Speeches and Congressional Testimony—October 1 to December 31, 2002

Contents

Page

Of the Comptroller of the Currency

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the American Bankers Association, Phoenix, Arizona, on corporate reform for banks, October 7, 2002 ____ 155

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before a session on banking supervision with the People's Bank of China, Beijing, China, October 14, 2002 ____ 162

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the North Carolina Bankers Association, Pinehurst, North Carolina, on reforming the system of funding bank supervision, October 22, 2002 ____ 169

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before America's Community Bankers, San Francisco, California, on the viability of the thrift charter, November 5, 2002 ____ 174

Of the Senior Deputy Comptroller for Large Bank Supervision

Statement of Douglas W. Roeder, Senior Deputy Comptroller for Large Bank Supervision, Office of the Comptroller of the Currency, before the U.S. Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, on how the OCC supervises large national banks in general and complex structured transactions such as those entered into by Enron, Washington, D.C., December 11, 2002 ____ 181

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the American Bankers Association, Phoenix, Arizona, on corporate reform for banks, October 7, 2002

It would be a gross understatement to say that the past year has been a trial for our country. Yet I'm firmly convinced that we're stronger today than we were before the terrorists struck on September 11—and before the string of corporate collapses that have done such grave damage to public confidence in our markets. Around the world we're confronting our enemies. At home we're coming to terms with abuses of corporate power that have cost many Americans their jobs, their pensions, and their investments—and, worst of all, their faith in the fairness and rationality of our economic system.

Crisis has always been a powerful catalyst for reform, and that's no exception today. Major companies in every field are cleaning up their balance sheets, facing up to previous shortcomings, improving the quantity and quality of the information they disclose, and embracing a variety of other measures aimed at restoring public trust.

A notable example has been the growing number of corporations that have said that they would start accounting for stock options as an expense. Their competitors will almost certainly face pressure—from the marketplace if not eventually from those who enforce the securities laws—to follow suit.

Sometimes small things can make a difference, and I believe that this issue of the proper accounting for options may be one of those cases. For quite a few years I have been encouraging bankers to focus less on short-term performance and more on long-term value and the stability of their institutions. Similar concerns have been voiced by many of my colleagues throughout the regulatory community. But it's sometimes difficult to make that case when executive compensation is closely tied to current stock prices. I recently read of one large institution whose CEO said with some pride that his *sole* compensation came in the form of stock options. That does not seem to me to be a very wise approach. To be sure, when the market for the company's stock is booming, such a CEO may bask in the glow of great wealth, at least wealth on paper. But there may be perverse incentives when the stock price falls—such as the incentive to reach further out on the risk spectrum in order to bolster earnings, or to engage in questionable accounting practices for the same purpose rather than hunkering down and addressing fundamentals, or taking actions that may preserve value for the future even at the cost of short-run hits to earnings.

It's also difficult to take the long-term focus when stock analysts are preoccupied with quarterly earnings targets and the market exacts severe penalties when targets are missed by a few pennies a share. But history shows us that those institutions that have taken the long view—that have been willing, for example, to accept an impact on current earnings in order to build up prudent loan loss reserves—are the ones that come through periods of economic stress in the best condition.

The primary impetus for corporate reform, however, is not coming from individual corporations, but from government at various levels, as well as from leading industry organizations. On July 30, as you know, the President signed into law the Sarbanes–Oxley Act—perhaps the most important piece of corporate reform legislation since the Depression. It amounts to a sweeping new framework for corporate governance: requiring, for example, that CEOs and CFOs return incentive-based compensation and trading profits following accounting restatements; accelerated reporting of insider transactions, whistleblower protections, better disclosure of off-balance-sheet transactions, auditor independence and rotation, increased frequency of SEC review, and much more.

Couple that with President Bush's initiative to root out financial crimes and stiffen sentences for corporate criminals and the recent actions of the SEC—including the requirement that senior officials personally certify the accuracy of financial statements—and I think we've sent an unmistakable message that previous standards of corporate conduct need to be reexamined.

It's important to keep in mind, of course, that the objective here is not simply corporate morality, in the abstract. The primary purpose is to preserve the confidence of investors and the public generally in the integrity of our markets—markets whose depth and transparency have been envied around the world.

High on the list of current concerns—and properly so—is the role of boards of directors in the overall picture of corporate governance. In many cases there's a gap between what the board is supposed to do and the role it actually plays. In the past it was not uncommon for outside directorships to go to people having connections that might be useful to the company and who were not likely to rock the boat. And it's just as troublesome when companies appoint competent and experienced people to their boards and leave them there to languish—unheeded, unnoticed, and uninvolved. "In all the years I've spent on various boards," one frustrated and disillusioned corporate veteran has written, "I've never heard a single suggestion from a director that produced any result at all."

But attitudes have clearly been changing and that disillusioned directors' experience may not be typical today. The best corporate managers have come to realize how important a conscientious and knowledgeable outside director can be, and particularly in today's environment I believe there is a much higher level of awareness in corporate America of the significant contributions that first-rate directors can make. And there are heartening signs of responsiveness from standard setters—once again crisis has been the catalyst for action. One of the key recommendations in the package recently released by the New York Stock Exchange calls for listed companies to ensure that a majority of board members—instead of at least three, as mandated under present rules—are independent of the company. Furthermore, the Exchange recommends that the audit, compensation, and nominating committees should consist entirely of independent directors. And it calls for independent directors to meet at regularly scheduled executive sessions—without the presence of management.

Financial services firms, of course, are just as vulnerable as any to managerial misconduct—maybe more so, given the nature of their business. That's why bankers like you operate under the most stringent and comprehensive regulation of any industry in the country. That includes a host of very specific provisions defining and restricting the relationship between financial institutions and their insiders, including directors.

That's also why some industry leaders—including the leadership of the American Bankers Association (ABA)—have argued that some of the initial proposals of the New York Stock Exchange regarding the independence of directors should not apply in all cases to banks. The Exchange has already modified its proposed rules to reflect the peculiar circumstances of the banking industry and I commend the ABA for continuing its constructive involvement in this process.

The fact that the relationship between bank directors and the financial companies on whose boards they sit are already defined and circumscribed by law and regulation is not the only salient difference between financial institutions and non-financial companies. For most of corporate America, it generally doesn't matter how the members of a corporate family relate to one another—at least where they are wholly owned subsidiaries of a publicly owned parent and do not have their own debt obligations held by outsiders. Intercompany transactions wash out in consolidated financial statements, and investors in the parent have no reason to be concerned whether transactions wholly within the family are on an arm's-length basis or whether one sub is being taken advantage of by another.

But, as the ABA noted in its comments to the Stock Exchange, banking organizations are different. Banks are federally insured, they are supported by a federal safety net, and they play a critically important role in their communities and in our economy. That's why there is a host of laws and regulations governing such things as how banks may lend to, swap assets with, or engage in concerted transactions with their affiliates and insiders; when they may pay dividends to their owners; and what expectations they should have for support from their parent company.

As regulatory rulings and statutory enactments have broadened the range of activities that can be conducted in financial conglomerates owning banks, the opportunities for intra-family dealings have been significantly increased. In fact, one of the motivating forces behind the Gramm–Leach–Bliley Act was to provide financial companies with greater opportunities to realize the "synergies" that might flow from being financial supermarkets, and to offer "one-stop shopping" to customers.

Thus, today we see bank securities and insurance affiliates prospecting for new customers in the bank's customer lists or seeking to exploit the bank's relationships to market nonbank products and services. Indeed, the bank in a diversified financial holding company is very likely to have the most extensive and enduring roster of customer relationships in the family, thus making it the major focal point for joint marketing programs. In the ordinary world of nonfinancial corporate enterprise, such prospecting for customers among affiliates obviously makes good sense. But in

the world of depository institutions things are different—or should be. There is another set of interests that has to be taken into account: the public interest, represented by the interests of the banking supervisors and the Federal Deposit Insurance Corporation as insurer of deposits. In this context it is important to assure that the interests of the bank are being properly regarded when affiliated companies seek to take advantage of their relationship with the bank.

This is not at all a new concern, and it arises in a multitude of circumstances. Let me give you a few examples of situations where caution is warranted:

- An individual controlling a bank causes the bank to maintain correspondent balances at another bank that agrees in return to make him a loan.
- A bank holding company that contributes operating loss deductions to a consolidated tax return causes the bank to pay upstream the amount of taxes the bank would have paid on a stand-alone return.
- A bank is charged fees by a holding company or controlling shareholder for providing various management services.
- Bank insiders operate an insurance agency that receives commissions on the sale of insurance to bank customers in connection with loans made by the bank.
- A bank shaves rates on a loan or agrees to less demanding covenants to please a customer of the bank's investment banking affiliate or in the hope of attracting new business for an affiliate.
- A bank relationship manager provides information and customer access to an insurance or securities affiliate to promote the sale of the affiliate's products.
- A bank contracts to buy a product or service from a third-party vendor in which a large shareholder or insider of the bank holds an ownership interest.
- A holding company under financial stress is being pressed by regulators to invest capital into a subsidiary bank, while bondholders threaten to sue if the holding company dissipates assets by plowing more funds into a bank that might fail anyway.

I don't mean to suggest for a moment that all of these situations are examples of impropriety. Indeed, a few of them are very common and, in principle, entirely appropriate. On the other hand, some may skirt the bounds of legality. But the common thread is that they all present an occasion for heightened concern about the interests of the bank—heightened because in each case the bank is dealing with a related party under circumstances in which the bank's interests could potentially be subordinated to the interests of that party.

In some cases the reason for concern may be the failure of insiders to recognize that intangible assets of the bank may be at risk of being transferred without appropriate compensation to the bank. A bank's customer relationships are assets of the bank, for example, and if the bank is going to give an affiliate a license to mine those assets it should be compensated. Certainly no bank would provide an unrelated third party with access to its customers without protecting its own interests—both its financial interest and its interest in maintaining a healthy relationship with its customers.

While this concept is occasionally overlooked, it is not rocket science. The notion that a company, and not its insiders, has the right to benefit from a variety of intangible assets that come into being simply because of its existence is grounded in a long history of legislative and judicial pronouncements. It underlies the requirement in the Securities Exchange Act of 1934 that insiders must turn over to their corporation any profit they make on short-swing transactions in the company's stock. And it underlies court decisions holding that corporate opportunities cannot be diverted to insiders and that premiums reaped on the sale of corporate control belong to the corporation.

Nonetheless, we are now being treated to a variety of lurid stories recounting, for example, how insiders were given lucrative opportunities by investment bankers to invest in IPOs (initial public offerings), in exchange for steering their company's business to that investment bank. The Attorney General of New York has, in my view, very properly asserted that such opportunities belong to the company, not to the insiders, and that they must account to their company for their unjust enrichment.

As I consider the relevance of today's corporate scandals to the world of insured depository institutions, I am reminded of a story I used to read to my kids, *The Lorax* [Random House, September 1971], by the late Theodor Seuss Geisel, better known as Dr. Seuss. The Lorax was the forest creature who defended the trees, the Truffula Trees, "the touch of whose tufts was much softer than silk." That made them irresistible to the rapacious Once-ler, who "built a small shop and chopped down the Truffula Trees with one chop." At intervals—and as the forest and all the creatures that depended on it slowly disappeared under the ax—the Lorax would angrily appear "with a sawdust sneeze," saying, "I am the Lorax, I speak for the trees." Alas, too late. That story probably did more to create a generation of environmentalists than anything else I know of.

And so, with apologies to Dr. Seuss, I ask this question: When an insured depository institution engages in transactions involving its parent or affiliate or insiders, "who speaks for the bank?" Who in the corporate family is looking at these situations solely from the perspective of the bank, with an independent view and with undivided loyalty to the bank? And how should we as regulators assure ourselves that the interests of the bank—and thus ultimately the interests protected by the federal safety net—are being properly regarded?

Some have suggested that we adopt a requirement that all insured banks have some number of truly independent directors—that is, directors who are not officers or employees of the bank and who do not sit on the board of the bank's holding company or some affiliate. This would clearly be a significant change from present practice for many banks. Yet what I perceive to be the currently prevailing patterns—either replicating all or part of the holding company board at the bank, or using bank officers, who may also be holding company officers, to comprise the bank board—does not assure the kind of independent view that I believe is needed.

Another approach might be to require that in situations in which a bank wants to enter into transactions with an affiliate, the bank's management engage some completely independent party—a special counsel or other outside advisor—to opine, from the bank's perspective, on the fairness of the transaction or on a procedure established for a series of such transactions. Still another approach might be to make clear to responsible bank officers and directors that in the absence of any independent review sanctions may be addressed to them personally if it is later determined that the bank's interests were not properly regarded.

I appreciate that any new approaches to corporate governance procedures such as these are not likely to be warmly embraced. Many bankers might—quite understandably—feel that they already have their banks' best interest at heart—and I believe that is most frequently the case. On the other hand, we have over the years seen enough situations in which the interest of a bank has been subordinated to other interests in the corporate family to give us concerns on this score. Moreover, the evolution of financial conglomerates, offering a variety of nonbanking products for which the bank's customers may be viewed as prime prospects causes me to want to be sure that the interests of our banks are being properly regarded.

This is another one of those situations—and we have seen many of them over the years—that cries out for an industry-generated solution. Time and time again we have seen legislative or regulatory initiatives adopted that might have been avoided or mitigated if the industry had had either some credible program of self-regulation or at least some standards of conduct expressing an industry consensus as to what is acceptable conduct. One need only recite the list of "compliance" laws enacted in the last 25 years—about which many bankers complain bitterly—to see the force of this point.

But where has the industry been in this time of turmoil in the field of corporate governance? If only out of enlightened self-interest, the industry could provide a useful service by expressing its own expectations and values, demonstrating that it recognizes—as I am confident it does—the importance of basic principles that have not been universally observed. Such an expression could have a material impact on investor confidence, among other things. At best it could have an impact on the need for even more legislation and regulation.

Consider this my challenge to you. But to be credible you've got to move quickly and with force. If you don't, the process of government policymaking will inevitably move forward, resulting in new requirements that will add to your costs and compliance burdens, and you will have passed up yet another opportunity. I don't mean to suggest that we will be sitting by waiting for you, for we have our own responsibilities to assure that the interests of the banks we supervise are properly protected. But what the industry itself can contribute could have a significant influence on what might emerge from the agencies or from Congress.

The kind of self-scrutiny we're going through today in so many areas of our economic life is never easy or comfortable. It exposes fallacies in some of our assumptions about the conduct of business and about human nature. It's teaching us things—about associations and about ourselves—many of us, given the choice, might prefer not to know.

But I believe there is no choice—not if we're to profit from our mistakes, restore confidence in our markets, and rebuild our productive capacity. Perhaps our greatest strength as a nation is the courage to confront our problems bravely and forthrightly and see them through to a solution. You have an enormously important role to play in the process.

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before a session on banking supervision with the People's Bank of China, Beijing, China, October 14, 2002

I am honored to be with officials of the People's Bank of China (PBOC), and I am grateful for the many courtesies extended to me since my arrival in your country. I have come to the People's Republic not only to build on the excellent working relationship that has developed with the PBOC and Governor Dai, whom I admire and respect, but also to build on the many years of Sino-American cooperation. China and the United States have much to learn from one another, and I trust that I will take home with me at least as much of value as I leave behind with you. I hope that my visit extends and enriches the long and constructive dialogue between our two great peoples.

The kindnesses you have extended to me are not only gratifying on a personal level. China's eagerness to hear from foreign visitors like myself, I think, speaks to the vast promise of its future. We Americans sometimes flatter ourselves by thinking that our economic success stemmed entirely from domestic sources and from our particular genius for invention. But the truth is more complicated than that. Over the course of our history, America, like all successful countries, has borrowed liberally from other societies—adapting principles and practices to the unique circumstances of our own culture, geography, and institutions.

In other words, the ideas exchanged across international borders may be just as valuable as the more tangible trade in goods and services in which nations engage.

That has been true in many areas, including banking and bank supervision. Americans have always had conflicting views toward banking, and that too was part of our inheritance from Great Britain. In the Tunnage Act of 1694, authorizing the incorporation of the Bank of England, the British Parliament recognized that it must have an orderly means of raising loans to conduct the affairs of state, and particularly to wage war. Then 26 years later, when Parliament passed the so-called Bubble Act, it essentially shut the door to further banking corporations, declaring, in what appeared to be a spirit of regret for its earlier actions, that such institutions were dangerous instruments of privilege and speculation.

These contradictory attitudes were transplanted to American soil. Even during our colonial period, Americans recognized that banks were necessary to meet the financial needs of the modern state and a developing economy. At the same time, banks were viewed with deep suspicion, if not hostility. Thomas Jefferson, the primary author of our Declaration of Independence, believed that banks were "more dangerous than standing armies."

Yet even Jefferson did not believe that the country could afford to dispense with banks altogether. Indeed, America needed banks even more than Britain did, for ours was a young, undeveloped, and far-flung country noticeably lacking in the great private accumulations of liquid wealth with

which England was blessed. In order to mobilize capital in such a place, banks were essential. In fact, Americans concluded that if we were to have any banks at all, we should have many of them—not only to serve potential customers for bank services, but also to discourage the rise of a small number of large and powerful institutions capable of exercising dangerous dominance over local economies.

From this reasoning flowed one of the most distinctive characteristics of the U.S. banking system. At its high water mark, in 1921, there were no fewer than 29,000 independent commercial banks in America. Even today, after decades of industry contraction, there are more than 8,000 U.S. banking companies, a number not equaled anywhere else in the world. (The slide in your package entitled "the banking industry is consolidating" reflects this.)

Viewed purely as an economic arrangement, this banking structure has probably never made much sense. Any system based on thousands of independent, mostly small, institutions might be viewed as a system inevitably lacking in stability and efficiency. But Americans were willing to sacrifice those qualities in a conscious trade off to preserve other values they cherished even more: competition, individual initiative, local responsiveness, and opportunity. Branch banking, despite its real economic benefits, was seen as a threat to those values—and as a step toward financial concentration and monopoly. That's why branching and bank consolidation were systematically suppressed by state and federal laws—some of which remained in effect until just a few years ago.

Americans did not depend entirely on the structure of their banking system to curb potential abuses of banking power. Government oversight and enforcement were also viewed as essential. But here too there have been inhibitions. Americans have always been uneasy with the idea of government intervention in the economy. Our experience as a colony left our people with deep suspicions of government authority—suspicions that linger to this day. The arrangements formalized in the U.S. Constitution, with its provisions for checks and balances and power sharing between the national government and the states, reflected these suspicions. Thus, in the same way—and for many of the same political reasons—that U.S. banks were encouraged to proliferate, a system of multiple bank chartering and regulatory authorities arose.

During the first half of the 19th century, the states dominated the field of banking. Each carried out its own program of bank chartering and supervision, reflecting wide variances in rigor and competence. The federal government's involvement was sporadic—and generally unwelcome. Not until the American Civil War, which redefined the relationship between the central government and the states, did a federal presence become a permanent part of the U.S. banking system in the form of the Office of the Comptroller of the Currency (OCC) and the national banking system, which our office supervises. I am proud to be the 28th person to hold the office of the Comptroller of the Currency since our founding in 1863.

It is significant that when the U.S. Congress created the national banking system, it did not choose to abolish state-chartered banking at the same time. Given the advantages they built into the

national charter, some lawmakers felt that such an outcome—a system consisting exclusively of national banks—was assured. But the state banks proved equal to the competitive challenge, and, as your slide shows, the U.S. has ever since had a dual system of state and national banks, under which national banks operate under the primary supervision of the OCC and state banks under the primary supervision of the 50 state banking departments.

Dual banking made for a complicated regulatory system that would soon grow more complicated still. But Americans didn't necessarily see regulatory complexity as a bad thing. It was viewed instead as a safeguard against the dangers of regulatory hegemony and abuse—and as an incentive to regulatory responsiveness and efficiency. Dividing regulatory authority between the federal government and the states—and then dividing it again, over a period of years, among three separate federal agencies—ensured that no single agency would be able to gain meaningful dominance. And because regulatory authority was checked and balanced in this way, Congress felt safe in endowing the OCC with considerable independence, both from its own control as well as from that of the executive branch within which the OCC was positioned.

The decision to create the OCC as an independent agency was quite an extraordinary step, and it was one that reflected Congress's understanding of the importance of supervision in the nation's overall banking scheme. Although formally a "bureau" of the Treasury Department—indeed, until the 1970s, the Comptroller's offices were actually housed within the main Treasury building in Washington—the OCC has always enjoyed considerable operational autonomy. Although appointed by the President with Senate confirmation, the President cannot remove the Comptroller before the expiration of the statutory five-year term without providing to the Senate in writing a statement of his reasons for doing so.

Just within the past decade, Congress passed additional legislation reaffirming the OCC's ability to submit legislative recommendations and testimony to Congress without prior approval or review in the Executive Branch. Moreover, Congress has forbidden the Treasury Department from intervening in any matter or proceeding before us, or from delaying or preventing the issuance of any rule or regulation by the OCC. I speak from personal experience—as Under Secretary of the Treasury for Domestic Finance before moving to the OCC—when I say that these rules have been scrupulously respected.

These structural firewalls have made it possible to successfully insulate the OCC from occasional pressures to support particular fiscal or monetary policies or to appoint politically connected individuals to supervisory positions. One measure of that success lies in the fact that my staff in Washington consists of civil servants who work under the merit system; while national bank examiners, of which there are currently more than 1500, have been recruited from the nation's universities and financial institutions, and commissioned after passing through a rigorous program of classroom instruction, on-the-job training, and continuing education. I hope you will not accuse me of being immodest when I say that our peers at home and abroad regard the OCC as the premier bank regulatory agency. But it's true.

So far, I have just spoken of one phase of OCC independence—independence from the executive branch of the federal government. Our relationship with Congress is somewhat different. Of course, the OCC is subject to all laws that Congress may make, and the Comptroller is regularly called upon to provide testimony on subjects of interest to legislators. But a crucial element of this relationship is the fact that we—unlike virtually all other agencies of our government—do not depend upon Congress to provide the funds we depend upon to finance our activities.

That is in accordance with Congress's own plan. In creating the OCC and the national banking system, it chose to remove the OCC from the normal budget and appropriations process—to remove it, that is, from its own direct control. It recognized that the power to approve a budget may confer an ability to direct policy, and that subjecting bank supervisors to the give-and-take of budget negotiations would inevitably lead to pressures for supervisory compromises. Thus, in a historic act of self-denial, Congress chose to restrict its own influence and authority rather than compromising the ability of the OCC to conduct its operations objectively and with independence. Instead, in a system that has continued to operate without interruption since the 1860s, banks are subject to annual fee assessments by the OCC, which since 1914 have been asset-based. They also pay fees to cover the cost of processing corporate applications. Those two sources together account for nearly 97 percent of the OCC's $413 million annual budget.

Our ability to deliver independent and professional bank supervision owes in large measure to the wisdom and selflessness of those who created the national banking system as a self-supported, self-financing entity.

Our longstanding belief that independence is crucial to effective bank supervision has received repeated confirmation elsewhere in the world. Indeed, the absence of supervisory independence has been implicated in almost every national financial crisis the world has recently seen. In Argentina, South Korea, Thailand, Japan, Turkey, and Indonesia, bank supervisors were unable to operate with the independence their responsibilities demanded. In each case, supervisors became instruments of government or central bank policies that subordinated the safety and soundness of financial institutions to other goals. In each case, banks were permitted—or even encouraged—to make loans in defiance of good credit practices in order to promote certain policy objectives, such as protecting inefficient industries. Moreover, in each case, the result was the same: supervision was discredited; the condition of the banking system deteriorated; the national economy suffered; and the process of recovery was seriously impeded by a crippled banking system. Some countries are still struggling with the consequences of such ill-advised supervisory policies.

These experiences help explain why, when the Basel Committee on Banking Supervision adopted its core principles for effective supervision in 1997, "operational independence and adequate resources" headed the list. And the experiences of other countries remind us of the importance of vigilance in defending supervisory independence here at home.

On another crucial issue of supervisory structure, however, global practice is less conclusive. That is the role of central banks—and, to a lesser degree, the deposit insurance agencies—in the supervisory arena. In this area there have been a wide variety of experiences and results. Many of the world's countries have opted to separate monetary policy from bank supervision. Austria, Canada, Germany, Japan, Norway, Mexico, and, recently, the United Kingdom, among others, have taken the step of removing the central bank from the supervisory function. The rationale is that there are inherent conflicts of interest between the two roles—that the goals of monetary policy—and a solvent deposit insurance fund—may not coincide with the demands of a safe, sound, and competitive banking system. For example, a central bank may decide that its overall monetary and macroeconomic objectives are better served by infusing capital into an insolvent institution, whereas the pure supervisor might have opted to close the bank. Similarly, the deposit insurer, if also endowed with supervisory responsibilities, may take a supervisory position that is highly adverse to risk-taking—good for the loss-ratios of the insurance fund, but perhaps not so good for the competitiveness of banks and their customers.

In the United States, nonetheless, we entrust the Federal Reserve and the Federal Deposit Insurance Corporation with significant responsibilities for bank supervision. As your slides show, state-chartered banks in America, in addition to their state supervisors, each have one primary federal bank supervisor: the FDIC if it's a state-chartered bank that is not a member of the Federal Reserve system (membership is optional for all state banks and mandatory for OCC-supervised national banks), and the Federal Reserve if the state bank is a Fed member.

We are often asked to explain why this complicated regulatory structure arose—and why we have not attempted systematically to simplify it. The question of origins has a relatively straightforward answer. I have already spoken of Americans' enduring suspicion of concentrated political authority and their belief that establishing multiple and competing government bureaucracies would serve to check their ambitions and excesses. Thus, when the Federal Reserve System was created in 1914—becoming the second federal agency with a bank supervisory mission—Congress simply layered it on top of the existing supervisory structure and parceled supervisory authority between the new Fed and the OCC. The same pattern held in 1933, when the FDIC—the third of the federal banking agencies—was created.

So it was not political cowardice, as some have suggested, that led Congress to avoid trying to abolish one agency when creating another to perform essentially the same, or a complimentary, function—although as you well know, abolishing government bureaucracies is never an easy task. There is a positive rationale for multiple agencies: that competition can be as productive in the public sector as in the private. In the case of bank supervision, the assumption has been that the agencies would each do their jobs better with bureaucratic competitors in the mix, challenging them to excel. Whether or not this was Congress's rationale, most agree that it has been the happy result.

In the case of U.S. banking, regulatory competition can take on a particular edge, because U.S. banks have the extraordinary ability not only to choose their chartering agency, but also to switch charters if they grow dissatisfied with the manner in which they're supervised. It's in the direct self-interest of the primary supervisors that depend upon assessment funding—the states and the OCC—to provide high quality, cost-effective supervision. And by most accounts, we do just that.

The other main reason why this somewhat unwieldy structure arose was because both the Federal Reserve and the FDIC made compelling cases in favor of their receiving significant supervisory responsibilities. The Fed has argued that it needs a "window" into the banking system to assist it in carrying out monetary policy, and the FDIC has made a plausible argument that the insurer's interests—and the health of the deposit insurance funds—must be taken into account in supervisory decisions that are likely to affect them. Thus, in addition to their routine responsibilities for state-chartered banks—responsibilities that, as already noted, are shared with state authorities—both the Fed and the FDIC have back-up supervisory authority for national banks that can be exercised in problem bank situations.

Once the Federal Reserve and the FDIC became permanent parts of our supervisory structure, the complexion of the U.S. dual banking system changed. Laws passed by Congress that were meant to apply to state as well as national banks were increasingly entrusted for administration to the federal supervisors of state banks, whose compliance with Congress's wishes could be better monitored. Thus, as your chart shows, most of the supervisory activities concerning state-chartered banks are carried out not by the states, but by the Federal Reserve and the FDIC. So there is probably less "duality" today than there has ever been in the 140-year history of the U.S. dual banking system.

As to why our system has persisted despite its unwieldiness, there are a couple of points to consider. The first is that there has never been a clear and compelling consensus for change. The U.S. banking industry and other interest groups have learned to live with—and take advantage of—our existing system. For them, change would be unwelcome. But even those groups that might be expected to support supervisory rationalization—consumer and public interest groups, for example—have been not expressed that support in any consistent or unified way. And the regulatory agencies themselves have never been enthusiastic about proposals to simplify supervision—especially when simplification would occur at their expense.

A second reason why our structure has remained in place is that the U.S. regulatory agencies, through trial and error, have learned to work effectively within it. We have created formal mechanisms for coordinating our efforts and avoiding duplication and unnecessary burden on U.S. financial institutions, as well as informal avenues for information sharing and consultation. I believe that the relationships that exist among U.S. supervisors validate the concept that lies at the heart of our structure—that competition among regulatory agencies can enhance the quality of supervision and help prevent it from becoming unduly burdensome for financial institutions.

The final and perhaps most important reason why our regulatory structure works is that it is an authentic reflection of our country's habits of mind and practice. While international experience suggests certain core principles of effective bank supervision—independence being chief among them—every country must find its own way of implementing those principles, in a manner consistent with its own culture and institutions. That is what the United States has successfully done over a period of many years. And that is one of the great challenges that confront the People's Republic of China. We at the OCC are delighted to assist in any way in that effort.

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the North Carolina Bankers Association, Pinehurst, North Carolina, on reforming the system of funding bank supervision, October 22, 2002

Most people visit this lovely resort for a break from life's stresses and tribulations. But this is also a place for serious contemplation about the challenges that we face as a society. That's what has brought presidents and heads of state to Pinehurst for many years; it's what brought the North Carolina Bankers Association here for this year's management team conference, and it's what brings me here to join you today.

These are nothing if not challenging times—for our country, facing new and knotty threats from abroad; for our economy, which continues to struggle for positive momentum; and for the banking industry, whose health is inextricably linked to its operating environment—an environment that holds more than the usual brace of challenges.

Challenge is by no means synonymous with crisis, of course, and, indeed, the continued vitality of the U.S. banking system is often cited as a major reason why the national economy continues to holds its own—however precariously—rather than slipping back into a dreaded "double-dip" recession. Here in North Carolina, for example, the banking system can be characterized as generally stable or improving—much better than one would expect given the recent performance of the state's economy and a significant source of the state economy's underlying strength.

Preliminary second quarter 2002 data for all North Carolina commercial banks show a 10 percent increase in net income, compared to the same period in 2001. Assets are up, though by a lesser percentage. More than twice as many institutions reported earnings gains over the previous period; the percentage of unprofitable institutions dropped by nearly a third. Return on equity and return on assets were significantly up, as was capital; nonperforming assets were down.

As I've suggested, these performance data are especially noteworthy given the conspicuous, if no doubt transitory, weaknesses in the state's economy—an unemployment rate that has been averaging close to seven percent, above the national average; a slowdown in housing starts; and slow progress in narrowing the gap between the richest and poorest citizens of this great state. The latest Federal Reserve Beige Book pointed to signs of stress in the state's crucial farm economy, and rising vacancy rates in commercial real estate. And that was before the dismal September on Wall Street, which presumably did nothing to bolster the confidence of those in North Carolina responsible for purchasing and hiring.

Not all the challenges confronting North Carolina bankers—and U.S. bankers generally—relate to the current economic uncertainty. Some of those challenges have more to do with secular

changes in the business of banking—changes that were already very much in evidence back in the innocent days when people were convinced that the business cycle had been repealed by the microchip revolution.

The consolidation of commercial banking in this country has been going on for a very long time and for a good many reasons. A certain percentage of the bank mergers of the past decade undoubtedly occurred for no other reason than that it became possible to do them. The Riegle–Neal Act of 1994 tore down the barriers to interstate branching, and bankers with interstate ambitions sometimes sought to achieve them on the quick. Since then, bank mergers have been driven by more fundamental considerations. Bankers have sought to capitalize on economies of scale, to leverage investments in technology, to diversify geographically, and to broaden product offerings to a more demanding and sophisticated financial consumer.

The results, as you know, have been mixed. While it is certainly true that not all of the promised benefits of this merger activity have materialized for banks, neither have most of the concerns of the critics. As the members of this audience can attest, our financial markets remain highly competitive; our citizens and our communities are, with few exceptions, exceedingly well served by depository institutions; commercial credit has remained widely available, to small businesses and large, on reasonable if not easy terms; employment in the banking industry has not declined appreciably, if at all; and there has been no shortage of new entrants to the banking business, despite the generally inhospitable economic environment.

Yet the structure of U.S. banking *has* changed in consequential ways, and that change is nowhere more plainly visible than here in North Carolina. Indeed, North Carolina may be *the* state whose fortunes—and whose very identity as a banking center—are most closely bound up with the trend toward financial consolidation. It's easy to forget how startling it would have seemed just 15 or 20 years ago to suggest that Charlotte would become one of the world's great banking centers. But it has become just that—thanks not only to the legal, economic, and technological developments I've already mentioned, but also to the vision and leadership of larger-than-life North Carolina bankers like Ed Crutchfield, Hugh McColl, and John Medlin, as well as to the equally hardworking but perhaps less heralded North Carolina bankers who lead this organization and those who make up its rank-and-file.

North Carolina's extraordinary rise to national and world prominence as a banking center—and as an economic power—is reflected in numbers that are at odds with national trends. In only five states of the union are there more commercial banks today than there were in 1984. North Carolina—which went from 68 in 1984 to 72 today—is one of them.

Yet when one focuses on the *distribution* of North Carolina banking assets, the picture comes into closer convergence with national trends. In 1984, the three largest North Carolina banks held 63 percent of total state assets. Today, the three largest control 95 percent. To slice it another way, where the 65 smallest North Carolina banks (out of a universe of 68) shared 37 percent

of state banking assets in 1984, the 69 smallest share five percent today. Obviously the pie has grown tremendously over that period, with total assets increasing by about thirty-fold, but that simply highlights the vast dominance—statistically speaking, at least—of the very largest banking corporations—which, of course, carry on their business not only in North Carolina, but throughout the country.

If you happen to represent one of those big banks, chances are that you take enormous and justifiable pride in those numbers—numbers that affirm everything you have worked to achieve. But what if you're here at Pinehurst representing the Millennia Community Bank of Greenville, with $24 million in assets—the smallest commercial bank in the state? What do these numbers mean to you?

The answer may be, much less than one would expect. When we look back years from now, the performance of community banks in the era of banking consolidation will stand as one of the truly inspiring stories of our economic age. Against daunting odds, community bankers have succeeded in keeping their franchises relevant and profitable through judicious adoption of technology, strict controls over operating costs, and a fixed focus on customer service and local responsiveness. You would probably dismiss the suggestion than any of you are heroes, but by demonstrating that there's a place for individual initiative even on a landscape dominated by giants, heroes are what you are nevertheless.

The consolidation of the banking business has been almost as much of a challenge for bank supervisors as it's been for bankers themselves. It's forced us to modify an approach to bank supervision that has been in place at the Office of the Comptroller of the Currency (OCC)—and at the federal and state agencies that have modeled their supervision after ours—for many decades. That approach was founded on the notion that commercial banks big and small were banks at the core—more alike than different, vulnerable to the same environmental forces and human mistakes. But experience has taught us that banks at either end of the spectrum—and North Carolina is richly endowed with both types—present very different risks to themselves and to the public interest, and necessitate official oversight of a wholly different nature and degree. The noncomplex procedures we now use for most community banks and the continual onsite presence we maintain at banks in our large bank program reflect this bifurcation. For the OCC, it has involved a totally different way of doing business.

Banking consolidation has also exposed what I believe are serious flaws in the way we fund supervision. I should say, "additional serious flaws," because I have already expounded at considerable length about the unfairness of a system that requires national banks to bear the full cost of their own supervision *and* to subsidize a significant portion of the supervision of their state-chartered competitors. The OCC, as you may know, has proposed to deal with that inequity with a plan that would draw upon earnings from the Bank Insurance Fund to offset the costs of *all* supervision—state and national—and do away with the assessment-based system that was introduced back in the horse-and-buggy days. Such a change would place state and national banks

on an equal footing, and end the discriminatory arrangement that delivers benefits to one favored class of financial institutions and forces national banks—and U.S. taxpayers—to foot the bill. I want to make very clear that our proposal would have significant benefits for state banks, because it would eliminate the need for state supervisors to impose any direct assessments on them.

Fairness aside, perhaps the most damning indictment of our current funding arrangement is that it undermines the very purposes for which it was established: the safety and soundness of all commercial banks and the health of our system of dual chartering options for those same banks.

It seems difficult to defend a funding system that, in times of economic stress, forces supervisors to turn to well-managed banks for the resources supervisors need to deal with problem institutions—another kind of unfair subsidy. But that's exactly what our current system does with regard to national banks.

It seems difficult to defend a system that has created a marketplace for charters—"bazaar" may be a better term—in which cost seems to be the principal thing that counts and qualitative factors—such as supervisory philosophy and responsiveness, examination quality, and the scope of permissible activities—are frequently disparaged or disregarded.

In fact, the subsidy renders meaningless any qualitative inferences that might otherwise be drawn from the fee disparity—about the relative efficiency of state and national supervisors, for example—because state assessments reflect only about 22 percent of the total costs of delivering supervision to state banks.

If I'm making widgets and some third party is generous enough to pick up 78 percent of my costs, I can probably afford not to worry too much about my efficiency and still sell my product for a lot less than the competition.

Maybe it's not so remarkable after all that this is a system that still has such vocal defenders.

The main reason why people defend such a system, I gather, despite these grievous and widely acknowledged defects, is that they're afraid that the alternative might be worse. They're afraid, especially, that under any fair and rational system of supervisory funding, some state banks might convert to the national charter, with potentially damaging institutional consequences for state supervisors and their federal counterparts involved in state bank supervision.

Here's where the trend toward industry concentration has cut uncomfortably close to the bone for bank supervisors. It's to be expected that we'd find the largest number of charter conversions among the largest pool of banks. Indeed, between 1990 and 2002, more than 90 percent of stand-alone flips out of the national charter—that is, those that occur in the absence of a merger or acquisition—involved community banks under $500 million in assets. Those are the institutions that tend to feel cost-cutting pressures most intensely and that are most likely to be attracted by the prospect of saving a few thousand dollars a year.

For the supervisory agency, the financial impact of such conversions is usually manageable. It can even be a positive if, as is the case at the OCC, the assessment structure is progressive, with community banks generally paying less than the pro rata share of their supervisory costs. Indeed, while we always regret it when a community bank decides to relinquish its national charter, the bank's action can often result in a net gain to our bottom line.

When a bank exceeds a certain size, however, its conversion can be damaging to the supervisory structure, for the departure of a well-managed larger bank may diminish resources that are needed to deal with more troubled institutions. And as large banks grow larger, the potential impact of a conversion gets disproportionately greater.

If that's true for the OCC, with its 2,200 national banks—the largest of which represents 16 percent of the total assets in the national banking system and 10 percent of total OCC assessment revenues—consider the vulnerability of half of the state banking departments, in which a single state bank accounts for more than 25 percent of the bank assets under state supervision. In eight states—including North Carolina—a single state bank accounts for more than 50 percent of the assets under state supervision. In any of those states, the loss of a large bank, to conversion, merger, or failure, could be devastating.

In that light, one can understand why some state supervisors might dig in their heels in opposition to the OCC's proposal to rationalize the supervisory fee structure—even though our proposal would clearly be beneficial for the banks they supervise. Over the years, a view has taken hold—a view that I believe is quite erroneous—that lower assessments are about all that the state charter has to offer, and that if the fee disparity were reduced or eliminated, state banks would flee en masse to the national charter.

But that needn't be the case, and I don't believe it would be. The state bank charter is not in such a state of decrepitude that it needs $1 billion a year in federal subsidies to shore it up—and I am surprised that the supervisors of state banks would implicitly take a contrary view.

For much more than a century, against far longer odds than it faces today, state banking has competed successfully through the application of grit, innovation, supervisory responsiveness, and other qualitative attributes that have unfortunately been cheapened in the current obsession with assessments. I am convinced that we can restore fairness of our system of supervisory funding, maintain the vitality of state supervision, and reinvigorate the system of dual chartering that contributed so significantly to the proud and productive history of commercial banking in our country.

Reforming our system of supervisory funding is no panacea. But I believe it's as good place as any to start.

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before America's Community Bankers, San Francisco, California, on the viability of the thrift charter, November 5, 2002

I want to thank Diane Casey and the America's Community Bankers (ACB) leadership for inviting me to be with you today. While I know that ACB's membership includes commercial banks, this organization plays a tremendously important role as the leading representative of the thrift industry.

There. I've used the "T" word, in full understanding that it's a term that's largely been banished by the industry it once described. With your forgiveness, I will use it occasionally in my remarks, but only in order to make a couple of points: first, to distinguish the main body of ACB members from the financial institutions supervised by the OCC, and second, to aid in discussing the trend that has all but obliterated what were once key differences between the two types of institutions.

My involvement with your industry spans about 40 years. When I was a young associate at my old law firm, I cut my litigation teeth representing savings and loans (S&Ls) in branch office hearings before the old Federal Home Loan Bank Board. And in the late 1960s I spent endless hours working on S&L holding company legislation. I came to value the thrift charter, and the unitary thrift holding company, as highly flexible formats for carrying on the business of a depository institution, and I still feel that way, even though savings associations and banks have come to look much more alike.

In those days, the differences between commercial banks and savings institutions were still wide and fundamental. The two occupied very different niches within the financial services industry; they undoubtedly competed for some of the same customers, but generally not in ways that the other could have easily replicated. Regulation Q drew a significant line between banks and thrifts. Most people thought of the two as distant cousins rather than competitors. Bank and thrift regulators traveled in their own circles as did their respective trade associations—and our interests diverged as often than they coincided.

What is remarkable is the extent to which the two industries have converged over the last quarter century. Today the public views savings associations as virtually indistinguishable from banks. Indeed, most savings institutions now explicitly hold themselves out as "banks," and—for reasons we all understand—their old identification as "savings and loans" has virtually disappeared—as has the "benefit" they enjoyed under Reg Q of being able to pay higher rates than banks.

Over the past several years, both sectors have seen significant consolidation and restructuring, significant growth of assets and deposits, and, most importantly, significant prosperity. Just since 1994, the number of federally insured savings associations has dropped by approximately 30

percent, commercial banks by about 25 percent. Total assets held by savings associations are up by a little more than 30 percent since 1994, commercial bank assets by just over 50 percent. Both industries today operate from strong positions of equity capital.

The trend toward convergence between the two industries is also evident from an examination of their respective balance sheets. At one time, non-mortgage consumer loans were virtually the exclusive realm of commercial banks. Today, consumer loans account for 8 percent of the loans held by savings institutions. That compares to about 11 percent of all loans held by banks with under $1 billion in total assets.

In other words, the differences between savings associations and commercial banks—especially community banks—are increasingly hard to find.

The same trend can be viewed from another perspective. Commercial banks once held very few real estate-related loans, especially residential mortgage loans. Today, one- to four-family mortgages constitute 25 percent of loans held by banks, and many more mortgages are originated and then securitized.

Indeed, real estate lending is today a major pillar of the national banking system, and a significant source of its strength. Today, at a time when national banks are still making fewer non-real estate loans than they did a year ago, real estate lending is up nearly 10 percent. Today, real estate loans constitute around 45 percent of total national bank loans—5 percent higher than in 1994 and a whopping 20 percent higher than in 1984.

Moreover, the securitization of residential real estate loans plays a large and increasing role in the growth of noninterest income at national banks. As of the second quarter of 2002, residential real estate loans comprised nearly two-thirds of the total stock of securitized loans outstanding at national banks, and income from securitized loans rose by more than 30 percent—a big part of the reason why total noninterest income at national banks was up by more than 8 percent over the same period last year.

What all this means, of course, is that the operational concerns—and macroeconomic trends—that keep ACB members up at night are, increasingly, many of the same trends and concerns that preoccupy the average national bank. Indeed, the vast majority of the institutions supervised by the Office of the Comptroller of the Currency (OCC)—some 2,000 of the 2,200 banks that make up the national system—are community banks, with under $1 billion in assets. Of those 2,000, about half are under $100 million in assets. You can't get more "community"—or more like the typical ACB member—than that.

More than 1,300 OCC examiners—nearly two-thirds of our total examiner force—are dedicated to community bank supervision. The issues that our examiners focus on—and the perspective they bring to those issues—have also changed to reflect the changes that have taken place in the banks they supervise.

Two decades ago, for example, OCC examiners would almost certainly have criticized any national bank with the kind of concentration in residential real estate that is commonplace—and that usually passes without criticism—today.

Two decades ago, OCC examiners would probably have viewed the consumer debt load and the condition of residential real estate markets as relatively minor risk factors for the national banking system. Today these are among the most important issues our analysts and examiners face, precisely because they have become so important to the safety and soundness of the institutions we supervise.

It's become a cliché in our present economy that the consumer is king—or queen. We can go even further: consumer spending over the last two years prevented what is so far the mildest recession in recent history from becoming much more serious. The willingness of American consumers to continue spending despite the dismal performance of many of their investments represents a vote of confidence in the fundamental health of our economy.

The combined effect of tax cuts and the dramatic decline in interest rates has been significant for the economy. Successive cuts in short-term rates—the Fed implemented 11 such cuts in 2001 alone—helped to keep auto sales brisk and to sustain one of the best housing markets in history. Fixed mortgage rates hit all-time lows this summer, and they have largely stayed there. New housing starts, sales of existing homes, and mortgage refinancing have soared to record levels, and property values generally risen with them. One estimate places the rise in property values over the past two years at $2.5 trillion—making up for no less than half the total loss in equity wealth over the same period. And mortgage refinancing has generated savings of about $150 billion in the form of cash-outs and lowered monthly payments.

That's $150 billion extra in the pockets of American consumers—a windfall that has until now helped keep our shops busy, our factories humming, and our employment stable.

The big question is whether we can sustain this level of activity. Is the consumer in a position to continue supporting the economy until business investment has rebounded to the point where it can bear its share of the economic load?

These days, the evidence is inconclusive. If it's good news that you're looking for on this front, you probably won't have trouble finding it. Indeed, many retail indicators continue to reflect strength.

But bank supervisors are professional worriers. Something in their DNA seems to cause them to find glasses half empty and to see dark clouds on every horizon. Even after adjusting for this somewhat dour outlook, we think there's legitimate cause for concern about whether consumers have the wherewithal to carry the load for the economy through these uncertain times.

A telling signal on the retail side is the drop in key indicators of consumer confidence. Last month the University of Michigan's Consumer Sentiment Index dropped to a nine-year low—the fifth consecutive monthly decline in that index. This appears to be no aberration; the Conference Board's Consumer Confidence Index has declined for five straight months and is now at its lowest level since November 1993.

This trend has been in evidence in auto showrooms. Despite the renewal of below-market financing deals, auto sales pulled back 5.2 percent in September. Sales rose for durable goods, as consumers loaded up on appliances and furniture for all of those new houses, but not enough to offset losses in autos.

A particularly disconcerting fact is that despite rock-bottom interest rates, debt service as a percentage of disposable income is higher than it's been since the mid-1980s. That's partly a reflection of the rise of consumer credit outstanding and partly due to the decline in median household income. In 2001, household income fell by 2.2 percent after adjusting for inflation, and the poverty rate rose for the first time since 1993. And there's little evidence of an impending turnaround, given rising unemployment claims and continued weakness in the job market.

It may be, in other words, that the consumer has already given about all that the consumer has to give. Indeed, debt load statistics suggest that consumers may have given too much, and that retail customers could be especially vulnerable to an unexpected economic jolt—in the form, say, of a spike in interest rates or energy costs, or what some believe is a long-overdue softening of the housing market.

There's widespread concern that in some parts of the country the good times in housing amount to a bubble that cannot last. The implications for the issuers of high loan-to-value first mortgages and home equity loans—one of the fastest-growing categories of consumer loans by national banks—are obvious. Indeed, this summer, mortgage foreclosures rose to the highest levels on record.

What are the other implications of a weakening consumer sector for national banks and savings associations? More to the point, what is the OCC doing to help the institutions it supervises manage the special risks that this complex and sensitive situation present?

I say "sensitive," because, as I've emphasized, consumer spending—and borrowing—is crucial to the health of the banking system and the economy, present and future. Obviously, it's in our interest to preserve the ability of banks to continue making prudent loans to business and consumers alike.

Having said that, we know from experience that the best way to maintain credit availability and healthy economic development is to safeguard the safety and soundness of the institutions that supply it. And the way we do that as bank supervisors is to assist lending institutions to identify, control, and manage risk—both new and existing.

As a case in point, we and the other Federal Financial Institutions Examination Council agencies, including the Office of Thrift Supervision (OTS), recently issued proposed guidance on credit card lending. It was the outgrowth of recent examination findings of inappropriate or weak account management, risk management, and loss allowance practices at some institutions—practices that give us particular concern in today's uncertain retail banking environment.

For example, we found that some institutions have been extending credit, increasing existing credit lines, or issuing additional lines with insufficient regard to the borrowers' ability to repay. In some instances, issuers failed to evaluate and document the borrower's creditworthiness; in others, institutions lacked adequate management information systems to get their arms around borrowers' total exposure; and some issuers have clearly paid insufficient attention to their workout and collection arrangements.

We have been particularly concerned about subprime lenders, especially those that freely grant credit-limit increases to cardholders—or that implicitly grant such increases by honoring over-limit charges and carrying the excess forward month after month with substantial penalty charges. Too often that leads to negative amortization, a situation in which the minimum monthly payment is insufficient to amortize the debt, and finance charges pile up to increase the amount owed. Subprime borrowers frequently lack the financial capacity to service this additional debt and the high fees associated with being in an over-limit status. It's not uncommon for subprime borrowers to be current on their debt, and yet, when finance charges and over-limit fees are added in, to wind up owing their creditors more *after* making the minimum payment than they did before. This is obviously an untenable situation for borrowers, but it also exposes lenders to the possibility of large unsecured losses. The consequences for banks—and for the economy—could be serious.

As supervisors, we believe it is important to avoid such an unhappy outcome. The guidance put out for comment spells out our expectations for prudent risk management practices for credit card activities. We expect issuing institutions to manage credit lines prudently—to fully test, analyze, and justify credit line assignment and line increase criteria. We expect that over-limit authorizations for subprime borrowers will be carefully considered, and that workout policies will be properly managed.

And while we recognize that it will take some time for financial institutions fully to phase in the policy changes that our guidance contemplates, we want to see financial institutions making an early and industrious effort to address those areas in which corrective action is most needed. Much rides on the outcome for national banks, for ACB members, and for all financial institutions—as well as for our economy.

That's another facet of the convergence of banks and savings associations that I mentioned earlier in my remarks. During the early 1980s, while S&L losses multiplied, banks operated in relatively safety.

Those days, I suspect, are gone forever. Whatever happens tomorrow—good or bad—will undoubtedly affect ACB member institutions and commercial banks without distinction. Now we're in it together.

That's why it's so important that we share views and insights across industry lines—and why I so appreciate the opportunity to speak to you this morning.

Before closing, let me speak to an issue that I know is on your minds, and that is the future of the thrift charter and the Office of Thrift Supervision. If, as some suggest, thrifts and commercial banks have become increasingly difficult to distinguish from one another, then it's logical to ask whether we need both charters. And even if the answer is that we should retain both, then it's not unreasonable to ask whether we still should have two federal agencies to supervise the two industries.

As I said before, I am a strong believer in the charter you hold, and I want to see it preserved. Indeed, I had hoped that financial modernization legislation would use the thrift charter as the model for all depository institutions—a kind of highest common denominator—and I regret that did not happen.

Some people have suggested that there is a compelling logic to merging OCC and OTS. There is no question, of course, that the crazy quilt of U.S. financial supervisory agencies offends some people's rigid conception of bureaucratic orderliness. Contraction among savings associations and attrition at OTS have fanned the consolidation flames. Indeed, the most recently announced OTS staff reductions would bring that agency's workforce below 1,000 for the first time. By contrast, in 1994, the number of OTS staffers stood at over 1,700.

You have all heard the line attributed to Mark Twain: "the report of my death was an exaggeration." The same can be said of OTS. It's now going on 14 years that OTS has been said to be on the verge of extinction. Notwithstanding these predictions, OTS is fully discharging its responsibilities under the law in a highly professional manner and playing a very important role in the supervision of our financial institutions. After several years of budget deficits, OTS Director Jim Gilleran has not only balanced OTS's budget, but now projects a small operating surplus. OTS continues to have a critical mass of institutions to supervise, and I see no useful purpose to be served in merging the two agencies. While it is true that banks and savings associations are looking more alike than ever before, there continue to be significant differences in the charters, in their holding companies, and in the legal frameworks under which they operate. These differences also weigh strongly in favor of the continuation of strong and effective representation of this segment of the financial services industry in Washington, such as that provided by Diane Casey and ACB. Any effort to merge the regulatory agencies would not only be disruptive, but would have to come to grips with these differences. Perhaps that's why no significant public constituency seems to have developed in favor of an OCC–OTS merger.

So let's hope that the next time a Comptroller of the Currency is invited to address the ACB annual convention, it is as the supervisor of a vibrant national banking system, vigorously competing with an equally vibrant group of savings associations under the supervision of an independent OTS. Freedom of choice for financial institutions is a goal worth preserving; I assure you that the OCC is committed to working toward that end.

Statement of Douglas W. Roeder, Senior Deputy Comptroller for Large Bank Supervision, Office of the Comptroller of the Currency, before the U.S. Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, on how the OCC supervises large national banks in general and complex structured transactions such as those entered into by Enron, Washington, D.C., December 11, 2002

Statement required by 12 USC 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.

Introduction

Chairman Levin, Ranking Member Collins, and members of the subcommittee, I am Douglas Roeder, senior deputy comptroller responsible for large bank supervision. Thank you for inviting the Office of the Comptroller of the Currency (OCC) to participate in this important hearing.

We share your concerns over the Enron debacle and commend you for holding this hearing. What happened to Enron employees, who lost their jobs and their retirement savings, is tragic. We also have a concern about the role national banks played in some transactions entered into by Enron. As I will discuss, both the banks themselves and the OCC are taking steps to try to guard against future occurrences of this type. It is important to keep in perspective, however, that the role of bank regulators is only one component of the challenge of preventing the repeat of an Enron-like disaster.

My testimony will address how the OCC supervises large national banks in general and complex structured transactions such as those entered into by Enron in particular. For clarity, when I refer to complex structured transactions, I mean highly customized financial transactions that often involve a derivative or off-balance-sheet component, such as a special purpose entity (SPE). I will discuss where we think we should broaden our supervisory focus and strengthen our processes and the steps we have taken to do so. I will also describe the OCC's coordination with the Securities and Exchange Commission (SEC), the Internal Revenue Service (IRS) and other agencies in cases where we believe there may have been violations of laws administered by those agencies. My testimony will close with comments on some of the steps the banks are taking to improve their own processes.

Large Bank Supervision

The OCC is responsible for supervising over 2,000 banks. Some of these banks are among the largest banks in the country, indeed the world; they offer a wide array of financial services and are engaged in millions of transactions every day. For maximum effect, the OCC has dedicated

teams of examiners actually residing in our largest national banks. Nonetheless, given the volume and complexity of bank transactions, it simply is not feasible to review every transaction in each bank, or for that matter every single product line or bank activity. Accordingly, we focus on those products and services posing the greatest risk to the bank.

The first step in risk-based supervision is to identify the most significant risks and then to determine whether a bank has systems and controls to measure, monitor, manage, and control those risks affecting the institution. Next, we assess the integrity and effectiveness of risk management systems, with appropriate validation through transaction testing. If we have concerns, then we "drill down" to test additional transactions. If this reveals problems, we have a variety of tools with which to respond, ranging from informal supervisory actions directing corrective measures, to formal enforcement actions, to referrals to other regulators or law enforcement.

Resident examiners apply risk-based supervision to a broad array of risks, including reputation risk and transaction risk. Because historically it is credit risk that has posed the greatest threat to safety and soundness of banks and, indeed, the banking system, bank supervisors have devoted significant attention to the supervision of credit risk. The case of Enron demonstrates just how significant other types of risk can be to the operations of a large financial institution.

As a result of this experience, the OCC will refine its approach to supervising aspects of bank operations that may cause reputation, litigation, and other operational risks in the area of complex structured transactions. Banks have also learned from this experience. As a result, they have tightened their procedures and controls. I will discuss both of these developments in greater detail below.

OCC Policies and Procedures for Complex Structured Transactions

Complex structured transactions, such as those entered into by Enron, are generally offered at only a small number of large banking companies, although other companies may conduct isolated transactions. Our supervision of complex products focuses on a bank's ability to manage the relevant credit, market, and transactions risks. Within the context of our risk-based supervisory approach, we believe we can enhance our supervision of complex structured transactions to better assess the broader risks inherent in those activities. To understand these planned supervisory changes, it is useful to start with the OCC's policies for dealing with complex structured transactions and then describe how we intend to enhance them.

As I mentioned previously, the types of transactions engaged in by Enron generally involved some type of derivative or off-balance-sheet product, often a special purpose entity (SPE). While derivatives (and SPEs) serve many legitimate purposes and have resulted in more efficient markets and enhanced the safety and soundness of our financial system, they, like any other tool,

can also be misused. The OCC's "Risk Management of Financial Derivatives" booklet (narrative: January 1997, procedures: February 1998), of the *Comptroller's Handbook,* explicitly addresses derivatives products and provides guidance for examiners to follow when evaluating a bank's risk management system for complex structured transactions. In the wake of Enron, we have asked ourselves how our current approach could be enhanced. We have identified several areas where we believe enhancements are warranted.

New product approval. OCC's evaluation of new product approval begins with an assessment of the bank's process. Our examiners evaluate the bank's system for ensuring that responsible senior managers approve new product offerings and that risk management reports adequately capture such products. We direct bankers to ensure that adequate technical knowledge and financial resources are in place before offering new products or services, and we emphasize the importance of a robust control environment that includes sign-off by all members of relevant areas, such as:

- risk control,
- operations,
- accounting,
- legal,
- audit, and
- senior line management.

Having a sound approval process for new products is essential; but equally important is the definition of new products. The reputation risk, including potential legal or regulatory action, to which a bank exposes itself, if it engages in questionable new products, can be significant. Our current policies provide that when bank management is deciding whether or not a product must be routed through the new product process, it should consider various factors:

- structure variations,
- pricing considerations,
- legal and regulatory compliance, and
- market characteristics.

When in doubt as to whether a product requires vetting through the new product approval process, we advise bank management to err on the side of conservatism and apply the process to the proposed product or activity.

Going forward, we will sample more extensively transactions going through the new products approval process. In particular, we will check on whether banks are following their own processes and whether proper review and authorization are received prior to engaging in complex structured transactions.

In addition, we are considering whether an amendment to our safety and soundness guidelines, which are part of our "Part 30" regulations, is in order. These interagency guidelines set out minimum safety and soundness standards for banking activities including:

- internal audit,
- credit underwriting,
- loan documentation, and
- internal controls.

Violation of a guideline can result in a bank having to prepare and submit a compliance plan, or it can result in a regulator taking an enforcement action. We are discussing with our sister banking agencies whether to revise these interagency guidelines to address more specifically board and senior management responsibilities for the approval and oversight of corporate strategies, business plans, and approval of new products that involve transactions such as complex structured products.

Customer appropriateness. While a given product may be approved through the new product approval process as an activity acceptable to the bank's board and senior management, the bank must also carefully consider the appropriateness of complex structured transactions for any particular client. In testing such controls, our focus has been on how well the bank assesses the sophistication of the customer. To that end, our examiners look at the bank's assessment of the nature of the customer's business and the purpose of the customer's derivatives activities. The examiners review the bank's evaluation of the possibility that a customer does not understand a transaction, or that the transaction is inconsistent with the customer's policies, thereby inhibiting the customer's ability to perform under the terms of the contract. To make this assessment, examiners review a sample of credit and marketing files to determine whether the files contain sufficient information to understand the risks the customer is attempting to manage, the types of derivatives expected to be used, and the overall impact on the customer's financial condition.

In testing a bank's controls on customer appropriateness, we will enhance our process and consider not only whether the bank has assessed the customer's ability to understand the transaction and to perform under the terms of the contract, but also if bank management understands the purpose and the customer's disclosure/accounting intent, so the bank does not become embroiled in questionable practices engaged in by its customers. We will test compliance with new policies and procedures, including policies regarding customer disclosures of material financings, and review audit's plans and performance.

Bank management involved in structured finance bears crucial responsibilities. Independent risk management personnel should be involved in the review of any transactions that appear to "push the envelope" and may expose the bank to undue risk. When in doubt, bank management should apply additional scrutiny, for example, obtaining opinions from bank counsel or accountants. While it is not realistic for banks to be responsible for how customers account for transactions on

their own financial statements, when uncertainty continues to exist regarding business needs or whether a transaction meets required standards, it is incumbent on bank management to carefully consider their actions and the potential impact on the bank and to decline to participate in transactions that do not meet the standards of integrity that the bank has established.

Large relationships. We think it is important that bank management has established controls that encompass the total relationship the bank has with its large customers. We plan to sample large relationships (even if credit risk is low) and "flag" structured products during our credit work for potential further review. We expect that this will involve using a cross-functional team of examiners to assess credit, price, compliance, and reputation risk associated with approved complex structured transactions. Competitive pressures are a natural part of any business environment, but care must be taken to assure that line managers eager to retain or expand business with important customers don't cross the line and jeopardize the trust and credibility that form the foundation of a bank. The lost business, diminished market capitalization, and increased funding costs that a bank may suffer if financial market participants lose confidence in a bank's control structure can significantly outweigh actual financial losses arising from direct exposures to the customer in question.

Cooperation with Other Agencies

Enron and other corporate governance scandals have revealed some weaknesses in our nation's accounting rules and in the oversight of the accounting profession. The Sarbanes–Oxley Act is a crucial response to those shortcomings. The Securities and Exchange Commission is in the process of adopting and amending regulations to carry out the Sarbanes–Oxley Act and the new Public Company Accounting Oversight Board has vital new responsibilities to oversee accounting standards and the accounting industry. These changes should go a long way toward addressing the weaknesses in our accounting regime and corporate governance that allowed Enron to happen.

For our part, in addition to our direct supervisory responsibilities under the federal banking laws, we work cooperatively with many other federal agencies and law enforcement. These include the other federal banking agencies, the Securities and Exchange Commission (SEC), and the Internal Revenue Service, and also National Association of Securities Dealers, Federal Trade Commission, the Department of Labor, Department of Justice, the Federal Bureau of Investigation, and the Secret Service. When we become aware of information that indicates a national bank may have violated a law or regulation under the jurisdiction of another agency, we make referrals to that agency. We cooperate, as needed, if the agency determines to pursue the matter. The cooperation may entail providing documents, information, and expertise, and making OCC examiners available to serve as witnesses in criminal trials and enforcement proceedings. When other agencies refer to the OCC potential violations of banking law, the OCC will investigate and take enforcement action, as appropriate. In addition, pursuant to OCC regulations, national banks file tens of thousands of suspicious activity reports with federal law enforcement agencies each year.

Focusing on the SEC, for example, the OCC has referred violations of federal securities law to the SEC and cooperated in SEC investigations. Similarly, we have received referrals and information from the SEC concerning infractions of banking laws. Our agencies have shared information concerning potential violations of law from examinations or inspections and from investigations, and OCC examiners have served as witnesses in SEC enforcement actions. In appropriate situations, we have coordinated our enforcement efforts and brought simultaneous or joint enforcement actions. The OCC and SEC also participate together in working groups, such as the National Interagency Bank Fraud Working Group and the Interagency Working Group on Financial Markets, which provide opportunities to share concerns and discuss matters of mutual interest.

Actions Taken by the Banks

The recent series of corporate scandals at Enron and other large corporations have served as a wake-up call for the corporate world, including banks. Whether or not they were involved with Enron, the banks that offer complex structured transactions realize that they can suffer great harm if they become embroiled in questionable activities engaged in by their customers. As a result, all have taken steps to improve their internal controls of complex structured transactions and special purpose entities (SPEs).

Some banks have made changes to management, established new oversight committees, developed new policies and/or procedures, tightened controls, improved internal reporting to management and the board, and improved disclosures. Other banks have centralized the process for establishment, use, and management of SPEs and conducted separate audits to review SPE activities.

Banks also have strengthened their review and approval processes for complex structured transactions in several ways. First, they too have realized how critical the definition of new products is to the new product approval process, and as a result they have expanded the definition of nonstandard products that require approval. Second, they have enhanced the approval process to provide for a broader range of senior-level management review from various areas of the bank, including audit, compliance, and legal. Third, banks are putting a greater focus on assessing customer motivation and appropriateness. Fourth, banks are implementing broader review procedures, which include securing representations from customers regarding disclosures and accounting treatment, and defining strict reporting standards with which customers must comply in order to obtain a structured product.

We believe these are all positive steps toward strengthening internal processes. We will evaluate the changes banks have made and will continue to monitor and assess these reforms as they are implemented. In our assessments, we are reviewing committee structures, charters, minutes and, most importantly, actions taken by management under the new control structures. We continue to sample complex structured transactions to ensure they receive appropriate approval, and to review

regulatory capital treatment of these products to ensure capital requirements are being applied appropriately. We have also reviewed special audit reports and board presentations on SPEs to assess uses, risk, control systems, and audit recommendations.

Progress has been made, but we believe that it is too early in the process to identify the full package of appropriate practices with respect to complex structured transactions. It takes some period of time to evaluate how well new policies and procedures will actually work in practice. To the extent that additional formal guidance from bank regulators is appropriate, we would expect to develop such guidance with our colleagues at the Federal Reserve Board and the Federal Deposit Insurance Corporation.

Conclusion

The Enron debacle has indeed been tragic. No one wants to see its circumstances repeated. While it is important to keep in perspective the role of bank regulators, we think there are steps we can take to improve our oversight of complex structured transactions. Similarly, the banking industry has recognized it can do a better job. We will continue to refine our processes for assuring that banks have, and follow, proper policies and procedures for dealing with all the risks involved in complex structured transactions.

Thank you once again for inviting the OCC to testify at this important hearing. I will be glad to answer any questions.