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U.S. CHAMBER OF COMMERCE

Statement of the U.S. Chamber of Commerce

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

TO: The Subcommittee on Financial Institutions and Consumer Credit

DATE: May 16, 2012

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

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

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

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

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

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

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

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

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

1. Overview

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

3. Process Concerns

a. Lack of Transparency

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

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

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

b. Lack of Cost Benefit Analysis

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

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

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

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

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

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

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

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

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

c. Rules Considered Out of Order and Not Completed

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

[1] Executive Order 13563

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

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

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

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

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

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

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

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

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

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

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

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

d. Regulatory Coordination and Investor Uncertainty

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

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

4. Other Substantive Concerns

a. One Size Does Not Fit All

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

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

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

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

b. Federal Reserve Discretion

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

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

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

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

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

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

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

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

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

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

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

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

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

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

5. Conclusion

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

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

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