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**TESTIMONY OF**  
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**OFFICE OF THE COMPTROLLER OF THE CURRENCY**  
**Before the**  
**COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS**  
**UNITED STATES SENATE**  
**May 12, 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 Johnson, Ranking Member Shelby, and members of the Committee, I appreciate the opportunity to provide an update on the Office of the Comptroller of the Currency's (OCC) implementation of the Dodd-Frank Act, and in particular, those provisions related to monitoring systemic risk and promoting financial stability, and on the operations and activities of the Financial Stability Oversight Council (FSOC).

As I described before this Committee in February, the OCC is actively working on approximately 85 Dodd-Frank Act projects. Broadly speaking, these projects fall into three major categories: our extensive efforts to prepare to integrate the OTS's staff and supervisory responsibilities into the OCC, and to facilitate the transfer of specific functions to the CFPB; our consultative role in a variety of rulemakings being undertaken by other agencies; and our own rule-writing responsibilities for implementing key provisions of the Act.

There are numerous provisions within the Dodd-Frank Act that address systemic issues that contributed to, or that accentuated and amplified the effects of, the recent financial crisis. These provisions include those that address flawed incentive structures and are designed to constrain excessive risk-taking activities; those that strengthen the resiliency of individual firms to financial shocks through stronger capital requirements and more robust stress-testing requirements; and those that address previous regulatory gaps, including the supervision of systemically important non-bank financial companies, and the orderly resolution of large banking organizations and non-bank financial companies in the event of failure. The OCC, along with other financial regulators, has rule-writing authority for many of these provisions, and I am pleased to report that we are

making good progress on our rulemaking efforts on these critical provisions. Since I last appeared before the Committee, the OCC and other agencies have issued notices of proposed rulemaking on the following provisions:

- Section 956, that prohibits incentive-based compensation arrangements that encourage inappropriate risk taking by covered financial institutions and are deemed to be excessive, or that may lead to material losses;
- Section 941, that addresses adverse market incentive structures by requiring a 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 by the agencies in their implementing regulations;
- Sections 731 and 764, that establish, for security-based swap dealers and major swap participants, capital requirements and margin requirements on swaps that are not cleared.

In my role as a director of the Federal Deposit Insurance Corporation, I also have approved the issuance of the FDIC's recent rulemakings under Title II of the Dodd-Frank Act related to its orderly liquidation authority.

Certainly one of the key provisions of the Dodd-Frank Act as it relates to systemic risk and financial stability, and the focus of my testimony today, is the creation of the Financial Stability Oversight Council. The FSOC brings together the views, perspectives, and expertise of Treasury and all of the financial regulatory agencies to identify, monitor, and respond to systemic risk. As my testimony will detail, Congress has 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 U.S., to promote market discipline, and to respond to emerging threats to the stability of the U.S. financial system.<sup>1</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 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. I would note that FSOC's activities and mandates complement the separate roles, responsibilities, and authorities that the OCC and other financial regulators have with respect to implementing specific provisions of the Dodd-Frank Act and more broadly in monitoring risks and conditions within the financial industry. For example, the OCC will continue to use our National Risk Committee and the insights we gain through our on- and off-site supervisory activities to identify, monitor, and respond to emerging risks to the banking system. We will, of course, also continue to share our insights and expertise with the FSOC in its deliberations.

While the process and systems that FSOC has created are positive steps forward, I would offer two cautionary notes.

First, 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

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

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, the OCC believes 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, 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, FSOC will provide 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.

The remainder of my testimony focuses on FSOC, with a discussion of the specific mandates Congress has given to the FSOC; its structure and operations; and finally its 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 U.S. that could arise from the material financial distress or failure, or ongoing activities, of large,

interconnected bank holding companies or non-bank 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>2</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 non-bank 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 U.S.<sup>3</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 U.S. 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>4</sup>

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<sup>2</sup> See section 112.

<sup>3</sup> See section 113(a)(1).

<sup>4</sup> See section 121.

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 non-bank financial companies.<sup>5</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>6</sup> proprietary trading and hedge fund activities;<sup>7</sup> the treatment of secured creditors in the resolution process;<sup>8</sup> and contingent capital for non-bank financial companies.<sup>9</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 non-bank financial companies and large, interconnected bank holding companies supervised by the Board.<sup>10</sup> The Federal Reserve, however, retains the authority to supervise and set standards for these firms.<sup>11</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

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<sup>5</sup> See section 112.

<sup>6</sup> See section 622.

<sup>7</sup> See section 619.

<sup>8</sup> See section 215.

<sup>9</sup> See section 115.

<sup>10</sup> See section 112.

<sup>11</sup> See section 165.

an existing or proposed accounting principle, standard, or procedure.<sup>12</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 U.S. The Council may also recommend to member agencies general supervisory priorities and principles<sup>13</sup> and issue nonbinding recommendations for resolving jurisdictional disputes among member agencies.<sup>14</sup>

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

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<sup>12</sup> See section 112.

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

<sup>14</sup> See section 119.

### **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 non-bank 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>15</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 U.S. The study concludes that the concentration

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<sup>15</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>.

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>16</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 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

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<sup>16</sup> A copy of the study is available at: <http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf>.

- 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>17</sup>

As I 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 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 Non-bank Financial Companies* – As noted earlier, in contrast to the Volcker

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<sup>17</sup> See: Financial Oversight Council, *Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds*, (January 2011) at 3.

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 non-bank 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, and staffs are in the process of reviewing the comments received and assessing how we should move forward with implementing this important provision of the Dodd-Frank Act. In response to concerns raised by commenters, there appears to be general agreement among the agencies on the need to provide and seek comment on additional details regarding FSOC's standards for assessing systemic risk before issuing a final rule. I fully support this decision. It is critical that FSOC 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. In this regard, consistent with statutory provisions, the designation of a non-bank 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 an 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 non-bank 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 U.S. 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 non-bank 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.
- *Consultative and Regulatory Coordination* – FSOC and its committees have also facilitated consultation and coordination on a number of important Dodd-Frank Act rulemakings. For example, Treasury played a coordinating role in the recently released notice of proposed rulemaking that would implement section 941 on credit risk retention, and is engaged in a similar role with respect to the Volcker rulemaking activities. As part of each Deputies Committee meeting, Treasury circulates a bi-weekly consultation report that provides a snapshot of pending rules for consultation. In this regard, the Council’s Resolution Authority/Resolution Plans Committee has provided input to the FDIC and FRB, and recommendations to the Council, on issues related to the various Title II rulemaking initiatives. These have included input on the FDIC’s and FRB’s recent joint rulemaking to implement resolution plan requirements for certain non-bank financial

companies and bank holding companies pursuant to Section 165(d) and the FDIC's rulemakings on its orderly liquidation authority pursuant to Section 209.

## **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.