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TESTIMONY OF
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Before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER PROTECTION

COMMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

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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 Brown, Ranking Member Corker, and members of the Subcommittee, my name is Dave Wilson, and I am currently the Deputy Comptroller for Credit and Market Risk at the Office of the Comptroller of the Currency. In July, I will assume the position of Senior Deputy Comptroller for Bank Supervision Policy and Chief National Bank Examiner at the OCC. I appreciate the opportunity to discuss the OCC's perspectives on lessons learned from the financial crisis and our ensuing approach to bank supervision.

My testimony addresses four key areas. First, I briefly summarize some of the major factors that contributed to the financial crisis. Next, I discuss lessons learned from the crisis and specific steps the OCC is taking to incorporate those lessons learned into our bank supervision activities and practices. With this background, I then describe the OCC's overall approach to bank supervision -- our role as supervisors, and the efforts we are taking to ensure that as we implement needed supervisory enhancements and the reforms mandated by the Dodd-Frank Act, our supervision remains balanced, fair, and appropriately tailored to the size and risk of individual institutions. Finally, pursuant to the Subcommittee's request, I provide a brief update on small business and real estate lending, mortgage servicing, and trading.

II. Factors that Contributed to the Financial Crisis

Numerous studies and papers have been written that explore in depth the causes and factors that led to the recent crisis. Rather than catalog and summarize those findings, I want to offer my perspective, as a bank examiner and supervisor, on key precipitating factors that both supervisors and bankers failed to adequately recognize and mitigate.

In many respects, the seeds for the crisis were sown by the prolonged period of a relatively benign economy that fostered a market environment where investors, lenders, and supervisors became overly complacent about risk. This environment, characterized by low interest rates, strong economic growth, excess liquidity, and very low rates of borrower defaults spurred investors to chase yields, and U.S. mortgage-backed securities offered higher yields on historically safe investments. Hungry investors tolerated increased risk to obtain those higher yields, especially from securities backed by subprime markets, where yields were highest. This demand attracted new mortgage lenders and brokers many of whom had limited business experience or financial strength and operated outside of the commercial banking system and with

little regulatory oversight. Increased risk layering – in the form of smaller down payments, lower required credit scores, higher debt-to-income ratios, reduced documentation of income, and temporary reductions in monthly payments – became prevalent as lenders and borrowers became willing to finance and take on ever higher levels of debt, often on the belief that such debt could be easily refinanced or extinguished through the sale of underlying assets whose prices, it was assumed, would continue to escalate. The rapid increase in market share by unregulated brokers and originators put pressure on regulated banks to lower their underwriting standards, which they did, though not to the same extent as was true for unregulated mortgage lenders.

Investor demand for yield was also affecting the commercial leveraged loan market as many institutional investors were willing to accept increasingly liberal repayment terms, reduced financial covenants, and higher borrower leverage in return for marginally higher yields. The apparent risk to commercial banks' own loan portfolios was considered limited, because such banks and bank affiliates increasingly followed an "originate-to-distribute" model, syndicating most of these exposures for sale to institutional investors rather than holding them on their balance sheets for extended periods.

Compensation structures that rewarded loan production over loan quality placed added incentives for lenders to originate and produce loan products. Over time, product structures and funding mechanisms became more complex and opaque as underlying loans were repackaged, tranced, and further leveraged and financed in the form of various securitization and off-balance sheet funding conduits. Some of these structures, such as complex collateralized debt obligations, were poorly understood. Credit rating agencies and investors had a false sense of security that, no matter how poor the underwriting of the underlying asset, the risk could be adequately mitigated through geographic and product diversification, sufficient credit tranching, and other financial engineering. In many cases, the net result was poorly underwritten loans that financed longer-term assets and that were funded through short-term wholesale funds providers who, as it was later revealed, were extremely sensitive to real or perceived risks.

Smaller community banks were not immune from the build-up of risks occurring in the system. In particular, as the larger players increased their market shares in various retail credit products, such as residential mortgage loans and credit cards, community banks increasingly had to look elsewhere for profitable lending opportunities. For many community bankers, the

housing and attendant real estate boom provided a natural area for growth – CRE (commercial real estate) lending for construction and development. This was especially true in areas with vibrant housing markets, where home building was a key part of the regional economy. Because this type of lending puts more of a premium on knowledge of individual borrowers and local market conditions, this type of lending is often well-suited for community banks. However, many smaller banks became overly concentrated in this sector and a smaller, but not insignificant, number fueled their rapid CRE growth – often in areas outside of their home market – with short-term volatile funding sources.

Lax underwriting, excessive leverage, rapid growth, and concentrations are all too familiar refrains from past credit cycles and were symptoms that, with the benefit of hindsight, supervisors and market participants should have better mitigated at a much earlier stage. What amplified these factors from past cycles was the manner in which these excesses were spread and disbursed throughout the global financial system. When the subprime mortgage market began to collapse, the opaqueness of the more complex product and funding structures made it difficult for bankers, investors, funds providers, and supervisors to readily assess the nature and scope of potential risk exposures. This uncertainty contributed to an abrupt shift in risk tolerance by many market participants across the globe and served to compound losses as investors attempted to unwind positions. Secondary market liquidity for mortgages and leveraged loan products largely evaporated, leaving many larger banks with an unfunded pipeline of loan commitments that would require on-balance sheet funding. Likewise, short-term funding vehicles, such as asset-backed commercial paper conduits, became strained as investors increasingly chose not to roll over maturing paper, placing further strains on the balance sheets of banks that served as sponsors to such conduits. Bankers and supervisors underestimated the resulting rapidity and depth of the global liquidity freeze.

As various external funding sources evaporated, concentrations and correlations that bank risk managers believed had been diversified away became more apparent. For example, direct exposures to subprime mortgages that had been avoided in a bank's lending operations nonetheless emerged through bank affiliate activities and affiliate-sponsored off-balance sheet vehicles. Products, markets, and geographic regions that previously were looked to as a source of risk diversification became more highly correlated as contagion effects spread across the globe and industry sectors.

The resulting strains of the financial crisis have been felt by both large and small banks. While the initial impact was largely confined to the largest institutions that were heavily reliant on wholesale funding, as the economy continued to deteriorate, banks of all sizes faced higher loan losses, lower margins, and reduced profitability, and are only now showing signs of recovery.

III. Lessons Learned and Areas for Continued Improvement for Bank Supervision

The financial crisis underscored that no amount of financial engineering can obviate the need for bankers and bank supervisors to adhere to and monitor the basic precepts of sound banking practice: prudent underwriting practices throughout the credit cycle; strong risk management systems that identify and control the build-up of risk concentrations across products and business lines; diversified funding sources, adequate loan loss reserves, and strong capital cushions that allow the bank to continue its normal operations during downturns or funding strains; and strong corporate governance, including compensation structures, that set the tone for balanced and prudent risk taking. While these fundamentals are clearly important, they primarily focus on the risks within an individual banking organization. As the financial crisis highlighted, bankers, and more importantly supervisors, must develop better tools to evaluate and address emerging risks across the system and how those risks may be interconnected. Similarly, regulators need to take steps to restore greater transparency and accountability by all market participants – lenders, borrowers, and investors – to facilitate market discipline on excessive risk taking and dispel reliance on potential or perceived government backstops.

The sections that follow describe in some detail steps that the OCC has or is taking to address each of these areas. But let me begin by noting that while the OCC believes that these lessons are applicable for banks of all sizes, we are cognizant of the need to tailor our expectations to the scope and complexity of each bank's activities. As a result, our expectations for large banking organizations are generally more stringent and higher than for community banks whose scale of operations and complexity are considerably smaller. While we believe large banks must be held to higher standards, we do not subscribe to the view that big, in and of itself, is bad. Our country's economic well-being is inevitably linked to the global economy and if the U.S. financial system is to remain a predominant force in the global environment, we need to have banking organizations that can compete effectively with their global counterparts across

product and business lines. Similarly, as we institute reforms to address some of the problems and abuses stemming from the last crisis, we need be careful that we do not attempt to wring all the risk or complexity out of the banking system. Banks' fundamental role is risk intermediation, and financial innovation and expansion of credit are important drivers of our economy. Banks must be able to respond to customer and investor demand for new and innovative products and services. As corporations become more risk management savvy, so do their demands for risk management products, such as various derivative instruments. Similarly, as technology advances, the methods and ways that consumers choose to interface with banks will become more complex and varied. We must allow banks to respond to this changing landscape provided that they do so in a manner that is safe and sound and conducted with integrity.

A. Prudent Underwriting Throughout the Cycle

The financial crisis underscored that underwriting standards matter, regardless of whether loans are being originated to hold on the bank's own balance sheet or sold to third party investors. Supervisors and banking organizations must be more diligent in ensuring that underwriting standards are not compromised by competitive pressures from unregulated firms, by investors who may be willing to take on more risk for incremental yield, or by desire for rapid growth or market share in products or geographic regions.

In the immediate aftermath of the subprime crisis, the OCC cautioned national banks that they should apply sound, consistent underwriting standards regardless of whether a loan is originated with the intent to hold or sell. Likewise, we have admonished national banks not to compromise their underwriting standards due to competitive pressures. Where we see signs of such slippage, we are intervening at an early stage. For example, last June in response to signs of slippage that examiners were seeing in some leveraged loan facilities, we issued guidance to our examiners that reinforced our supervisory expectations for this type of lending and directed them to criticize or classify credits that exhibit minimal repayment capacity, excessive leverage or weak/nonexistent covenants, even when the credits had been recently advanced.

Because of the adverse impact that competitive pressures can have on underwriting standards, the OCC has been a strong proponent for national, uniform standards for certain lending products, most notably residential mortgage loans.

As we take steps to promote more consistent and uniform underwriting practices and standards and to lean in more forcefully when we see slippage either in the system or at individual banks, we are mindful of the need to strike an appropriate balance. Ensuring that banks remain safe and sound, while at the same time meeting the credit needs of their communities and customers is one of the OCC's core missions, and knowing when to bear down is one of the most fundamental calls that examiners and policy makers must make. Waiting too long or supervising too lightly will result in some banks using federally insured deposits to make unsafe loans that can ultimately cause them to fail. On the other hand, supervising too strictly or inconsistently can cause banks to become too conservative and deny loans to creditworthy borrowers.

Since the onset of the financial crisis, the OCC has taken a number of actions to improve our ability to objectively monitor trends in credit quality and underwriting standards to help us determine when stronger supervisory intervention is needed. These actions supplement our more traditional tools of on-site examinations, the annual interagency Shared National Credit review, and the OCC's annual underwriting survey. In 2009, we began collecting and analyzing detailed loan-level data on home equity, credit card, CRE, and large corporate syndicated credits at some of the largest national banks. This effort builds off of the highly valuable Mortgage Metrics data project that the OCC initiated in 2008 and provides us with much more granular level data than could be collected cost-effectively through the Call Report. This comprehensive loan-level credit data allows us to conduct comparative analysis of credit risk across large banks in a timelier manner and to identify potential systemic risk issues. In addition, these large comprehensive data sets provide us with the ability to conduct more forward-looking analyses to determine what could happen to credit quality under varying economic scenarios and assumptions. A key focus of our large bank examination and policy staff will be to identify and institutionalize critical underwriting metrics and related benchmarks so that we can objectively track the migration of practices over the course of future credit cycles. By limiting our data collection to the largest players, we are able to develop a system-wide view while minimizing undue reporting and compliance costs on smaller institutions.

For smaller institutions, our emphasis has been more tailored and focused on ensuring that these banks effectively recognize and manage the inherent concentrations that they may have in their lending portfolios. These efforts have included targeted examinations of key

portfolios, most notably CRE portfolios, and providing examiners and bankers more analytical tools to assess how stresses in external market factors may affect those portfolios.

B. Strong Risk Management Systems that Identify and Control Risk Concentrations

The financial crisis exposed weaknesses in many banks' risk management systems and models. In many cases, risk concentrations accumulated undetected across products, business lines, and legal entities within an organization. Complex product structures and various off-balance sheet funding structures obfuscated certain exposures and risks. Credit risk models relied too heavily on historical correlations and did not adequately address their risk exposures to highly-rated CDOs and other structured securities. Similarly, banks' internal stress tests failed to fully capture the risks that could be posed from various "tail" events and from off-balance sheet structures that were legally separate from the firm, but that the firm ultimately supported in order to maintain relationships with counterparties, funds providers, and investors. Many stress tests failed to fully estimate the potential severity and duration of stress events or focused on a single line of business.

Strengthening risk management practices and institutionalizing more robust and enterprise-wide stress testing has and continues to be a point of supervisory emphasis, particularly at the largest national banks. Given the need to implement such practices across the entire banking organization, we are working closely with our colleagues at the Federal Reserve on many of these efforts.

Given the importance and the role that these large institutions play in the overall financial stability of the U.S., we have instructed our examiners that these organizations should not operate with anything less than strong risk management and audit functions – anything less will no longer be sufficient. To build out this capability, examiners are directing these banks to improve their risk concentration aggregation and stress testing processes, requiring more robust model validations, and stepping up their challenges of quantitative models and the key assumptions supporting those models. These examiner directives have been supplemented with supervisory guidance, including the enhanced risk management requirements adopted by the Basel Committee for banks operating under the Basel II capital framework. Critics of Basel II have focused on the potential for an internal-models-based approach to produce lower capital charges for certain portfolios, a concern that has been addressed in the past year by substantial strengthening of the framework and the increased capital levels under Basel III. Meanwhile, the

great benefit of the framework has been, and remains, its requirement for more stringent and robust risk management standards at applicable banks. The compliance costs associated with the Basel II advanced approaches rule is one reason why the OCC and other U.S. banking agencies limited its mandatory application to the largest U.S. banking organizations.

More recently, in April, the OCC and Federal Reserve issued guidance on model risk management that expands upon the OCC's previous guidance on model validation. The guidance articulates the elements of a sound program for effective management of risks that arise when using quantitative models in bank decision making. It also provides guidance to OCC examining personnel and national banks on prudent model risk management policies, procedures, practices, and standards. Last week, the OCC, Federal Reserve, and FDIC issued for comment *Proposed Guidance on Stress Testing for Banking Organizations with More than \$10 Billion in Total Consolidated Assets*. This joint interagency guidance outlines high-level principles for stress testing practices, applicable to all banking organizations with more than \$10 billion in total consolidated assets. The proposed guidance highlights the importance of stress testing as an on-going risk management practice that supports a banking organization's forward-looking assessment of its risks. It outlines broad principles for a satisfactory stress testing framework, and describes the manner in which stress testing should be employed as an integral component of risk management. While not intended to provide detailed instructions for conducting stress testing for any particular risk or business area, the proposed guidance describes several types of stress testing activities and how they may be most appropriately used by banking organizations. Although the guidance does not explicitly address the stress testing requirements imposed upon certain companies by section 165 (i) of the Dodd-Frank Act, the agencies anticipate those provisions, to be addressed in a future rulemaking, will be consistent with the principles in the proposed guidance.

As with other risk management practices, the OCC believes certain aspects of stress testing – such as scenario analysis of key portfolios – can also be a valuable tool for smaller banks. Thus, as previously noted, we have been working with community bankers to improve their ability to stress test CRE and other highly concentrated and volatile portfolios. For example, we have instructed banks that their stress testing of CRE transactions should consider the effect of multiple variables (e.g., changes in interest rates, vacancy rates, and capitalization rates), and that such stress tests should be performed periodically throughout the life of the loan.

To assist community bankers in identifying and assessing potential CRE vulnerabilities, we developed, and have made available via our National BankNet Web site, loan level CRE stress testing tools that bankers can use. We also have developed a portfolio level model, which our examiners are now testing. Our intent is to also publish this on BankNet after proper validation. In addition to these tools, we provide examiners with access to various market databases that allow them to monitor and analyze CRE trends by major geographies and product types and are developing additional tools that they can use in their discussions with bank management about potential concentrations.

While more robust stress testing and improved risk management can help identify and mitigate the risks arising from concentrations, the financial crisis illustrated that there may be some types and levels of concentrations that, in a severe or protracted downturn, may simply be too large for a bank to absorb. Indeed, a common thread in the vast majority of bank failures in both this and previous credit cycles has been a concentration in certain types of CRE lending. Many of these banks had other risk management weaknesses that accentuated their CRE problems; however, some banks that had sound underwriting and internal controls for the CRE operations nonetheless failed due to their level of concentrations to this sector and the cascading effects that the downturn had on their borrowers and projects. This is the primary reason why we are directing smaller banks with these types of concentrations to shore up their capital base and to maintain capital levels above required regulatory minimums. Consistent with the GAO's recent report on CRE concentrations, we are continuing to assess and discuss with our supervisory colleagues whether additional clarification on supervisory expectations or other measures, such as more explicit limits, capital requirements, or triggers within the Prompt Corrective Action framework may be warranted to address the risks posed by excessive concentrations.

C. Diversified Funding, Strong Capital Cushions, and Adequate Loan Loss Reserves

In periods of severe financial stress, having sufficient liquidity, loan loss reserves, and capital become paramount in ensuring a bank's continued operations. Each of these components of a strong balance sheet had weakened in the years preceding the crisis.

As previously noted, many banks – both large and small – relied excessively on short-term and volatile funding sources to expand and fuel their growth. As banks competed for short-term profits and higher margins, traditional sources of asset-based liquidity, such as short-term,

readily marketable securities were replaced with less liquid assets that offered higher yields. Many banks' liquidity plans assumed that there would be a continuously ready market for highly-rated assets that could provide liquidity and likewise failed to fully anticipate the liquidity demands resulting from their "originate to distribute" loan pipelines or off-balance sheet conduits. This combination of factors – undue reliance on short-term liabilities, little asset liquidity, and a growing accumulation of off-balance sheet assets that would require funding – proved disastrous for some firms when the short-term funding markets abruptly shut down in 2007.

Similarly, the crisis clearly demonstrated that common equity is superior to other capital instruments in its ability to absorb losses on a going-concern basis. Hybrid capital instruments that paid cumulative dividends and/or had a set maturity date had become an ever-larger proportion of the capital base for bank holding companies of all sizes, but were found lacking. While many banks hold innovative instruments that would have permitted them to defer or cancel dividends, during the financial crisis many banks did not exercise this option, which could have preserved liquidity and capital, for fear that such actions would reinforce market perceptions of the bank's weakened financial condition. Many non-U.S. banks even exercised call options to redeem hybrid instruments for fear that failure to do so would send strong market signals about the deteriorating condition of the bank.

Correcting these shortcomings has been the focus of considerable work by the OCC and other regulators and, as Acting Comptroller Walsh noted in his testimony before the full Committee in February, is the objective of various provisions of the Dodd-Frank Act.¹ The hallmark of this work internationally has been the enhanced and more stringent global capital and liquidity standards for large, internationally active banks adopted by the Basel Committee, known as Basel III. These reforms, when integrated with the various capital and liquidity provisions of Dodd-Frank will materially affect the level and composition of capital and liquidity for large banks. Together, these reforms tighten the definition of what counts as regulatory capital; expand the types of risk captured within the regulatory capital framework; increase overall capital requirements; establish an international leverage ratio applicable to global financial institutions that constrains leverage from both on- and off-balance sheet exposures; and

¹ See: Testimony of John Walsh, Acting Comptroller of the Currency, before the Committee on Banking, Housing and Urban Affairs of the United States Senate, February 17, 2011.

provide for a more balanced consideration of financial stability in bank supervision practices and capital rules. The Basel reforms also introduce global minimum liquidity standards that set forth explicit ratios that banks must meet to ensure that they have adequate short-term liquidity to offset cash outflows under acute short-term stresses and maintain a sustainable maturity structure of assets and liabilities.

Since the Basel III enhancements can take effect in the U.S. only through formal rulemaking by the banking agencies, U.S. agencies have the opportunity to integrate certain Basel III implementation efforts with the heightened prudential standards required by the Dodd-Frank Act. Such coordination in rulemaking will ensure consistency in the establishment of capital and liquidity standards for similarly situated organizations, appropriately differentiate relevant standards for less complex organizations, and consider broader economic impact assessments in the development of these standards. Beyond the Basel III reforms, we have been directing banks of all sizes to improve their capital planning and liquidity risk management processes to ensure their ability to adequately fund and support anticipated growth and withstand unforeseen events. As part of this effort, we expect all banks to maintain a contingency funding plan that sets forth the bank's strategy for addressing unexpected liquidity shortfalls.

One of the most striking sidebars in the story of the financial crisis is the unprecedented speed with which once well-capitalized institutions succumbed to their credit losses. One reason for this is that banks held historically low levels of loan-loss reserves coming into the current recession. We agree with the findings and recommendations of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) Financial Crisis Advisory Group on the need to amend accounting standards that contributed to the delayed recognition of losses on loans. Specifically, the accounting rules and the way they were applied made it difficult for bankers to reserve for losses that could be reasonably anticipated. The result was that when subsequent charge-offs on impaired loans did occur, the loan loss reserves were not there to support them, and higher provision levels reduced capital. This accelerated the spiral into insolvency for many financial institutions. As the FASB and IASB (collectively, the Boards) have recognized, this emphasizes the need for a revised accounting model for more adequate loan losses to supplement the strong capital cushions required by prudential regulators. The OCC has been a strong proponent of this need to make the loan loss allowances more forward looking so that banks can appropriately build their reserves when inherent credit risk is

increasing, rather than waiting until loan problems are obvious. The OCC has been actively engaged in efforts by the Boards to revise the current impairment model for recognizing loan losses to provide for more forward-looking reserves. As part of this effort, OCC staff has served as the U.S. banking agencies' representative on the IASB's Expert Advisory Panel on Impairment and participated in various educational sessions as well as drafting interagency and Basel Committee comments to the Boards on this issue.

A challenge we and the industry face as implementation of these and other reforms mandated by the Dodd-Frank Act move forward is assessing their potential interaction and cumulative impact on banks' business models and strategic plans. While we support efforts to raise and strengthen capital and liquidity cushions, these standards must be reflective of the underlying risks and not become so excessive that they serve to promote rather than discourage risk-taking. In addition, we are concerned that some of the parameters underlying the Basel III liquidity standards are excessively conservative and, if implemented in their current form, could unnecessarily impede banks' balance sheet capacity for lending activities.

D. Strong Corporate Governance

The financial crisis highlighted that risk management is, and must be, more than simply a collection of policies, procedures, limits, and models. Effective risk management requires a strong corporate culture and corporate risk governance. This culture must be set, embraced, and enforced by the bank's board of directors and its senior management, and it must permeate all of the bank's activities. This is a point of emphasis in all of our meetings with senior management teams and directors. We are reminding bank directors that they should not be passive bystanders and should be willing and able to provide credible challenges to bank management on key issues and strategic plans. Informed directors are well positioned to engage in value-added discussions that provide knowledgeable approvals, guidance to clarify areas of uncertainty, and prudently question the propriety of strategic initiatives, human capital decisions (including compensation arrangements), and the balance between risk taking and reward.

Fulfilling these roles and responsibilities can be especially challenging for directors at smaller institutions who may have fewer resources or outside expertise to assist them. To assist them in this task, we offer a comprehensive series of director workshops, taught by some of our senior supervisory staff. These workshops, offered throughout the year in various locations across the country, cover four topics: a director's fundamental responsibilities, risk assessment,

compliance risk, and credit risk. Participants receive an extensive package of resources, including a pre-course reading packet, course materials, a CD containing selected OCC Web and telephone seminars, and other supporting materials.

A key component of prudent corporate governance is the establishment of well-defined and understood risk tolerances and limits. At larger banks, the science of defining and measuring risk tolerance levels has typically been confined to the business unit and more micro levels of the organization. While these lower level risk limits are generally effective in controlling individual areas of risk taking, they do not enable senior management or board members to monitor or evaluate concentrations and risks on a firm-wide basis. Consequently, we are directing larger banks to complement existing risk tolerance structures with more comprehensive measures and limits of risk addressing the amount of capital or earnings that may be at risk on a firm-wide basis, including the amount of risk that may be taken in each line of business, and the amount of risk that may be taken in each of the key risk categories monitored by the banks. For banks of all sizes, we are emphasizing the need for sound enterprise-wide asset-liability management systems that identify, monitor, and effectively limit the bank's liquidity and interest rate risks exposures. As part of our on-going supervisory process, we are reviewing compliance with these directives.

As previously noted, flawed incentive compensation practices in the financial industry were among the factors contributing to the financial crisis. To address this issue, in June 2010, the OCC and other federal banking agencies issued guidance on sound incentive compensation policies and practices. Key tenets of that guidance are that such practices should appropriately balance risk and reward; be compatible with effective controls and risk management; and be supported by strong corporate governance, including active and effective oversight by the organization's board of directors. In April, the OCC and other regulators issued proposed rules to implement the incentive-based compensation provisions of section 956 of the Dodd-Frank Act. This rule would build upon the agencies' June 2010 guidance by requiring the reporting of certain incentive-based compensation arrangements and prohibit incentive-based compensation arrangements that provide excessive compensation or that could expose the institution to inappropriate risks that could lead to material financial loss. Consistent with the statute, institutions with less than \$1 billion in assets would not be subject to this rule.

E. Identifying, Assessing, and Addressing Emerging Risks Across the Financial System

As I noted earlier, the financial crisis demonstrated the need for supervisors to improve their ability to identify, assess, and address emerging risks not only within a banking organization, but across the banking and broader financial system. Strengthening supervisors' ability to identify and respond to emerging systemic risks is clearly a key objective of the Dodd-Frank Act and a core mission of the FSOC. Beyond the measures provided for by the Dodd-Frank Act and the activities being conducted through the FSOC and its various staff committees, the OCC has taken a number of steps to enhance our ability to identify and respond to risks across the industry and financial system.

As previously noted, we are now obtaining granular, loan level information on key credit portfolios from the largest national banks to help identify underwriting and performance trends across the system. We have also developed a liquidity risk monitoring program to standardize liquidity monitoring information across 15 of the largest national banks and to provide more forward looking assessments of liquidity mismatches and capacity constraints that could signal future problems. We also have established network groups among our examiners at large national banks to facilitate information sharing and promote consistent supervisory actions for nine key risk areas.

In 2008, we established a Financial Markets Group within the agency and tasked it with the build-out of a market intelligence program. Their mission is to seek out early warning signs of emerging and systemic risk issues. This team is comprised of highly experienced bank examiners and subject matter specialists, and they spend considerable time meeting with bank investors, bank counterparties, bank analysts, and other relevant stakeholders to gain insights on emerging trends. To support the work of the OCC's National Risk Committee (NRC), this group has also developed a dashboard of metrics that provide early indicators of the build-up of risks within the system that may signal the need for firmer supervisory intervention at a juncture when such action can be modulated and most effective. These metrics are designed to provide warning signs before risks become manifested in market performance such as prolonged periods of low volatility that can promote complacency among investors and bankers and lead to excessive risk taking. While any one metric would be insufficient grounds for firmer intervention, warning signals across a number of measures will trigger a more formal review and assessment of the

risks and the need for appropriate supervisory response by the OCC's NRC and Committee on Bank Supervision.

F. Restoring Transparency and Market Discipline

The problems that supervisors and market participants faced when trying to assess the nature and scope of exposures in complex structured products, off-balance sheet funding vehicles, derivatives, and trading strategies have been well documented. In many cases these challenges were further exacerbated by complex organizational structures of individual firms.

Providing greater transparency in financial statements has been a key objective of recent proposals by the FASB, and the OCC has provided its views and expertise on these proposals. One of the most significant revisions, as it pertains to various securitization and off-balance sheet funding vehicles that were prevalent before the crisis, has been the adoption and implementation of revisions to the Accounting Standards Codification (ASC) Topic 860, *Transfers and Servicing*, and ASC Topic 810, *Consolidation* (through Statements No. 166, *Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140*, No. 167, *Amendments to FASB Interpretation No. 46(R)*). As a result of these statements, many securitized assets must now be reflected on banks' balance sheets. The OCC and other federal banking agencies have amended the agencies' risk-based capital rules to be consistent with these accounting changes. Many of the derivatives-related provisions of the Dodd-Frank Act will likewise provide greater transparency through increased disclosures and more extensive use of central counterparties or clearinghouses.

The combined provisions of Titles I and II of the Dodd-Frank Act that provide the authority to extend the Federal Reserve's supervisory oversight of certain non-bank financial companies and for the orderly liquidation of failing financial companies that pose significant risk to the financial stability of the U.S., are critical tools in restoring market discipline and accountability for large financial firms. Through FSOC, the OCC is actively engaged in efforts to implement these provisions.

As problems in the mortgage market have vividly demonstrated, improved transparency and disclosures about the terms, costs, and risks of retail banking products are critical to promote informed consumer choice and responsibility. We have long supported that goal and applaud the Consumer Financial Protection Bureau's initiative to start this process through the testing of revised residential mortgage disclosure forms.

IV. OCC's Supervisory Approach – Balanced Supervision, Tailored to Risks

The OCC's core mission is to assure the safety and soundness of the institutions subject to our jurisdiction and to ensure that those institutions support fair access to financial services and fair treatment of their customers. We carry out this mission through our on-going supervisory activities. Through these activities we evaluate banks' compliance with applicable laws, regulations, and supervisory requirements, and we assess whether they have adequate risk management systems, controls, and capital to support the size, scope, and complexity of their activities. Where we find weaknesses or violations, we direct management to take appropriate and timely corrective action. Provided that the bank has the requisite corporate governance, risk management, and capital infrastructure to support risk taking, it is not the job or role of an examiner to determine whether or what lines of business, products, or strategic focus is appropriate – these are decisions that the bank's board must make. Likewise, examiners do not tell bankers which loans to make or deny. However, they will assess whether such loans have been prudently underwritten, properly risk-rated, and, if any show signs of trouble, are appropriately classified and reserved for.

As I previously noted, one of the most difficult jobs we have in carrying out this mission is knowing when and how hard to tap on the brakes to rein in excessive risk taking without causing bankers to become so conservative or uncertain about regulatory actions that they unduly restrict credit. We are acutely aware that our actions – both on the policy side at the 50,000 foot level, and on the ground, through our on-site examinations – can and do influence banks' behavior and their appetite for taking risk. We also recognize that in past downturns, many believed that overzealous regulators and examiners exacerbated the contraction in credit.

One of the lessons we learned is the detrimental effect of waiting too long to warn the industry about excesses building up in the system, resulting in bankers and examiners slamming on the brakes too hard when the economy experienced problems. This is one reason why we are working to develop better tools that will enable us to identify signs of accelerating risk taking at an earlier stage when our actions can be more modulated. We know that it is critical that our expectations for bankers be clear and consistent, that the “rules of the game” under which banks operate not be changed abruptly, and that changes in regulatory policies are made in an open and transparent manner that provides bankers with reasonable timeframes to make necessary

adjustments. This will be especially true as bankers try to absorb and comply with the myriad of rules and regulations that will result from the implementation of the Dodd-Frank Act.

We are particularly mindful that new or changing regulatory requirements can often have a disproportionate cost and burden on community banks due to their limited size and resources. For this reason, as we develop regulations, supervisory policies, and examination standards, we strive to provide sufficient flexibility in the application of those standards to reflect the size and complexity of the institution. As the complexity and scope of a bank's activities and its potential impact on the financial system increases, so do our expectations for their internal controls and risk management systems.

To provide consistency and continuity in our supervision, we organize our supervision programs around a common framework and national perspective that is then supplemented by the hands-on knowledge of our examiners. Our supervision by risk framework establishes a common examination philosophy and structure that is used at all national banks. This structure includes a common risk assessment system (RAS) that evaluates each bank's risk profile across eight risk areas – compliance, credit, interest rate, liquidity, operational, price, reputation, and strategic – and assigns each bank an overall composite rating and component ratings on the bank's capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risks using the interagency Uniform Financial Ratings System (informally known as CAMELS). Specific examination activities and supervisory strategies are tailored to each bank's risk profile. These strategies are updated and approved annually. While tailored to each individual bank's risk profile, they also incorporate key agency supervisory priorities for the coming year.

To reflect the different expectations for controls and risk management between large and small banks, our bank supervision programs and core examination procedures to determine a bank's RAS and CAMELS ratings are aligned across two primary lines of business: Midsize and Community Bank Supervision, and Large Bank Supervision. Upon full integration of OTS, we will align federal thrifts into these lines of business.

Our community bank supervision program is built around our local field offices located in over 60 cities throughout the U.S. Every national community bank is assigned to an examiner who monitors the bank's condition on an on-going basis and who serves as the focal point for communications with the bank. The primary responsibility for the supervision of individual community banks is delegated to the local Assistant Deputy Comptroller, who is under the

oversight of a district Deputy Comptroller, who in turn, reports to our Senior Deputy Comptroller, Jennifer Kelly. The frequency of our on-site examinations for community banks follows the statutory provisions set forth in 12 USC 1820(d), with on-site exams occurring every twelve to eighteen months. The scope of these examinations is set forth in the OCC's Community Bank Supervision handbook and requires sufficient examination work and transaction testing to complete the core assessment activities in that handbook, and to determine the bank's RAS and CAMELS ratings. On-site activities are supplemented by off-site monitoring and quarterly analyses to determine if significant changes have occurred in the bank's condition or activities.

Our Large Bank program is organized with a national perspective. It is centralized and headquartered in Washington, and structured to promote consistent uniform coordination across institutions. As part of our Large Bank Supervision program, we maintain on-site resident examination staff that conducts on-going supervisory activities and targeted examinations of specific areas of focus. This process allows the OCC to maintain an on-going program of risk assessment, monitoring, and communication with bank management and directors. Given the volume and complexity of the literally hundreds of thousands of transactions that flow through large banking organizations, it is not feasible to review every transaction in each bank, or for that matter, every single product line or bank activity in each supervisory cycle. Nonetheless, as in our community bank examinations, examiners must complete sufficient work and transaction testing throughout the year to complete the core assessment activities set forth in the OCC's Large Bank Supervision handbook, and to determine the bank's RAS and CAMELS ratings. The on-site teams at each bank are led by an Examiner-in-Charge, who reports directly to the Deputy Comptrollers in our Large Bank Supervision Office, and in turn, to our Senior Deputy Comptroller, Mike Brosnan.

In January 2010, we updated and revised our RAS system as it applies to both community and large banks to reflect and incorporate lessons learned from the financial crisis. We also have directed examiners to be more forward looking when they are assessing and assigning RAS ratings. Specifically, when assessing direction of risk for all risk categories, examiners should consider current practices in the bank and how those practices, combined with other quantitative and qualitative factors, affect direction of risk over the next 12 months. For example, the direction of credit risk may be increasing if a bank has relaxed its underwriting standards during

a strong economic cycle, even though the volume of troubled credits and credit losses remain low. Similarly, the direction of liquidity risk may be increasing if a bank has not implemented a well-developed contingency funding plan during a strong economic cycle, even though existing liquidity sources are sufficient for current conditions. We will be reinforcing this message with our examination staffs at our upcoming staff conferences in July that will bring together all of our examination staffs across our lines of business and those examiners who are joining the OCC from the Office of Thrift Supervision.

In both our Midsize and Community Bank Supervision and Large Bank Supervision programs, we have mechanisms in place to ensure that our supervisory policies and procedures are applied in a consistent and balanced manner. Every report of examination is reviewed and approved by the responsible ADC or Deputy Comptroller before it is finalized. Both units have formal quality assurance processes that assess the effectiveness of our supervision and compliance with OCC policies. Our examination force is kept abreast of emerging issues and supervisory policies through weekly email updates and periodic nation-wide conference calls, team meetings, and staff conferences.

A key element of the OCC's supervisory philosophy is open and frequent communication with the banks we supervise. In this regard, our senior management teams encourage any banker that has concerns about a particular examination finding to raise those concerns with his or her examination team and with the district management team that oversees the bank. Should a banker not want to pursue those chains of communication, our Ombudsman's office provides a venue for bankers to discuss their concerns informally or to formally request an appeal of examination findings. The OCC's Ombudsman is fully independent of the supervisory process, and he reports directly to the Comptroller. In addition to hearing formal appeals, the Ombudsman's office provides bankers with an impartial ear to hear complaints and a mechanism to facilitate the resolution of disputes with our supervisory staff.

The OCC also recognizes the importance of communicating regularly with the industry outside of the supervision process to clarify our expectations, discuss emerging issues of interest to the industry, and respond to bankers' concerns. We participate in numerous industry-sponsored events, as well as conduct a variety of outreach activities, including Meet the Comptroller events, chief executive officer roundtables, and teleconferences on topical issues.

V. Current State of Small Business and Real Estate Lending, Mortgage Servicing, and Trading Lines of Business

The Subcommittee's letter of invitation noted the uncertainty that remains in small business and real estate lending, mortgage servicing, and trading, and requested the OCC's views on the state of those business lines. Let me conclude with a brief overview of each.

A. Small Business Lending

National banks are significant providers of small business credit, but discerning trends in small business lending is difficult due to the variety of lending facilities that small business owners use for financing. One proxy for a portion of small business lending is the data collected in the quarterly Call Reports on commercial and industrial loans in amounts less than \$1 million and agricultural loans less than \$500,000. In the last few years, the outstanding balance of these loans has declined, reflecting both demand and supply factors. Mirroring trends in the broader economy, demand for credit by many businesses has weakened as both businesses and their consumers have scaled back spending and investments. It is also true that some bankers, in response to deteriorating credit and economic conditions, have become more risk averse and selective in their lending.

The OCC recognizes the important role of small businesses in the economy, their dependence on banks for credit, and the difficulty that some small business owners have reported in obtaining new credit or renewing existing credit. In response to these concerns, in February 2010, the OCC and other federal banking agencies issued a statement on creditworthy small businesses. The statement is intended to facilitate small business lending and provide bankers with more regulatory certainty by outlining our expectations for prudent underwriting practices. In this statement and in our on-going discussions with examiners and bankers, we reiterate our policies that we encourage bankers to lend to creditworthy borrowers and to work constructively with borrowers who may be facing difficulties, and that examiners should take a balanced approach and not criticize banks that follow sound lending practices.

We actively encourage national banks to participate in various government programs that are designed to support small business lending. These include the Small Business Administration loan guarantee programs and the \$30 billion Small Business Lending Fund program established as part of the Small Business Jobs Act of 2010. To-date approximately 106

national banks have applied for this program, and we are in the process of providing Treasury with information to assist them in evaluating those requests.

There is some evidence that credit conditions for small business lending are improving. In our recent annual credit underwriting survey, a few respondents have eased small business underwriting standards in anticipation of market growth and an opportunity to compete. Just over half of the banks in the survey are planning to grow their small business lending portfolio greater than 10 percent over the next year. Many of the largest national banks have revamped and built up their small business lending operations.

Despite these positive signs, the on-going lack of sales revenue and widespread uncertainty about the economy continue to hamper small business owners' sentiments and bankers' ability to develop loan growth in this market segment. In its May 2011 report on small business economic trends, the National Federation of Independent Business (NFIB) stated credit supply was not the problem for the overwhelming majority of small business owners and that weak sales and uncertainty continue to be major factors for the lack of credit demand.² This uncertainty is reflected in the NFIB's small business optimism index: while this index has bounced back from the 2009 lows, its level has declined in March and April.³

B. Real Estate Lending

Commercial real estate lending is a prominent business line for many national banks and is a sector that the OCC monitors very closely. While there are signs that the commercial real estate markets are beginning to stabilize, we are a long way away from a full recovery. Vacancy rates across all major property types are starting to recover, but remain high by historical standards. We expect vacancy rates to remain elevated and recovery to be slow.

Capitalization rates – the rate of return demanded by investors – have also shown recent signs of stabilization. Cap rates fell substantially from 2002 through 2007 to a point where they often did not fully reflect the risks associated with the properties being financed. Then they increased markedly in 2008 and 2009 as investors became more risk averse. Recently, cap rates appear to have stabilized, particularly for high quality assets, but the spreads being demanded by investors, relative to Treasuries, for lower quality assets remain wide.

² See: NFIB Small Business Economic Trends, May 2011, pg 2.

³ Ibid, pg. 4.

A key driver for property values and CRE loan performance is the net operating income (NOI) – or cash flows – generated by the underlying commercial properties. Overall, NOI has continued to decline due to soft rental rates. While we expect the rate of decline to lessen, only apartments are expected to show meaningful NOI growth this year, with other major market segments expected to turn positive in 2012.

Property prices have also shown some signs of stabilization. Although the Moody's All Property Index recorded a decline of 4.2 percent in March 2011, transaction volumes have increased. We expect volatile prices until underlying market fundamentals improve consistently.

The trends and performance of CRE loans within the national banking system mirror those in the broader CRE market. While there are signs of stabilization in charge-off rates and a decline in non-performing loans, levels remain elevated and continue to require significant attention by bank management and supervisors. The effect of the distressed CRE market on individual national banks varies by the size, location, and type of CRE exposure. Because charge-off rates for construction loans led performance problems in the sector, banks with heavier concentrations in this segment tended to experience losses at an earlier stage. Performance in this segment is expected to improve more rapidly as the pool of potentially distressed construction loans has diminished. In contrast, performance of income-producing commercial mortgages continues to be more stressed and one that we continue to monitor closely.

C. Mortgage Servicing

As the Subcommittee's letter of invitation references, the mortgage servicing business is also under severe stress. Its business model was already challenged by the mortgage crisis, and that challenge is now compounded by widespread deficiencies in foreclosure processing. Through our recent consent orders, the OCC is focused on fixing the very serious problems we found in foreclosure processing; ensuring that any borrowers harmed by shoddy practices receive appropriate remedies; and getting mortgage markets operating again. Yet as Acting Comptroller Walsh recently noted in his remarks before the Housing Policy Council of the Financial Services Roundtable, additional challenges and uncertainties loom ahead for this line of business.⁴ The new Basel III framework will require that servicing rights beyond relatively modest levels be

⁴ See: Remarks by John Walsh, Acting Comptroller of the Currency, Before the Housing Policy Council of The Financial Services Roundtable, May 19, 2011, available at: <http://www.occ.gov/news-issuances/speeches/2011/pub-speech-2011-60.pdf>.

deducted from capital for regulatory capital calculations, effectively increasing the capital requirements for mortgage servicers. The Dodd-Frank Act will impose a myriad of new requirements that mortgage lenders will need to address. As the Acting Comptroller noted, while each of these requirements individually have merit, it is hard to predict how all of these requirements will work together.

In addition to the requirements of Dodd-Frank, an important area for reform in the mortgage servicing business is the need for uniform mortgage servicing standards that apply to all facets of servicing the loan, from loan closing to payoff. A number of months ago, to further this effort and interagency discussions, the OCC developed a framework for comprehensive mortgage servicing standards that we shared with other agencies, and other agencies put forward their recommendations as well. We now have underway an active interagency effort to develop a set of comprehensive, nationally applicable mortgage servicing standards. As an example, these standards would address:

- Handling borrower payments, including applying payments to principal and interest and taxes and insurance before they are applied to fees, and avoiding payment allocation processes designed primarily to increase fee income;
- Providing adequate borrower notices about their accounts and payment records, including a schedule of fees, periodic and annual statements, and notices of payment history, payoff amount, late payment, delinquency, and loss mitigation;
- Providing an easily accessible single point of contact for borrower inquiries about loss mitigation and loan modifications;
- Ensuring appropriate levels of trained staff to meet current and projected workloads;
- Responding promptly to borrower inquiries and complaints, and promptly resolving disputes;
- Providing an avenue for escalation and appeal of unresolved disputes;
- Effective incentives to work with troubled borrowers, including early outreach and counseling;
- Making good faith efforts to engage in loss mitigation and foreclosure prevention for delinquent loans, including modifying loans to provide affordable and sustainable payments for eligible troubled borrowers;

- Implementing procedures to ensure that documents provided by borrowers and third parties are maintained and tracked so that borrowers generally will not be required to resubmit the same documented information;
- Eliminating “dual track” processes where legal steps to foreclose on a property or conduct a foreclosure sale go forward even when a borrower has completed an application for a loan modification or is in a trial or permanent modification and is not in default on the modification agreement;
- Notifying borrowers of the reasons for denial of a loan modification, including information on the NPV calculation; and
- Implementing strong foreclosure governance processes that ensure compliance with all applicable legal standards and documentation requirements, and oversight and audit of third party vendors.

While we are at an early stage in this interagency process, the OCC is optimistic that the agencies can achieve significant reforms in mortgage servicing practices across the board for all types of mortgage servicing firms. These types of standards should help put the mortgage servicing business on sound footing for the future.

D. Trading Activities

Trading revenues in the banking system have been quite strong, as the industry reported record trading revenues in both 2009 and 2010. After a loss of \$836 million in 2008, insured commercial banks reported trading revenues of \$22.6 billion and \$22.5 billion in 2009 and 2010 respectively despite reductions in trading assets and risk. A key driver of the strong results has been predominately one-way bull markets as bonds, equities, commodities, and foreign currencies rallied. In the first quarter of 2011, insured commercial banks added another \$7.4 billion in trading revenues. Notwithstanding the current strength of trading revenues, however, there are a number of issues that create uncertainty, and will likely limit, trading revenues prospectively. Section 619 of the Dodd-Frank Act restricts many forms of proprietary trading, but for banks, stand alone proprietary trading has generally accounted for a relatively small portion of trading activity, so the impact of this change should be limited. There are, however, other provisions of the Act that could affect trading activities at national banks.

Legislative mandates to increase central clearing may reduce trading activity generally and narrow profit margins. Recently proposed swap margin rules require, for the first time, initial margin for inter-dealer and dealer/financial end-user trading activity, raising costs and potentially

reducing the transaction volumes that create revenue. Revenues from securitization activities remain weak due to continued weakness in loan volumes and underlying asset prices for housing. In addition, securitization markets may be affected by uncertainty associated with implementation of the Dodd-Frank Act risk retention requirements and proposed changes in the regulatory capital treatment of mortgage servicing rights. Finally, bull markets for the past two years have stimulated client demand for risk management products, reduced market-making risk, and increased interest income spread on market-making inventory resulting from the steep yield curve. The potential for markets to be less bullish and to become more volatile may put further pressure on bank trading revenues.

VI. Conclusion

The financial crisis exposed fundamental weaknesses in risk management and supervisory practices across the financial industry and supervisory community. Numerous initiatives, including those mandated by the Dodd-Frank Act, are underway to address these failures. The OCC has and is continuing to take steps to enhance its supervision programs and to implement its responsibilities under the Dodd-Frank Act. As we implement these changes, we will strive to do so in a manner that, to the greatest extent possible, continues to allow all U.S. financial firms to compete fairly both within our own financial system and the broader global economy. We are also mindful of the special role that community banks play in our financial system and the disproportionate burden that changing regulatory requirements can pose to these entities. In this respect, our overarching goal and mission remains the same – to assure the safety and soundness of the institutions under our jurisdiction, to ensure that they treat their customers fairly, and in carrying out this mission, to conduct our supervision in a balanced and fair manner that reflects and is tailored to the risks posed by each institution.