

Testimony of Dennis M. Kelleher
President and CEO
Better Markets, Inc.
United States Senate Committee on Banking, Housing, and Urban Affairs
“FSOC Accountability: Nonbank Designations”
March 25, 2015

Thank you Chairman Shelby, Ranking Member Brown, and Members of the Committee for the opportunity to provide Better Markets’ views about the Financial Stability Oversight Council (the “Stability Council”).

Better Markets is a nonprofit, nonpartisan organization that promotes the public interest in the domestic and global capital and commodity markets. It advocates for transparency, oversight, and accountability with the goal of a stronger, safer financial system that is less prone to crisis and failure, thereby eliminating or minimizing the need for more taxpayer funded bailouts. To do this, Better Markets engages in the rulemaking process, public advocacy, independent research, and litigation. For example, it has filed more than 150 comment letters in the U.S. rulemaking process related to implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and has had dozens of meetings with regulators. Our website, www.bettermarkets.com, includes information on these and the many other activities of Better Markets.

I am the President and CEO of Better Markets. Prior to starting Better Markets in October 2010, I held three senior staff positions in the Senate: Chief Counsel and Senior Leadership Advisor to the Chairman of the Democratic Policy Committee; Legislative Director to the Secretary of the Democratic Conference; and Deputy Staff Director and General Counsel to what is now known as the HELP Committee. Previously, I was a litigation partner at the law firm of Skadden, Arps, Slate, Meagher & Flom, where I specialized in securities and financial markets in the U.S. and Europe. Prior to obtaining degrees at Brandeis University and Harvard Law School, I enlisted in the U.S. Air Force while in high school and served four years active duty as a crash-rescue firefighter. I grew up in central Massachusetts.

“No More AIGs”

Yesterday, March 24, was the six year anniversary of the testimony given by then Treasury Secretary Timothy Geithner and then Federal Reserve Chairman Ben Bernanke before the House Financial Services Committee on the American International Group (AIG) bonus controversy. The surprise and shock of the U.S. having to bailout a private, international insurance conglomerate like AIG with about \$185 billion was compounded by the disgust at AIG for nonetheless paying bonuses to some of its employees who were involved in the reckless trading that led to the collapse of the company and the need for it to be bailed out in the first place.

Triple-A rated AIG's involvement in hundreds of billions of dollars of complex, high risk derivatives gambling was a total surprise in September 2008. No one (outside of the too-big-to-fail Wall Street banks that were its counterparties) had any idea that AIG was in that line of business or, more shockingly, had not reserved or set aside anything close to sufficient amounts to cover any potential losses. Given these facts, and its extensive interconnectedness with the entire U.S. and global banking and finance systems, its inability to cover its own derivatives gambling losses unexpectedly threatened the collapse of the U.S. and world economies.

The result was an historic, unlimited bailout where, initially, the U.S. government effectively threw money into the massive hole AIG created: first, \$85 billion, then a week later another \$85 billion, ultimately reaching about \$185 billion in cash bailouts. It is fitting that we are here six years later discussing the Stability Council because its very existence and purpose is to prevent a situation like AIG from ever happening again.

"No more AIGs" should be the Stability Council's motto. Never again should a private company appear out of nowhere and threaten to collapse the entire U.S. and global financial systems. Never again should the U.S. Treasury or taxpayers have to cover the losses of a private company that threaten the stability of our economy or the living standards of our citizens.

And, most importantly, never again should the U.S. have to suffer the **consequences** of future AIGs: the devastating economic wreckage inflicted on Americans from coast to coast who lost their jobs, homes, savings, retirements, educations, and so much more. As Better Markets has documented, the 2008 crisis will cost the US more than \$12 trillion in lost economic output.¹ That too is why the Stability Council was created, and is an important part of its mission.

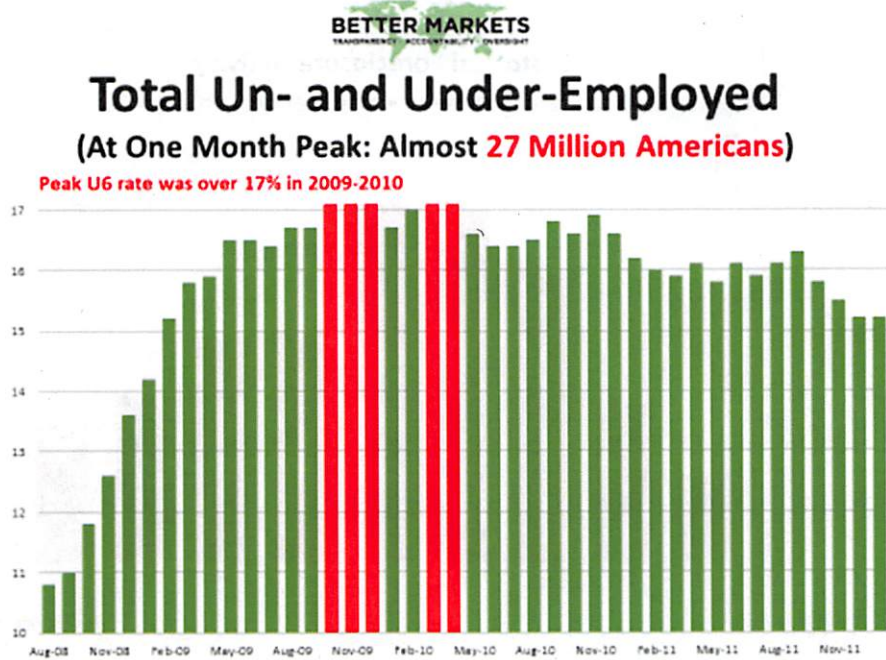
No more economic calamities from unexpected collapses of companies that threaten the stability of the United States

While only a few short years ago, too many have forgotten – or choose to ignore – that the 2008 crash was the worst financial crash since the Great Crash of 1929 and caused the worst economy since the Great Depression of the 1930s. Just a few highlights of that economic wreckage:

- Unemployment and under-employment skyrocketed, peaking in late 2009, early 2010 to a rate of over 17 percent. The one-month peak of what is referred to as the

¹ Better Markets, *The Cost of the Wall Street-Caused Financial Collapse and Ongoing Economic Crisis is more than \$12 Trillion* (Sept. 15, 2012), available at http://bettermarkets.com/sites/default/files/Cost%20of%20The%20Crisis_2.pdf.

“U6” rate was almost 27 million Americans out of work or forced to work part time rather than full time as shown below:



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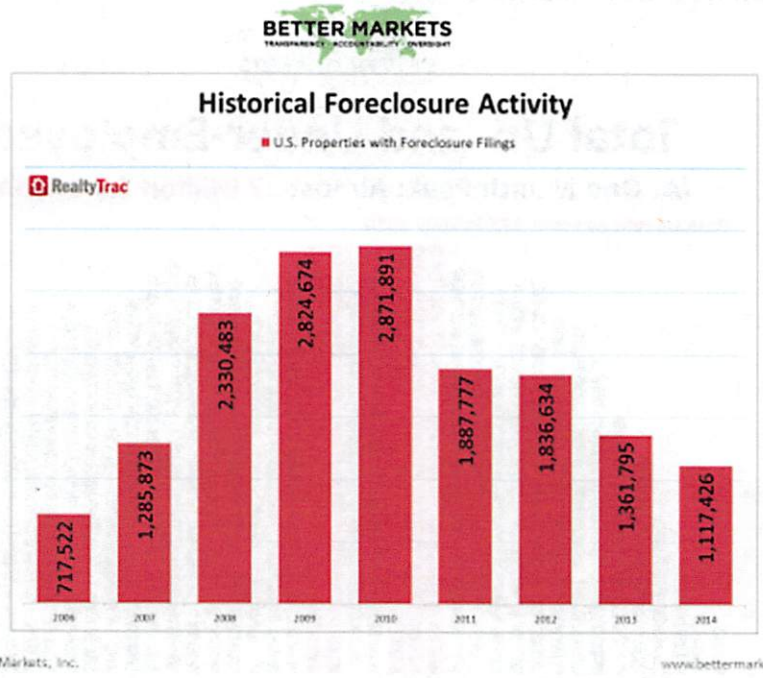
- Housing prices collapsed to 2001 levels and have remained at persistently low levels far beyond the official end of the recession:



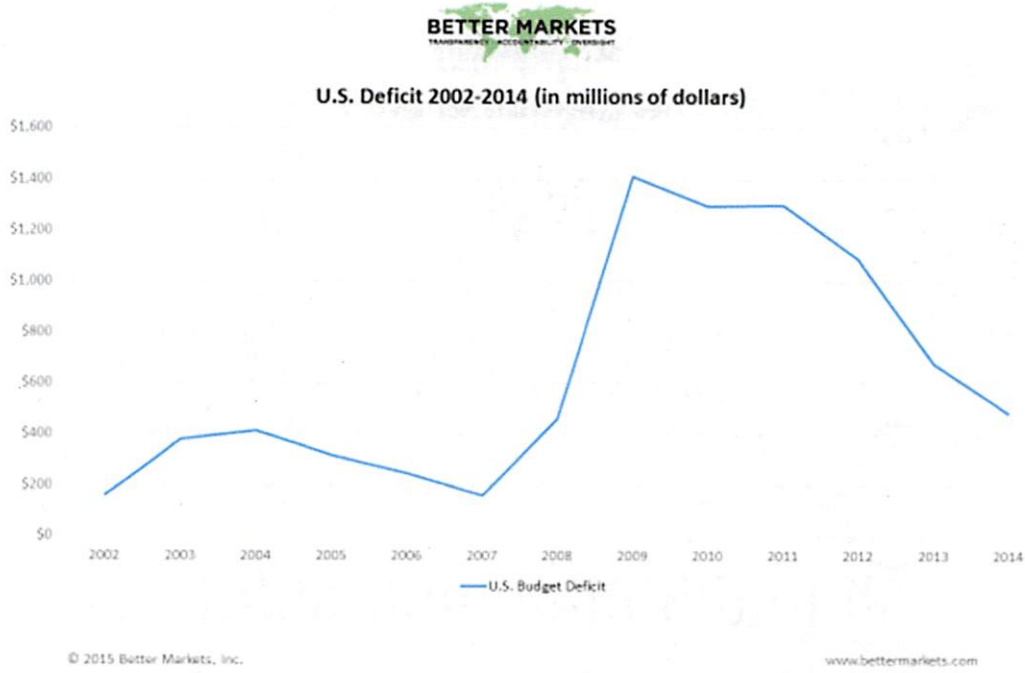
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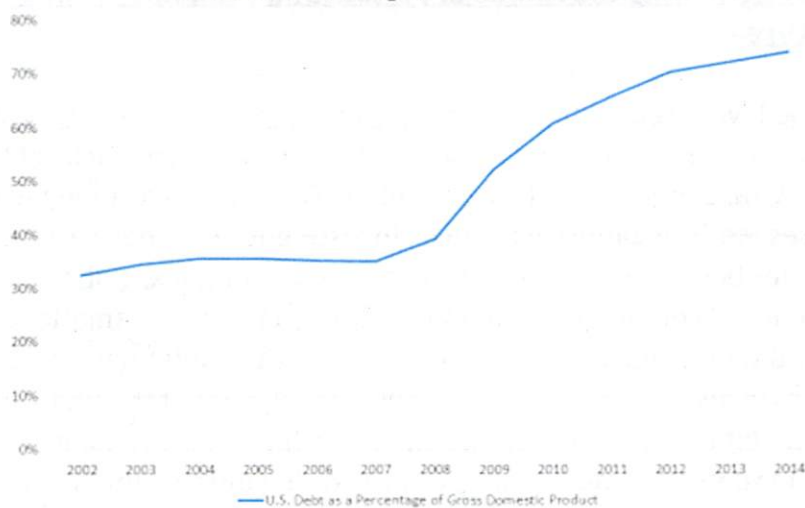
- Americans experienced foreclosure at record rates:



- Tax revenues plummeted at the federal, state and local level, and essential spending on social needs skyrocketed as layoffs exploded, causing the deficit and debt to dramatically increase:



U.S. Debt as a Percentage of Gross Domestic Product



This massive economic wreckage resulted from the financial crash of 2008 and the near collapse of the U.S. and global financial systems. The Stability Council was created to be an early warning system to help detect and prevent this type of financial, economic and human calamity from ever happening again.

With that as the essential context for understanding and thinking about the Stability Council, the testimony that follows addresses three main points:

1. Congress created the Stability Council in response to the catastrophic failure of unregulated systemic threats like AIG, and the Stability Council's success is vital to strengthening the financial system and economy while reducing future systemic threats.
2. The Stability Council's implementation of Section 113 of the Dodd-Frank Act shows that it is using its power deliberately and judiciously. And, recent significant changes demonstrates it is listening and responding appropriately to constructive input from stakeholders.
3. Additional proposals to change the Stability Council would impair or cripple its ability to protect American families, workers, and taxpayers from another financial crash and economic calamity.

1. Congress created the Stability Council in response to the catastrophic failure of unregulated systemic threats like AIG, and the Stability Council's success is vital to strengthening the financial system and economy while reducing future systemic threats.

The Stability Council was created to close the gigantic gap in the regulatory system that arose from changes in the financial industry and the regulatory rollbacks of the late 1990s. In particular, following Congressional passage of the Gramm-Leach-Bliley Act and the Commodity Futures Modernization Act, banks, investment firms, derivatives dealers, and insurance companies became supersized into enormous, complex, global, and interconnected financial companies. While the industry changed dramatically, the regulatory system did not, and as a result, on the eve of the 2008 financial crisis our financial regulators focused, at most, on their specific segment of the financial services industry without looking at broader threats and risks. Importantly, none of the regulators were responsible for detecting, addressing, or preventing unseen, unknown, and unexpected risks and threats.

The best known example of this phenomenon was AIG. In 2008 AIG was the world's largest insurance company. However, in addition to selling traditional products like health and life insurance, a division of AIG called AIG Financial Products ("AIG FP") accumulated hundreds of billions of dollars of liabilities by selling credit default swaps, a type of derivative that "insured" the buyer of the swap against certain credit risks. This caused AIG to become deeply interconnected through the entire financial system. While AIG's traditional insurance business was overseen by the states, AIG's other lines of business were supposed to be overseen by the Office of Thrift Supervision, a regulator charged with overseeing small savings and loans organizations. Due to competition among regulators, among other reasons, AIG was able to shop around for the weakest regulation possible, which the Office of Thrift Supervision provided in exchange for collecting the fees AIG paid for its regulation.

When the mortgage-backed and other securities AIG FP was "insuring" failed, AIG lacked the capital necessary to fulfill its obligations. The result is well known: the federal government was forced to bailout AIG with about \$185 billion, take on AIG's obligations, bailout its counterparties including many foreign banks, and enable the payment of \$218 million in bonuses to some of AIG FP's executives who were involved in the company's reckless risk-taking in the first place.

AIG's failure, and subsequent bailout, happened in large part because no regulator was responsible for overseeing the systemic risk posed by the firm or, for that matter, posed by any firm. AIG's insurance business was regulated by state insurance commissioners; its thrift was insufficiently regulated by the Office of Thrift Supervision; and its credit default swaps business was largely unregulated due to legal prohibitions on the regulation of such swaps, among other reasons.

That is why, in the immediate aftermath of the crisis, it was **very widely agreed** that fixing this incredibly consequential regulatory gap required the creation of a single regulator responsible for overseeing systemic risk across the financial system. In fact, following the crisis, politicians and financial industry participants testified to the public and Congress that one of the essential ways of preventing such a crisis from happening again was to create such a systemic risk regulator.

A sample of those statements include the following:

“We must create a systemic risk regulator to monitor the stability of the markets and to restrain or end any activity at any financial firm that threatens the broader market.”

– Henry Paulson, former Secretary of the Treasury²

“One of the reasons this crisis could take place is that while many agencies and regulators were responsible for overseeing individual financial firms and their subsidiaries, no one was responsible for protecting the whole system from the kinds of risks that tied these firms to one another.”

– Robert S. Nichols, President and Chief Operating Officer, Financial Services Forum³

“I believe an interagency council with a strong authority in a focused area, in this case monitoring and directing the response to risks that threaten overall financial stability, could, like the [National Security Council], serve the Nation well in addressing complex and multifaceted risks.”

– Paul Schott Stevens, President and CEO, Investment Company Institute⁴

² [How to Watch the Banks](#): New York Times OP-ED (Feb. 15, 2010).

³ [Testimony](#) at House Financial services Committee (July 17, 2009).

⁴ [Testimony](#) at Senate Banking Committee hearing (July 23, 2009).

“A systemic risk regulator that has access to information about any systemically important financial institution – whether a bank, broker-dealer, insurance company, hedge fund or private equity fund – could have the necessary perspective to ensure firms are not exploiting the gaps between functional regulators, or posing a risk to the larger system.”

– Randolph C. Snook, Executive Vice President, Securities Industry and Financial Markets Association (SIFMA)⁵

“The ABA strongly supports the creation of a systemic regulator. In retrospect, it is inexplicable that we have not had a regulator that has the explicit mandate and the needed authority to anticipate, identify, and correct, where appropriate, systemic problems. To use a simple analogy, think of the systemic regulator as sitting on top of Mount Olympus looking out over all the land. From that highest point the regulator is charged with surveying the land, looking for fires. Instead, we have had a number of regulators, each of which sits on top of a smaller mountain and only sees its part of the land. Even worse, no one is effectively looking over some areas. This needs to be addressed.”

– Edward L. Yingling, then President and Chief Executive Officer, American Bankers Association⁶

Based in part on this testimony, Congress created the Stability Council as part of the Dodd-Frank Act, and tasked the Stability Council with the mission of identifying and responding to risks to the financial stability of the United States. As such, the Stability Council is the front line macro-prudential regulator that serves as the early warning system needed to identify such threats, and address the challenges presented by the shadow-banking system to the financial stability of the U.S.

Congress gave the Stability Council a number of important tools to carry out this mission including the ability to:

- Designate nonbank financial companies as systemically important and subject those companies to supervision by the Federal Reserve
- Make policy and enforcement recommendations to primary financial regulators
- Collect information through the Office of Financial Research

⁵ Testimony at House Financial Services Committee (July 17, 2009).

⁶ Testimony at House Financial Services Committee (Mar. 17, 2009).

- Publish annual reports about systemic risks to the financial system

In addition, for the first time, the Stability Council enables all of the financial regulators to communicate with each other regularly and gain the benefit of each regulator's expertise. All of these tools provide the Stability Council with the ability to take a holistic view of the financial system, just as the ICI, ABA, SIFMA and Financial Services Forum, among many others, said was so necessary.

The ability to designate nonbank financial companies for prudential supervision by the Federal Reserve is among the most important tools Congress provided the Stability Council. The ability to designate a company for enhanced supervision is the primary mechanism to prevent any firm or activity – like the derivatives dealing at AIG FP – from slipping through the regulatory cracks. For that reason, ensuring that the Stability Council can continue to adequately and appropriately use this authority is critically important to protecting America's families, workers, savers, communities, taxpayers, financial system, and economy as a whole.

2. The Stability Council's implementation of Section 113 of the Dodd-Frank Act shows that it is using its power deliberately and judiciously. And, recent significant changes demonstrates it is listening and responding appropriately to constructive input from stakeholders.

Under Section 113 of the Dodd-Frank Act, the Stability Council has the authority to designate a nonbank financial company for enhanced prudential regulation by the Federal Reserve only if it finds that:

“material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States.”

Before making such a designation, the Stability Council is required to consider ten specific factors, plus any other risk-related factors the Stability Council finds appropriate.

To provide a standard method for considering these designations, on April 11, 2012 the Stability Council released a final rule and interpretive guidance implementing a three-stage process for designating non-bank companies for enhanced regulation,⁷ outlined below:

⁷ Financial Stability Oversight Council, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 77 Fed. Reg. 21637 (Apr. 11, 2012).

- In Stage 1, the Stability Council “narrow[s] the universe of nonbank financial companies to a smaller set” by evaluating the size, interconnectedness, leverage, and liquidity risk and maturity mismatch of nonbanks.
- If a firm has been identified in Stage 1, in Stage 2 the Stability Council then “conduct[s] a robust analysis of the potential threat that each of those nonbank financial companies could pose to U.S. financial stability,” based on data from existing public and regulatory sources.
- Finally, if a firm makes it to Stage 3, then the Stability Council conducts a more detailed review using information obtained directly from the nonbank financial company. At this point, the Stability Council, by a two-thirds vote (including that of the Treasury Secretary who is also the Stability Council Chairman), may make a Proposed Determination with respect to any company. A firm subject to a Proposed Determination may request a hearing to contest the determination. After the hearing, the Stability Council may vote, again by two-thirds, to make a Final Determination. Throughout this stage, firms may provide written comments to or meet with Stability Council staff and discuss their potential designation.

Importantly, on February 4, 2015 – **not** three years after finalizing its rule **and** only last month – the Stability Council approved a series of very significant changes to the designation process designed to improve transparency and public accountability.⁸ (Those changes are attached as Exhibit A hereto.) Those changes include:

- First, the Stability Council will now engage with companies during the designation process to a greater extent than previously. For example, the Stability Council will notify a company when it is under Stage 2 review, and any such company may provide data for the Stability Council to review prior to Stage 3. The Stability Council will alert companies when they have not been recommended to Stage 3. Finally, the Stability Council will begin communications with a company’s primary regulator or supervisor during Stage 2, rather than Stage 3.
- Second, the Stability Council will now more fully engage with designated companies during its annual review of a company’s designation to improve the de-designation process. Going forward, if a designated company contests its designation during that annual review, and if the Stability Council votes not to rescind the designation, it will provide the company and primary regulators with an explanation why. This change, and others to the de-designation process, are a significant improvement that will adequately allow a designated company to document that it no longer meets the

⁸ Financial Stability Oversight Council, *Supplemental Procedures Relating to Nonbank Financial Company Determinations* (Feb. 4, 2015), available at <http://www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental%20Procedures%20Related%20to%20Nonbank%20Financial%20Company%20Determinations%20-%20February%202015.pdf>.

statutory criteria without harming the Stability Council's ability to protect the financial system, the economy, and the public.

- Finally, the Stability Council will provide increased transparency to the public. Previously, if a company announced it was under consideration for designation, the Stability Council would neither confirm nor deny that. Now, if the company publicly confirms that is under consideration the Stability Council will confirm that upon request to do so by a third party. The Stability Council will also annually publish the number of companies considered for designation along with the number of companies considered but not designated. Finally, the Stability Council has agreed to publish further details of how its Stage 1 thresholds are calculated in the future.

These changes were very significant and telling for two reasons. First, as a matter of process, the Stability Council's actions demonstrate that it listens carefully to those who comment on its activities and responds with meaningful action. Such actions are all too rare and the Stability Council should be applauded for doing so.

Second, as a matter of policy, the changes make the Stability Council's designation determinations better, which will ensure better outcomes for the firms under review and the public. Increased communications between the Stability Council and firms under consideration for designation will enable a more robust, data based decision-making process based on all material information. Additionally, increased public disclosure and transparency will build trust and confidence that the Stability Council is on watch and fulfilling its important role.

In its very short life of less than five years, the Stability Council has designated just four non-bank financial institutions for enhanced supervision. In each instance, the Stability Council acted prudently, designating the firm only after conducting a thorough analysis and concluding that each one satisfied the applicable statutory standards. Each fits the requirements for designation by having a system-wide reach and being so interconnected with other financial companies that its failure would cause damage to the financial system and real economy.

The clearest example of this is AIG.⁹ AIG was so large and interconnected that, as the subprime bubble burst, its credit default swap portfolio was so large that it became insolvent, unable to pay its counterparties, and had to be bailed out by taxpayers. As the Stability Council said in its public final basis for designating AIG,

⁹ Financial Stability Oversight Council, *Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc.* (July 8, 2013), available at <http://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis%20of%20Final%20Determination%20Regarding%20American%20International%20Group,%20Inc.pdf>.

“Individual exposures to AIG may be relatively small, but in the aggregate, the exposures are large enough that material financial distress at AIG, if it were to occur, could have a destabilizing effect on the financial markets.”

Furthermore, AIG and its subsidiary are the reference entities “for a combined \$70 billion in notional single-name CDS, which is significant and comparable to several of the largest money-center banks, investment banks, bond insurers, and prime brokers,” meaning that its failure would have a large impact on other, non-AIG companies.

Like AIG, GE Capital was so deeply affected by the financial crisis that it required a \$139 billion bailout for fear that a collapse would greatly affect other financial firms. In its designation, the Stability Council explained that “there is approximately \$77 billion in gross notional credit default swaps outstanding for which GECC is the reference entity,” even larger than the notional value for AIG.¹⁰ Furthermore, GE Capital’s portfolio of assets, \$539 billion as of December 31, 2012, is “comparable to those of the largest U.S. BHCs.” As such, among other things, any rapid liquidation of GE Capital’s assets could lead to a fire sale of the securities of other large corporations, including of the largest financial institutions.

The Stability Council also determined that Prudential met the statutory criteria after determining that the financial system is significantly exposed to Prudential “through the capital markets, including as derivatives counterparties, creditors, debt and equity investors, and securities lending and repurchase agreement counterparties.”¹¹ It also found that the complexity and interconnectedness of Prudential would make it difficult for the firm to be resolved, posing a material threat to U.S. financial stability.

The Stability Council made a similar determination in the case of MetLife.¹² In this case, the Stability Council found that there would be a severe negative impact on the financial system if a situation occurred in which MetLife was forced to liquidate its holdings. The Stability Council’s public final basis for designating the insurance company states that, “[a] large-scale forced liquidation of MetLife’s large portfolio of relatively illiquid assets, including corporate debt and asset-backed securities (ABS), could disrupt trading or funding markets.” This is because “[a]s of September 30, 2014, MetLife held \$108 billion of U.S. corporate securities at fair value, and \$70 billion of asset-backed securities and mortgage-backed securities at fair value.” The resulting fire sale would depress prices for the assets MetLife holds, similar to the fire sale which resulted from the Prime Reserve Fund’s failure in 2008.

¹⁰ Financial Stability Oversight Council, *Basis of the Financial Stability Oversight Council’s Final Determination Regarding General Electric Capital Corporation, Inc.* (July 8, 2013), available at <http://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis%20of%20Final%20Determination%20Regarding%20General%20Electric%20Capital%20Corporation,%20Inc.pdf>

¹¹ Financial Stability Oversight Council, *Basis of the Financial Stability Oversight Council’s Final Determination Regarding Prudential Financial, Inc.* (Sept. 19, 2013), available at <http://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf>.

¹² Financial Stability Oversight Council, *Basis of the Financial Stability Oversight Council’s Final Determination Regarding MetLife, Inc.* (Dec. 18, 2014), available at <http://www.treasury.gov/initiatives/fsoc/designations/Documents/MetLife%20Public%20Basis.pdf>.

Whatever one wishes to say about the Stability Council's designation process or the decisions it has reached, the Stability Council can hardly be accused of acting hastily or over-broadly. Four designations in less than five years is far fewer than what could have been done given the number of nonbank financial companies that failed, received bailouts, or posed systemic risk during the financial crisis just a few short years ago.¹³ Furthermore, the three insurance companies designated by the Stability Council are also all listed on the Financial Stability Board's list of Global Systemically Important Insurers, suggesting that the Stability Council's actions are not without merit.

Clearly the Stability Council is acting deliberatively and carefully when considering and making designation determinations.

3. Additional proposals to change the Stability Council would impair or cripple its ability to protect American families, workers, and taxpayers from another financial crash and economic calamity.

Regarding the consideration of any changes to the Stability Council, it must be remembered that it is **not even five years old**. During that time it has had to translate legislative text regarding a stability council into a working reality of **the** Stability Council. As if that wasn't enough, it had to do so with fifteen member agencies, organizations, and departments, with, as is well known, all that entails. And it had to do it from the still smoldering ashes of the financial crash, in the midst of the ongoing economic crisis, and in the face of relentless attacks and criticism.

Frankly, although not perfect, it is a remarkable achievement. In addition, as it did all that, it has listened carefully to those who think it might be able to improve its procedures, including criticism from Better Markets. After careful consideration and deliberation, the Stability Council, as set forth above, has recently adopted a number of very significant changes and those changes should be allowed to be implemented before any additional changes are legislatively imposed on the Stability Council. Given its willingness to listen, change, and improve, the Stability Council deserves no less.

Making matters worse, most of the legislative changes proposed would prevent the Stability Council from carrying out its mission, and would leave our financial system and economy vulnerable to another crisis. Indeed, a number of proposals have recently been put forward that would severely weaken the Stability Council and, in fact, make future AIGs **more** likely. An overview of those proposals, including an explanation of how they would prevent the Stability Council from fulfilling its critical role follows.

¹³ See U.S. Gov't Accountability Office, Rep. No. GAO-11-696, *Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance* (July 2011); ProPublica, *Bailout Recipients*, available at <https://projects.propublica.org/bailout/list/simple>.

Proposal: Require the Stability Council to make certain decisions within arbitrary time considerations, and force the Stability Council to begin the designation process again unless it meets those time constraints.

Impact: It is in no one's interest for the Stability Council to act in haste. The Stability Council's process for designating a nonbank financial institution should be deliberative and not rushed. Requiring a decision to be made within an arbitrary deadline could put the Stability Council in an untenable situation, potentially forcing them to designate in haste or forego an otherwise necessary and important designation. These scenarios are simply unacceptable, given the importance of Stability Council's mission and the consequences of designation or a failure to designate when appropriate and necessary.

Proposal: Require that the designation of a nonbank financial company be a last resort that is taken only after all other regulatory steps are exhausted.

Impact: This proposal disregards the already very high bar and robust process that the Stability Council must go through before designation (as set forth above and in the law and regulations). It has no reasonable rationale and it would add substantial burdens that would only constrain the Stability Council with no countervailing benefit.

Importantly, designation authority was designed not only to respond to the last crisis, but to be a forward-looking warning system to prevent systemic risks that could cause the next crisis. For that reason, the Stability Council needs the flexibility and discretion to identify new and emerging risks and keep abreast with market developments and financial innovations. Furthermore, these proposals would add yet more unnecessary layers of work for the Stability Council and primary regulatory agencies, creating risky delays that would undermine the Stability Council's mission.

Proposal: Reform the designation process by subjecting it to additional process constraints like cost-benefit analysis.

Impact: Imposing such economic analysis obligations on the Stability Council is as unwise as it is unwarranted. It will only force the Stability Council to engage in an inherently inaccurate yet burdensome process, encumber and delay the Stability Council's work, and ultimately make any designation a more inviting target for legal challenge in court. When applied to financial regulation, cost-benefit analysis is

more aptly described as “**industry cost-only analysis**,” in which industry focuses exclusively on the costs of regulation while ignoring the benefits.¹⁴

The case of designating a firm for enhanced regulation by the Federal Reserve lends itself to just this one-sided analysis, as the designated entity will always be able to cite a long list of specific (if highly questionable) quantifiable costs that would appear to cast designation as unjustifiable. Yet viewed holistically, the benefits of designation are potentially enormous and, in many respects, incalculable, representing the tangible and intangible gains that come from averting another financial crisis, systemic collapse, and untold trillions in bailouts. As traditionally framed, however, cost-benefit analysis does not capture these benefits and does not yield a balanced and accurate picture.

In addition, the process is time-consuming and resource intensive. It will inevitably slow down the designation process and sap the Stability Council’s resources, which would be far better spent on its core mission of detecting and analyzing potential risk and responding appropriately.

Finally, a cost-benefit requirement will also make it easier for a designated company to litigate the designation, just as industry groups have relentlessly challenged Securities and Exchange Commission and Commodity Futures Trading Commission regulations alleging insufficient analysis of costs and benefits relating to mutual fund governance, conflict minerals, and position limits. As these cases demonstrate, should Congress choose to require the Stability Council to conduct quantitative cost-benefit analysis it would cause a litigation bonanza, creating yet another opportunity for industry to argue that the costs imposed upon them should be more highly prioritized than the benefit to the public of preventing a future crash. This would severely weaken the Stability Council’s ability to protect the public and carry out its congressionally directed mandates.

Proposal: Give the primary regulator heightened deference in the designation process.

Impact: No one questions that a company’s primary regulator may have significant insights into the workings of that industry and that the primary regulator can provide much needed assistance in understanding the nuances of a company’s balance sheet, activities, risks and related issues. However, that regulator may not be in the best position to decide whether the company poses a systemic risk, since they lack the broader perspective that the Stability Council was created to provide. It is also undeniable that individual regulators may bring certain biases to bear,

¹⁴ Better Markets, *Setting The Record Straight On Cost-Benefit Analysis And Financial Reform At The SEC* (July 30, 2012), available at <http://www.bettermarkets.com/sites/default/files/Setting%20The%20Record%20Straight.pdf>.

stemming from a sense of “turf” or a desire to downplay the systemic risks that may have evolved under their “watch.” There is also the well-known problem of regulatory capture. Thus, the primary regulator may oppose actions that would otherwise be necessary to protect the public from systemic risks. In short, the statutory framework already requires the Stability Council to consult the primary regulator for any entity being considered for designation, and requiring any further deference would be unnecessary and counterproductive.

Proposal: Delay the Stability Council’s ability to designate a firm for enhanced regulation until the Federal Reserve explains what enhanced measures it will impose as a result of the designation.

Impact: Two of the core purposes of the Stability Council are to **identify** and **respond** to risks to the financial stability of the United States. By law, the Stability Council has the authority to do so by designating companies as systemically important. This authority differs significantly from that of the Federal Reserve, which must determine how best to regulate a designated company. Because the duties of these two agencies are different, the Stability Council should not be required to wait for the Federal Reserve before carrying out its legal obligations. The systemic importance of a company, and the Stability Council’s decision to designate it as such, should not be dependent upon or influenced by how the company might or might not be regulated after designation.

Proposal: Change the method by which the Stability Council votes.

Impact: The key decisions made by the Stability Council already require supermajorities. These decisions are complex and require a great deal of judgment over which reasonable minds might disagree. While the Stability Council should – and does – strive for consensus, there may come a time when some members oppose an action while a supermajority of seven believe the risk to financial stability warrants action. It would be a serious mistake if the Stability Council were unable to go forward under this scenario, preventing action and putting our financial system to significant risk.

Proposal: Expand the number of members on the Stability Council, either by increasing membership or by requiring regulatory agencies to vote to determine how the agency head will vote during Stability Council proceedings.

Impact: The Stability Council already consist of fifteen members, ten voting members and five non-voting members. Expanding it further risks creating a body that is so large it would be ineffective. This would also risk politicizing the decision-making process, turning any Stability Council vote into a partisan exercise and an opportunity for scoring political points. This proposal would therefore lead to unnecessary delays and weaker actions as a result.

CONCLUSION

Thank you again for the opportunity to appear before you today. I look forward to answering your questions.

EXHIBIT A

Financial Stability Oversight Council
Supplemental Procedures
Relating to Nonbank Financial Company Determinations
February 4, 2015

Background

Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) authorizes the Financial Stability Oversight Council (the Council) to determine that a nonbank financial company shall be supervised by the Board of Governors of the Federal Reserve System and be subject to enhanced prudential standards if the Council determines that material financial distress at the company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company, could pose a threat to the financial stability of the United States.

Over the last several months, as part of the Council's ongoing evaluation of how it conducts its work, the Council has reviewed its practices related to the evaluation of nonbank financial companies under section 113 of the Dodd-Frank Act. This review included engagement with financial companies, trade associations, nonbank financial companies subject to previous Council determinations, public interest groups, and Congressional stakeholders.

Based on this review, the Council has adopted the following procedures that the Council intends to use for determinations in non-emergency situations, to supplement its rule and interpretive guidance regarding nonbank financial company determinations (Rule and Guidance).¹ The Council will continue to work to identify and evaluate additional potential changes to its practices and procedures that would promote active engagement with companies under consideration for a determination and transparency to the public.

The Rule and Guidance provide a detailed description of the analysis that the Council intends to conduct, and the processes and procedures that the Council intends to follow, during its review of nonbank financial companies. In the Rule and Guidance, the Council created a three-stage process for identifying companies for determinations. Each stage of the process involves an analysis based on an increasing amount of information to determine whether a company meets one of the statutory standards for a determination. In the first stage of the process (Stage 1), the Council applies six quantitative thresholds (described in the Rule and Guidance) to a broad group of nonbank financial companies to identify a set of companies that merit further evaluation. In Stage 2, the Council conducts a preliminary analysis of the potential for the companies identified in Stage 1 to pose a threat to U.S. financial stability. Based on the analysis conducted during Stage 2, the Council identifies companies that merit further review in Stage 3, which builds on the Stage 2 analysis with additional quantitative and qualitative analyses. The Council may make a proposed determination regarding a company based on the results of the analyses conducted during this three-stage review. If the Council makes a proposed determination, the

¹ Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 12 C.F.R. part 1310 (2013).

Council provides the company with notice and an explanation of the basis of the proposed determination. The company may request a hearing to contest the proposed determination. After any hearing, the Council may make a final determination regarding the company.

The Council's evaluation of nonbank financial companies is supported by the staff-level Nonbank Financial Company Designations Committee (Nonbank Designations Committee). The Nonbank Designations Committee is overseen by the Council's Deputies Committee, which is composed of one representative from the staff of each Council member or member agency.

The procedures described below supplement the Rule and Guidance, and are organized into three categories: engagement during evaluations for potential determinations; engagement during annual reevaluations of determinations; and transparency to the public.

Engagement During Evaluations for Potential Determinations

Engagement with Companies

- The Council's practice has been to notify a nonbank financial company under evaluation only if the company is advanced to Stage 3. The Council now will notify a nonbank financial company within 30 days after the Deputies Committee instructs the Nonbank Designations Committee to form an analytical team to commence an active review of the company in Stage 2. Prior to approving a company for active review, the Deputies Committee will consider any preliminary information gathered by the Nonbank Designations Committee.
- A company under active review in Stage 2 may submit to the Council any information it deems relevant to the Council's evaluation and may, upon request, meet with analytical team staff. In addition, analytical team staff will, upon request, provide the company with a list of the primary public sources of information being considered during the Stage 2 analysis, so that the company has an opportunity to understand the information the Council may rely upon during Stage 2.
- If the Council votes to not advance a company from Stage 2 to Stage 3, the Council will notify the company in writing of the Council's decision. The notice will clarify that a vote not to advance the company from Stage 2 to Stage 3 at that time does not preclude the Council from notifying the company in the future that it is again under active consideration in Stage 2.
- If the Council votes to advance a company from Stage 2 to Stage 3, the Council's current practice is to provide the company with an opportunity to submit written materials to the Council to contest the Council's consideration of the nonbank financial company for a proposed determination. In addition, analytical team staff will now meet with the company's representatives at the start of Stage 3 to explain the evaluation process and the framework for the Council's analysis. If the analysis in Stage 2 has identified specific aspects of the company's operations or activities as the primary focus for the evaluation, staff will notify the company of those issues, although the issues will be subject to change based on the ongoing analysis. After this meeting, the Council will provide the company with a request for information that will generally indicate how the requested items relate

to the Council's framework for analyzing potential risks described in the Rule and Guidance.

- Consistent with the Council's current practice, during Stage 3, a company may submit to the Council any information it deems relevant to the Council's evaluation and may request meetings with analytical team staff regarding any issue the company deems appropriate.
- The Council's Deputies Committee will grant a request to meet with a company in Stage 3 on a mutually agreed-upon date, subject to receiving the request at least 30 days prior to the proposed meeting, to allow the company to present any information or arguments it deems relevant to the Council's evaluation.
- Pursuant to the Dodd-Frank Act, the Council can, in its sole discretion, determine whether to grant a request for an oral hearing for any company subject to a proposed determination. The Council intends to grant any timely request for an oral hearing from a company subject to a proposed determination, and for any such hearing to be conducted by the Council members.

Engagement with Existing Regulators

Under the Dodd-Frank Act, the Council must consult with the primary financial regulatory agency, if any, for each nonbank financial company or subsidiary of a nonbank financial company that is being considered for a determination before the Council makes any final determination with respect to such company. The Council's practice has generally been to begin the consultation process in Stage 2 with the primary financial regulatory agencies or home country supervisors, as appropriate, and to consult in Stage 3 with such regulators in a timely manner before the Council makes any final determination with respect to the company.

- For any company under active review in Stage 2 that is regulated by a primary financial regulatory agency or home country supervisor, the Council will notify such regulator or supervisor that the company is under active review no later than such time as the company is notified. The Council will seek to begin the consultation process with such regulator or supervisor during Stage 2, before the Council votes on whether to advance the company to Stage 3.
- In addition, if the Council votes to advance a company to Stage 3, the Council will seek to continue its consultation with such regulator or supervisor during Stage 3, before voting on whether to make a proposed determination regarding the company.
- Further, for any company regulated by a primary financial regulatory agency or home country supervisor, promptly after the Council votes to make a proposed or final determination regarding the company, the Council will provide such regulator or supervisor with the nonpublic written explanation of the basis of the Council's proposed or final determination.

Engagement During Annual Reevaluations of Determinations

- The Council reevaluates each of its determinations not less than annually and will rescind a determination if it determines that the company no longer meets the statutory standards for a determination. Before the Council's annual reevaluation of a nonbank financial company subject to a Council determination, the company will be provided an opportunity to meet with staff on the Nonbank Designations Committee to discuss the scope and process for the review and to present information regarding any change that may be relevant to the threat the company could pose to financial stability, including a company restructuring, regulatory developments, market changes, or other factors.
- If a company contests its determination during the Council's annual reevaluation, the Council intends to vote on whether to rescind the determination and provide the company, its primary financial regulatory agency, and the primary financial regulatory agency of its significant subsidiaries with a notice explaining the primary basis for any decision not to rescind the determination. The notice will address the material factors raised by the company in its submissions to the Council contesting the determination during the annual reevaluation.
- The Council will provide each company subject to a determination an opportunity for an oral hearing before the Council once every five years at which the company can contest the determination.

Transparency to the Public

- The Council's practice has been not to publicly announce the name of any nonbank financial company that is under evaluation for a determination prior to a final determination with respect to such company. However, if a company that is under active review in Stage 2 or that has been advanced to Stage 3 publicly announces the status of its review by the Council, the Council now intends, upon the request of a third party, to confirm the status of a company's review.
- When the Council makes a final determination, it provides the company with a detailed statement of the basis for the Council's decision and publicly releases a written explanation of the basis for the final determination. The Council is subject to statutory and regulatory requirements to maintain the confidentiality of certain information submitted to it by a nonbank financial company under review for a potential determination.² As a result, the Council's public basis cannot include confidential information that was submitted by a company to the Council in connection with the Council's evaluation of the company. Nevertheless, the Council is committed to continuing to set forth sufficient information in its public bases to provide the public with an understanding of the Council's analysis while protecting sensitive, confidential information submitted by the company to the Council.

² See Dodd-Frank Act section 112(d)(5), 12 U.S.C. § 5322(d)(5); 12 C.F.R. part 1310.20(e).

- The Council also will publish in its annual reports the numbers of nonbank financial companies that, since the publication of the Council's prior annual report, (1) the Council voted to advance to Stage 3, (2) the Council voted not to advance to Stage 3, (3) became subject to a proposed or final determination, and (4) in the aggregate are subject to a final determination at that time.
- In addition, the Council will in the coming months publish on its website further details explaining how the Stage 1 thresholds are calculated, which may address issues such as how the Council evaluates the use of various accounting standards for purposes of Stage 1; components of the six Stage 1 thresholds; and practices for calculating the thresholds when incomplete data regarding a company are available.