economic advice to the Commission. Its functions include policy analysis, economic research, expert testimony, education, and training.

Dr. Kirilenko has been with the CFTC since 2008. Prior to his appointment Dr. Kirilenko provided expert economic advice to Commission staff working on rulemakings, including with regard to cost-benefit analysis.

Prior to Dr. Kirilenko's appointment as Chief Economist, the Acting Chief Economist was Dr. James Moser, the Deputy Chief Economist, who ensured the continuing functioning of the office. Dr. Moser's career has included work at the Federal Reserve Bank of Chicago, the Chicago Mercantile Exchange and in academia.

OCE staff economists play an integral role in the cost and benefit considerations as well as other aspects of agency rulemakings. OCE staff consists of both Ph.D. and pre-Ph.D. economists trained in conducting policy analysis, economic research, expert testimony, education, and training.

Q.17. Commissioner O'Malia issued a dissenting statement on the President's budget request for the CFTC. Among other things, he objected that the "budget fails to outline a specific strategy for implementation of the Dodd-Frank Act that utilizes technology as a means to leverage budgetary and staff resources in fulfilling the Commission's oversight and surveillance responsibilities." Please explain how you are using technology to reduce the number of full time employees that the CFTC needs.

A.17. The CFTC's FY2012 budget request includes $66 million for technology and allocates $25 million for Dodd-Frank implementation. For pre-Dodd-Frank information technology requirements, the Commission's FY2012 information technology budget request would allow the Commission to continue its focus on enhancing the Commission's technology to keep pace with the futures marketplace by implementing:

- Automated surveillance of the futures markets through the development of trade practice and market surveillance alerts,
- The capability to create ownership and control linkages between trading activity and aggregated positions,
- Computer forensics capability in support of enforcement investigations,
- Security controls to ensure continued compliance with National Institute of Standards and Technology (NIST) and Federal Information Security Management Act (FISMA) requirements, and
- Human resources systems to improve upon our antiquated systems that have been unable to effectively support recent FTE growth.

The Dodd-Frank Act for the first time sets up a new registration category for swap data repositories. The bill requires registrants—

including swap dealers, major swap participants, SEFs, and DCMs—to have robust record keeping and reporting, including an audit trail, for swaps. The resources requested will ensure that the Commission is able to integrate its systems with swap repositories that are being established in the United States and internationally. The Commission's capacity to study and respond to ordinary trading practices or technological trading innovations will be greatly enhanced. Specific technological objectives include:

- Adapting existing automated surveillance and comprehensive analysis solutions to maximize the utility of the data residing in swap repositories;
- Establishing a robust technology infrastructure for systems that provide reliable intelligence about our markets and that assist the Commission in monitoring voluminous transaction processing;
- Standardizing the collection of order data for disruptive trade practice analysis;
- Advancing computing platforms for high-frequency and algorithmic trading surveillance and enforcement;
- Expanding data transparency through enhancements to the CFTC.gov Web site; and
- Implementing enhanced market and risk surveillance technology to oversee positions across swaps, options, and futures markets.

The CFTC, for the first time in its history, will need the technological capability to aggregate position and trading data across swaps and futures markets. The Commission also will need to be able to aggregate the position, trading and other information stored in SDRs as there may be more than one SDR per asset class. The Dodd-Frank Act does not mandate any registered repository or data warehouse for such data aggregation purposes. However, the CFTC and other regulators will need a comprehensive view of the entire derivatives market, including combined futures and swaps data, to execute their missions. These aggregate capabilities include the ability to collect, store, readily access and analyze data for market surveillance, risk surveillance, enforcement, and position limit purposes.

Q.18. Chairman Gensler, at a recent derivatives conference, Dr. Kay Swinburne, a member of the European Parliament's Economic and Monetary Affairs Committee, observed "I've probably seen Gary Gensler and his team in the European Parliament more than his ministers in the U.S., and it gives an indication of how desperate they are that we actually stay in line with what they already have as a framework, ... I have to say the more they pressurize the European Parliament, the more likely it is that they will push back and go in a slightly different direction." [2] If, in fact, the European Parliament decides to go in a different direction, what impact will that have on the competitiveness of U.S. financial mar-

[2] Rob McGlinchey, "U.S., Industry Warned Over Lobbying E.U. Over Derivatives", *Derivatives Week* (Nov. 30, 2010).

kets? On which aspects of derivatives regulation is it most important for the U.S. and E.U. to have consistent regulations?

A.18. In the process of implementing the derivatives reforms in the Dodd-Frank Act, the Commission is actively coordinating with international regulators to promote robust and consistent standards and avoid conflicting requirements in swaps oversight. As we do with domestic regulators, we are sharing many of our memos, term sheets and draft work product with international regulators. The Commision has been consulting directly and sharing documentation with the European Commission, the European Central Bank, the U.K. Financial Services Authority, the new European Securities and Markets Authority and regulators in Canada, France, Germany, and Switzerland. Recently, I met with Michel Barnier, the European Commissioner for Internal Market and Services, to discuss ensuring consistency in swaps market regulation.

This close coordination will facilitate robust and consistent standards, including with regard to central clearing, trading on exchanges or electronic trading platforms, reporting and higher capital requirements for noncleared swaps. While the European Union should not be expected to adopt identical regulations as the U.S., indications are that the ultimate outcome of the European legislation will be consistent with the objectives of Dodd-Frank in these four key areas.

Meetings with officials from the European Commission and European Parliament at provide continued encouragement with regard to U.S. and European Union cooperation.

Q.19. Some disharmonies appear to be arising between the SEC and CFTC approaches. What is your plan for eliminating those disparities, particularly because the two agencies regulate many of the same market participants?

A.19. Section 712(a)(7) of the Dodd-Frank Act recognized the differences between CFTC- and SEC-regulated products and entities. It provides that, in adopting rules, the CFTC and SEC shall treat functionally or economically similar products or entities in a similar manner, but are not required to treat them in an identical manner. The Commissions work towards consistency in the agencies' respective rules to the extent possible through consultation and coordination continually carried out since the enactment of the Dodd-Frank Act. This close coordination has benefited the rulemaking process and will strengthen the markets for both swaps and security-based swaps.

Q.20. The CFTC's Dodd-Frank rulemaking initiatives to date have not been limited to items that are mandated by the Act, but have also included some actions that are purely discretionary. End-users and market participants are already spending substantial amounts of time and money to come into compliance with the mandatory provisions of the Dodd-Frank Act. Under your approach, they will have to bear the additional costs of complying with discretionary rules. Please describe the analysis you did to determine whether end-users and market participants can bear the compliance costs of so many new rules in such a short period of time.

A.20. The CFTC strives to include well-developed considerations of costs and benefits in each of its proposed rulemakings. Relevant

considerations are presented not only in the cost-benefit analysis section of the CFTC's rulemaking releases, but additionally are discussed throughout the release in compliance with the Administrative Procedure Act, which requires the CFTC to set forth the legal, factual and policy bases for its rulemakings.

In addition, Commissioners and staff have met extensively with market participants and other interested members of the public to hear, consider and address their concerns in each rulemaking. CFTC staff hosted a number of public roundtables so that rules could be considered in line with industry practices and address compliance costs consistent with the obligations of the CFTC to promote market integrity, reduce risk, and increase transparency and protect the public interest.

With each proposed rule, the Commission has sought public comment regarding costs and benefits.

In enacting title VII of the Dodd-Frank Act, Congress gave the CFTC latitude with respect to the effective dates of particular requirements. In May, the Commission re-opened many of its comment periods that had closed and extended some existing comment periods so that the public could comment in the context of the entire mosaic of proposed rules. This opportunity was available with respect to all relevant proposed rules, giving the public and market participants the opportunity to comment on compliance costs and to make recommendations regarding the schedule of implementation. That extended comment period closed on June 3, 2011. In addition, on May 2 and 3, 2011, CFTC and SEC staff held roundtable sessions to obtain views of the public with regard to implementation dates of the various rulemakings. Prior to the roundtable, on April 29, CFTC staff released a document that set forth concepts that the Commission may consider with regard to the effective dates of final rules for swaps under the Dodd-Frank Act. The Commission is also receiving written comments on that subject. Since the beginning of the rulemaking process, the Commission has worked closely with other Federal regulators and will continue to do so.

Q.21. Chairman Gensler, the approach that the CFTC took with respect to swap execution facilities (SEFs) is at odds with the SEC's approach, which allows for a meaningful alternative to exchange trading. Explain how your approach is consistent with the statutory language. You have long called for bringing OTC derivatives onto "regulated exchanges or similar trading venues." Do you believe that there is a role in the swaps markets for a meaningful alternative to an exchange that allows, for example, firms seeking to manage their risk to choose whether to disseminate their requests for quotes to one or more market participants?

A.21. The CFTC and SEC consult and coordinate extensively to harmonize our rules to the greatest extent possible. These continuing efforts began with the enactment of the Dodd-Frank Act. This close coordination will benefit the rulemaking process.

With regard to the SEF rulemakings, the CFTC's proposed rule will provide all market participants with the ability to execute or trade with other market participants. It will afford market participants with the ability to make firm bids or offers to all other mar-

ket participants. It also will allow them to make indications of interest—or what is often referred to as "indicative quotes"—to other participants. Furthermore, it will allow participants to request quotes from other market participants. These methods will provide hedgers, investors, and Main Street businesses the flexibility to trade using a number of methods, but also the benefits of transparency and more market competition. The proposed rule's approach is designed to implement Congress' mandates for a competitive and transparent price discovery process.

The proposal also allows participants to issue requests for quotes, with requests distributed to a minimum number of other market participants. It also allows that, for block transactions, swap transactions involving nonfinancial end-users, swaps that are not "made available for trading" and bilateral transactions, market participants can get the benefits of the swap execution facilities' greater transparency or, if they wish, could be executed by voice or other means of trading.

In the futures world, the law and historical precedent is that all transactions are conducted on exchanges, yet in the swaps world many contracts are transacted bilaterally. While the CFTC will continue to coordinate with the SEC to harmonize approaches, the CFTC also will consider matters associated with regulatory arbitrage between futures and swaps. The Commission has received public comments on its SEF rule and will move forward to consider a final rule only after staff has had the opportunity to summarize them for consideration and after Commissioners are able to discuss them and provide feedback to staff.

Q.22. In contrast to the SEC's Title VII implementation, the CFTC's implementation of Title VII to date has been marked by divided votes. Do you believe that consensus is important to ensure that the CFTC's regulations are balanced, targeted, and effective? Under what circumstances do you believe it is appropriate to adopt rules without the unanimous consent of the Commission?

A.22. The majority of Commission votes on Dodd-Frank rulemakings have been unanimous. The Commission rulemaking process benefits greatly from the close consultation between all of the Commissioners and their staffs. Commissioners work together to achieve a common understanding and to reach consensus wherever possible.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM GARY GENSLER

Q.1. A serious topic of discussion in the financial markets these past few days is the announcement of a proposed merger between the NYSE-Euronext and the Deutsche Börse.

- If this merger takes place, what will be the potential impact on the implementation of the provisions of the Dodd-Frank Act, particularly in respect to the trading and clearing of derivatives?
- Is there a potential that this merger will enhance the availability of regulatory arbitrage by allowing market participants

the ability to circumvent the requirements of Dodd-Frank by providing easier access to foreign trading and clearing venues?

- Should we be concerned with any anticompetitive implications of this further consolidation of trading and clearing platforms?

A.1. The CFTC's implementation of the Dodd-Frank Act would be unaffected by the merger.

The Dodd-Frank Act also broadened the CFTC's oversight to include authority to register foreign boards of trade (FBOTs) providing direct access to U.S. traders. To become registered, FBOTs must be subject to regulatory oversight that is comprehensive and comparable to U.S. oversight. This new authority enhances the Commission's ability to ensure that U.S. traders cannot avoid essential market protections by trading contracts traded on FBOTs that are linked with U.S. contracts.

There are six FBOTs that are implicated by the merger. Deutsch Boerse owns all or part of Eurex Deutschland, Eurex Zurich and the European Energy Exchange. NYSE-Euronext owns Liffe, Euronext Amsterdam and Euronext Paris. All six of these FBOTs currently provide for direct access to their trading systems from the U.S. pursuant to Commission staff no-action letters and will be required to register if proposed rules are made final.

As a general matter the anticompetitive implications of any merger is a legitimate consideration and one that the CFTC is required to take into account under the Commodity Exchange Act.

Q.2. To what extent is your agency working with your relevant domestic and foreign counterparts in respect to the possible merger between the New York Stock Exchange and the Deutsche Börse? Are you working to ensure that arrangements will be in place for cooperation in supervision and enforcement and for information sharing, all of which will be required as a result of this potential merger? Should we expect formal MOUs on supervisory cooperation to precede a cross-border merger?

A.2. The Commission has an ongoing and productive working relationship with Germany's Bundesanstalt fur Finanzdienstleistungsaufsicht (BAFIN). Our agency is committed to using that relationship to ensure adequate information sharing and regulatory cooperation.

Q.3. The Securities, Insurance, and Investment Subcommittee held a hearing in December that focused, in part, on the increasing interconnectedness of today's modern markets and the need for effective oversight of trading across products and venues. Today's traders buy and sell options, futures, and equities interchangeably in dozens of marketplaces around the world. Yet, our regulatory oversight mechanism largely relies on a model where each marketplace is primarily responsible for policing the activities on its platform. Given the recently announced potential merger of NYSE Euronext with Deutsche Börse Group, it seems as though the trading marketplaces are only becoming more interconnected. What are your thoughts regarding how to an implement an effective regulatory oversight infrastructure to police trading done both by Americans around the world and by traders around the world in our increasingly interconnected and international marketplaces?

A.3. Under the Commodity Exchange Act, futures exchanges are required in the first instance to implement a robust market surveillance program. The CFTC addresses these challenges through surveillance on a cross-market basis. This allows the CFTC to detect cross-market trading abuses.

The CFTC surveillance staff receives daily transaction and position data for all trading that takes place on futures exchanges registered with the CFTC. This information comes from both the exchanges and brokers. As a result, even trades that are initiated from foreign locations will be disclosed to the CFTC.

FBOTs that permit the direct access of U.S. persons to their trading of contracts that might have an impact on U.S. exchange contracts are subject to surveillance. For example, the CFTC has entered into a surveillance arrangement with the United Kingdom Financial Services Authority (FSA) to share data with respect to trading in energy contracts on ICE Futures U.K. that settle off of the price of contracts on NYMEX. The CFTC's FBOT proposed rules would require such surveillance arrangements.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM GARY GENSLER

Q.1. *Exchanges and Clearinghouses.* I'm concerned that the exchanges or clearinghouses, both for derivatives and securities, could themselves become "too big to fail" and systemically significant. What steps are you taking to ensure that their size and risks are properly managed so that they do not become "too big to fail"?

A.1. The Commission has proposed rules to establish regulatory standards for CFTC-registered derivative clearing organizations (DCOs) to comply with statutory core principles. The proposed rule addresses requirements for a DCO's risk management framework, chief risk officer, measurement of credit exposure, margin requirements and other risk control mechanisms (including risk limits, review of large trader reports, stress tests, swaps portfolio compression, and reviews of clearing members' risk management policies and procedures).

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARNER FROM GARY GENSLER

Q.1. For each of the witnesses, though the Office of Financial Research does not have a Director, what are each of you doing to assist OFR in harmonizing data collection, compatibility, and analysis?

A.1. The Commission has been working closely with the OFR to help develop a strategy for managing initial data required by the OFR to monitor and study systemic risk in the U.S. financial markets. The CFTC also has coordinated with the OFR in the development of a universal Legal Entity Identification standard that is consistent with the Commission's and the SEC's rulemakings.

In addition, to support the FSOC, the CFTC is providing both data and expertise relating to a variety of systemic risks, how those risks can spread through the financial system and the economy and potential ways to mitigate those risks. Commission staff also co-

ordinates with Treasury and other Council member agencies on each of the studies and proposed rules issued by the FSOC.

Q.2. Chairman Shapiro and Chairman Gensler, can each of you explain what budget cuts will mean for the ability of your agencies to ensure markets are safe, protected from abuse, and don't create the types of risks that nearly destroyed our economy?

A.2. The CFTC must be adequately resourced to police the markets and protect the public. The CFTC is taking on a significantly expanded scope and mission. By way of analogy, it is as if the agency previously had the role to oversee the markets in the state of Louisiana and was just mandated by Congress to extend oversight to Alabama, Kentucky, Mississippi, Missouri, Oklahoma, South Carolina, and Tennessee.

With seven times the population to police, far greater resources are needed for the public to be protected. The President's FY2012 budget request of $308 million would provide the CFTC with the personnel and IT resources estimated to be needed to begin to undertake its expanded mission. Without sufficient funding for the agency, our Nation cannot be assured of effective enforcement of new rules in the swaps market to promote transparency, lower risk, and protect against another crisis. Insufficient funding would hamper our ability to seek out fraud, manipulation, and other abuses at a time when commodity prices are rising and volatile. Until the CFTC completes its rule-writing process and implements and enforces those new rules, the public remains unprotected.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MERKLEY FROM GARY GENSLER

Q.1. *Derivatives Oversight.* Counterparty risk and other risks associated with derivatives played a central role in the financial crisis, especially in fueling the argument that firms such as AIG were too big or too interconnected to fail. What oversight systems do you plan to have in place to ensure that any accommodations made in the course of rulemaking for nonfinancial commercial parties do not create holes in the regulatory structure that permit the accumulation of hidden or outsized risk to the U.S. financial system and economy.

A.1. In the Dodd-Frank Act, Congress recognized the different levels of risk posed by transactions between financial entities and those that involve nonfinancial entities, as reflected in the nonfinancial end-user exception to clearing. The risk of a crisis spreading throughout the financial system is greater the more interconnected financial companies are to each other. Interconnectedness among financial entities allows one entity's failure to cause uncertainty and possible runs on the funding of other financial entities, which can spread risk and economic harm throughout the economy. Consistent with this, the CFTC's proposed rules on margin requirements focus only on transactions between financial entities rather than those transactions that involve nonfinancial end-users.

The Dodd-Frank Act provides for comprehensive regulation of dealers, which ensures that every derivatives transaction—includ-

ing those excepted from clearing and trading requirements—will be regulated. The CFTC's proposed capital rules take commercial end-user transactions into account to ensure that swap dealers are adequately capitalized to help prevent future failures. Furthermore, improved price transparency through electronic trading platforms and real time public reporting will help to ensure that positions held by counterparties are properly valued and that exposures between swap dealers and end-users are transparent to both sides. Lastly, the requirement that the details of all transactions be reported to swap data repositories will ensure that the Commission and self-regulatory organizations have the data needed to monitor risks in the derivatives markets.

Q.2. *Markets Oversight.* As you may know, Korean securities regulators recently imposed a 6 month ban on a large European bank from engaging in proprietary trading in Korean markets after it came to light that the bank manipulated the Seoul stock market. With the proposed acquisition of the New York Stock Exchange by a European börse, markets are becoming more international and interconnected than ever before. Do you feel you have the tools you need to monitor trading across multiple markets and across multiple products? If not, what steps do you need to take and what additional tools do you need from Congress to assist you in accomplishing your critical mission of ensuring our markets operate with integrity?

A.2. In general, the Commission has ample experience monitoring trading on a variety of platforms, across multiple markets and across multiple products. The CFTC surveillance staff receives daily transaction and position data for all trading that takes place on registered futures exchanges. This information comes not only from the exchanges but also from brokers. Even trades that are initiated from foreign locations are disclosed to the CFTC.

The CFTC also has taken measures to ensure that trading by U.S. persons through direct electronic access arrangements on foreign boards of trade (FBOT) in contracts that might have an impact on U.S. exchange contracts are subject to specified requirements. For example, the CFTC has entered into a surveillance arrangement with the United Kingdom Financial Services Authority (FSA) to share data with respect to trading in energy contracts on ICE Futures U.K. that settle off of the price of contracts on NYMEX. The CFTC's FBOT proposed rules would require such surveillance arrangements.

The CFTC must be adequately resourced to police the markets, including implementing the Dodd-Frank Act's provision for registration of foreign boards of trade. The CFTC is taking on a significantly expanded scope and mission. By way of analogy, it is as if the agency previously had the role to oversee the markets in the State of Louisiana and was just mandated by Congress to extend oversight to Alabama, Kentucky, Mississippi, Missouri, Oklahoma, South Carolina, and Tennessee.

With seven times the population to police, far greater resources are needed for the public to be protected. Without sufficient funding for the agency, our Nation cannot be assured of effective enforcement of new rules in the swaps market to promote trans-

parency, lower risk, and protect against another crisis. We need additional funding to seek out fraud, manipulation, and other abuses at a time when commodity prices are rising and volatile.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM GARY GENSLER

Q.1. CFTC Commissioners Michael Dunn, Scott O'Malia, and Jill Sommers, have all commented on the lack of economic data on the CFTC proposed rule on commodity speculative position limits. Commissioner Michael Dunn stated: "To date, CFTC staff has been unable to find any reliable economic analysis to support either the contention that excessive speculation is affecting the markets we regulate, or that position limits will prevent excessive speculation." Do you intend to hold off going forward with the rule until you have the kind of economic data that Commissioner stated was lacking?

A.1. Position limits have served since the Commodity Exchange Act passed in 1936 as a tool to curb or prevent excessive speculation that may burden interstate commerce. When the CFTC set position limits in the past, the agency sought to ensure that the markets were made up of a broad group of market participants with a diversity of views. At the core of our obligations is promoting market integrity, which the agency has historically interpreted to include ensuring that markets do not become too concentrated.

The CFTC's January position limits proposal would reestablish position limits in agriculture, energy and metals markets. It includes one position limits regime for the spot month and another regime for single-month and all-months combined limits. It would implement spot-month limits, which are currently set in agriculture, energy, and metals markets, sooner than the single-month or all-months-combined limits. Single-month and all-months-combined limits, which currently are only set for certain agricultural contracts, would be reestablished in the energy and metals markets and be extended to certain swaps. These limits will be set using the formula proposed in January based upon data on the total size of the swaps and futures market collected through the position reporting rule the Commission hopes to finalize early next year. It is only with the passage and implementation of the Dodd-Frank Act that the Commission will have broad authority to collect data in the swaps market.

Q.2. It is my understanding that under Title VII of Dodd-Frank, the CFTC has initiated 40 rulemakings. Despite the abbreviated comment periods, some commenters have done their own analysis and identified flaws in agency cost-benefit analyses. For example, a group of energy companies, in response to a proposed rulemaking by the CFTC, estimated that the personnel costs for swap dealers and major swap participants in connection with implementing a comprehensive risk management plan would be at least "63 times greater than the Commission's estimate." How do you intend to incorporate this feedback and others to adjust these proposed rules to provide less costly alternatives and not make this just a check the box exercise for a decision that has already been made?

A.2. The Administrative Procedure Act (APA) requires the CFTC to provide notice and an opportunity to comment before finalizing rules that will impose new obligations on any person or group of persons. The CFTC considers all of the comments it receives to inform its final rulemaking. To ensure that its final rulemakings have reasoned bases, the CFTC and its staff will review all estimates of costs and benefits that are received from commenters and any data supporting them. This will enable the Commission to adopt rules as required by the Dodd-Frank Act while ensuring that they do not impose unnecessary costs on market participants and the public.

Q.3. I understand that you and your staff are working very hard and talking to each other during the proposal stage, but from the outside it looks like too often the agencies are proposing inconsistent approaches to the same rule sets. For instance, on the Swap Execution Facility rules, the SEC seems to be taking a more flexible approach relative to what you've developed. And their approach seems to be more consistent with what the Europeans are looking at so it will minimize the risk of regulatory arbitrage. Rather than one agency jumping out in front of the other agency the point of coordination should be to propose consistent approaches to the same rule sets. How do you intend to achieve great harmonization, timing, minimize inconsistent rules, and avoid regulatory arbitrage—specifically with respect to the SEF?

A.3. The CFTC and SEC consult and coordinate extensively to harmonize our rules to the greatest extent possible. These continuing efforts began with the enactment of the Dodd-Frank Act. This close coordination will continue and will benefit the rulemaking process.

With regard to the SEF rulemakings, the CFTC's proposed rule will provide all market participants with the ability to execute or trade with other market participants. It will afford market participants with the ability to make firm bids or offers to all other market participants. It also will allow them to make indications of interest—or what is often referred to as "indicative quotes"—to other participants. Furthermore, it will allow participants to request quotes from other market participants. These methods will provide hedgers, investors, and Main Street businesses the flexibility to trade using a number of methods, but also the benefits of transparency and more market competition. The proposed rule's approach is designed to implement Congress' mandates for a competitive and transparent price discovery process.

The proposal also allows participants to issue requests for quotes, with requests distributed to a minimum number of other market participants. It also allows that, for block transactions, swap transactions involving nonfinancial end-users, swaps that are not "made available for trading" and bilateral transactions, market participants can get the benefits of the swap execution facilities' greater transparency or, if they wish, could be executed by voice or other means of trading.

In the futures world, the law and historical precedent is that all transactions are conducted on exchanges, yet in the swaps world many contracts are transacted bilaterally. While the CFTC will continue to coordinate with the SEC to harmonize approaches, the

CFTC also will consider matters associated with regulatory arbitrage between futures and swaps. The Commission has received public comments on its SEF rule and will move forward to consider a final rule only after staff has had the opportunity to summarize them for consideration and after Commissioners are able to discuss them and provide feedback to staff.

Q.4. Dodd-Frank requires that risk retention be jointly considered by the regulators for each different type of asset and includes a specific statutory mandate related to any potential reforms of the commercial mortgage-backed securities to limit disruptions. Given the importance of rigorous cost-benefit and economic impact analyses and the need for due consideration of public comments, do your agencies need more time than is provided by the looming April deadline?

A.4. Section 941 of the Dodd-Frank Act, pertaining to the regulation of credit risk retention, is an amendment to the Securities Exchange Act of 1934. It applies to the Securities and Exchange Commission as well as the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation. The Dodd-Frank Act does not involve the CFTC in this area.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM GARY GENSLER

Q.1. Chairman Gensler, during your appearance before the full House Agriculture Committee last week, you stated that "proposed rules on margin requirements should focus only on transactions between financial entities rather than those transactions that involve nonfinancial end-users." While this was good news to end-users, there is still concern that regulations could impact end-users if banks or other counterparties to these contracts are required to post margin and charge a fee to its end-user counterparties. How would you address this concern? More generally, how do you believe the CFTC can best fulfill Congress' intent to exempt end-users from capital and margin requirements?

A.1. The CFTC's proposed margin rule does not require margin to be paid or collected on transactions involving nonfinancial end-users hedging or mitigating commercial risk.

Q.2. Under the Commodities Exchange Act (CEA), which was repealed by Dodd-Frank, physical forwards were excluded from the definition of swap. In the recent rule on agricultural swaps, the CFTC ruled that a physical contract meets the definition of swap. However, in your testimony before the full House Agriculture Committee you indicated that the Rural Electric Cooperatives were not dealing in swaps, but forwards or forwards with embedded options. Would you please explain how the definitions of "swap" and "agricultural swap" can be reconciled given your comments? Do you believe that forwards with embedded options, such as capacity contracts, reserve sharing agreements, and all-requirements contracts will be excluded from the draft definition of "swap" that you will be releasing shortly?

A.2. In response to a Joint Advance Notice of Proposed Rulemaking regarding definitions issued by the SEC and the CFTC last year, a number of commenters requested that the forward exclusion from the swap definition be clarified. Under the Commodity Exchange Act, the CFTC does not regulate forward contracts. Over the decades, market participants have come to rely upon a series of orders, interpretations and cases regarding the forward contract exclusion. Consistent with that history, the Dodd-Frank Act excluded from the definition of swaps "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." In its proposed rule on product definitions, the Commission expressed the view that the principles underlying its 1990 Statutory Interpretation Concerning Forward Transactions should apply to the forward exclusion from the swap definition with respect to nonfinancial commodities as it does to futures contracts. Market participants that regularly make or take delivery of the referenced commodity in the ordinary course of their business, where the book-out transaction is effectuated through a subsequent, separately negotiated agreement, should qualify for the forward exclusion from the swap definition. Forwards with embedded options would likely qualify for the forward exclusion so long as the optionality was not as to the obligation to deliver.

Q.3. As you know, commercial end-users could be excluded from the new clearing requirements under Dodd-Frank if they are using the swap to hedge "commercial risk" something you discussed in last week's House Agriculture Committee hearing. Because end-users are merely using swaps to hedge risk, then why subject them to CFTC jurisdiction? Could you also provide insight to how broadly "commercial risk" will be defined through CFTC regulation?

A.3. The CFTC's proposed rules do not require transactions involving nonfinancial end-users hedging or mitigating commercial risk to be cleared or traded on trading platforms. Furthermore, the CFTC's proposed margin rule does not require margin to be paid or collected on transactions involving nonfinancial end-users hedging or mitigating commercial risk.

The CFTC and SEC issued a joint proposed rule to further define the term "major swap participant." The CFTC issued a proposed rule related to the nonfinancial end-user exception from the clearing requirement. Both proposals include discussion meant to illuminate the conditions under which positions are to be regarded as held for hedging or mitigating commercial risk. Both proposals demonstrate the belief that whether a position hedges or mitigates commercial risk should be determined by the facts and circumstances at the time the swap is entered into and should take into account the person's overall hedging and risk mitigation strategies. The Commission invited comment on a number of aspects important to this consideration and is reviewing submitted comments.

Q.4. I have noticed that your rulemakings have failed to account for or document the enormous costs that will be imposed on the industry and in many cases fail to even note that the agency will need to hire, train, and support a large number of professional staff

members to perform the work that your proposed rule creates for the agency.

You have claimed, in recent Congressional testimony, that section 15(a) of the CEA excuses you from performing a complete cost and benefit analysis and allows you to justify your rulemaking by speculating about benefits to the market. What is your justification for ignoring your obligation to fully analyze the costs imposed on third parties and on the agency by your rulemaking?

SEC. 15. (7 U.S.C. 19) CONSIDERATION OF COSTS AND BENEFITS AND ANTITRUST LAWS.
(a) COSTS AND BENEFITS.—
(1) IN GENERAL.—Before promulgating a regulation under this Act or issuing an order (except as provided in paragraph (3)), the Commission shall consider the costs and benefits of the action of the Commission.
(2) CONSIDERATIONS.—The costs and benefits of the proposed Commission action shall be evaluated in light of—
(A) considerations of protection of market participants and the public;
(B) considerations of the efficiency, competitiveness, and financial integrity of futures markets;
(C) considerations of price discovery;
(D) considerations of sound risk management practices; and
(E) other public interest considerations.
(3) APPLICABILITY.—This subsection does not apply to the following actions of the Commission:
(A) An order that initiates, is part of, or is the result of an adjudicatory or investigative process of the Commission.
(B) An emergency action.
(C) A finding of fact regarding compliance with a requirement of the Commission.

A.4. See response after Question 5.

Q.5. Many have raised concerns that the CFTC does not have adequate funds to implement many of the rules it is proposing. In fact, Commissioner Dunn made the following request at the very first CFTC Open Meeting on Dodd-Frank rulemaking:

> I would ask that staff provide an estimate of the cost of each proposed regulation and an analysis detailing whether the CFTC can delegate duties to SROs to fulfill the mandates of Congress. Further, I would ask staff working in concert with the Chairman to provide the Commissioners with a list of prioritizing regulations based on available funding.

Has the Commission performed or will it be performing a cost benefit analysis of each of the various rules it is proposing?

A.5. The CFTC strives to include well-developed considerations of costs and benefits in each of its proposed rulemakings. Relevant considerations are presented not only in the cost-benefit analysis section of the CFTC's rulemaking releases, but additionally are discussed throughout the release in compliance with the Administrative Procedure Act, which requires the CFTC to set forth the legal, factual, and policy bases for its rulemakings.

In addition, Commissioners and staff have met extensively with market participants and other interested members of the public to hear, consider and address their concerns in each rulemaking. CFTC staff hosted a number of public roundtables so that rules could be proposed in line with industry practices and address compliance costs consistent with the obligations of the CFTC to promote market integrity, reduce risk, and increase transparency as directed in Title VII of the Dodd-Frank Act. Information from each of these meetings—including full transcripts of the roundtables—is available on the CFTC's Web site and has been factored into each applicable rulemaking.

With each proposed rule, the Commission has sought public comment regarding costs and benefits.

Q.6. The CFTC's analysis for several of these rules seems widely inconsistent with outside cost-benefit analysis for the same rules. For instance, your business conduct standards rule could increase costs for pension funds and municipalities significantly. In performing the cost-benefit analysis for proposed business conduct standards, did the CFTC quantify the effect these additional regulatory burdens would have on the market? Particularly, did the CFTC consider that these burdens could compel dealers to choose not to enter into trades with municipalities and other "special entities" such as pension funds?

A.6. The Commission's proposed business conduct standards rules track the statutory directive under the provisions of the Dodd-Frank Act that create a higher standard of care for swap dealers dealing with Special Entities, including municipalities and pension funds. The Commission's proposed rules were drafted following consultations with Special Entities and potential swap dealers and were designed to enable swap dealers to comply with their new duties in an efficient and effective manner. The Commission is reviewing the comments it has received on the proposed rules to ensure that the final rules achieve the statutory purpose without imposing undue costs on market participants. The proposed rulemaking release specifically asks that the public provide comment regarding associated costs and benefits.

Q.7. I'm concerned about the costs some of these rules are going to place on end-users. While the Dodd-Frank Act requires the CFTC to consider the special role of "block trades" when adopting real-time swap reporting requirements, the CFTC's real-time reporting proposal includes a very narrow definition of "block trade" and a very short 15-minute delay for public dissemination of block trade information. I'm concerned the increased costs of this narrow interpretation could make it costly for end-users to enter into the block trades they use to hedge their own risks. Has the CFTC considered the impact these increased costs have on end-user risk management?

A.7. The CFTC's proposed rules regarding real-time reporting of swap transaction and pricing data defined "large notional swap" and "block trade" and specified a delay of 15 minutes for the public reporting of swap transaction data only for block trades that are executed pursuant to the rules of a swap execution facility or designated contract market. The proposed rulemaking does not pro-

vide specific time delays for large notional swaps that are not executed on a swap execution facility or a designated contract market, such as those entered into by nonfinancial end-users hedging or mitigating commercial risk. The proposal seeks comment regarding the appropriate time delay for these transactions.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM JOHN WALSH

Q.1. Recently, some have voiced concerns that the timeframe for the rulemakings required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is too short to allow for adequate consideration of the various comments submitted or to review how the new rules may impact our financial markets. Does the current timeframe established by Dodd-Frank allow each rulemaking to be completed in a thoughtful and deliberative manner?

A.1. We recognize that the deadlines established for many of the rules required by the Dodd-Frank Act demonstrate Congress' concern that the Act's regulatory reforms be promptly implemented. This goal is in some tension with the time necessary to resolve the novel and complex legal and practical issues presented by a many of the statutory provisions and, in many instances, the time necessary to comply with Congress' direction for joint or coordinated rulemaking conducted by a number of different agencies. We are working diligently toward all of these goals, but getting the substance of the rulemakings right is our primary objective.

Q.2. In defining the exemption for "qualified residential mortgages," are the regulators considering various measures of a lower risk of default, so that there will not just be one "bright line" factor to qualify a loan as a Q.R.M.?

A.2. Section 941 provides a complete exemption from the credit risk retention requirements for ABS collateralized solely by qualified residential mortgages. The agencies' proposed rule establishes the terms and conditions under which a residential mortgage would qualify as a QRM. The proposed rule generally would prohibit QRMs from having product features that contributed significantly to the high levels of delinquencies and foreclosures since 2007—such as failure to document income, "teaser" rates, or terms permitting negative amortization or interest-only payments—and also would establish conservative underwriting standards designed to ensure that QRMs are of high credit quality. These underwriting standards include, among other things, maximum front-end and back-end debt-to-income ratios of 28 percent and 36 percent, respectively; a maximum loan-to-value (LTV) ratio of 80 percent in the case of a purchase transaction; and a 20 percent down payment requirement in the case of a purchase transaction.

If the agencies are persuaded by comments that the QRM underwriting criteria are too restrictive on balance, the preamble discusses several possible alternatives:

- Permit the use of private mortgage insurance obtained at origination of the mortgage for loans with LTVs higher than the 80 percent level specified in the proposed rule. The guarantee provided by private mortgage insurance, if backed by sufficient

capital, lowers the credit risk to investors by covering the unsecured losses attributable to the higher LTV ratio once the borrower defaults and the loan is liquidated. However, to include private mortgage insurance in the QRM criteria, Congress required the agencies to determine that the presence of private mortgage insurance lowers the risk of default—not that it reduces the ultimate amount of the loss. The OCC will be interested in the information provided by Commenters on this topic, and any data they can provide.

- Impose less stringent QRM underwriting criteria, but also impose more stringent risk retention requirements on non-QRM loan ABS to incentivize origination of the QRM loans and reflect the relatively greater risk of the non-QRM loan market.
- Create an additional residential mortgage loan asset class along side the QRM exemption—such as the underwriting asset classes for commercial loans, commercial mortgages, and auto loans under the proposed rule—with less stringent underwriting standards or private mortgage insurance, subject to a risk retention requirement set somewhere between 0 and 5 percent.

Q.3. What data are you using to help determine the definition of a Qualified Residential Mortgage?

A.3. Section 941 requires the agencies to define qualified residential mortgage "taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default." Therefore, in considering how to determine if a mortgage is of sufficient credit quality, the agencies examined data from several sources.

- The agencies reviewed data on mortgage performance supplied by the Applied Analytics division (formerly McDash Analytics) of Lender Processing Services (LPS). To minimize performance differences arising from unobservable changes across products, and to focus on loan performance through stressful environments, for the most part, the agencies considered data for prime fixed-rate loans originated from 2005 to 2008. This data set included underwriting and performance information on approximately 8.9 million mortgages.
- The agencies also examined data from the 1992 to 2007 waves of the triennial Survey of Consumer Finances (SCF) conducted by the Federal Reserve Board. Because families' financial conditions will change following the origination of a mortgage, the analysis of SCF data focused on respondents who had purchased their homes either in the survey year or the previous year.
- The agencies also examined a combined data set of loans purchased or securitized by the GSEs from 1997 to 2009. This data set consisted of more than 75 million mortgages, and included data on loan products and terms, borrower characteristics (*e.g.,* income and credit score), and performance data through the third quarter of 2010.

Based on these and other data sets, and as supported by a body of academic literature, the agencies believe that the underwriting

criteria for QRMs in the proposed rule have low credit risk, even in severe economic conditions.

Q.4. Please discuss the current status and timeframe of implementing the Financial Stability Oversight Council's (FSOC) rulemaking on designating nonbank financial companies as being systemically important. As a voting member of FSOC, to what extent is the Council providing clarity and details to the financial marketplace regarding the criteria and metrics that will be used by FSOC to ensure such designations are administered fairly? Is the intent behind designation decisions to deter and curtail systemically risky activity in the financial marketplace? Are diverse business models, such as the business of insurance, being fully and fairly considered as compared with other financial business models in this rulemaking?

A.4. On January 18, 2011, the Council approved publication of a notice of proposed rulemaking (NPRM) that outlines the criteria that will inform the Council's designation of such firms and the procedures the FSOC will use in the designation process. The NPRM closely follows and adheres to the statutory factors established by Congress for such designations. The framework proposed in the NPRM for assessing systemic importance is organized around six broad categories, each of which reflects a different dimension of a firm's potential to experience material financial distress, as well as the nature, scope, size, scale, concentration, interconnectedness, and mix of the company's activities. The six categories are: size, interconnectedness, substitutability, leverage, liquidity, and regulatory oversight.

The comment period for this NPRM closed on February 25, 2011, and staffs are in the process of reviewing the comments received and making recommendations for upcoming discussions by FSOC principals on how to proceed with implementing this important provision of the Dodd-Frank Act. With regard to the concerns voiced by some commenters and members of Congress, the OCC is committed to ensuring that the Council strikes the appropriate balance in providing sufficient clarity in our rules and transparency in our designation process, while at the same time avoiding overly simplistic approaches that fail to recognize and consider the facts and circumstances of individual firms and specific industries. Ensuring that firms have appropriate due process throughout the designation process will be critical in achieving this balance.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM JOHN WALSH

Q.1. The Dodd-Frank Act requires an unprecedented number of rulemakings over a short period of time. As a result, some deadlines have already been missed and some agencies expect to miss additional deadlines. It appears that many of the deadlines in Dodd-Frank are not realistic. Which Dodd-Frank deadlines do you anticipate not being able to meet? If Congress extended the deadlines, would you object? If your answer is yes, will you commit to meeting all of the statutory deadlines? If Congress affords additional time for rulemaking under the Dodd-Frank Act, will you be able to produce higher-quality, better coordinated rules?

A.1. We recognize that the deadlines established for many of the rules required by the Dodd-Frank Act demonstrate Congress' concern that the Act's regulatory reforms be promptly implemented. This goal is in some tension with the time necessary to resolve the novel and complex legal and practical issues presented by a many of the statutory provisions and, in many instances, the time necessary to comply with Congress' direction for joint or coordinated rulemaking conducted by a number of different agencies. We are working diligently toward all of these goals, but getting the substance of the rulemakings right is our primary objective.

Q.2. Secretary Geithner recently talked about the difficulty of designating nonbank financial institutions as systemic. He said, "it depends too much on the state of the world at the time. You won't be able to make a judgment about what's systemic and what's not until you know the nature of the shock." [1] If it is impossible to know which firms are systemic until a crisis occurs, the Financial Stability Oversight Council will have a very difficult time objectively selecting systemic banks and nonbanks for heightened regulation. As a member of the Council, do you believe that firms can be designated *ex ante* as systemic in a manner that is not arbitrary? If your answer is yes, please explain how.

A.2. On January 18, 2011, the Council approved publication of a notice of proposed rulemaking (NPRM) that outlines the criteria that will inform the Council's designation of such firms and the procedures the FSOC will use in the designation process. The NPRM closely follows and adheres to the statutory factors established by Congress for such designations. The framework proposed in the NPRM for assessing systemic importance is organized around six broad categories, each of which reflects a different dimension of a firm's potential to experience material financial distress, as well as the nature, scope, size, scale, concentration, interconnectedness, and mix of the company's activities. The six categories are: size, interconnectedness, substitutability, leverage, liquidity, and regulatory oversight.

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Q.3. Section 112 of the Dodd-Frank Act requires the Financial Stability Oversight Council to annually report to Congress on the

[1] *See,* Special Inspector General for the Troubled Asset Relief Program, "Extraordinary Assistance Provided to Citigroup, Inc." (SIGTARP 11-002) (Jan. 13, 2011) (available at: *http://www.sigtarp.gov/reports/audit/2011/Extraordinary%20Financial%20Assistance%20Provided%20to%20Citigroup,%20Inc.pdf*), at 43.

Council's activities and determinations, significant financial market and regulatory developments, and emerging threats to the financial stability of the United States. Each voting member of the Council must submit a signed statement to the Congress affirming that such member believes the Council, the Government, and the private sector are taking all reasonable steps to ensure financial stability and mitigate systemic risk. Alternatively, the voting member shall submit a dissenting statement. When does the Council expect to supply the initial report to Congress?

A.3. Discussions about the format and structure of this report are underway by the FSOC members.

Q.4. Which provisions of Dodd-Frank create the most incentives for market participants to conduct business activities outside the United States? Have you done any empirical analysis on whether Dodd-Frank will impact the competitiveness of U.S. financial markets? If so, please provide that analysis.

A.4. The OCC has not done any analysis of this type.

Q.5. More than 6 months have passed since the passage of the Dodd-Frank Act, and you are deeply involved in implementing the Act's approximately 2,400 pages. Which provisions of the Dodd-Frank Act are proving particularly difficult to implement? Have you discovered any technical or substantive errors in the Dodd-Frank legislation? If so, please describe them.

A.5. The attachment to these Questions and Answers describes three areas where, as we have previously testified to the Committee, clarifying amendments to the Dodd-Frank Act may be appropriate: the requirement in section 939A that agencies remove all references to credit ratings from their regulations; the ambiguities in the requirement for leverage and risk-based capital requirements in section 171; and the overlap in the respective roles of the banking agencies and the CFPB with respect to fair lending supervision.

Q.6. What steps are you taking to understand the impact that your agency's rules under Dodd-Frank will have on the U.S. economy and its competitiveness? What are the key ways in which you anticipate that requirements under the Dodd-Frank Act will affect the U.S. economy and its competitiveness? What are your estimates of the effect that the Dodd-Frank Act requirements will have on the jobless rate in the United States?

A.6. The OCC has not undertaken an analysis of the overall impact that the requirements of the Dodd-Frank Act will have on the U.S. economy or on the jobless rate in the United States. At this time, we are not aware that such a study has been done by any other Government agency.

Q.7. What steps are you taking to assess the aggregate costs of compliance with each Dodd-Frank rulemaking? What steps are you taking to assess the aggregate costs of compliance with all Dodd-Frank rulemakings, which may be greater than the sum of all of the individual rules' compliance costs? Please describe all relevant reports or studies you have undertaken to quantify compliance costs for each rule you have proposed or adopted. Please provide an

aggregate estimate of the compliance costs of the Dodd-Frank rules that you have proposed or adopted to date.

A.7. Thus far, the OCC has published notices of proposed rulemakings that would implement provisions of the Dodd-Frank Act concerning: Incentive-Based Compensation Arrangements; Retail Foreign Exchange Transactions; Credit Risk Retention; Capital Floors; and Margin and Capital Requirements for Covered Swap Entities. The OCC estimated the costs and burdens of these rulemakings pursuant to the Unfunded Mandates Reform Act (UMRA) and the Paperwork Reduction Act (PRA): UMRA requires the OCC to prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in expenditure by State, local, and tribal governments, in the aggregate, or by the private sector of $100 million or more, adjusted for inflation, in any 1 year. PRA requires the OCC to determine the paperwork burden for requirements contained in its rules.

Please note that it is difficult to estimate these costs with precision because these Dodd-Frank requirements are new and may interact with other Dodd-Frank requirements in unexpected ways. Thus, these estimates may change once we can better evaluate these interactions. The UMRA and PRA estimates for these rulemakings are set forth below:

- *Establishing a Floor for the Capital Requirements Applicable to Large Internationally Active Banks (Interagency NPRM implementing DFA section 171 published 12/30/10).* The OCC determined under the UMRA that the rulemaking would add no compliance costs for national banks. The OCC also determined that the proposal would change the basis for calculating a data element that must be reported to the agencies under an existing requirement and therefore would have no impact under the PRA.
- *Incentive Compensation (Interagency NPRM implementing DFA Section 956 published 4/14/11).* Pursuant to UMRA, the OCC determined that the proposed interagency rule will not result in expenditures by State, local, and tribal governments, or the private sector, of $100 million or more in any 1 year. The OCC also estimated that the total PRA burden for national banks would be 17,800 hours (13,040 hours for initial set-up and 4,760 hours for ongoing compliance).
- *Retail Foreign Exchange Transactions (NPRM implementing DFA section 742 published 4/22/11).* The OCC determined pursuant to UMRA that the proposed rule will not result in expenditures by State, local, and tribal governments, or by the private sector, of $100 million or more in any 1 year. OCC also estimated that the total PRA burden for national banks and service providers would be 67,254 hours.
- *Credit Risk Retention (Interagency NPRM implementing DFA section 941 published 4/29/11).* Pursuant to UMRA, the OCC estimated that national banks would be required to retain approximately $2.8 billion of credit risk, after taking into consideration the proposed exemptions for qualified residential mortgages and other qualified assets. The OCC also estimated the paperwork burden of the various record keeping and reporting

requirements associated with the risk retention proposal for national bank securitization sponsors and creditors to be 20,483 hours.

- *Margin and Capital Requirements for Covered Swap Entities (Interagency NPRM implementing DFA sections 731 and 764 to be published 5/11/11).* The OCC estimated that the initial margin cost of the proposed rule is $25.6 billion. Record keeping and administrative costs are estimated to be approximately $10.8 million. The OCC estimated the paperwork burden of complying with the various record keeping and reporting requirements associated with the swap margin and capital proposal to be 5,780 hours.

Q.8. Section 115 of the Dodd-Frank Act asks the Financial Stability Oversight Council to make recommendations to the Federal Reserve on establishing more stringent capital standards for large financial institutions. In addition, Section 165 requires the Fed to adopt more stringent standards for large financial institutions relative to smaller financial institutions. Chairman Bernanke's testimony for this hearing implied that the Basel III framework satisfies the Fed's obligation to impose more stringent capital on large financial institutions. As a member of the Financial Stability Oversight Council, do you agree with Chairman Bernanke that the Basel III standards are sufficient to meet the Dodd-Frank Act requirement for more stringent capital standards? Please explain the basis for your answer.

A.8. While the FRB is still working on a proposed rulemaking to implement this aspect of the Dodd-Frank Act, I generally concur with Chairman Bernanke's assessment that the Basel III standards provide a suitable framework for implementing the enhanced prudential capital requirements for large institutions required by section 165 of Dodd-Frank. As noted in my written statement, the Basel III reforms focus on many of the same issues and concerns that the Dodd-Frank Act sought to address. Like Dodd-Frank, the Basel III reforms tighten the definition of what counts as regulatory capital by placing greater reliance on higher quality capital instruments; expand the types of risk captured within the capital framework; establish more stringent capital requirements; provide a more balanced consideration of financial stability and systemic risks in bank supervision practices and capital rules; and call for a new international leverage ratio requirement and global minimum liquidity standards. Because the Basel III enhancements can take effect in the U.S. only through formal rulemaking by the banking agencies, U.S. agencies have the opportunity to integrate certain Basel III implementation efforts with the heightened prudential standards required by Dodd-Frank. Such coordination in rulemaking will ensure consistency in the establishment of capital and liquidity standards for similarly situated organizations, appropriately differentiate relevant standards for less complex organizations, and consider broader economic impact assessments in the development of these standards.

Q.9. Numerous calls have arisen for a mandatory "pause" in foreclosure proceedings during the consideration of a mortgage modification. Currently, what is the average number of days that cus-

tomers of the institutions that you regulate are delinquent at the time of the completed foreclosure? If servicers were required to stop foreclosure proceedings while they evaluated a customer for mortgage modification, what would be the effect on the foreclosure process in terms of time and cost. What effect would these costs have on the safety and soundness of institutions within your regulatory jurisdiction. Please differentiate between judicial and nonjudicial States in your answers and describe the data that you used to make these estimates.

A.9. OCC Mortgage Metrics data shows that the average delinquency status of the 608,000 completed foreclosures in 2010 was 16.0 months—19.0 months in judicial States and 15.5 months in nonjudicial States. For the nearly 1.3 million loans in process of foreclosure at December 21, 2010, the average delinquency was 16.9 months—17.3 months in judicial States and 16.8 months in nonjudicial States. OCC Mortgage Metrics is a monthly, loan-level data collection on nearly 33 million loans serviced by nine of the largest U.S. mortgage servicing institutions.

As stated in our testimony, the time to complete a foreclosure process in most States can take 15 months or more and in many cases can be as long as 2 years. While the OCC cannot directly estimate the effects of pausing foreclosure proceedings while a customer is being considered for a mortgage modification, this has the potential to further extend the time to complete foreclosures.

Servicers are likely to incur additional operational costs with elimination of dual track as this will require changes to business processes, systems, and staffing. However, the OCC cannot directly estimate the cost to servicers associated with pausing foreclosure proceedings because cost will be dependent on a number of variables such as the amount of time it takes to complete a loan modification, duration of the foreclosure pause, and whether a modification can be accomplished.

In addition to increased operational cost, a mandatory pause in foreclosure proceedings could, in certain cases, be contrary to investor agreements, including requirements of the GSEs. These conflicts could expose bank servicers to potential damages and penalties. Also, additional costs associated with introducing new procedural steps (pauses/resumptions) and time delay into the foreclosure process has the potential to lessen the net revenue stream from servicing. This may require bank servicers to write down the value of the mortgage servicing rights (MSR) carried on their balance sheet. As well, this may reduce the fair value and liquidity of MSRs.

Q.10. The burden of complying with Dodd-Frank will not affect all banks equally. Which new Dodd-Frank Act rules will have the most significant adverse impact on small and community banks? Which provisions of Dodd-Frank will have a disparate impact on small banks as compared to large banks? Do you expect that the number of small banks will continue to decline over the next decade? If so, is the reason for this decline the Dodd-Frank Act? Have you conducted any studies on the costs Dodd-Frank will impose on small and community banks? If so, please describe the results and provide copies of the studies.

A.10. While much of the focus of the reforms mandated by Dodd-Frank is on larger financial institutions, the OCC recognizes that community banks will also be affected by many provisions of the Act. We have not conducted any specific studies on the costs that Dodd-Frank will impose on small and community banks. However, as we move forward with rulemakings to implement the various provisions of Dodd-Frank, we will seek comment on the effects of the rules on small entities as defined and provided for in the Regulatory Flexibility Act.

The sheer scope and number of forthcoming regulations that bankers will need to be aware of and respond to will be a challenge for all banks, but even more so for community banks with limited compliance, regulatory, and legal staff.

In her April 6, 2011, testimony before the Committee's Financial Institutions Subcommittee, Senior Deputy Comptroller Jennifer Kelly discussed some of the challenges presented for community banks by Dodd-Frank.[2] As she stated in her written testimony, the challenges banks face have several dimensions: new regulation—both new restrictions and new compliance costs—on businesses they conduct, limits on revenues for certain products, and additional regulators administering both new and existing regulatory requirements. In the context of community banks, a particular concern will be whether these combine to create a tipping point causing banks to exit lines of business that provide important diversification of their business, and increase their concentration in other activities that raise their overall risk profile.

For example, the Dodd-Frank Act imposes a range of new requirements on the retail businesses that are "bread-and-butter" for many community banks. The costs associated with small business lending will increase when new HMDA-style reporting requirements become effective. Longstanding advisory and service relationships with municipalities may cause the bank to be deemed a "municipal advisor" subject to registration with the Securities and Exchange Commission (SEC) and rules issued by the SEC and the Municipal Securities Rulemaking Board. Also, checking account relationships with customers are likely to be reshaped to recover the costs associated with providing debit cards if debit interchange fees are restricted.

The new Consumer Financial Protection Bureau (CFPB) is charged with implementing new requirements that will affect banks of all sizes. These include new standards for mortgage loan originators; minimum standards for mortgages themselves; limits on charges for mortgage prepayments; new disclosure requirements required at mortgage origination and in monthly statements; a new regime of standards and oversight for appraisers; and a significant expansion of the current HMDA requirements for mortgage lenders to report and publicly disclose detailed information about mortgage loans they originate (13 new data elements).

The CFPB is also authorized to issue new regulations on a broad range of topics, including, but not limited to:

[2] Available at: *http://www.occ.gov/news-issuances/congressional-testimony/2011/pub-test-2011-42-written.pdf.*

- additional disclosure requirements to "ensure that the features of any consumer financial product or service, both initially and over the life of the product, are fully, accurately, and effectively disclosed to consumers in a manner that permits consumers to understand the costs, benefits, and risks associated with the product or service, in light of the facts and circumstances";
- new regulations regarding unfair, deceptive, or "abusive" practices; and
- standards for providing consumers with electronic access to information (retrievable in the ordinary course of the institution's business) about their accounts and transactions with the institution.

While clearer, more meaningful, and accessible consumer disclosures are clearly desirable, it is important to recognize that the fixed costs associated with changing marketing and other product-related materials will have a proportionately larger impact on community banks due to their smaller revenue base. The ultimate cost to community banks will depend on how the CFPB implements its new mandate and the extent to which it exercises its exemptive authority for community banks.

Community banks also may be particularly impacted by the Dodd-Frank Act's directive that Federal agencies modify their regulations to remove references to credit ratings as standards for determining creditworthiness. This requirement impacts standards in the capital regulations that are applicable to all banks. National banks are also affected because ratings are used in other places in the OCC's regulations, such as standards for permissible investment securities. As a result, institutions would be required to do more independent analysis in categorizing assets for the purpose of determining applicable capital requirements and whether debt securities are permissible investments—a requirement that will tax especially the more limited resources of community institutions.

Regardless of how well community banks adopt to Dodd-Frank Act reforms in the long-term, in the near- to medium-term these new requirements will raise costs and possibly reduce revenue for community institutions. The immediate effects will be different for different banks, depending on their current mix of activities, so it is not possible to quantify those impacts with accuracy. In the longer term, we expect to see banks adjust their business models in a variety of ways. Some will exit businesses where they find that associated regulatory costs and risks are simply too high to sustain profitability, or they will decide how much of the added costs can, or should, be passed along to customers. Others will focus on providing products and services to the least risky customers as a way to manage their regulatory costs and risks. Some will elect to concentrate more heavily in niche businesses that increase revenues but also heighten their risk profile. While we know there will be a process of adaptation, we cannot predict how these choices will affect either individual institutions or the future profile of community banking at this stage.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM JOHN WALSH

Q.1. Can you provide your view on the Basel III framework and also the extent, if any, that Basel III may conflict with the requirements of the Dodd-Frank Act and how are you responding to these conflicts?

A.1. As noted in my written statement, the Basel III reforms focus on many of the same issues and concerns that the Dodd-Frank Act sought to address. These reforms of the Basel Committee are designed to strengthen global capital and liquidity standards governing large, internationally active banks and promote a more resilient banking sector. Like Dodd-Frank, the Basel III reforms tighten the definition of what counts as regulatory capital by placing greater reliance on higher quality capital instruments; expands the types of risk captured within the capital framework; establishes more stringent capital requirements; provides a more balanced consideration of financial stability and systemic risks in bank supervision practices and capital rules; and calls for a new international leverage ratio requirement and global minimum liquidity standards. Since the Basel III enhancements can take effect in the U.S. only through formal rulemaking by the banking agencies, U.S. agencies have the opportunity to integrate certain Basel III implementation efforts with the heightened prudential standards required by Dodd-Frank. Such coordination in rulemaking will ensure consistency in the establishment of capital and liquidity standards for similarly situated organizations, appropriately differentiate relevant standards for less complex organizations, and consider broader economic impact assessments in the development of these standards.

My September 30, 2010, testimony before this Committee [1] and my January 19, 2011, speech before the Exchequer Club [2] elaborated on the interplay between Basel III framework and capital requirements under Dodd-Frank.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM JOHN WALSH

Q.1. *Capital, Leverage, and Liquidity Requirements for Systemically Significant Firms.* One of the most important reforms in Dodd-Frank was requiring systemically significant companies to hold more capital and have better liquidity to prevent another crisis. The crisis would not have happened had we not allowed big banks and some nonbanks to acquire so much debt and leverage. What steps are being taken to ensure that these capital, leverage, and liquidity requirements are implemented robustly?

A.1. As noted in my written testimony, the Dodd-Frank Act requires the banking agencies and Financial Stability Oversight Council to develop numerous studies and regulations that will materially affect the level and composition of capital and liquidity for both banks and certain nonbank companies. The requirements are

[1] Available at: *http://www.occ.gov/news-issuances/congressional-testimony/2010/pub-test-2010-119-written.pdf.*

[2] Available at: *http://www.occ.gov/news-issuances/speeches/2011/pub-speech-2011-5.pdf.*

similar to and reinforce actions taken by the Basel Committee to strengthen global capital and liquidity standards for large, internationally active banks (Basel III). Together, these reforms tighten the definition of what counts as regulatory capital; expand the types of risks captured within the regulatory capital framework; increase overall capital requirements; establish an international leverage ratio applicable to global financial institutions that constrains leverage from both on- and off-balance sheet exposures; and provide for a more balanced consideration of financial stability in bank supervision practices and capital rules. The Basel reforms also introduce global minimum liquidity standards that set forth explicit ratios that banks must meet to ensure that they have adequate short-term liquidity to offset cash outflows under acute short-term stresses and maintain a sustainable maturity structure of assets and liabilities.

Because the Basel III enhancements can take effect in the U.S. only through formal rulemaking by the banking agencies, U.S. agencies have the opportunity to integrate certain Basel III implementation efforts with the heightened prudential standards required by Dodd-Frank. Such coordination in rulemaking will ensure consistency in the establishment of capital and liquidity standards for similarly situated organizations, appropriately differentiate relevant standards for less complex organizations, and consider broader economic impact assessments in the development of these standards.

The Basel Committee is also developing a methodology to identify and apply heightened capital standards for globally significant financial institutions. As with other aspects of the Basel reforms, one of the challenges that the OCC and other U.S. banking agencies face is integrating and coordinating these proposals with the capital-related requirements of Dodd-Frank.

My written testimony also highlighted the other following efforts underway to implement key capital related provisions of Dodd-Frank:

- Under Sections 115(a) and 115(b) of Dodd-Frank, in order to prevent or mitigate risk to financial stability, the FSOC may make recommendations to the FRB [1] concerning the establishment of prudential standards applicable to nonbank financial companies supervised by the FRB and certain large bank holding companies. These prudential standards, which are to be more stringent than those applicable to other companies that do not pose similar risk to financial stability, are expected to address risk-based capital requirements, leverage limits, and liquidity requirements, among other provisions.
- Section 171(b) of Dodd-Frank provides for a floor for capital requirements going forward. On December 30, 2010, the banking agencies published a notice of proposed rulemaking addressing the requirements of section 171(b). The public comment period on this proposal closed February 28, 2011, and the Agencies

[1] Under section 165 of Dodd-Frank, the FRB, on its initiative or pursuant to recommendations by FSOC under Sections 115(a) and 115(b), shall establish prudential standards applicable to nonbank financial companies supervised by the FRB and certain large bank holding companies.

are currently reviewing the comments and working on a final rule.

- Section 616(c) of Dodd-Frank amends the International Lending Supervision Act of 1983 by providing that each Federal banking agency shall seek to make capital standards countercyclical, so that the amount of required capital increases in times of economic expansion and decreases in times of economic contraction, consistent with safety and soundness. Consistent with this provision, the agencies are actively considering the establishment of countercyclical capital requirements in proposed regulations implementing the Basel III reforms.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM JOHN WALSH

Q.1. *Safety and Soundness Concerns.* In the last 2 years, Congress passed the Credit CARD Act reining in unfair credit card practices, and the Dodd-Frank Act which included new capital rules for banks and interchange fee reform.

Can you please share the OCC's views of these proposals, specifically their effects on capital levels at nationally chartered banks?

A.1. As noted in my testimony, the various capital provisions of the Dodd-Frank Act, when coupled with the capital reforms that have been adopted by the Basel Committee on Banking Supervision (referred to as Basel III), will result in higher levels, and stronger components of required regulatory capital for national banks. For example, Basel III and section 165 of Dodd-Frank compel the establishment of more stringent prudential standards for certain large companies, including standards relating to risk-based capital, leverage, and liquidity. In addition, both Basel III and section 171 of Dodd-Frank limit the extent to which banking organizations may use hybrid capital instruments, such as trust preferred securities, as a component of their regulatory capital base. As a result, both regimes will affect capital levels at nationally chartered banks in various ways, including: effectively requiring banks to hold more capital in the form of common equity; establishing more stringent standards on the types of risks captured within the regulatory capital framework; and requiring higher minimum regulatory capital ratios. The OCC and other U.S. banking agencies will be issuing a notice of proposed rulemaking that sets forth a proposal on how these reforms would be applied in the United States, and whether or not the reforms should apply to all U.S. banking institutions.

Beyond changes to baseline capital standards, both Dodd-Frank and Basel III will impose additional capital requirements on systemically important financial institutions, with Dodd-Frank focusing on institutions with total consolidated assets of $50 billion and above.

Two other provisions of Dodd-Frank may also have a direct effect on national banks' capital requirements going forward. Section 171 provides for a floor for any capital standards going forward. And, as noted in my written testimony, the provisions of Section 939A regarding the use of credit ratings in the agencies' regulations will also affect the agencies' current and future risk-based capital standards and may constrain our ability to incorporate, in a cost-

efficient and consistent manner, more granular risk-weights that reflect the underlying risks of various types of assets.

The amount by which these provisions and other provisions of the Dodd-Frank Act will require national banks to raise their current capital levels will depend in part on adjustments banks may make to their balance sheet compositions and business activities. In general, we expect that many banks will need to increase their capital levels by retaining more earnings and/or seeking new capital. In addition, we also believe that these and other changes—including the provisions of the Credit CARD Act and interchange provisions of Dodd-Frank—are compelling banks to revisit and make adjustments to their business models to reflect higher capital hurdle rates and/or reduced profitability for various business lines. Such adjustments may result in a shift to lower risk activities that require less capital or reductions in the amount of assets that banks choose to hold.

Q.2. In your testimony, you note that "[mortgage servicing] deficiencies have resulted in violations of State and local foreclosure laws, regulations, or rules" but that "loans were seriously delinquent, and that servicers maintained documentation of ownership and had a perfected interest in the mortgage to support their legal standing to foreclose." There have been recent news reports about a nationwide foreclosure fraud settlement. One *Wall Street Journal* story stated, "The deal wouldn't create any new Government programs to reduce principal. Instead, it would allow banks to devise their own modifications or use existing Government programs[.]"

What specific laws, regulations, or rules were violated?

A.2. The Federal banking regulators conducted horizontal examinations of foreclosure processing at 14 federally regulated mortgage servicers during the fourth quarter of 2010. The primary objective of each review was to evaluate the adequacy of controls and governance over servicers' foreclosure processes and assess servicers' authority to foreclose. The reviews focused on issues related to foreclosure-processing functions.

The reviews found critical weaknesses in servicers' foreclosure governance processes, foreclosure document preparation processes, and oversight and monitoring of third-party vendors, including foreclosure attorneys. While findings varied across institutions, the weaknesses at each servicer, individually and collectively, resulted in unsafe and unsound practices that included violations of applicable Federal and State law and requirements. Our reviews found significant weaknesses in document preparation: improper affidavits were submitted and documents were notarized improperly. In many cases, these weaknesses constituted violations of State attestation and notarization requirements.

Q.3. Did the OCC's review specifically examine issues involving misapplication of mortgage payments or lost modification documents? These are the most persistent complaints that my office receives and the anecdotal evidence suggests that these problems may be widespread.

A.3. In connection with the reviews of documentation in foreclosure files and assessments of servicers' custodial activities, examiners found that borrowers whose files were reviewed were seriously de-

linquent on their mortgage payments at the time of foreclosure and that servicers generally had sufficient documentation available to demonstrate authority to foreclose on those borrowers' mortgages. Further, examiners found evidence that servicers generally attempted to contact distressed borrowers prior to initiating the foreclosure process to pursue loss-mitigation alternatives, including loan modifications. Documents in the foreclosure files may not have disclosed certain facts that might have led examiners to conclude that a foreclosure should not have proceeded however, such as misapplication of payments that could have precipitated a foreclosure action or oral communications between the borrower and servicer staff that were not documented in the foreclosure file.

Examiners did note cases in which foreclosures should not have proceeded due to an intervening event or condition, such as the borrower (a) was covered by the Servicemembers' Civil Relief Act, (b) filed for bankruptcy shortly before the foreclosure action, or (c) qualified for or was paying in accordance with a trial modification.

Q.4. What will servicers receive in return for a national mortgage foreclosure fraud settlement? Will they be provided with immunity from any criminal prosecution?

A.4. The OCC's orders are separate from actions that could be taken by other agencies and provide no immunity from criminal prosecution.

The OCC based its enforcement actions on the findings of examinations conducted as part of the interagency horizontal reviews undertaken by the Federal banking regulators in the fourth quarter of 2010. These enforcement actions do not preclude determinations regarding assessment of civil money penalties, which the OCC is holding in abeyance. As we gather additional information from continuing exam work and the "look-back" required by our orders about the extent of harm from processing failures, this will inform our decision on civil money penalties.

Although the OCC coordinated closely with other Federal agencies, the actions by the Federal banking regulators were not part of the Federal/State settlement efforts that remain in process. Having established the scope of problems in our area of jurisdiction, the bank regulators had to move forward. It is our mission to ensure both safety and soundness and fair treatment of consumers, and meeting those objectives demanded action. To delay further would have delayed providing financial remediation to borrowers and left safety and soundness issues of the banks not fully addressed.

Q.5. Will any mortgage modifications provided for in the settlement include principal reduction? If so, according to what standards?

A.5. This question relates to potential terms of the Federal/State settlement involving multiple Federal agencies and State Attorneys General. The OCC's order is not part of that potential settlement.

Q.6. What is OCC's view of the effects of principal writedowns for both banks and borrowers?

A.6. The OCC is sympathetic to the plight of homeowners who may be facing financial difficulty in honoring their mortgage obligations or who are now "underwater" with the current value of the home

less than what is due on their mortgage. However, we have significant concerns about proposals that would mandate a shift in mortgage modification efforts from a focus on making mortgage payments affordable, based on an analysis of the borrower's ability to repay, to one of principal forgiveness based on whether they are "underwater" on their mortgage. To date, mortgage modification programs have focused on providing borrowers with the opportunity to stay in their homes by making the first mortgage payment "affordable." This is done whenever the economics show it is better to modify than foreclose. These modifications are designed to solve for borrower capacity to pay rather than willingness to pay, an approach we think is both balanced and appropriate. These modifications generally do not provide for debt forgiveness but lenders can and have forgiven mortgage debts as part of certain modifications and in short sale or deed-in-lieu transactions.

In contrast, Government mandates for servicers to engage in principal forgiveness raises a number of fundamental concerns. Such programs inevitably raise fairness issues with respect to otherwise similarly situated homeowners whose home values have declined. Consider the following example: two borrowers buy homes in the same neighborhood for $400,000 each in 2006. Borrower A financed 100 percent of the purchase; Borrower B put 50 percent down. Property values in the area have since declined 50 percent. Borrower A obtains a loan modification which includes principal forgiveness down to 100 percent loan-to-value (LTV); Borrower B is not eligible for a modification because his loan is already 100 percent LTV. Three years from now both properties have appreciated and are worth $250,000. Borrower A, with no funds at risk, now has equity of $50,000, while Borrower B has a net loss of $150,000. As this example illustrates; if not properly structured, a principal forgiveness program will reward borrowers who speculated or assumed excessive risk. Further, such programs could create moral hazard by diminishing borrowers' willingness to continue to make their mortgage payments should home values further decline.

Proposals that call for mortgage servicers, rather than the investors who own the underlying mortgage, to bear the bulk of losses associated with any principal forgiveness program likewise raise concerns about equitable treatment. It is the investor, not the servicer, who assumed the risk when purchasing the mortgage. Apart from the fees associated with their role as servicer, the servicer does not receive and is not entitled to returns (principal and interest) from the mortgage, but yet under some proposals, would be forced to assume much of the loss associated with principal write downs.

In summary, the mortgage market developed with all established set of readily understood rules and practices which are embedded in law and contracts. This includes lien preferences, private mortgage insurance, and when borrowers are responsible for deficiency balances. In proposing debt forgiveness outside of these existing frameworks, one will likely enrich some at the expense of others because existing contracts/practices could not have envisioned the debt forgiveness structure. The unintended consequences may well be hard to anticipate or control.

If pursued, principal forgiveness should be tied to borrower need based on verified capacity to repay. Providing principal forgiveness in situations where a borrower will still be unlikely or unwilling to make the new payments on a sustained basis simply delays the recognition of loss and the ultimate resolution of the underlying property.

Finally, it is important to stress that the issue of principal forgiveness is distinct and separate from requiring banks to recognize losses on mortgages that they hold. While the OCC has and continues to encourage bankers to work constructively with troubled borrowers by offering sustainable mortgage modifications, we have been equally clear that bankers must maintain systems to identify problem assets, estimate incurred credit losses for those assets, and establish appropriate loan loss reserves and/or initiate write-downs sufficient to absorb estimated losses consistent with generally accepted accounting principles and regulatory policies.

Q.7. Should banks be setting aside capital to cover investors' mortgage-backed securities putback claims? What are the current regulatory obstacles, if any, to their doing so?

A.7. We are directing national banks to maintain adequate reserves for potential losses and other contingencies and to make appropriate disclosures, consistent with applicable U.S. generally accepted accounting principles and Securities and Exchange Commission's disclosure rules. We do not believe there are any regulatory obstacles that prevent banks from taking such actions.

Q.8. Please describe your agencies' views of the risks related the banks' servicing divisions, including:

The losses stemming from the servicing divisions of the banks that you regulate.

A.8. The costs to service loans have increased as a result of the dramatic increase in loan defaults and associated loss mitigation activities. For example, the average annual cost to service a loan with capitalized mortgage servicing rights has increased from $81 per loan in 4Q2009 to $105 in 4Q2010, an increase of 30 percent. In addition, the cost to service will further increase as servicers implement remedial actions to address well publicized foreclosure documentation and processing deficiencies. These rising costs, when not offset by servicing income and fees, may have an adverse effect on mortgage banking profitability. In addition, a prolonged decline in net servicing income may depress the value and marketability of mortgage servicing rights (MSR) assets, a significant component of bank Tier 1 capital at banks with large mortgage servicing operations.

Q.9. What further losses, if any, do you expect.

A.9. Increased cost to service, particularly on delinquent or defaulted loans and loans in foreclosure, is likely a permanent change to the mortgage banking business model. In addition, reforms effected through uniform national servicing standards may further add to servicer costs due to required changes in staffing, processes, and systems needed to implement the new standards. While some of this higher cost may be variable, depending on the volume of mortgage delinquencies and foreclosures, much of the additional

cost will be fixed. Mortgage banking companies likely will attempt to recover the additional costs through higher servicing fees to the extent permissible by law and investor guidelines, which in turn may be passed on to borrowers in the form of higher interest rates and loan fees.

Q.10. How have your agencies have changed your examination procedures relating to banks' servicing divisions.

A.10. In the coming months, OCC examiners will be assessing adequacy of action plans related to the enforcement actions taken against the eight largest national bank mortgage servicers, and validating implementation of required remedial actions, including customer restitution when necessary. This supervisory assessment of compliance with formal enforcement actions will result in increased regulatory oversight and supervision over mortgage servicing operations.

Q.11. Whether there will be uniform standards for servicing examination across all Federal banking agencies.

A.11. The OCC, along with the other Federal banking agencies, is currently engaged in an effort to establish national mortgage servicing standards to promote the safe and sound operation of mortgage servicing and foreclosure processing, including standards for accountability and responsiveness to borrower issues. These national standards will improve the transparency, oversight, and regulation of mortgage servicing and foreclosure processing, and establish additional thresholds for responsible management and operation of mortgage servicing activities. Uniform national mortgage servicing and foreclosure processing standards that are consistently applied and enforced across the industry would reduce the complexity and risk associated with the current servicing environment, help promote accountability and appropriateness in dealing with consumers, and strengthen the housing finance market. This initiative to develop and enforce uniform national servicing standards will require close coordination among the agencies and will include engaging the Government-sponsored enterprises (GSEs), private investors, consumer groups, the servicing industry, and other regulators.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARNER FROM JOHN WALSH

Q.1. For each of the witnesses, though the Office of Financial Research does not have a Director, what are each of you doing to assist OFR in harmonizing data collection, compatibility, and analysis?

A.1. The OCC continues to work closely with staff within the Department of Treasury responsible for standing up the Office of Financial Research (OFR). Senior OCC officials have participated in regular meetings at Treasury, sharing information, commenting on proposals, and providing other input based on the OCC's experience working with supervisory and other banking data.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MERKLEY FROM JOHN WALSH

Q.1. *Community Banks and Economic Growth.* I have heard from some of my local community banks that certain capital, accounting, and examination rules may be working at cross purposes with the ability of community banks to serve the economic growth needs of the families and small businesses they serve in their communities, especially when compared to standards applied to the largest national banks. I wish to bring several to your attention and ask that you comment:

- The Financial Accounting Standards Board's proposed exposure draft on "Troubled Debt Restructurings" (TDRs) has been pointed out as possibly creating a capital disincentive for banks to engage in work-outs and modifications with their business borrowers because of the effect of immediately having to declare those loans "impaired." In addition, for banks over $10 billion in asset size, there may be additional direct costs for FDIC premiums based on a formula that considers TDR activity.
- The disallowance to Risk-Based Capital of the amount of Allowance for Loan Losses (ALLL) in excess of 1.25 percent of Risk Weighted Assets has been flagged as a challenge in this environment, where some firms have ALLL that significantly exceeds that threshold. This may serve to understate the risk-based capital strength of the bank, adding to costs and negatively impacting customer and investor perceptions of the bank's strength.
- It has been reported that examiners have rejected appraisals that are less than 9 months old when regulatory guidance calls for accepting appraisals of up to 12 months.
- Community banks are subject to examination in some cases as frequently as every 3 months. In contrast, some suggest that our largest national banks may not ever undergo an examination as thorough, with the challenges surrounding loan documentation, foreclosure, and MERS as a glaring example of the results.

Are there regulatory or supervisory adjustments in these or related areas that need to be made to facilitate community banks' abilities to serve their communities?

In addition, have you considered ways in which capital charges, accounting rules, and examination rules for community banks in particular can be adapted to be less procyclical, such that they do not become stricter into an economic downturn and lighter at the top of an upturn?

Finally, what procedures do you have in place to ensure that our community banks and our largest national banks are not subject to differing examination standards, even when they are examined by different regulators?

A.1. The OCC is mindful of the economic challenges, and the regulatory and compliance burdens facing community banks. As we develop regulations, supervisory policies, and examination standards, we strive to provide sufficient flexibility in the application of those

standards to reflect the size and complexity of the institution. To put it a different way, while all national banks are generally held to the same set of standards and regulations, the methods and controls they use to implement those standards may vary, based on their size and complexity.[1] As the complexity and scope of a bank's activities increase, so do our expectations for their internal controls and risk management systems.

The OCC applies the same risk-based supervisory philosophy for community and large bank examinations for evaluating risk, identifying material and emerging problems, and ensuring that individual banks take corrective action before problems compromise their safety and soundness. The OCC's Bank Supervision Process examination handbook establishes a common examination philosophy and structure that is used at all national banks. This structure includes a common risk assessment system that evaluates each bank's risk profile across eight risk areas—compliance, credit, interest rate, liquidity, operational, price, reputation, and strategic—and assigns an overall composite and component ratings on a bank's capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risks using the interagency Uniform Financial Institution Rating System (CAMELS).

With respect to specific issues you raised for comment:

The Financial Accounting Standards Board (FASB) Proposed Exposure Draft on Troubled Debt Restructurings

When the FASB first issued the exposure draft on troubled debt restructurings, we had concerns about their interpretation that potentially created automatic triggers of TDR determinations based on credit availability in the market to borrowers. We believe the proposal would have caused a significant increase in the number of troubled debt restructurings reported by our banks. However, after receiving comments from the public including our comment letter, the FASB changed its position to be consistent with the way our examiners currently evaluate modifications. As a result, we expect that the final guidance from the FASB will have very little impact on our national banks.

Cap on the Amount of Allowance for Loan and Lease Losses (ALLL) Allowed in Risk-Based Capital

Under the agencies' risk-based capital rules, a bank may include as a component of their Tier 2 capital, their ALLL up to a maximum of 1.25 percent of risk-weighted assets. Part of the rationale for this limitation is that ALLL covers losses that a bank expects to incur, whereas the purpose of holding capital is to cover unforeseen or unexpected losses. Given these relatively distinct functions, the U.S. banking agencies have historically limited the amount of ALLL that can be counted towards a bank's capital base. Nevertheless, we recognize the challenges this limitation has created for many banks and will consider this issue as we move forward with revising our capital regulations.

[1] There are some instances where we apply different standards. For example, under the OCC's risk-based capital rules, the largest national banks are subject to the so-called advanced approaches rule for computing risk-based capital for credit risk and are also subject to an operational risk capital component.

Frequency of Appraisals

The agencies' real estate lending regulations and guidelines set forth the requirement that banks should have policies and procedures that address the type and frequency of collateral valuations. The frequency of such valuations is case specific and will depend upon market conditions and the nature and status of the collateral being financed. For properties or projects that are performing as planned, prudent guidelines might specify obtaining periodic updated valuations for portfolio risk monitoring. The October 2009 interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts stated:

> As the primary sources of loan repayment decline, the importance of the collateral's value as a secondary repayment source increases in analyzing credit risk and developing an appropriate workout plan. The institution is responsible for reviewing current collateral valuations (*i.e.,* an appraisal or evaluation) to ensure that their assumptions and conclusions are reasonable. Further, the institution should have policies and procedures that dictate when collateral valuations should be updated as part of its ongoing credit review, as market conditions change, or a borrower's financial condition deteriorates.

For loans that are experiencing financial difficulty or being restructured or worked out, we would expect a bank to understand its collateral risk by having or obtaining current valuations of the collateral supporting the loan and workout plan.

The OCC has emphasized these concepts in our guidance to examiners. In a September 2008 memorandum we explained:

> There are no standard criteria for determining the useful life of an appraisal (may be less than a year; may be more than a year). Considerations for reappraisal should include the age of the original appraisal, the condition of the underlying property, and changes in market conditions. Some factors that may necessitate the ordering of a new or updated appraisal include: measurable deterioration in the performance of the project, marked deterioration in market conditions, material variance between actual conditions and original appraisal assumptions, volatility of the local market, change in project specifications (condo to apartment; single tenant to multitenant; *etc.*), loss of significant lease or take-down commitment, increase in presales fallout, inventory of competing properties, and changes in zoning or environmental contamination.

Frequency of Examinations

The frequency of on-site examinations of insured depository institutions is prescribed by 12 U.S.C. 1820(d). Under these provisions, national banks must receive a full-scope, on-site examination at least once during each 12-month period. This requirement may be extended to 18 months if all of the following criteria are met:

- Bank has total assets of less than $500 million.
- Bank is well capitalized as defined in 12 CFR 6.

- At the most recent examination, the OCC assigned the bank a rating of 1 or 2 for management as part of the bank's rating under UFIRS and assigned the bank a composite UFIRS rating of 1 or 2.
- Bank is not subject to a formal enforcement proceeding or order by the FDIC, OCC, or the Federal Reserve System.
- No person acquired control of the bank during the preceding 12-month period in which a full-scope, on-site examination would have been required but for this section.

The frequency of our on-site examinations for community banks follows these statutory provisions, with on-site examinations occurring every 12 to 18 months, depending on the bank's size and condition. The scope of these examinations is set forth in the OCC's Community Bank Supervision handbook and requires sufficient examination work to complete the core assessment activities in that handbook, and determine the bank's Risk Assessment and CAMELS ratings. The depth and specific areas of examination focus are determined by the level and nature of the bank's risks. More frequent examinations may be conducted if the bank is operating under all enforcement action, if there have been material changes in the bank's condition or activities, or if it is a troubled institution. For all community banks, on-site activities are supplemented by off-site monitoring and quarterly analyses to determine if significant changes have occurred in the bank's condition or activities.

For the largest national banks, the OCC maintains an on-site resident examination staff that conducts ongoing supervisory activities and targeted examinations of specific areas of focus. As in our community bank program, examiners must also conduct sufficient work to complete the core assessment activities set forth in the OCC's Large Bank Supervision handbook, and determine the bank's Risk Assessment and CAMELS ratings.

Procyclical Accounting and Capital Requirements

The OCC, both independently and as part of discussions within the Basel Committee and other groups, has considered ways to make capital charges, accounting rules, and examination rules less procyclical for banks, including community banks. For example, as part of the Basel III enhancements announced in December, the Basel Committee is introducing a number of measures to address procyclicality and raise the resilience of the banking sector in good times. These measures have the following key objectives:

- constrain leverage in the banking system through the introduction of all international leverage ratio;
- dampen any excess cyclicality of the minimum capital requirement;
- promote more forward-looking loan loss provisions; and
- conserve capital to build buffers at individual banks and the banking sector that can be used in stress.

As it relates to efforts to constrain procyclicality of loan loss provisioning, the OCC has been a strong proponent of the need to make the ALLL more forward looking so that banks can appropriately build their reserves when their credit risk is increasing,

rather than waiting until such losses have been incurred. The OCC has been actively engaged in efforts by the FASB and the International Accounting Standards Board (IASB) to revise the current impairment model for recognizing loan losses to provide for more forward-looking reserves. As part of this effort, OCC staff has served as the U.S. banking agencies' representative on the IASB's Expert Advisory Panel on Impairment.

In addition, section 616(c) of the Dodd-Frank Act requires the Federal banking agencies to seek to make capital standards and other provisions of Federal law countercyclical. The Agencies will continue efforts to mitigate procyclicality in regulations and guidance, consistent with this statutory mandate, including those requirements adversely affecting community banks.

Q.2. Our largest financial firms today operate across many national boundaries. Some firms are aiming to conduct 50 percent or more of their business internationally. Can you update the Committee on the status and any challenges regarding the establishment of mechanisms, plans, and other aspects of coordination between international regulatory bodies to ensure that financial firms operating internationally can be effectively placed into the Dodd-Frank resolution regime and are not otherwise able to attain "too big to fail" status through international regulatory arbitrage?

A.2. There are a number of significant efforts, domestically and internationally, that have taken place or are in process to address the difficult issue of cross-border resolution of financial institutions. A major challenge in resolving cross-border firms is the disparate nature of jurisdictional resolution laws and procedures along with the jurisdictional nature of costs associated with the resolution of such firms. As the issues are quite complex, solutions are being sought on multiple fronts, as follows:

- Crisis Management Groups (CMGs) have been established and operational for over a year for the world's largest banks. The CMGs are comprised of the home and major host supervisors of such institutions and are working with the firms to develop recovery and resolution plans (RRPs). RRPs detail contingency plans to address situations of severe distress and failure of these global firms.
- The U.S. regulators (primarily the FDIC) are holding bilateral meetings with foreign jurisdictions to identify solutions to resolution issues (*e.g.,* requirements to recognize a bridge bank) that have been identified at the CMG meetings.
- The Financial Stability Board (FSB) is developing guidance on the essential elements of recovery and resolution plans and criteria for authorities to assess the resolvability of individual institutions. U.S. regulators are also currently engaged in writing regulations for the implementation of Section 165(d) of the Dodd-Frank Act, which requires designated firms to submit resolution plans.
- The Basel Committee on Banking Supervision (BCBS) has developed recommendations for cross-border resolutions, and is currently surveying members on implementation of those recommendations.

- The FSB is also developing guidance on cross-border resolutions that will identify the essential resolution tools and powers, including: sector-specific attributes of resolution regimes that are necessary to protect depositors, policy holders, and investors, as well as restructuring mechanisms, which may include contractual and/or statutory debt-equity conversion and write-down tools; critical framework conditions for effective cross-border cooperation and information sharing in managing and resolving a distressed financial institution; and essential elements of institution-specific cross-border cooperation agreements.
- The FSB and BCBS are evaluating the feasibility of contractual and statutory bail-ins to serve as a loss-absorption instrument and resolution tool in the national context and in the context of systemic cross-border firms.

Q.3. Please also update the Committee on the status of the regulation of international payments systems and other internal systemic financial market utilities so that the entities that manage or participate in them are not able to avoid the resolution regime through international regulatory arbitrage.

A.3. Section 804 of the Dodd-Frank Act provides the Financial Stability Oversight Council (the Council or FSOC) with the authority to identify and designate as systemically important a financial market utility (FMU) if the Council determines that the failure of the FMU could create or increase the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the U.S. financial system. At its March 18, 2011, meeting, the Council approved the publication of a NPRM that describes the criteria, analytical framework, and process and procedures the Council proposes to use to designate an FMU as systemically important. The NPRM includes the statutory factors the Council is required to take into consideration and adds subcategories under each of the factors to provide examples of how those factors will be applied. The NPRM also outlines a two-stage process for evaluating and designating an FMU as systemically important.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM JOHN WALSH

Q.1. Dodd-Frank requires that risk retention be jointly considered by the regulators for each different type of asset and includes a specific statutory mandate related to any potential reforms of the commercial mortgage-backed securities to limit disruptions. Given the importance of rigorous cost-benefit and economic impact analyses and the need for due consideration of public comments, do your agencies need more time than is provided by the looming April deadline?

A.1. The agencies published a proposed rule to implement the Dodd-Frank credit risk retention requirements on April 29, 2011; public comments on the proposal are due on June 10, 2011. The fact that the agencies did not issue final rules by the April, 2011, statutory deadline reflects the complexity of the rulemaking and

the care necessary to strike the right balance among the various public policy objectives of the statute. The OCC and the other agencies intend to proceed promptly to consider the comments and prepare a final regulation once the comment period has closed.