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**Testimony of  
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**Before the**

**SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT  
OF THE  
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS  
UNITED STATES SENATE**

**March 18, 2009**

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

## **Introduction**

Chairman Reed, Ranking Member Bunning, and members of the Subcommittee, my name is Timothy Long and I am the Senior Deputy Comptroller for Bank Supervision Policy and Chief National Bank Examiner at the Office of the Comptroller of the Currency (OCC). I welcome this opportunity to discuss the OCC's perspective on the recent lessons learned regarding risk management, as well as the steps we have taken to strengthen our supervision and examination processes in this critical area, and how we supervise the risk management activities at the largest national banking companies.

Your letter of invitation also requested our response to the findings of the GAO regarding the OCC's oversight of bank risk management. Because we only received the GAO's summary statement of facts on Friday night, we have not had an opportunity to thoroughly review and assess their full report and findings. Therefore, I will only provide some brief observations on their initial findings. We take findings and recommendations from the GAO very seriously and will be happy to provide Subcommittee members a written response to the GAO's findings once we have had the opportunity to carefully review their report.

## **Role of Risk Management**

The unprecedented disruption that we have seen in the global financial markets over the last eighteen months, and the events and conditions leading up to this disruption, have underscored the critical need for effective and comprehensive risk management processes and systems. As I will discuss in my testimony, these events have revealed a number of weaknesses in banks' risk management processes that we and the industry must address. Because these problems are global in nature, many of the actions we are taking are in coordination with other supervisors around the world.

More fundamentally, recent events have served as a dramatic reminder that risk management is, and must be, more than simply a collection of policies, procedures, limits and models. Effective risk management requires a strong corporate culture and corporate risk governance. As noted in the March 2008 Senior Supervisors Group report on “Observations on Risk Management Practices During the Recent Market Turmoil,” companies that fostered a strong risk management culture and encouraged firm-wide identification and control of risk, were less vulnerable to significant losses, even when engaged in higher risk activities.<sup>1</sup>

While current economic conditions have brought renewed attention to risk management, it is during periods of expansionary economic growth when risk management can be most critical and challenging both for bankers and supervisors. Financial innovation and expansion of credit are important drivers of our economy. Banks must be able to respond to customer and investor demand for new and innovative products and services. They must also be able to compete with firms that may be less regulated and with financial service companies across the globe. Failure to allow this competition risks ceding the prominent role that U.S. financial firms have in the global marketplace.

Banks are in the business of managing financial risk. Competing in the marketplace and allowing market innovation means that there will be times when banks lose money. There will also be times when, despite a less favorable risk/reward return, a bank will need to maintain a market presence to serve its customers and to retain its role as a key financial intermediary. These are not and should not be viewed as risk management failures. The job of risk management is not to eliminate losses or risk, but

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<sup>1</sup> *See* Senior Supervisors Group Report, “Observations on Risk Management Practices,” at [http://www.newyorkfed.org/newsevents/news/banking/2008/SSG\\_Risk\\_Mgt\\_doc\\_final.pdf](http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf).

rather to ensure that risk exposures are fully identified and understood so that bank management and directors can make informed business decisions about the firm's level of risk.

In this regard, a key issue for bankers and supervisors is determining when the accumulation of risks either within an individual firm or across the system has become too high, such that corrective or mitigation actions are needed. Knowing when and how to strike this balance is one of the most difficult jobs that supervisors and examiners face. Taking action too quickly can constrain economic growth and impede credit to credit worthy borrowers; waiting too long can result in an overhang of risk becoming embedded into banks and the marketplace. Effective risk management systems play a critical role in this process.

### **Risk Management Lessons Learned**

It is fair to ask what the banking industry and supervisors have learned from the major losses that have occurred over the past 18 months. The losses have been so significant, and the damage to the economy and confidence so great, that we all must take stock of what we missed, and what we should have done differently to make sure that we minimize the possibility that something like this happens again. Below are some of our assessments:

- ***Underwriting Standards Matter, Regardless of Whether Loans are Held or Sold*** – The benign economic environment of the past decade, characterized by low interest rates, strong economic growth and very low rates of borrower defaults led to complacency on the part of many lenders. Competitive pressures drove business line managers to ease underwriting standards for the origination of credit and to assume increasingly complex and concentrated levels of risk. Increased investor appetite for

yield and products, fueled by a global abundance of liquidity, led many larger banks to adopt the so-called “originate-to-distribute” model for certain commercial and leveraged loan products, whereby they originated a significant volume of loans with the express purpose of packaging and selling them to investors. Many of these institutional investors were willing to accept increasingly liberal repayment terms, reduced financial covenants, and higher borrower leverage on these transactions in return for marginally higher yields. Similar dynamics were occurring in the residential mortgage markets, where lenders, primarily non-bank lenders, were aggressively relaxing their underwriting standards.

Given the abundance of liquidity and willing investors for these loans, lenders became complacent about the risks underlying the loans. However, in the fall of 2007 the risk appetite of investors changed dramatically and, at times, for reasons not directly related to the exposures that they held. This abrupt change in risk tolerance left banks with significant pipelines of loans that they needed to fund as the syndicated loan and securitization markets shut down. Bankers and supervisors underestimated the rapidity and depth of the global liquidity freeze. A critical lesson, which the OCC and other federal banking agencies noted in their 2007 Shared National Credit results, is that banking organizations should ensure that underwriting standards are not compromised by competitive pressures. The agencies warned that “consistent with safe and sound banking practice, agent banks should underwrite funding commitments in a manner reasonably consistent with internal underwriting standards.”<sup>2</sup>

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<sup>2</sup> See Joint Release, NR 2007-102 at: <http://www.occ.treas.gov/ftp/release/2007-102.htm> .

- ***Risk Concentrations Can Accumulate Across Products and Business Lines and Must be Controlled*** – Risk concentrations can arise as banks seek to maximize their expertise or operational efficiencies in a highly competitive business. Community banks can often develop significant concentrations as their lending portfolios tend to be highly concentrated in their local markets. For larger institutions, a key issue has been the ability to aggregate risk exposures across business and product lines and to identify risks that may be highly correlated. For example, many national banks underestimated their exposure to subprime mortgages because they did not originate them. Indeed, some senior bank management thought they had avoided subprime risk exposures by deliberately choosing to not originate such loans in the bank – only to find out after the fact that their investment bank affiliates had purchased subprime loans elsewhere to structure them into collateralized debt obligations. Because of inadequate communication within these firms, those structuring businesses were aggressively expanding activity at the same time that retail lending professionals in the bank were avoiding or exiting the business because of their refusal to meet weak underwriting conditions prevalent in the market. These failures were compounded when products, markets, and geographic regions that previously were looked to as a source of risk diversification became more highly correlated as contagion effects spread across the globe. Additionally, significant corporate acquisitions, especially if they were not consistent with the bank’s business strategy and corporate culture, affected the institutions’ financial well being, their risk positions and reputations, and placed significant strains on their risk management processes.
- ***Asset-Based Liquidity Provides a Critical Cushion*** – There is always a tension of how much of a bank’s balance sheet capacity should be used to provide a cushion of

liquid assets – assets that can be readily converted to liquid funds should there be a disruption in the bank’s normal funding markets or in its ability to access those markets. Because such assets tend to be low risk and, thus, low yielding, many banks have operated with very minimal cushions in recent years. These decisions reflected the abundance of liquidity in the market and the ease with which banks could tap alternative funding sources through various capital and securitization markets. Here again, when these markets became severely constrained, many banks faced significant short-term funding pressures. For some firms, these funding pressures, when combined with high credit exposures and increased leverage, resulted in significant strains and, in some cases, liquidity insolvency.

- ***Systemically Important Firms Require State-of-the-Art Infrastructure*** – As noted in a number of visible cases during this period of market turmoil, a large firm’s ability to change its risk profile or react to the changing risk tolerance of others is dependent on an extremely robust supporting infrastructure. The velocity with which information is transmitted across financial markets and the size, volume and complexity of transactions between market participants has been greatly expanded through technology advancements and globalization of markets. Failure to have sufficient infrastructure and backroom operations resulted in failed trades and increased counterparty exposures, increasing both reputation and credit risks.
- ***Need for Robust Capital Levels and Capital Planning Processes*** – Although we are clearly seeing strains, the national banking system, as a whole, has been able to withstand the events of the past 18 months due, in part, to their strong levels of regulatory capital. The strong levels of capital in national banks helped to stabilize the financial system. National banking organizations absorbed many weaker

competitors (e.g., Bear Stearns, Countrywide, and WAMU). This relative strength is more apparent when compared to the highly leveraged position of many broker-dealers. Nonetheless, it is clear that both banks' internal capital processes and our own supervisory capital standards need to be strengthened to more fully incorporate potential exposures from both on- and off-balance sheet transactions across the entire firm. In addition, capital planning and estimates of potential credit losses need to be more forward looking and take account of uncertainties associated with models, valuations, concentrations, and correlation risks throughout an economic cycle.

These findings are consistent with reports issued by the SSG's report on "Risk Management Practices," the Financial Stability Forum's (FSF) report on "Enhancing Market and Institutional Resilience," the Joint Forum's report on "Cross –Sectoral Review of Group-wide Identification and Management of Risk Concentrations," and the Basel Committee on Banking Supervision's consultative paper on "Principles for Sound Stress Testing Practices and Supervision."<sup>3</sup> Two common themes from these reports and other studies in which the OCC has actively participated are the need to strengthen risk management practices and improve stress testing and firm-wide capital planning processes. The reports also note several areas where banking supervisors need to enhance their oversight regimes. The recommendations generally fall into three broad categories: 1) providing additional guidance to institutions with regard to the risk management practices and monitoring institutions' actions to implement those

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<sup>3</sup> Senior Supervisors Group Report, "Observations on Risk Management Practices," at [http://www.newyorkfed.org/newsevents/news/banking/2008/SSG\\_Risk\\_Mgt\\_doc\\_final.pdf](http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf); Financial Stability Forum, "Enhancing Market and Institutional Resilience," at [http://www.fsforum.org/publications/FSF\\_Report\\_to\\_G7\\_11\\_April.pdf](http://www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf); Joint Forum, "Cross-sectoral review of group-wide identification and management of risk concentrations" at <http://www.bis.org/publ/joint19.htm>; and Basel Committee on Banking Supervision Report, "Sound principles for stress testing practices and supervision," at <http://www.bis.org/publ/bcbs147.htm>.



recommendations; 2) enhancing the various aspects of the Basel II risk-based capital framework; and 3) improving the exchange of supervisory information and sharing of best practices.

### **OCC Supervisory Responses**

The OCC has been actively involved in the various work groups that issued these reports, and we are taking a number of steps, primarily in our large bank supervision program, to ensure that our supervisory process and the risk management practices of our institutions incorporate these recommendations. I will focus on the three key areas identified by the Subcommittee: liquidity risk management, capital requirements, and enterprise-wide risk management.

#### ***Liquidity Risk Management***

The sudden and complete shutdown in many traditional funding markets was not contemplated by most contingency funding plans. This period of market disruption has magnified the risks associated with underestimating liquidity risk exposures and improperly planning for periods of significant duress. The SSG report specifically noted that better performing firms carefully monitored their on- and off-balance sheet risk exposures and actively managed their contingent liquidity needs. In April 2008, the OCC developed a liquidity risk monitoring program to standardize liquidity monitoring information across our large bank population and provide more forward looking assessments. We developed a template for the monthly collection of information about balance sheet exposures, cash flow sources and uses, and financial market risk indicators. Our resident examiners complete this template each month and then work with our subject matter specialists in the Credit and Market Risk (CMR) division in Washington to produce a monthly report that summarizes the liquidity risk profile, based on levels of

risk and quality of risk management, for 15 banking companies in our Large and Mid-size bank programs. These risk profiles provide a forward looking assessment of liquidity maturity mismatches and capacity constraints, both of which are considered early warning signals of potential future problems.

In September 2008, the Basel Committee on Banking Supervision (Basel Committee) issued a report on, “Principles for Sound Liquidity Risk Management and Supervision.”<sup>4</sup> This report represents critical thinking that was done by supervisors in over 15 jurisdictions on the fundamental principles financial institutions and supervisors must adopt to provide appropriate governance of liquidity risk. OCC subject matter specialists in our CMR division were actively involved in the development of this important paper on risk management expectations, and are now contributing to the second phase of this work which is focused on identifying key liquidity metrics and benchmarks that may be valuable for enhancing transparency about liquidity risk at financial institutions. We are also working with the other U.S. federal banking agencies to adapt and apply these key principles more broadly to all U.S. banking institutions through an interagency policy statement.

The OCC reviews bank liquidity on an ongoing basis and we have incorporated these valuable lessons into our evaluations. Our strategic bank supervision operating plan for 2009 directs examiners at our largest national banks to focus on banks’ firm-wide assessments of their liquidity risk and the adequacy of their liquidity cushions (short-term liquid assets and collateralized borrowing capacity) to meet short and medium term funding needs, as well as on the effectiveness of their liquidity risk management, including management information systems and contingency funding plans.

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<sup>4</sup> *See* Basel Committee on Banking Supervision, “Principles for Sound Liquidity Management and Supervision,” at <http://www.bis.org/publ/bcbs144.htm>.

## ***Capital Requirements***

The market turmoil has highlighted areas where the current Basel II capital framework needs to be strengthened. The OCC, through its membership on the Basel Committee and work with the FSF, has been actively involved in formulating improvements to the capital framework. Among the refinements recommended by the Basel Committee in its January 2009 consultative papers are higher capital requirements for re-securitizations, such as collateralized debt obligations, which are themselves comprised of asset-backed securities.<sup>5</sup> These structured securities suffered significant losses during the recent market turmoil. Other proposed changes to the Basel II framework would increase the capital requirements for certain liquidity facilities that support asset-backed commercial paper conduits.

In addition, the Basel Committee has proposed requirements for certain banks to incorporate default risk and credit migration risk in their value-at-risk models. These proposals are designed to better reflect the risks arising from the more complex, and less liquid, credit products that institutions now hold in their trading portfolios. The intention is also to reduce the extent of regulatory capital arbitrage that currently exists between the banking and trading books.

The January consultative paper that proposed enhancements to the Basel II framework would also strengthen supervisory guidance regarding Pillar 2, or the supervisory review process of Basel II. Specifically, the proposed supervisory guidance would address firm-wide governance and risk management; capturing the risk of off-

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<sup>5</sup> *See*: “Proposed enhancements to the Basel II framework,” “Revisions to the Basel II Market Risk Framework,” and “Guidelines for computing capital for incremental risk in the trading book,” January 2009 at <http://www.bis.org/press/p090116.htm>.

balance sheet exposures and securitization activities; and incentives to manage risk and returns over the long-term.

More recently, following its meeting last week, the Basel Committee announced additional initiatives to strengthen capital in the banking system. These include introducing standards to promote the build up of capital buffers that can be drawn down in periods of stress, as well as a non-risk-based capital measure like our leverage ratio.<sup>6</sup> Once the Basel Committee finalizes these and other changes to the Basel II framework, the OCC and other federal banking agencies will jointly consider their adoption in the U.S. through the agencies' notice and comment process.

### ***Enterprise Risk Management***

As previously noted, the recent market turmoil has highlighted the importance of a comprehensive firm-wide risk management program. The SSG report advised that striking the right balance between risk appetite and risk controls was a distinguishing factor among firms surveyed in its study. Additionally, the FSF report noted that, "Supervisors and regulators need to make sure that the risk management and control framework within financial institutions keeps pace with the changes in instruments, markets and business models, and that firms do not engage in activities without having adequate controls."<sup>7</sup>

Proper risk governance was a key focus of guidance that the OCC, the SEC, and other federal banking regulators issued in January 2007 on complex finance activities.<sup>8</sup> That guidance stressed the need for firms to have robust internal controls and risk

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<sup>6</sup> See "Initiatives on capital announced by the Basel Committee," March 12, 2009 at: <http://www.bis.org/press/p090312.htm>.

<sup>7</sup> See "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience," April 2008 at: [http://www.fsforum.org/publications/r\\_0804.pdf](http://www.fsforum.org/publications/r_0804.pdf).

<sup>8</sup> See: OCC Bulletin 2007-1, "Complex Structured Finance Transactions" at <http://www.occ.gov/ftp/bulletin/2007-1.html>.

management processes for complex structured finance transactions. The guidance emphasized the importance of a strong corporate culture that includes and encourages mechanisms that allow business line and risk managers to elevate concerns to appropriate levels of management and to ensure the timely resolution of those concerns. It also stressed the need to ensure appropriate due diligence at the front-end, before products are offered, to ensure that all risks have been appropriately considered and can be effectively identified, managed and controlled. At the OCC, approval of new or novel banking activities is predicated on the bank having sufficient risk management controls in place.

Assessing management's ability to effectively identify, measure, monitor, and control risk across the firm and to conduct effective stress testing is a key focus of our examination strategies for large national banks this year.

Stress tests are a critical tool for effective enterprise-wide risk assessments. Such tests can help identify concentrations and interconnected risks and determine the adequacy of capital and liquidity. As with most other issues, the success of a stress testing program depends importantly on the support and sponsorship provided by senior management. In banks where risk management functions did not perform well, stress testing typically was a mechanical exercise. Management viewed stress tests as more of a "requirement" than an important risk management tool that could lead to internal discussions and debate about whether existing exposures constituted unacceptable risks.

In addition, many stress tests failed to fully estimate the potential severity and duration of stress events and to identify and capture risks across the firm. Often, stress tests would focus on a single line of business and/or use only historical statistical relationships. When designing a stress test, particularly after a prolonged period of abundant liquidity, low credit spreads and low interest rates, it is important to probe for

weaknesses in the portfolio that may not be evident from historically-based stress exercises. Expert judgment can help define scenarios to address the likely breakdown in normal statistical relationships, as well as feedback loops, in a crisis. Such scenario-based stress tests, often dismissed as implausible by business unit personnel, allow firms to shock multiple market factors (e.g., interest rates credit spreads and commodity prices) simultaneously. Such stress tests are an important way to capture risks missed in traditional stress testing exercises, such as market liquidity risk and basis risk.

### **OCC's Supervision of Risk Management at Large National Banks**

Let me now turn to how we apply and incorporate our perspective on risk management into the supervision of large national banks. The OCC is responsible for supervising over 1,600 banks, including some of the largest in the world that offer a wide array of financial services and are engaged in millions of transactions every day.

Pursuant to the provision of the Gramm Leach Bliley Act (GLBA), the OCC serves as the primary federal banking regulator for activities conducted within the national bank charter and its subsidiaries, except for those activities where jurisdiction has been expressly provided to another functional supervisor, such as the Securities and Exchange Commission (SEC), for certain broker-dealer activities. Nonetheless, we work closely with the Federal Reserve Board, the SEC, and other appropriate regulators to help promote consistent and comprehensive supervision across the company.

The foundation of the OCC's supervisory efforts is our continuous, on-site presence of examiners at each of our 14 largest banking companies. These 14 banking companies account for approximately 89% of the assets held in all of the national banks under our supervision. The resident examiner teams are supplemented by subject matter

specialists in our Policy Division and PhD economists from our Risk Analysis Division trained in quantitative finance.

Our Large Bank program is organized with a national perspective. It is highly centralized and headquartered in Washington, and structured to promote consistent uniform coordination across institutions. The onsite teams at each of our 14 largest banks are led by an Examiner-In-Charge (EIC), who reports directly to the Deputy Comptrollers in our Large Bank Supervision Office in Washington, DC. The Large Bank Deputies are in ongoing communication with the EICs, in addition to holding monthly calls and quarterly face-to-face meetings with all EICs. To enhance our ability to identify risks and share best practices across the large bank population, we have established a program of examiner network groups in Large Banks. There are eight main network groups (Commercial Credit, Retail Credit, Mortgage Banking, Capital Markets, Asset Management, Information Technology, Operational Risk and Compliance) and numerous subgroups. These groups facilitate sharing of information, concerns and policy application among examiners with specialized skills in these areas. The EICs and leadership teams of each of the network groups work closely with specialists in our Policy and Risk Analysis Divisions to promote consistent application of supervisory standards and coordinated responses to emerging issues.

All of this enables the OCC to maintain an on-going program of risk assessment, monitoring, and communication with bank management and directors. Nonetheless, given the volume and complexity of bank transactions, it 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 through risk-based supervision.

Resident examiners apply risk-based supervision to a broad array of risks, including credit, liquidity, market, compliance and operational risks. Supervisory activities are based upon supervisory strategies that are developed for each institution that are risk-based and focused on the more complex banking activities. Although each strategy is tailored to the risk profile of the individual institution, our strategy development process is governed by supervisory objectives set forth annually in the OCC's bank supervision operating plan. Through this operating plan, the OCC identifies key risks and issues that cut across the industry and promotes consistency in areas of concerns. With the operating plan as a guide, EICs develop detailed strategies that will direct supervisory activities and resources for the coming year. Each strategy is reviewed by the appropriate Large Bank Deputy Comptroller. Our risk-based supervision is flexible, allowing strategies to be revised, as needed, to reflect the changing risk profile of the supervised institutions. We have a Quality Assurance group within our Large Bank program that selects strategies to review as part of a supervisory program review to ensure reasonableness and quality supervision.

Our supervisory goal is to ensure banks have sound risk governance processes commensurate with the nature of their risk-taking activities. Risk management systems must be sufficiently comprehensive to enable senior management to identify and effectively manage risk throughout the firm. Therefore, examinations of our largest banks focus on the overall integrity and effectiveness of risk management systems.

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 identify and manage those risks. Next, we assess the integrity and effectiveness of risk management systems, with appropriate validation through transaction testing. This is accomplished through our



supervisory process which involves a combination of ongoing monitoring and targeted examinations. The purpose of our targeted examinations is to validate that risk management systems and processes are functioning as expected and do not present any significant supervisory concerns. Our supervisory conclusions, including any risk management deficiencies, are communicated directly to bank senior management. Thus, not only is there ongoing evaluation, but there is also a process for timely and effective corrective action when needed. To the extent we identify concerns, we “drill down” to test additional transactions.

These concerns are then highlighted for management and the Board as “Matters Requiring Attention” (“MRAs”) in supervisory communications. Often these MRAs are line of business specific, and can be corrected relatively easily in the normal course of business. However, a few MRAs address more global concerns such as enterprise risk management or company-wide information security. We also have a consolidated electronic system to monitor and report outstanding MRAs. Each MRA is assigned a due date and is followed-up by on-site staff at each bank. If these concerns are not appropriately addressed within a reasonable period, 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.

Our supervision program includes targeted and on-going analysis of corporate governance at our large national banks. This area encompasses a wide variety of supervisory activities including:

- Analysis and critique of materials presented to directors;
- Review of board activities and organization;

- Risk management and audit structures within the organization, including the independence of these structures;
- Reviews of the charters, structure and minutes of significant decision making committees in the bank;
- Review of the vetting process for new and complex products and the robustness of new product controls; and
- Analysis of the appropriateness and adequacy of management information packages used to measure and control risk.

It is not uncommon to find weaknesses in structure, organization, or management information, which we address through MRAs and other supervisory processes described above. But more significantly, at some of our institutions what appeared to be an appropriate governance structure was made less effective by a weak corporate culture, which discouraged credible challenge from risk managers and did not hold lines of business accountable for inappropriate actions. When the market disruption occurred in mid 2007, it became apparent that in some banks, risk management lacked support from executive management and the board to achieve the necessary stature within the organization, or otherwise did not exercise its authority to constrain business activities. At institutions where these issues occurred, we took strong supervisory actions, and we effected changes in personnel, organization and/or processes.

Just as we adjust our strategies for individual banks, we also make adjustments to our overall supervisory processes, as needed. And of course we are adjusting our supervisory processes to incorporate the lessons we have learned during this period of extreme financial distress. For example, recent strategy guidance prepared by our Large

Bank network groups and issued by Large Bank senior management increases our focus on:

- Risk concentrations across the enterprise;
- Refinancing risk arising from illiquidity in credit markets and changes in underwriting standards that limit the ability of many borrowers to refinance debt as originally intended;
- Collections, recovery and loss mitigation programs;
- Decision modeling;
- Liquidity contingency planning;
- Allowance for loan and lease loss adequacy;
- Capital buffers and stress assessments; and
- Syndication and other distribution processes and warehouse/pipeline controls.

Our supervisory activities at individual banks are often supplemented with horizontal reviews of targeted areas across a group of banks. These horizontal reviews can help us to identify emerging risks that, while not posing a significant threat to any one institution could, if not corrected, pose more system-wide implications for the industry. For example, reviews of certain credit card account management practices several years ago revealed that as a result of competitive pressures, banks were reducing minimum payments required from credit card customers to the point where many consumers could simply continue to increase their outstanding balances over time with no meaningful reduction in principal. We were concerned that these competitive pressures could mask underlying deterioration in a borrower's condition and could also result in consumers becoming over-extended. Because of the highly competitive nature of this business, we recognized that we needed to address this problem on a system-wide basis

and as a result, worked with the other federal banking agencies to issue the 2003 guidance on Credit Card Account Management Practices.<sup>9</sup>

In addition to the aforementioned liquidity monitoring data we have begun collecting, we have also initiated loan level data collection from our major banks for residential mortgages, home equity loans, large corporate credits, and credit card loans. This data is being used to enhance our horizontal risk assessments in these key segments and offers a tool for examiners to benchmark their individual institution against the industry.

More recently, in early 2008 we began developing a work plan to benchmark our largest national banks against the risk management “best practices” raised in various reports issued by the President’s Working Group (PWG), SSG, FSF, and Basel Committee. OCC staff developed a template for our examining staff to collect information to conduct this benchmarking exercise and we shared this with our colleagues at the PWG and SSG. In the interest of expanding the pool of firms and expediting the collection of risk management information, agency principals elected to use the SSG as the forum for undertaking the risk management assessment. In December 2008, a self-assessment template was sent to 23 globally active financial firms and the completed self-assessments are now in the process of being collected and shared among the participating agencies. These self-assessments will be supplemented with interviews at selected firms to discuss the status of addressing risk management deficiencies already identified and also probe for further information on emerging issues that may not yet be evident.

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<sup>9</sup> *See* OCC Bulletin 2003-1, “Credit Card Lending: Account Management and Loss Allowance Guidance,” at <http://www.occ.gov/ftp/bulletin/2003-1.doc>.

To summarize, the goal of our supervision is to ensure that banks are managed in a safe and sound manner, to identify problems or weaknesses as early as possible and to obtain corrective action. Through our examinations and reviews, we have directed banks to be more realistic in assessing their credit risks; to improve their valuation techniques for certain complex transactions; to raise capital as market opportunities permit; to aggressively build loan loss reserves; and to correct various risk management weaknesses.

As previously noted, we have a staff of specialists who provide on-going technical assistance to our on-site examination teams. Our Risk Analysis Division includes 40 PhD economists and mathematicians who have strong backgrounds in statistical analysis and risk modeling. These individuals frequently participate in our risk management examinations to help evaluate the integrity and empirical soundness of banks' risk models and the assumptions underlying those models. Our policy specialists assist by keeping abreast of emerging trends and issues within the industry and the supervisory community. Staffs from our CMR, Operational Risk, and Capital Policy units have been key participants and contributors to the ongoing work of the SSG, FSF, PWG and Basel Committee.

In 2008, we established a Financial Markets Group within the agency and tasked them with the build-out of a market intelligence program. Their mission is to look around corners, to seek out early warning signs of emerging and/or systemic risk issues. This team is comprised of highly experienced bank examiners and subject matter specialists hired from the industry, and they spend considerable time meeting with bank investors, bank counterparties, bank competitors, bank analysts, and other relevant stakeholders. Their work is discussed with members of the OCC's senior management

team on a bi-weekly basis, or more frequently when needed, and discussed in detail with the OCC's National Risk Committee members, who represent all lines of bank supervision within the OCC, as well as our legal and economics teams.

### **Coordination with Other Supervisors**

Successful execution of our supervisory priorities requires an effective working relationship with other supervisors, both domestically and internationally. The events of the past 18 months highlight the global nature of the problems we are facing and the need for global responses.

The OCC has taken a significant leadership role in the interagency work underway to address risk management issues raised during this period of market turmoil. Comptroller Dugan is an active member of the PWG and also serves as the Chair of the Joint Forum. In that capacity, he has sponsored critical work streams to address credit risk transfer, off-balance sheet activities and reliance on credit rating agencies. The Joint Forum work not only builds transparency about how large, financial conglomerates manage critical aspects of risk management, but it also serves as a vehicle for identifying risk management “best practices.”

Close coordination with our supervisory colleagues at the other banking agencies, as well as the securities agencies, has proven beneficial for all parties – firms, supervisors and policy makers. One example where this is evident has been the cooperative work among major market players and key regulators (the New York Federal Reserve Bank, the Federal Reserve Board, the OCC, the SEC, and other key global regulators) to strengthen the operational infrastructure and backroom processes used for various over-the-counter (OTC) derivative transactions. This is another example where a collective effort was needed to address problems where there was not a clear incentive for any

individual firm to take corrective action. As a result of these efforts, we have seen material improvements in the reduction of unconfirmed trades across all categories of OTC derivatives, with the most notable reduction in the area of credit derivatives, where the large dealers have reduced by over 90% the backlog of credit derivatives confirmations that are outstanding by more than 30 days.

### **GAO Report**

As I noted in my introduction, we received the GAO's draft statement of findings on Friday night and, as requested, provided them with summary comments on those draft findings on Monday morning. Once we receive the GAO's final report, we will give careful consideration to its findings and any recommendations therein for improvement in our supervisory processes. We will be happy to share our conclusions and responses with the Subcommittee.

As I have described in my testimony, the OCC has a strong, centralized program for supervising the largest national banks. But clearly, the unprecedented global disruptions that we have witnessed across the credit and capital markets have revealed risk management weaknesses across banking organizations that need to be fixed and we are taking steps to ensure this happens. In this regard, it is important to recognize that risk management systems are not static. These systems do and must evolve with changes in markets, business lines, and products. For example, improving and validating risk models is an ongoing exercise at our largest institutions. Therefore it should not be surprising that we routinely have outstanding MRAs that direct bank management to make improvements or changes to their risk models and risk management practices. This is an area where we continuously probe to look for areas of improvement and best practices. As I described earlier, we have systems in place to monitor and track these

MRAs and, when we determine that the bank is not making sufficient progress to address our concerns, we can and do take more forceful action. However, unless we believe the model deficiency is so severe as to undermine the bank's safety and soundness, we will allow the bank to continue to use the model as it makes necessary refinements or adjustments. Given the iterative process of testing and validating risk models, it simply is not realistic to suggest that a bank suspend its operations or business whenever it needs to make enhancements to those processes.

One of the GAO's major findings is that institutions failed to adequately test for the effects of a severe economic downturn scenario. As I have discussed, we agree that the events of the past 18 months have underscored the need for improved and more robust stress testing. Banks' stress tests need to more fully incorporate potential interconnection risks across products, business lines and markets, and evaluate such exposures under extreme tail-events. The OCC was actively involved in developing the January 2009 report issued by the Basel Committee cited by the GAO. Indeed, many of the findings and recommendations in that report were drawn from our findings and work in our large banking institutions. We will be working with these institutions to ensure that they incorporate those recommendations into their stress testing processes.

### **Conclusion**

The events of the past 18 months have highlighted and reinforced the need for effective risk management programs and revealed areas where improvements are needed. I believe the OCC and the banking industry are taking appropriate steps to implement needed changes. I also believe that these events have demonstrated the strength of the OCC's large bank supervision program. Throughout the recent market turmoil, our resident examination staffs at the largest institutions have had daily contact with the



business and risk managers of those institutions' funding, trading, and lending areas to enable close monitoring of market conditions, deal flow and funding availability. Their insights and on-the-ground market intelligence have been critical in helping to assess appropriate policy and supervisory responses as market events have continued to unfold. Indeed, I believe that the OCC's large bank supervision program, with its centralized oversight from Washington D.C., and highly experienced resident teams of bank examiners and risk specialists, is the most effective means of supervising large, globally active financial firms.