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TESTIMONY OF
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before the
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

February 6, 2014

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.

Chairman Johnson, Ranking Member Crapo, and members of the Committee, thank you for the opportunity to appear before you today. As the national economy continues to improve, so do the balance sheets of the financial institutions that the Office of the Comptroller of the Currency (OCC) supervises. The industry's improved strength is reflected in stronger capital, improved liquidity, and timely recognition and resolution of problem loans. We are mindful, however, of the lessons of the financial crisis, and we have learned from that experience. We have taken a close look at how we supervise national banks and federal savings associations (collectively, banks) and have devoted considerable time and resources to improving the way we do our job.

With this in mind, I will begin my testimony today by describing the independent peer review study, which was undertaken at my direction, to assess the effectiveness of OCC's supervision of large and midsize banks. I will also discuss the OCC's recently proposed heightened expectations guidelines, designed to strengthen the risk management and governance practices of our large banks. We are setting a high bar for the institutions we supervise, and, as our international peer review project demonstrates, we are asking no less of ourselves.

In addition, as the Committee requested, I will discuss the OCC's expectations of the banks that we supervise with regard to their ability to defend both their systems and their customers' confidential information from cyber threats, as well as our role in supervising the retail payment system activities of banks. While banks are highly regulated, the financial services industry is an attractive target for cyber attacks, and therefore, we recognize the need to ensure that banks are doing everything necessary to protect themselves and their customers' information. To ensure we stay on top of the evolving threats to the financial services industry, the OCC is committed to refining our supervisory processes on an ongoing basis and to

participating in public-private partnerships to help keep abreast of and respond to emerging threats.

Finally, my testimony will address our ongoing efforts to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act) and to strengthen bank capital. Specifically, I will discuss the newly finalized risk-based capital rules, as well as the proposed liquidity rules and enhanced leverage capital ratio requirement. I also will provide an overview of the finalized “Volcker” rules and our progress in implementing specific provisions of Title VII of the Act. I will conclude with a summary of other rulemaking projects required by the Act on which we have made substantial progress, including the appraisal and credit risk retention rules.

I. Improving Financial Stability through Enhanced Prudential Regulation and Supervision

A. *International Peer Review Study*

Throughout our 150-year history, effective supervision of national banks has been the core mission of the OCC. While the scope of that mission has expanded to include federal savings associations, our focus on quality supervision has not changed.

To do our job effectively, we must maintain controls and a review program that is every bit as rigorous as what we expect of our banks. This proposition underlies the OCC’s new Enterprise Governance unit, which will conduct independent reviews of each OCC business line. These reviews will enhance existing processes, including quality assurance programs that each business line maintains.

The financial crisis showed how important supervision is to the soundness of the banking system, and I feel strongly that we need to do everything possible to ensure the effectiveness of

OCC supervision. Last year, I brought together a team of senior international regulators to provide an independent and unvarnished assessment of the OCC's supervision program for large and midsize banks. Even the very best organizations have room to improve, and in fact, one of the hallmarks of a healthy culture is an organization's willingness to engage in a process of continual improvement. This is something the OCC has done throughout its 150 years. However, in the wake of the financial crisis, I believed it was particularly important to establish a process to assess our strengths and weaknesses and evaluate where we could do better.

The peer review team was comprised of veteran bank regulators from countries whose financial systems proved to be particularly resilient during the financial crisis. It was chaired by Jonathan Fiechter, a former OCC Senior Deputy Comptroller who, until recently, served as a senior official with the International Monetary Fund, where he headed the Monetary and Capital Markets Department's financial supervision and crisis management group.

In December 2013, I received and released to the public the peer review team's report.¹ Its recommendations cover six key areas: mission, vision, and strategic goals; identification of risk; ratings systems; staffing; scope and consistency of the OCC's supervisory strategies; and our enterprise governance function. I am gratified that the report highlighted a number of areas in which the OCC has been very successful. As the chair of the peer review team noted in his transmittal letter to me, "The OCC is fortunate to have such a highly motivated, experienced, and professional staff dedicated to carrying out the work of the OCC." The report praised the lead expert program² in our Midsize Bank Supervision business line, as well as the work of our

¹ See OCC News Release 2013-184 for a copy of the report, available at: <http://www.occ.gov/news-issuances/news-releases/2013/nr-occ-2013-184.html>.

² The lead expert program assigns an expert to each key risk area. These experts, who are independent from exam staff, review and opine on our annual supervisory strategy and supervisory communications for each large and midsize bank we supervise. This program ensures that the OCC consistently handles issues across the agency's portfolio.

National Risk Committee.³ The peer review team also noted that our supervisory staff demonstrated a strong commitment to rigorous supervision of the institutions we regulate and pride in the OCC as a supervisory agency. Further, the team validated a number of initiatives that we had already begun, including eight strategic initiatives to address challenges and opportunities facing the agency. These strategic initiatives focus on retention and recruitment, bank and thrift supervision, leadership, agency funding, technology, internal and external communication, and an enterprise-wide self-assessment process focused on continuous improvement.

While the peer review team found much to praise, its report also highlighted areas in which its members believe the OCC could improve. For example, the report addresses the OCC's resident examination program and the relationship between the OCC's Risk Assessment System and the interagency CAMELS⁴ rating system. After receiving the report, I set up senior-level working groups to evaluate and prioritize the recommendations and develop specific implementation plans for areas where the groups conclude that there are opportunities for improvement. I am committed to a full review of the issues and recommendations identified in the report and to continuous improvement in the way the OCC does business.

³ The OCC's National Risk Committee (NRC) monitors the condition of the federal banking system, as well as emerging threats to the system's safety and soundness. The NRC also monitors evolving business practices and financial market issues and helps to shape supervisory efforts to address emerging risk issues. NRC members include senior agency officials who supervise banks of all sizes, as well as officials from the legal, policy, and economics departments. The NRC helps to formulate the OCC's annual bank supervision operating plan that guides our supervisory strategies for the coming year. The NRC also publishes the *Semiannual Risk Perspective* report to provide information to the industry and the general public on issues that may pose threats to the safety and soundness of OCC-regulated financial institutions.

⁴ The OCC's risk assessment system provides a framework that OCC examiners use to measure, document, and communicate the OCC's conclusions about the quantity of risk, quality of risk management, and direction of risk for eight risk categories. The interagency CAMELS rating system integrates six component areas: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. Evaluations of these component areas take into consideration an institution's size and sophistication, the nature and complexity of its activities, and its risk profile.

B. Heightened Expectations

Because of their size, activities, and implications for the U.S. financial system, large banks require more rigorous regulation and supervision. To support this objective, the OCC recently issued a proposal that would provide additional supervisory tools to examiners aimed at strengthening risk management practices and governance of large banks. This proposal codifies and builds on a set of supervisory “heightened expectations” that embody critical lessons learned from the financial crisis.

The financial crisis taught us the importance of comprehensive and effective risk management; the need for an engaged board of directors that exercises independent judgment; the need for a robust audit function; the importance of talent development, recruitment, and succession planning; and a compensation structure that will not incentivize inappropriate risk taking. In 2010, we began communicating our heightened expectations to the banks through discussions at board meetings and in writing. We continued to refine and reinforce these heightened expectations through our ongoing supervisory activities and frequent communication with bank management and boards of directors. We spent time educating our examiners and bankers to clarify our expectations and specifically noted our requirement for a frank assessment of the gaps between existing and desired practices. The OCC also began to examine each large institution for compliance with the expectations and has included in each bank’s Report of Examination an overall rating of how the bank meets these heightened expectations.

Our recent proposal builds upon and formalizes the heightened expectations program in the form of enforceable guidelines that would generally apply to insured national banks, insured federal savings associations, and insured federal branches of foreign banks with average total consolidated assets of \$50 billion or more.

The proposed guidelines set forth minimum standards for the design and implementation of a bank's risk governance framework and provide minimum standards for the board's oversight of the framework. The bank's risk governance framework should address all risks to a bank's earnings, capital and liquidity, and reputation that arise from the bank's activities. The proposal also sets out roles and responsibilities for the organizational units that are fundamental to the design and implementation of the framework. These units, often referred to as a bank's three lines of defense, are front line business units, independent risk management, and internal audit. Together, these units should establish an appropriate system to control risk taking. Underlying the framework is a risk appetite statement that articulates the aggregate level and types of risk a bank is willing to assume in order to achieve its strategic objectives, consistent with applicable capital, liquidity, and other regulatory requirements.

The proposed guidelines also contain standards for boards of directors regarding oversight of the design and implementation of a bank's risk governance framework. It is vitally important that each director be engaged in order to understand the risks being taken by his or her institution and to ensure that those risks are well managed. Informed directors who exercise independent judgment can better question the propriety of strategic initiatives and assess the balance between risk taking and reward. An effective board also should actively oversee management. Directors should be in a position to present a credible challenge to bank management while fulfilling their duty to preserve the sanctity of the national bank or federal savings association charter. By sanctity of the charter, I mean that directors must ensure that the institution operates in a safe and sound manner. The national bank or federal thrift should not simply function as a booking entity for the holding company. It is a special corporate franchise that is the gateway to federal deposit insurance and access to the discount window.

The guidelines are proposed as a new appendix to Part 30 of our regulations. Part 30 codifies an enforcement process set out in a statutory provision that authorizes the OCC to prescribe operational and managerial standards. If a bank fails to satisfy a standard, the OCC may require it to submit a compliance plan detailing how it will correct the deficiencies and how long that will take. The OCC can issue an enforceable order if the bank fails to submit an acceptable compliance plan or fails in any material way to implement an OCC-approved plan.

Higher supervisory standards for the large banks we oversee, such as those in the proposed guidelines, along with bank management's implementation of these standards, are consistent with the Dodd-Frank Act's broad objective of strengthening the financial system. We believe that this increased focus on strong risk management and corporate governance will help banks maintain the balance sheet improvements achieved since the financial crisis and make them better able to withstand the impact of future crises.

II. Data Security

There are few issues more important to me or to the OCC than the emerging risks posed by the increasing sophistication of cyber attacks. One of my highest priorities is to ensure that banks continue to improve their ability to protect both their systems and their customers' data against cyber attacks. While the banking sector is highly regulated and has been subject to stringent information security requirements for decades, we recognize that both our supervision and our guidance to banks must be regularly updated to keep pace with the rapidly changing nature of cyber threats. For this reason, when I became Chairman of the Federal Financial Institutions Examination Council (FFIEC), I called for the creation of a working group on cybersecurity issues to be housed under the FFIEC's task force on supervision. The working group has already begun to meet with intelligence, law enforcement, and homeland security

officials, and it is exploring additional approaches bank regulators can take to ensure that institutions of all sizes have the ability to safeguard their systems.

Recent events, such as the Distributed Denial of Service attacks on banks and the information security breaches at Target and Neiman Marcus, highlight the sophisticated nature of evolving cyber threats, as well as the interdependencies that exist in today's payment systems. They also remind us of the impact that cyber attacks have on consumers and financial institutions. When accounts are compromised, the affected consumers often pay a stiff price in terms of lost time and the expense of restoring their credit information, even though they are protected against fraudulent card charges by their financial institutions. In addition to the inconvenience to and burden on consumers, financial institutions, including community banks that issue credit and debit cards, often end up bearing the costs when bank customer information maintained by merchants is compromised. Banks have borne the expense of replacing cards, providing credit monitoring services, responding to high volumes of customer inquiries, monitoring for fraudulent transactions, and reimbursing customers for fraud losses.

Information security has long been an integral part of the OCC's supervisory process. We have a variety of tools and broad authority to require the banks we regulate and their service providers to protect their own systems and their customers' data and to take steps to identify, prevent, and mitigate identity theft, no matter how a customer's information was acquired. Over the years, the OCC, on its own and through the FFIEC, has published guidance and handbooks that have made clear our expectations about acceptable risk management processes and procedures for safeguarding information.

A. *Information Security Guidelines and Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice*

Following the 1999 enactment of the Gramm-Leach-Bliley Act, the OCC, in conjunction with the Federal Deposit Insurance Corporation (FDIC) and the Board of Governors of the Federal Reserve System (Federal Reserve) (collectively, the federal banking agencies) published enforceable information security guidelines that set forth standards for administrative, technical, and physical safeguards financial institutions must have to ensure the security and confidentiality of customer information. These interagency guidelines require banks to develop and implement formal information security programs.

These programs need to be tailored to the bank's assessment of the risks it faces. These risks include internal and external threats to customer information and any method used to access, collect, store, use, transmit, protect, or dispose of the information. Each bank must consider the specific security measures set forth in the guidelines and adopt those that are appropriate for the institution. Given the evolving threat and technology environment, the guidelines require a bank's information security program to be dynamic – to continually adapt to address new threats, changes in technology, and new business arrangements. We also expect banks to routinely test their systems for vulnerabilities and to address the weaknesses they discover.

To ensure effective oversight, the guidelines require that information security programs be approved by an institution's board of directors. The board must also oversee the program's development, implementation, and maintenance, and it must review annual reports that describe the bank's compliance with the guidelines.

Since banks often depend upon service providers to conduct critical banking activities, the guidelines also address how banks must manage the risks associated with their service

providers that have access to customer information. This past October, the OCC released updated guidance that emphasizes the importance of risk management practices for critical activities throughout the lifecycle of the third-party relationship.⁵ The guidance also stresses our expectation that the board and management ensure that appropriate risk management practices are in place, establish clear accountability for day-to-day management of these relationships, and periodically conduct independent reviews of these relationships.

While strong and resilient information security programs are critical, the evolving nature and sophistication of cyber attacks also require banks to have strong and well-coordinated incident response programs that can be put into action when a cyber attack or security breach does occur. Nearly a decade ago, the OCC, in conjunction with the FDIC and Federal Reserve, issued guidance to supplement the information security guidelines titled “Response Programs for Unauthorized Access to Customer Information and Customer Notice.” This guidance addresses breaches of customer information maintained by or on behalf of banks and makes clear that the OCC expects each bank to implement an incident response program with specific policies and procedures to address unauthorized access to customer information. We expect a bank’s incident response program to include a process for notifying customers and taking appropriate steps, not only to contain and control the incident, but also to prevent further unauthorized access to or use of the customer information. The bank is expected to notify both law enforcement and its primary regulator and to provide customers with information they need, such as how to place a fraud alert on their credit reports.

During and following cyber attacks on the financial sector, the OCC plays an important role in identifying risks to bank systems and bank customer information and conveying

⁵ See OCC Bulletin 2013-29 “Third Party Relationships: Risk Management Guidance” available at: <http://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html>.

appropriate risk management practices to the industry, including defensive strategies and tactics to contain attacks. The OCC gathers information from our affected banks and shares information with other government agencies. We have participated in briefings for our banks, service providers, and examiners on specific cyber threats. In addition, through our membership in both the Financial and Banking Information Infrastructure Committee and the Financial Services Information Sharing and Analysis Center, which are part of the financial sector's public-private partnerships, we share information regarding cyber threats and discuss various means to improve the security and resiliency of the financial sector.

B. Identity Theft Red Flags

While the information security guidelines require banks to safeguard the customer information that they maintain or that is maintained on their behalf, banks also are required to be on the alert for identity theft involving their customers' information, no matter how and where an identity thief acquired the information. Pursuant to section 114 of the FACT Act, the federal banking agencies, together with the National Credit Union Administration (NCUA) and the Federal Trade Commission, issued regulations in 2007 titled "Identity Theft Red Flags and Address Discrepancies." The final rules require each financial institution and creditor to develop and implement a formal identity theft prevention program that includes policies and procedures for detecting, preventing, and mitigating identity theft in connection with account openings and existing accounts. The program must cover any consumer account or any other account that the financial institution or creditor offers or maintains for which there is a reasonably foreseeable risk to consumers or to the safety and soundness of the financial institution or creditor from identity theft. In addition, it must include policies and procedures to identify relevant red flags, detect red flags incorporated into the program, respond appropriately to the red flags that are

detected, and ensure the program is updated periodically to reflect changes in risks to customers and to the institution from identity theft.

The agencies also issued guidelines to assist covered entities in developing and implementing an identity theft prevention program. The guidelines include a supplement that identifies 26 patterns, practices, and specific forms of activity that are “red flags” signaling possible identity theft. These include alerts, notifications, or other warnings received from consumer reporting agencies or service providers, the presentation of suspicious documents or suspicious personal identifying information, the unusual use of or other suspicious activity related to a covered account, or notice from customers, victims of identity theft, or law enforcement authorities. When a bank detects identity theft red flags, the bank is expected to respond by taking steps that include monitoring accounts, contacting the customer, changing passwords, closing and reopening the account, and notifying law enforcement, as appropriate.

C. Retail Payment Systems

Banks provide essential retail payment transactions and services to businesses and consumers, including the acceptance, collection, and processing of a variety of payment instruments and participation in clearing and settlement systems. From the initiation of a retail payment transaction to its final settlement, banks are exposed to certain risks, such as credit, liquidity, compliance, reputation, and operational risks, including fraud, particularly during settlement activities. These risks may arise from interactions with payment system operators and other third parties.

Recent technological advances are expanding the opportunities for the development of innovative payment products and services. New electronic payment instruments and systems offer gains in efficiency by allowing for the rapid and convenient transmission of payment information among system participants. However, without appropriate safeguards, these new

products and services can also permit fraud, money laundering, and operational disruption to occur. In addition, nonbank third parties are increasingly participating in retail payment systems, contributing to innovation but also adding complexity to the transaction chain, which may increase risk in payment processes. Retail payment risk management is increasingly difficult, requiring close attention to the changing nature of risk and robust oversight.

The OCC, on its own and through the FFIEC, has issued guidance on identifying and controlling risks associated with retail payment systems and related banking activities. Risk profiles vary significantly based on the size and complexity of a bank's retail payment products and services, expertise, technology infrastructure, and dependence on third parties. The OCC expects banks engaging in these activities to be aware of the inherent risks of their activities and implement appropriate risk management processes. OCC examiners also assess risk levels and risk management practices at banks and schedule oversight activities based upon the risk profile of the bank and the complexity of the products and services offered.

Banks not only must comply with federal requirements but also with state laws and regulations relating to payment systems and with the operating rules of clearing houses and bankcard networks, such as Payment Card Industry-Data Security Standards (PCI-DSS). In addition, we expect all banks to maintain effective internal controls, including robust fraud detection systems and financial, accounting, technical, procedural, and administrative controls necessary to minimize risks in the retail payment transaction, clearing, and settlement processes. These measures, when effectively employed, reduce payment system risk, ensure that individual transactions are valid, and mitigate processing and other errors. Effective controls also ensure that the retail payments infrastructure operates with integrity, confidentiality, and availability.

D. The OCC's Supervision Program

The OCC's ongoing supervision program addresses information security and identity theft prevention for banks, including with respect to bank participation in the payment system. The supervisory program involves teams of examiners who evaluate information security and identity theft controls and risk management during their examinations of banks. Our most experienced examiners supervise the largest institutions and also participate, with the FDIC and Federal Reserve, in examinations of the largest bank technology service providers. The OCC's supervision, including of information technology, continues to evolve as the risks facing the industry change. Both on our own and through the FFIEC, we update examiner training, regulatory guidance, and examiner booklets. We also issue alerts to address risks stemming from increasingly complex bank operations and third-party relationships, new technologies, and the increasing volume and sophistication of cyber threats.

When necessary, the OCC uses our enforcement process to ensure compliance with our standards. When we have found serious gaps in meeting our supervisory expectations, we have taken enforcement actions that include cease and desist orders and civil money penalties. In some cases, the OCC has also found it necessary to compel banks to notify their customers of breaches involving personal information.

The OCC also has taken enforcement actions against bank insiders who were engaged in identity theft-related activities or were otherwise involved in serious breaches or compromises of customer information. These enforcement actions have included orders prohibiting individuals from working in the banking industry, personal cease and desist orders restricting the use of customer information, significant civil money penalties, and orders requiring restitution.

The OCC is committed to maintaining a robust regulatory framework that requires banks to protect their systems and their customers' information. The volume and sophistication of the

cyber threats to our payment systems and other financial infrastructures are evolving rapidly. Furthermore, these systems are dependent on other critical infrastructures that are also vulnerable to these threats, such as telecommunications and energy, which are outside of the industry's direct control. For this reason, we will continue to look for ways to improve our supervisory processes and make the system stronger, through collaboration and cooperation with industry participants, as well as other regulatory and government agencies, such as law enforcement.

III. Capital and Liquidity

A. Capital

Last year, the OCC, FDIC, and Federal Reserve finalized a rule that comprehensively revises U.S. capital standards. This rule strengthens the definition of regulatory capital, increases risk-based capital requirements, and amends the methodologies for determining risk-weighted assets. It also adds a new, stricter leverage ratio requirement for large, internationally active banks. These revisions reflect enhancements to the international capital framework published by the Basel Committee on Banking Supervision and are a result of lessons learned from the financial crisis. The standards are consistent with and complement the Dodd-Frank Act by strengthening our nation's financial system. They reduce systemic risk and improve the safe and sound operation of the banks we regulate.

Some of the revisions applicable to large, internationally active banks became fully effective on January 1 of this year. Most revisions, including the narrowing of instruments that count as regulatory capital, will be phased in over several years. For the largest, internationally active banks, this phase-in has already begun. For all other banks, the phase-in will begin in 2015.

Leverage Ratio Capital Requirements

Regulatory capital standards in the United States have long included both risk-based capital and leverage requirements, which work together, each offsetting the other's potential weaknesses while minimizing incentives for regulatory capital arbitrage. Among the more important revisions to the domestic capital rules was the addition of stricter leverage ratio requirements applicable to the largest, internationally active banks.

Under longstanding domestic capital requirements, all banking organizations⁶ must meet a minimum leverage ratio. Our recent revisions to the capital rules now require certain large banking organizations also to meet a "supplementary leverage ratio" requirement. Unlike the more broadly applicable leverage ratio, this supplementary leverage ratio incorporates off-balance sheet exposures into the measure of leverage. It is expected to be more demanding because large banking organizations often have significant off-balance sheet exposures that arise from different types of lending commitments, derivatives, and other activities.

To further strengthen the resiliency of the banking sector, in August of last year, the federal banking agencies published a notice of proposed rulemaking (NPR) that would increase substantially the supplementary leverage ratio requirement for the largest and most systemically important banking organizations. Under the NPR, these banking organizations would be required to maintain even more tier 1 capital for every dollar of exposure in order to be deemed "well capitalized."

In January, the Basel Committee finalized revisions to the international leverage ratio standards upon which the federal banking agencies based the supplementary leverage ratio NPR.

⁶ The U.S. "banking organizations" subject to minimum capital rules include national banks, state member banks, federal savings associations, and top-tier bank holding companies domiciled in the U.S. not subject to the Federal Reserve's Small Bank Holding Company Policy Statement (12 CFR part 225, appendix C), as well as top-tier savings and loan holding companies domiciled in the U.S., except certain savings and loan holding companies that are substantially engaged in insurance underwriting or commercial activities.

While some reports have suggested these revisions amounted to a watering down of the international standards, a more accurate depiction of the changes relative to U.S. standards requires more elaboration. Although these standards have been relaxed relative to a Basel Committee proposal issued in June 2013, the committee's final standards are generally comparable to the final U.S. standards published last year and the measure of exposure used in the NPR.

Two areas where the final Basel standards differ from the U.S. standards are the treatment of credit derivatives and off-balance sheet commitments. With respect to credit derivatives, the final Basel standards require a bank to treat a promise to pay a counterparty in the event of a credit default as the equivalent of providing a loan to the counterparty, because both transactions effectively involve the extension of credit. This requirement is more stringent than the current U.S. rules, which focus only on the counterparty credit risk associated with credit derivatives. With respect to off-balance sheet commitments, the Basel leverage calculation includes a portion of the potential exposure amount for certain off-balance sheet commitments, rather than the entire potential exposure amount. This change reduces the exposure measure relative to the current U.S. standards, which generally assume that all of these commitments will be completely drawn at the same time.

Even considering the change to the exposure measure for certain commitments, our preliminary analysis suggests that, in the aggregate, the final Basel standards will generate a larger measure of exposure – and will therefore be more stringent – than the current and proposed U.S. standards. However, this is likely to vary by bank. Banks with large credit derivatives portfolios likely will see greater increases in their exposure measures relative to other banks.

Additionally, when considering the impact of the Basel standards, it is important to keep in mind that the NPR would increase the minimum supplementary leverage ratio requirements for systemically important banking organizations in the U.S. to 6 percent at the bank level and 5 percent at the bank holding company level. While we are still considering comments received on this proposal, the OCC continues to support stronger leverage ratio standards than the 3 percent international minimum. The federal banking agencies will consider the revisions to the Basel Committee's leverage ratio framework, as well as the comments received in response to the NPR, as we continue with our work. The OCC supports the interagency efforts to ensure that the supplementary leverage ratio will serve as an effective backstop to the risk-based ratios and will work with the FDIC and the Federal Reserve to move forward with the rulemaking process in the near term.

B. Enhanced Liquidity Standards

Adequate and appropriate liquidity standards for the banks we regulate are an important post-financial crisis tool that is central to the proper functioning of financial markets and the banking sector in general. The federal banking agencies, working together, have made significant progress in implementing the Basel Committee's Liquidity Coverage Ratio in the United States. These liquidity standards will help ensure that banking organizations maintain sufficient liquidity during periods of acute short-term financial distress.

In November of last year, the federal banking agencies issued a proposal that would require certain large financial companies, including large national banks and federal savings associations, to hold high-quality liquid assets on each business day in an amount equal to or greater than its projected cash outflows minus its projected inflows over a 30-day period of significant stress. The comment period for the proposed rule ended on January 31, 2014. The

agencies are reviewing the comments and will be developing a final rule that I hope can be issued by the end of the year.

The federal banking agencies also are working with the Basel Committee to develop another liquidity requirement, the Net Stable Funding Ratio, to complement the Liquidity Coverage Ratio and enhance long-term structural funding. The Net Stable Funding Ratio would require banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. The Basel Committee recently published a consultative paper for comment that defines the requirements for this ratio. Once finalized, the federal banking agencies will work to implement a U.S. rule, which is planned to go into effect on January 1, 2018.

It is expected that these standards, once fully implemented, will complement existing liquidity risk guidance and enhanced liquidity standards to be issued by the Federal Reserve, in consultation with the OCC, as part of the heightened prudential standards required under section 165 of the Dodd-Frank Act.

IV. Volcker Rule

The statutory provision referred to as the Volcker Rule is set forth in section 619 of the Dodd-Frank Act. Section 619 prohibits a banking entity from engaging in short-term proprietary trading of financial instruments and from owning, sponsoring, or having certain relationships with hedge funds or private equity funds (referred to here, and in the final regulations, as covered funds).⁷ Notwithstanding these prohibitions, section 619 permits certain financial activities,

⁷ The statute defines the term “banking entity” to cover generally any insured depository institution (other than a limited purpose trust bank), any affiliate or subsidiary of an insured depository institution, and any company that controls an insured depository institution. See 12 U.S.C. 1851(h)(1).

including market making, underwriting, risk-mitigating hedging, trading in government obligations, and organizing and offering a covered fund.

On December 10, 2013, the OCC, Federal Reserve, FDIC, Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC) adopted final regulations implementing the requirements of section 619.⁸ In accordance with the statute, the final regulations prohibit banking entities from engaging in impermissible proprietary trading and strictly limit their ability to invest in covered funds. At the same time, the regulations are designed to preserve market liquidity and allow banks to continue to provide important client-oriented services.

In developing the final regulations, the agencies carefully considered the more than 18,000 comments received on the proposed regulations from a diverse group of interests—including banks, securities firms, consumer and public interest groups, Members of Congress, foreign governments, and the general public.⁹ Commenters raised numerous significant and complex issues with respect to the proposed regulations, and provided many—sometimes conflicting—recommendations. For example, the agencies heard from various commenters regarding the distinction between impermissible proprietary trading and permitted market making, and with respect to the definition of a covered fund. These comments often highlighted key differences in the markets and asset classes subject to regulation by the respective agencies under the Volcker Rule. In contrast, other commenters urged the agencies to construe the

⁸ See 79 FR 5536 (Jan. 31, 2014). The OCC, Federal Reserve, FDIC, and SEC issued a joint regulation, and the CFTC issued a separate regulation adopting the same common rule text and a substantially similar preamble.

⁹ Of the 18,000 comment letters, more than 600 were unique comment letters, and the remaining letters were from individuals who used a form letter. The agencies each also met with a number of the commenters to discuss issues raised by the proposed regulations and have published summaries of these meetings.

statutory mandate narrowly to avoid the potential for evasion of the proprietary trading and covered fund prohibitions.

To meet these challenges, the agencies worked closely with each other in developing the final regulations, from the principal level down to staff at all the agencies who worked long days, nights, and weekends, to grapple with extraordinarily complex and important policy issues. Though the final regulations have been published, the OCC is continuing to work closely and cooperatively with the other agencies as we work on our supervisory implementation of the final regulations during the conformance period, which runs through July 21, 2015.¹⁰

The statute applies to all banking entities, regardless of size; however, not all banking entities engage in activities presenting the risks the statute sought to curb. One of my priorities in the Volcker rulemaking was to make sure that the final regulations imposed compliance obligations on banking entities in proportion to their involvement in covered activities and investments. The final regulations appropriately recognize that not all banking entities pose the same risk and impose compliance obligations accordingly. So, a community bank that only trades in “plain vanilla” government obligations has no compliance obligations whatsoever under the final regulations. Community banks that engage in other low-risk covered activities will be subject to only minimal requirements.

All banking entities, including community banks, will need to divest impermissible covered fund investments under the final regulations. Recently, however, the agencies heard, and promptly responded to, a concern raised by community institutions that the final regulations

¹⁰ Section 619 authorized a two-year conformance period, until July 21, 2014, for banking entities to conform their activities and investments to the requirement of the statute. The statute also permits the Federal Reserve to extend this conformance period, one year at a time, for a total of no more than three additional years. In a separate action, the Federal Reserve has extended the conformance period for an additional year until July 21, 2015, and has indicated that it plans to monitor developments to determine whether additional extensions of the conformance period are in the public interest.

treated certain investments in a way that was inconsistent with another important provision of the Dodd-Frank Act. Banking entities of all sizes hold collateralized debt obligations backed primarily by trust preferred securities (TruPS CDOs). These TruPS CDOs, originally issued some years ago as a means to facilitate capital raising efforts of small banks and mutual holding companies, would have been subject to eventual divestiture and immediate write-downs under the applicable accounting treatment under generally accepted accounting principles. As a number of community institutions pointed out to the agencies, this result was inconsistent with the Collins Amendment to the Dodd-Frank Act,¹¹ where Congress expressly protected existing TruPS as a component of regulatory capital for the issuing institution so long as the securities were issued by bank holding companies with less than \$15 billion in consolidated assets or by mutual holding companies.

To mitigate the unintended consequences of the final regulations and harmonize them with the Collins Amendment, the agencies, on January 14, 2014, adopted an interim final rule to permit banking entities to retain an interest in or sponsor a TruPS CDO acquired before the final regulations were approved, provided certain requirements are met.¹² Among others, the banking entity must reasonably believe that the offering proceeds from the TruPS CDO were invested primarily in trust preferred securities issued prior to May 19, 2010, by a depository institution holding company below a \$15 billion threshold or by a mutual holding company. To help community institutions identify which CDO issuances remain permissible, the OCC, FDIC, and Federal Reserve have also issued a non-exclusive list of TruPS CDOs that meet the requirements of the interim final rule.

¹¹ See 12 U.S.C. 5371(b)(4)(C).

¹² See 79 FR 5223 (Jan. 31, 2014).

For banking entities that engage in a high volume of trading and covered fund activities, namely, the largest banks, the final regulations will impose some significant changes. These large firms have been preparing for these changes since the statute became effective in July 2012, and have been shutting down impermissible proprietary trading operations. Now that the final regulations have been released, these institutions will need to take steps during the conformance period to bring their permitted trading and covered fund activities, such as market making, underwriting, hedging, and organizing and offering covered funds, into compliance with the requirements of the final regulations. Large banking entities must develop robust compliance programs, and they will be required to compile and report quantitative metrics on their trading activities that may serve as an indicator of potential impermissible proprietary trading or a high-risk trading strategy. Banking entities will not be able to use covered funds to circumvent the proprietary trading restrictions, and they will not be able to bail out covered funds they sponsor or invest in.

Of course, issuing a final regulation is only the beginning of the agencies' implementation process. Equally important is how the agencies will enforce it. The OCC is committed to developing a robust examination and enforcement program that ensures the banking entities we supervise come into compliance and remain compliant with the Volcker Rule. In the near term, our priority is implementing examination procedures and training to help our examiners assess whether banks are taking the necessary steps to come into compliance with the final regulations by the end of the conformance period, and we are actively engaged in these efforts. Using these procedures, examiners will direct banks they examine to identify the range and size of activities and investments covered by the final regulations, and will assess banks' processes and systems for metrics reporting and their project plans for bringing their trading

activities and investments into conformance with the final regulations. Moreover, key OCC subject matter experts across our policy and supervision divisions are developing training for our examiners to be held later in 2014. We will build upon these initial procedures and training through the course of the conformance period as we further assess the progress and needs of our examiners.

The agencies also are working to ensure consistency in application of the final regulations. I am pleased to report that the OCC has led the formation of an interagency working group to address and collaborate on developing responses to key supervisory issues that arise under the final regulations. That interagency group held its first meeting in late January and will continue to meet on a regular basis going forward. The OCC is also participating in interagency training on the final regulations this spring and summer under the auspices of the FFIEC.

When fully implemented, I believe the final regulations will achieve the legislative purpose for which the Volcker Rule was enacted. The final regulations will limit the risks the prohibited activities pose to the safety and soundness of banking entities and the U.S. financial system in a way that will permit banking entities to continue to engage in activities that are critical to capital generation for businesses of all sizes, households, and individuals, and that facilitate liquid markets.

V. Derivatives - Title VII

Pursuant to sections 731 and 763 of the Dodd-Frank Act, banks that are “swap dealers” must register with the CFTC, and those that are “securities-based swap dealers” must register with the SEC. The swap activities of banks that must register are subject to substantive requirements under Title VII of the Act. At this time, nine national banks have provisionally registered as swap dealers.

Sections 731 and 763 also require the federal banking agencies, together with the Federal Housing Finance Agency (FHFA) and the Farm Credit Administration (FCA), to impose minimum margin requirements on non-cleared swaps and security-based swaps for swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants that are banks. These agencies published a proposal to implement these requirements on May 11, 2011.

After issuing the U.S. proposal, the federal banking agencies participated in efforts by the Basel Committee and International Organization of Securities Commissions (IOSCO) to address coordinated implementation of margin requirements across the G-20 nations. Following extensive public comment, the Basel Committee and IOSCO finalized an international framework in September of 2013.

The federal banking agencies, together with the FHFA and the FCA, have reviewed this framework and the comments received on the U.S. proposal. The federal banking agencies received more than 100 comments from banks, asset managers, commercial end users, trade associations, and others. Many commenters focused on the treatment of commercial end users, urging the agencies to exempt transactions with such entities from the margin requirements in a manner consistent with the approach taken in the Basel Committee-IOSCO framework. The federal banking agencies are currently evaluating the changes indicated under the framework and suggested by commenters and expect to issue a final rule in the coming months.

Additionally, banks that are registered swap dealers are subject to the derivatives push-out requirements in section 716 of the Dodd-Frank Act. This provision, which became effective on July 16, 2013, generally prohibits federal assistance to swap dealers. The statute required the OCC to grant banks it supervises a transition period of up to 24 months to comply. We have

granted a 24-month transition period to nine national banks and four federal branches. We concluded that the transition period is necessary to allow banks to develop a transition plan for an orderly cessation or divestiture of certain swap activities that does not unduly disrupt lending activities and other functions that the statute required us to consider.

VI. Other Dodd-Frank Rulemakings

The OCC has made considerable progress on other Dodd-Frank requirements. In August of last year, we issued a final rule to implement a provision in section 610 of the Act, which requires that an institution's lending limit calculation account for credit exposure arising from derivatives and securities financing transactions. The new rule specifies methods to calculate this credit exposure. In addition, we joined the other members of the FFIEC and the SEC in November to propose Joint Standards for Assessing Diversity Policies and Practices of Regulated Entities. These proposed standards implement a provision in section 342 of the Dodd-Frank Act and are intended to promote transparency and awareness of diversity within these entities.

A. Appraisals

The Dodd-Frank Act contains a number of provisions relating to appraisals, and the federal banking agencies, along with the NCUA, FHFA, and the Bureau of Consumer Financial Protection (CFPB), continue to work to implement these provisions. As I have previously reported, these agencies issued a final rule last year requiring all creditors, subject to certain exceptions, to comply with additional appraisal requirements before advancing credit for higher-risk mortgage loans. This past December, these agencies issued a supplemental final rule to revise one of the exemptions and include two additional exemptions. These changes reduce regulatory burden and reflect comments the agencies received from the public.

In the coming months, the agencies plan to publish a proposal to establish minimum requirements for state registration of appraisal management companies, known as AMCs, which serve as intermediaries between appraisers and lenders. This rule will ensure that appraisals coordinated by AMCs adhere to applicable quality control standards and will facilitate state oversight of AMCs. The proposal also will implement the Dodd-Frank Act requirement that the states report to the FFIEC's Appraisal Subcommittee information needed to administer a national AMC registry.

The agencies also are working collaboratively on a proposal to implement specific quality control standards for automated valuation models, which are computer models used to assess the value of real estate that serves as collateral for loans or pools of loans. We expect to issue this proposal later in 2014. Finally, the agencies are considering rulemaking options to complement an interim final rule issued by the Federal Reserve in 2010 that implements statutory appraisal independence requirements.

B. Credit Risk Retention

The federal banking agencies, together with FHFA, the SEC, and the Department of Housing and Urban Development, continue to work on implementing the credit risk retention requirements for asset securitization in section 941 of the Dodd-Frank Act. In 2011, these agencies proposed a rule to implement section 941 and received over 10,000 comments, which offered many thoughtful suggestions. These agencies concluded that the rulemaking would benefit from a second round of public review and comment, and we repropoed the rule in September 2013. Although the reproposal includes significant changes from the original proposal, its focus is the same -- to ensure that sponsors are held accountable for the performance of the assets they securitize.

The comment period for the reproposal has now closed, and we are working on a final rule. While we expect to complete this project in the near future, the interagency group is working through some significant issues. For example, the agencies received a substantial number of comments regarding the definition of “qualified residential mortgage” and the extent to which it should incorporate the CFPB’s definition of “qualified mortgage.” The agencies also received numerous comments, including some from members of this Committee, regarding the treatment of collateralized loan obligations. We are carefully considering these and other issues, with the goal of balancing meaningful risk retention with the availability of credit to individuals and businesses.

C. Incentive-Based Compensation Arrangements

Finally, the OCC continues to work on the implementation of section 956 of the Dodd-Frank Act, which requires us to prescribe regulations or guidelines regarding incentive-based compensation. The federal banking agencies, along with the NCUA and the SEC, proposed a rule that would require the reporting of certain incentive-based compensation arrangements by a covered financial institution and would prohibit incentive-based compensation arrangements at a covered financial institution that provides excessive compensation or could expose the institution to inappropriate risks leading to a material financial loss. The agencies received thousands of comments on this proposal and will address the issues raised by the commenters in the final rule.

Conclusion

Thank you again for the opportunity to appear before you and to update the Committee on the OCC’s continued work to implement the Dodd-Frank Act and enhance our efforts to regulate our country’s national banks and federal savings associations.