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**TESTIMONY OF**  
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**AND CHIEF NATIONAL BANK EXAMINER**

**OFFICE OF THE COMPTROLLER OF THE CURRENCY**

**Before the**

**SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS**  
**FINANCIAL SERVICES COMMITTEE**  
**UNITED STATES HOUSE OF REPRESENTATIVES**

**April 14, 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.

## **I. Introduction**

Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee, my name is Timothy Long and I am the Senior Deputy Comptroller for Bank Supervision Policy and Chief National Bank Examiner at the Office of the Comptroller of the Currency (OCC). In this role, I serve as the OCC's representative on the Financial Stability Oversight Council's Deputies Committee. I appreciate the opportunity to provide the OCC's perspectives on the functions and operations of the Financial Stability Oversight Council (FSOC or Council) and to briefly describe its major accomplishments to date.

Throughout the discussions and deliberations that led to the passage of the Dodd-Frank Wall Street and Consumer Protection Act (the Dodd-Frank Act), the OCC supported the creation of a council that would bring together the views, perspectives, and expertise of Treasury and all of the financial regulatory agencies to identify, monitor, and respond to systemic risk.<sup>1</sup> As my testimony will detail, Congress, with the passage of the Dodd-Frank Act, set forth very specific mandates regarding the role and function of FSOC in a number of areas, but certainly the overarching mission that Congress assigned to the Council is to identify risks to the financial stability of the United States, to promote market discipline, and to respond to emerging threats to the stability of the U.S. financial system.<sup>2</sup>

I believe FSOC enhances the agencies' collective ability to fulfill this critical mission by establishing a formal, structured process to exchange information and to

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<sup>1</sup> See April 4, 2009, Statement of John C. Dugan before the Committee on Banking, Housing, and Urban Affairs, United States Senate, pg. 2: "We believe many of the Administration's proposed reforms will strengthen the financial system and help prevent future market disruptions of the type we witnessed last year, including the following: Establishment of a Financial Stability Oversight Council."

<sup>2</sup> See Section 112(a)(1).

probe and discuss the implications of emerging market, industry, and regulatory developments for the stability of the financial system. Through the work of its committees and staff, FSOC also is providing a structured framework and metrics for tracking and assessing key trends and potential systemic risks. While the process and systems that FSOC has created are positive steps forward, I would offer two cautionary notes.

First, I believe that FSOC's success ultimately will depend not on its structure, processes, or metrics, but on the willingness and ability of FSOC members and staff to engage in frank and candid discussions about emerging risks, issues, and institutions. These discussions are not always pleasant as they can challenge one's longstanding views or ways of approaching a problem. But being able to voice dissenting views or assessments will be critical in ensuring that we are seeing and considering the full scope of issues. In addition, these discussions often will involve information or findings that will need further verification; that are extremely sensitive either to the operation of a given firm or market segment; or if misconstrued, that could undermine public and investor confidence and thereby create or exacerbate a potentially systemic problem. As a result, I believe that it is critical that these types of deliberations – both at the Council and staff level – be conducted in a manner that assures their confidential nature.

Second, even with fullest deliberations and best data, I believe it is inevitable that there will still be unforeseen events that may result in substantial risks to the system, markets, or groups of institutions. Business and credit cycles will continue. It is not realistic to expect that FSOC will be able to prevent such occurrences. However, I do believe FSOC provides a mechanism to communicate, coordinate, and respond to such

events so as to help contain and limit their impact, including, where applicable, the resolution of systemically important firms.

My testimony has three sections. First, I provide a brief summary of some of the specific mandates Congress has given to the FSOC. Next, I provide an overview of the FSOC's structure and operations. Finally, I discuss the Council's achievements to date.

## **II. FSOC's Statutory Mandates**

FSOC's primary mission, as set forth in section 112 of the Dodd-Frank Act is to:

- 1) Identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace;
- 2) Promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and
- 3) Respond to emerging threats to the stability of the U.S. financial system.

The Dodd-Frank Act assigns FSOC a variety of roles and responsibilities to carry out its core mission<sup>3</sup> that are described in greater detail throughout the Act. In some cases, the Council has direct and ultimate responsibility to make decisions and take actions. Most notable of these is the authority given to FSOC to determine that certain nonbank financial companies shall be supervised by the Federal Reserve Board and subject to heightened prudential standards, after an assessment as to whether material financial distress at such companies would pose a threat to the financial stability of the

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<sup>3</sup> See section 112.

United States.<sup>4</sup> Similarly, the Council is charged with the responsibility to identify systemically important financial market utilities and payment, clearing, and settlement activities.

In addition, affirmation by two-thirds of the Council is required in those cases where the Federal Reserve determines that a large, systemically important financial institution poses a grave threat to the financial stability of the United States such that limitations on the company's ability to merge, offer certain products, or engage in certain activities are warranted, or if those actions are insufficient to mitigate risks, the company should be required to sell or otherwise transfer assets or off-balance items to unaffiliated entities.<sup>5</sup>

The FSOC is also empowered to collect information from member agencies and other federal and state financial regulatory agencies as necessary in order to monitor risks to the financial system, and to direct the Office of Financial Research under the Treasury Department to collect information directly from bank holding companies and nonbank financial companies.<sup>6</sup>

The Dodd-Frank Act also identified specific areas where the Council is to provide additional studies, including recommendations, to inform future regulatory actions. These include studies of the financial sector concentration limit applicable to large financial firms imposed by the Act;<sup>7</sup> proprietary trading and hedge fund activities;<sup>8</sup> the

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<sup>4</sup> See section 113(a)(1).

<sup>5</sup> See section 121.

<sup>6</sup> See section 112.

<sup>7</sup> See section 622.

<sup>8</sup> See section 619.

treatment of secured creditors in the resolution process;<sup>9</sup> and contingent capital for nonbank financial companies.<sup>10</sup>

In other areas, the Council's role is more of an advisory body to the primary financial regulators. For example, the Dodd-Frank Act requires the Council to make recommendations to the Federal Reserve concerning the establishment of heightened prudential standards for risk-based capital, liquidity, and a variety of other risk management and disclosure matters for nonbank financial companies and large, interconnected bank holding companies supervised by the Board.<sup>11</sup> The Federal Reserve, however, retains the authority to supervise and set standards for these firms.<sup>12</sup> The Council is also given authority to review, and as appropriate, may submit comments to the Securities and Exchange Commission and any standard-setting body with respect to an existing or proposed accounting principle, standard, or procedure.<sup>13</sup> Similarly, FSOC is assigned a consultative role in several rulemakings by member agencies, including for all of the rules that the FDIC writes pursuant to Title II of the Dodd-Frank Act regarding the orderly liquidation of failing financial companies that pose a significant risk to the financial stability of the United States. The Council may also recommend to member agencies general supervisory priorities and principles<sup>14</sup> and issue nonbinding recommendations for resolving jurisdictional disputes among member agencies.<sup>15</sup>

I believe the varied roles and responsibilities that Congress assigned to the Council appropriately balance and reflect the desire to enhance regulatory coordination

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<sup>9</sup> See section 215.

<sup>10</sup> See section 115.

<sup>11</sup> See section 112.

<sup>12</sup> See section 165.

<sup>13</sup> See section 112.

<sup>14</sup> See section 112.

<sup>15</sup> See section 119.

for systemically important firms and activities while preserving and respecting the independent authorities and accountability of primary supervisors. For example, under section 120, FSOC has the authority to recommend to the primary financial agencies that they apply new or heightened standards and safeguards for a financial activity or practice conducted by firms under their respective jurisdictions should the Council determine that the conduct of such an activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among financial institutions, the U.S. financial markets, or low-income, minority, or underserved communities. Each agency retains the authority to not follow such recommendations if circumstances warrant and the agency explains its reasons in writing to the Council.

### **III. FSOC Structure and Operations**

The FSOC has established committees and subcommittees comprised of staff from the member agencies to help carry out its responsibilities and authorities. These groups report up through a Deputies Committee of senior staff from each agency. The Deputies Committee generally meets on a bi-weekly basis to monitor work progress, review pending items requiring consultative input, discuss emerging systemic issues, and help establish priorities and agendas for the Council. A Systemic Risk Committee and subcommittees on institutions and markets provide structure for the FSOC's analysis of emerging threats to financial stability. Five standing functional committees support the FSOC's work on the following specific provisions assigned to the Council: designations of systemically important nonbank financial companies and of financial market utilities and payment, clearing, and settlement activities; heightened prudential standards; orderly

liquidation authority and resolution plans; and data collection and analysis. OCC staff are active participants and contributors to each of these committees. In addition to these groups, the FSOC also has an informal interagency legal staff working group that assists with various legal issues concerning the Council's operations and proceedings. Each of these committees and work groups is supported by staff from Treasury.

#### **IV. Accomplishments To-Date**

Since its creation with the enactment of the Dodd-Frank Act, the Council has met four times, with meetings occurring approximately every six weeks. As with any newly formed body, a large proportion of the Council's early work was focused on the necessary administrative rules and procedures that will govern the Council's operations. In addition to the creation and staffing of the aforementioned committees, this work has included the adoption of a transparency policy for Council meetings; rules of organization that describe the Council's authorities, organizational structure, and the rules by which the Council takes action; establishment of a framework for coordinating regulations or actions required by the Dodd-Frank Act to be completed in consultation with the Council; approval of an initial operating budget for the Council; and the publication of a proposed rulemaking to implement the Freedom of Information Act requirements as it pertains to Council activities.

The Council has also taken action on a number of substantive items directly related to its core mission and mandates. These include the following:

- *Study and Recommendations Regarding Concentration Limits on Large Financial Companies*<sup>16</sup> – Section 622 of the Dodd-Frank Act establishes a financial sector concentration limit that generally prohibits a financial company from merging, consolidating with, or acquiring another company if the resulting company’s consolidated liabilities would exceed 10 percent of the aggregate consolidated liabilities of all financial companies. Pursuant to the mandate in section 622, on January 18, 2011, the Council approved the publication of this study of the extent to which the concentration limit would affect financial stability, moral hazard in the financial system, the efficiency and competitiveness of U. S. financial firms and financial markets, and the cost and availability of credit and other financial services to households and businesses in the United States. The study concludes that the concentration limit will have a positive impact on U.S. financial stability. It also makes a number of technical recommendations to address practical difficulties likely to arise in its administration and enforcement, such as the definition of liabilities for certain companies that do not currently calculate or report risk-weighted assets.
- *Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds*<sup>17</sup> – As mandated by the Dodd-Frank Act, FSOC conducted a study on how best to implement section 619 of the Act (commonly known as the “Volcker Rule”), which is designed to improve the safety and soundness of our nation’s banking system by prohibiting propriety trading

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<sup>16</sup> A copy of the study is available at:  
<http://www.treasury.gov/initiatives/Documents/Study%20on%20Concentration%20Limits%20on%20Large%20Firms%2001-17-11.pdf>.

<sup>17</sup> A copy of the study is available at:  
<http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20619%20study%20final%201%2018%2011%20rg.pdf>.

activities and certain private fund investments. To help formulate its recommendations, the Council published a Notice and Request for Information in the *Federal Register* on October 6, 2010, and received more than 8,000 comments from the public, Congress, and financial services market participants. Key themes in those comments urged agencies to:

- Prohibit banking entities from engaging in speculative proprietary trading or sponsoring or investing in prohibited hedge funds or private equity funds;
- Define terms and eliminate potential loopholes;
- Provide clear guidance to banking entities as to the definition of permitted and prohibited activities; and
- Protect the ability of banking firms to manage their risks and provide critical financial intermediation services and preserve strong and liquid capital markets.

After careful consideration of these comments, on January 18, 2011, the Council approved publication of its study and recommendations that are intended to help inform the regulatory agencies as they move forward with this difficult and complex rulemaking. The study endorses the robust implementation of the Volcker Rule and makes ten broad recommendations for the agencies' consideration.<sup>18</sup>

As the Acting Comptroller noted at the Council meeting at which this matter was considered, the OCC believes this study strikes a fair balance between identifying considerations and approaches for future rulemaking, and being overly prescriptive. As

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<sup>18</sup> See: Financial Oversight Council, *Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds*, (January 2011) at 3.

noted earlier, this is an area where Congress chose to make a careful and, in my view, judicious distinction in authorities – requiring the Council to conduct the study and make recommendations, but leaving responsibility for writing the implementing regulations to the relevant supervisory agencies. Recognizing this distinction is essential to the process because the rulewriting agencies are required by law to invite – and consider—public comments as they develop the implementing regulations. This means the agencies must conduct the rulemaking without prejudging its outcome. We and the other agencies are in the midst of developing the proposed implementing rule and will be soliciting comment on all aspects of it when it is published.

- *Proposed Rulemakings on Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies* – As noted earlier, in contrast to the Volcker Rule where the Council’s role is primarily one of an advisory body, the Council is directly given authority under the Dodd-Frank Act to designate systemically important nonbank financial firms for heightened supervision. On October 1, 2010, the Council approved for publication an advance notice of proposed rulemaking (ANPR) that sought public comment on the implementation of this provision of the Dodd-Frank Act. Approximately 50 comments were received on the ANPR. 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. The FSOC is currently in the process of reviewing the comments received and, in consultation with the members, is beginning to formulate a final rule. As noted in the NPRM, the Council expects to begin assessing the systemic importance of nonbank financial companies shortly after adopting a final rule. Consistent with statutory provisions, the designation of a nonbank firm as systemically important will require consent by no fewer than two-thirds of the voting members of the Council, including the affirmative vote of the Chairperson of the Council. Before being designated, a firm will be given a written notice that the Council is considering making a proposed determination with opportunity to submit materials applicable to such a determination. Firms also are provided the right to a hearing once they receive a written notice of proposed determination.

- *Proposed Rulemakings on Authority to Designate Financial Markets Utilities as Systemically Important* – Section 804 of the Dodd-Frank Act provides FSOC with the authority to identify and designate as systemically important a financial market utility (FMU) if FSOC 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. On December 21, 2010, the Council published an ANPR regarding the designation criteria in section 804. The Council received 12 comments in response to the ANPR. 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. This process includes opportunities for a prospective FMU to submit materials in support of or opposition to a proposed designation. Consistent with statutory provisions, any designation of an FMU will require consent by the same supermajority and affirmative vote procedure described above for designation of nonbank firms. The Council must also engage in prior consultation with the Federal Reserve Board and the relevant federal financial agency that has primary jurisdiction over the FMU.

- *Systemic Risk Monitoring* – The Council and its committees are also making strides in providing a more systematic framework for identifying, monitoring, and deliberating potential systemic risks to the financial stability of the United States. Briefings and discussions on potential risks and the implications of current market developments – such as recent events in Japan, the Middle East, and Northern Africa – on financial stability are a key part of the closed deliberations of each Council meeting, allowing for a free exchange of information and insights. As part of these discussions, members assess the likelihood and magnitude of the risks, the need for additional data or analysis, and whether there is a current need to supplement or redirect current actions and supervisory oversight to mitigate these risks. In addition, the Council’s Data Subcommittee has overseen the development and production of a standard set of analyses that FSOC members receive prior to each Council meeting that summarize current conditions and

trends related to the macroeconomic and financial environment, financial institutions, financial markets, and the international economy.

- *Annual Systemic Risk Report* – Section 112 of the Dodd-Frank Act requires the FSOC to annually report to and testify before Congress on the activities of the Council; significant financial market and regulatory developments; potential emerging threats to the financial stability of the U.S.; all determinations regarding systemically important nonbank financial firms or financial market utilities or payment, clearing and settlement activities; any recommendations regarding supervisory jurisdictional disputes; and recommendations to enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets, to promote market discipline, and to maintain investor confidence. Work is under way in preparing the first of these reports and much of the aforementioned work on systemic risk monitoring will help shape its content. It is our understanding that Treasury plans to issue the report later this year.

## **V. Conclusion**

The Dodd-Frank Act has assigned FSOC important duties and responsibilities to help promote the stability of the U.S. financial system. The issues that the Council will confront in carrying out these duties are, by their nature, complex and far-reaching in terms of their potential effects on our financial markets and economy. Developing appropriate and measured responses to these issues will require thoughtful deliberation and debate among the members. The OCC is committed to providing its expertise and perspectives and in helping the Council achieve its mission.