Quarterly Journal

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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.

I. Introduction

Mr. Chairman, Ranking Member Frank, and members of the committee, I appreciate this opportunity to review the condition of the national banking system and the state of the Office of the Comptroller of the Currency (OCC). My written statement covers three principal areas. First, I will report to you on the current state of the national banking system, which is sound. Second, I will describe how the OCC strives to manage our financial resources efficiently and deploy our human resources effectively to ensure that the national banking system maintains its sound condition and its vital role in our country's economy.

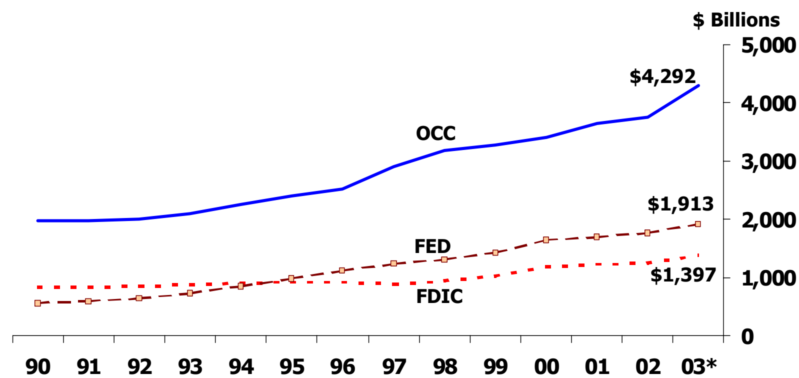
The third section of my statement highlights three areas of our work that are of central significance to the way national banks will conduct business in this new century. There, I will describe our risk-focused approach to supervising the national banking system. I will also provide an update on the progress of the ongoing international and domestic deliberations about prospective revisions to the Basel risk-based capital framework. Finally, I will highlight the importance of an attribute that is key to the national bank charter—the ability of national banks to operate under uniform, nationwide standards, consistent with federal law—and I will try to correct what I believe are some fundamental misunderstandings on several points concerning the regulations we have recently issued on applicability of state law to national banks and their operating subsidiaries. I also want to reiterate our willingness to work cooperatively with state officials on referrals and resolution of customer complaints, and identification and timely response to any inappropriate practices by the institutions we respectively supervise.

II. The Condition of the National Banking System

The OCC supervises federally chartered national banks and federally licensed branches of foreign banks. As of year-end 2003, the national banking system consisted of approximately 2100 banks (26 percent of all commercial banks). Of these, approximately 2000 were Federal Deposit Insurance Corporation (FDIC)-insured banks, holding total assets of $4.3 trillion (56 percent of all commercial banking assets). The rest were uninsured bank and trust companies. The OCC also supervises 53 federal branches of foreign banks. While the number of national banks has declined

for nearly two decades, the national bank share of total system assets has remained roughly constant. The national banking system includes many of the largest banks by asset size, but community national banks are by far the most numerous in the system.

Assets by Federal bank supervisor



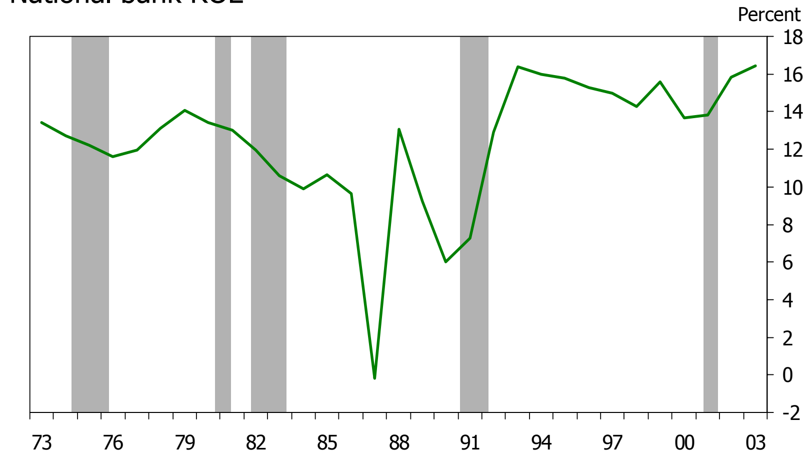
Source: Integrated Banking Information System (OCC). *Data as of December 31, 2003

The financial performance and condition of the banking system is strong. Bank earnings have remained at historically high levels for a decade. Until 2002, aggregate net income for national banks had never exceeded $12.5 billion in a quarter, and the industry's average return on assets had never exceeded 1.5 percent, at least not since the quarterly reporting began in 1984. But since the beginning of 2002, national banks have exceeded both earnings milestones in every quarter but one. In 2003, national banks set new records for both return on equity and return on assets. Although the slow economy led to weakness in some areas, including business lending, the contractions in these areas were more than offset by growth elsewhere.

Total loans held by banks continued to expand throughout the recent economic cycle, growing by 7.8 percent in 2002 and 7.6 percent in 2003. In contrast, starting with the recession of 1990-91, total loans held by national banks fell for 10 consecutive quarters. Where the earlier recession affected all sectors of the economy, the recent recession was concentrated more extensively in the business sector, in part due to the fallout from the tech/telecomm bubble in the late 1990s. This caused a sharp fall in the demand for business loans, particularly at large banks.

National bank ROE at record high

National bank ROE

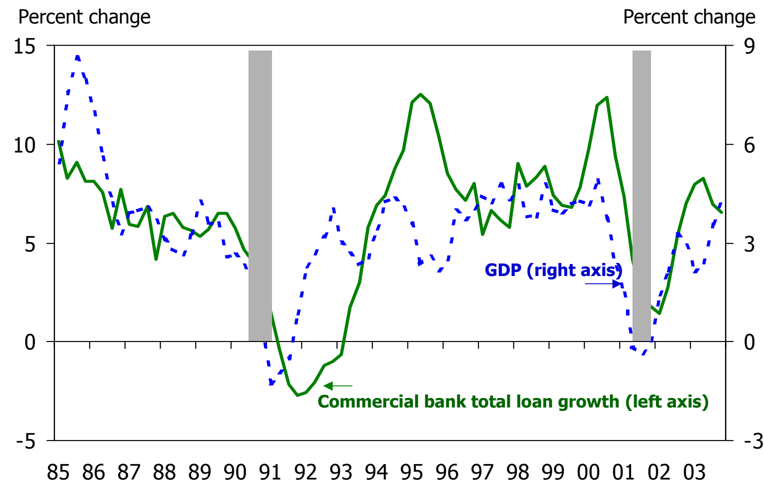


Source: Integrated Banking Information System (OCC)

Data as of year-end. Shaded areas represent periods of recession.

The reduction in corporate lending by banks also was due to the competitive influence of the low rates on corporate bonds. Many large and even medium-size firms have been able to access the bond market at very low rates throughout this economic slowdown, which has further reduced the demand for larger commercial loans. This has affected especially the lending activity at the largest banks, because they tend to have potential business customers who have greater access to other financial options. Community banks, however, taking advantage of their knowledge of local markets and business needs, have maintained their business lending throughout this cycle, with increases reported in their commercial and industrial (C&I) and commercial real estate loan books.

The mortgage and consumer sectors have been a strong source of loan growth for national banks. Residential real estate loans held by national banks rose at an annual rate of about 20 percent in both 2002 and 2003. Within this broad category, home equity lending has grown particularly fast, rising by 21 percent in 2001, 38 percent in 2002, and 37 percent in 2003. Throughout this cycle, consumers have taken advantage of the declining mortgage rates to extract funds from the increased value of their homes. Some of these funds from the refinancing and home equity loan activity have been used, however, to pay off higher interest credit card and installment debt.



The low interest rate environment has been a plus and a minus for banks. Smaller banks with their greater reliance on retail funding have seen steady erosion in their net interest margins. By contrast, the largest banks, which rely more on wholesale funding, until recently experienced relatively high net interest margins. As of December 2003, the net interest margin for banks in all asset size groups has fallen below their historic averages. Despite the decline in margins, banks have reported continued growth in net interest income due to the strong expansion in household lending. As long as margins remain compressed, however, this growth in income is vulnerable if volume of activity in the consumer markets falls.

The low interest rate environment also raises concerns about the extent to which banks may be taking on interest rate risk in an effort to maintain their interest income. Effective management of this risk will be important for banks in all asset size groups as the economy recovers, which is often accompanied by an increase in interest rates. We have alerted national banks to our concerns on this score and provided advice on approaches on how best to address this "low rate set-up." [1]

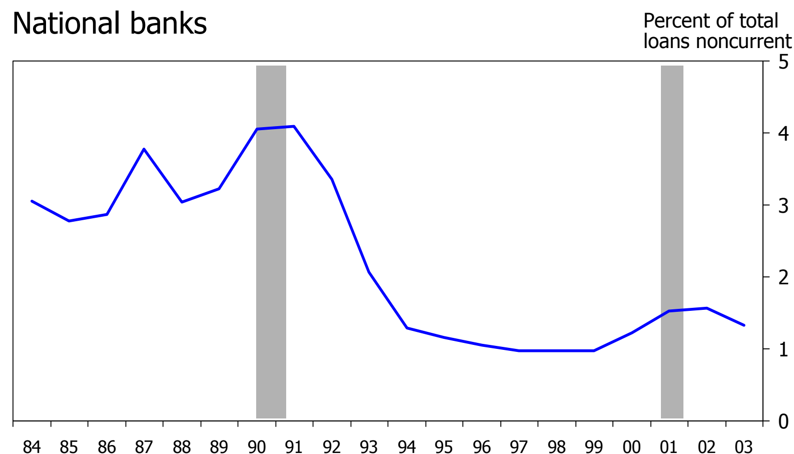
Deposits have continued to flow into banks, especially large banks, as might be expected when low interest rates hold down returns on alternative money market instruments. Deposits at national banks grew at 6.0 percent in 2001, 7.6 percent in 2002, and 8.6 percent (year-over-year)

[1] OCC Bulletin 2002-19, "Supplemental Guidance on Unsafe and Unsound Investment Portfolio Practices," May 22, 2002.

in 2003. The increase in deposits has fueled growth in bank assets. The assets of national banks grew 9.8 percent in 2003 (year-over-year), as compared to a 0.1 percent decline reported at this point of the recovery from the last recession. Nevertheless, we believe banks must be vigilant in their assessment of the potential sensitivity of their sources of funds to changes in the economic environment or, in some cases, the bank's own performance. The high level of liquidity in the banking system could be reduced rapidly if the relative yield on alternative investments increased sharply or if banks failed to maintain certain performance levels required to retain some sources of funds.

While credit quality deterioration is typically an issue during recessions, the most recent experience for national banks was much better than during the previous recession. This may well reflect national banks' response to cautions issued by the OCC to bankers in the late 1990s to be vigilant about their underwriting standards. The noncurrent loan ratio for national banks (loans at least 90 days past due plus nonaccruals) reached a peak of 4.4 percent in 1991Q2; in contrast, at the peak in this economic cycle, reported in 2002Q2, the noncurrent ratio was 1.6 percent. For large banks (over $1 billion in assets), the noncurrent loan ratio has now declined to 1.3 percent, near pre-recession levels. Smaller banks (under $1 billion in assets) were not as affected by the stresses in the nonfinancial corporate markets and thus experienced only a modest decline in credit quality during the recession. While credit quality appears to be improving for the banking industry, the OCC continues to watch developments in areas that remain vulnerable, such as small business lending and certain real estate markets and property types.

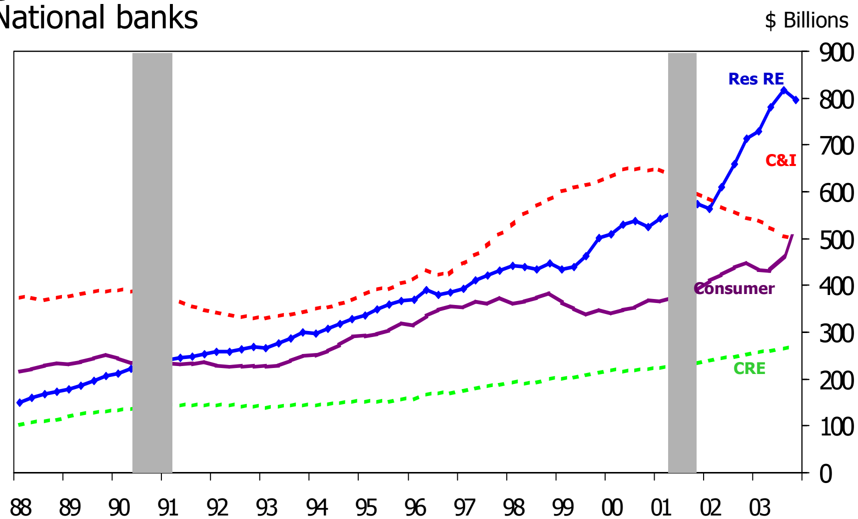
Noncurrent loans remained well below level of early 90s



Source: Integrated Banking Information System (OCC) Data as of year-end. Shaded areas represent periods of recession.

The data on failure and new entrants to the commercial banking system also reflects a very dynamic and healthy banking system. In 2003, two banks failed—one national and one state bank. By contrast, 100 commercial banks—including 33 national banks and 67 state banks—failed in 1992, the first year of recovery after the 1990–91 recession. The commercial banking system also had 111 new entrants in 2003; this compares to 40 new banks in 1992.

Banks' business strategies have continued to evolve in response to demographic shifts, changes in technology, and improvements in risk management. Larger banks have moved increasingly into retail lending during a period of strong growth in demand from the household sector. Large banks have benefited from their geographic diversification and have captured economies of scale by moving to automated processing of standardized products like home mortgages. Small national banks have seen more modest growth in retail lending. Economies of scale are reflected in the continued improvement in the efficiency ratio for large banks (noninterest expense to net operating revenue), a factor that also has contributed significantly to overall bank performance in recent years. In contrast, small banks have expanded their business lending, where many continue to find profitable niches offering customized products in local markets.



While the national banking system has displayed strong performance, even during the recent recession, history teaches that we cannot know for certain what lies ahead, and banks' capital provides important protection against that uncertainty. National banks remain well capitalized and rest on a much firmer capital base than they did a decade ago. In 1990, for example, 6.3 percent of banks had risk-based capital ratios below 8 percent, which we would now consider undercapitalized, and 18.3 percent were below 10 percent. Today, all national banks, with the exception of a few small banks under special supervision, have risk-based capital ratios above 8 percent, and more than 90 percent of national banks have risk-based capital ratios above 10 percent.

III. The State of the OCC

The OCC's mission is accomplished through three major programs: supervise (including risk analysis), charter, and regulate. The OCC is headquartered in Washington, D.C., operates the Ombudsman's office in Houston, and maintains district offices in Chicago, Dallas, Denver, and New York. The agency has 48 field offices and 23 satellite locations in cities throughout the United States, has stationed resident examiner teams in the 24 largest banking companies supervised, and maintains an examining office overseas in London. The agency has approximately 2,800 employees, the vast majority of which are bank examiners. To accomplish our mission in FY 2003, we used 2,761 full-time equivalents (FTEs), down slightly from 2,792 in 2002, and 2,837 in 2001. Total examiner FTEs were 1,837 in 2003, 1,853 in 2002, and 1,888 in 2001.

The OCC receives no appropriated funds. Our funding is derived from assessments and fees and we set our budget each year based on agency practices and our estimation of available revenue for the upcoming year. Our budget has been balanced during all the years that I have served as Comptroller, and we have the resources available, as needed, to assure that we fulfill all dimensions of our responsibilities as supervisor and regulator of the national banking system. We guard against potential disruption to our operations due to major, unpredictable events affecting our funding, for example, through a contingency reserve that is funded on an incremental basis as part of the budget process, each year.

Effective supervision of a dynamic national banking system in a changing financial services marketplace demands careful management of our financial resources and thoughtful deployment of the first-rate work force we have been able to attract. In recent years, the OCC has placed a heavy emphasis to improving the discipline with which we manage our financial resources and building enhanced accountability into the way we manage our human resources.

Improving Financial Performance

For the past five years, the OCC's financial management initiatives have been strongly focused on improving the planning, budgeting, and program evaluation processes; strengthening financial accountability and internal management controls; and modernizing our financial operating systems. The OCC maintained its "green" rating—the highest of three possible ratings—on the Financial

Performance Initiative[2] and received from its external auditors, Gardiner, Kamya, and Associates, an unqualified opinion on its FY 2003 financial statements with no material weaknesses. We have received an unqualified opinion on our financial statements for 39 consecutive years. We close our books within three days of month-end each month, and our independent auditors are able to issue their audit report by November 15th each year.

Our ongoing commitment is to ensure that timely, accurate, and relevant management information is conveniently available to OCC program managers. Over the past five years we have improved the OCC's planning, budgeting, and program evaluation process in major respects. Since the first quarter of FY 2002, we have employed quarterly budgeting and implemented a procedure that requires advance approval for significant reprogramming actions. During FY 2003, we developed a five-year variable projection model that uses revenue, budget, reserve target, and actual reserve projections to allow management to better understand the financial impact of their business decisions on the future operations of the OCC. For FY 2004 we have adopted a new activity-based accounting code structure that will assist OCC managers in making staffing decisions and ensuring that resources are used in alignment with the OCC's strategies.

We have in place a strong quality management program that employs regular reviews and special studies designed to foster continuous organizational improvement. The OCC's program analysis unit evaluates program efficiency and effectiveness and assists management in ensuring that OCC programs are strategically aligned with our objectives. The combination of administrative funds control processes and a strong management control program helps us ensure that we maintain integrity and accountability in all of the OCC's programs and operations.

We recently upgraded our financial management and acquisitions system ($MART) to Web-based technology. $MART is a state-of-the-art system that is Joint Financial Management Improvement Program (JFMIP)- and U.S. standard general ledger-compliant. The system has allowed us to integrate the budget execution function with the core functions of accounts payable, accounts receivable, asset management, and general ledger. $MART provides users with on-line access to daily status of funds and financial performance reports, and it provides appropriate security over financial information. Utilizing the features in $MART and management information provided by our new activity-based accounting structure, we expect to continue making progress throughout FY 2004 in further integrating budgeting and performance management and program evaluation.

Responding to New Management Challenges

The OCC supports the Department of Treasury's 2003–2008 strategic goals of promoting prosperous U.S. and world economies; preserving the integrity of financial systems; and ensuring professionalism, excellence, integrity, and accountability in the management and conduct of the

[2] The Financial Performance Initiative is one of the five initiatives in the President's Management Agenda. The Office of Management and Budget (OMB) scores the progress of each agency toward accomplishing these initiatives using a green/yellow/red scoring system. The Department of the Treasury scores its own bureaus, including OCC, in a similar

Department of Treasury. The OCC has established four strategic goals to achieve its mission and contribute to the achievement of the Department of Treasury's strategic goals. The OCC's goals, as defined in our 2003-2008 strategic plan, are a safe and sound national banking system; a flexible legal and regulatory framework that enables the national banking system to provide a full competitive array of financial services; fair access to financial services and fair treatment of bank customers; and an expert, highly motivated and diverse workforce that makes effective use of OCC resources. Described below are initiatives we have undertaken in two key areas that present cutting-edge management challenges.

Expanded e-Government and IT Security

The OCC developed a three-year plan to fully implement the Clinger–Cohen Act and capital planning best practices. The plan was implemented in FY 2003, and significant progress was made during the FY 2004 budget cycle. The FY 2004 capital planning process significantly increased the involvement of all OCC business units, and training was provided on the capital planning program, e-Government initiatives, and the OMB's business case development.

We have recently implemented Web-based interaction with national banks, including optional electronic filing of an increasing number of applications and electronic notification to banks of consumer complaints received by the OCC Ombudsman. The OCC also has recently deployed phase one of the automated learning information center for OCC employees, a state-of-the-art learning management and delivery system. We are now initiating phase two, which includes the development of operational, management, and integrated reporting capability. The learning management system is becoming a model for other agencies.

In the area of IT security, the OCC created a computer security incident response center to monitor, respond, and report to Treasury regarding virus attacks, intrusion attempts, and other security incidents.

We have integrated security considerations into capital planning and system development processes and inventoried all information-processing systems and grouped them for certification and accreditation. The OCC has also improved our continuity of operations by implementing an IT recovery strategy that is commensurate with the threats and risks of the post-9/11 era.

Emergency Preparedness

Immediately following the terrible events of 9/11, we established a Contingency Planning Oversight Committee to conduct a comprehensive review of the OCC's emergency management program and contingency plans. The committee was tasked with analyzing the existing program and plans to determine what changes were needed to address new and emerging threats. The result of the committee's work was the development and implementation of a Continuity of Operations Plan that ensures the OCC can respond to any emergency impacting our operations and can continue to perform essential functions necessary to support the mission of the OCC and the banking

and finance sector of the nation's critical infrastructure. We recently re-organized our critical infrastructure protection and security functions into a new business unit to continue focusing on this work and allow the OCC to begin performing an even greater role in the planning and coordination activities of the banking and finance sector.

During the past two years the OCC completed a comprehensive physical risk assessment of our headquarters facility and implemented new security procedures and security systems at our key facilities. We also developed, implemented, and tested new information technology disaster recovery strategies for those key information systems and applications necessary to support the OCC's essential functions. In addition to our physical and information assets, we also focused on the protection and safety of our most important asset, our employees. The OCC was one of the first federal agencies to issue survival kits to all employees and one of the first to develop, implement, and successfully test shelter-in-place procedures. We have also developed a testing, training, and exercise plan that allows us to educate and prepare employees and which also enables us to identify and correct weaknesses in our contingency plans and emergency operations.

Positioning our Workforce for the Future

The most important asset the OCC has is its people. One of the challenges we face is to ensure that the structure and expertise of our workforce continues to evolve as the national banking industry changes. The OCC restructured its district offices last year by combining the existing six district offices into four offices to better realign our workforce with the location of the banks we supervise. We have managed these efforts carefully to maximize the choices available to employees affected by the restructuring and to minimize disruption to our ongoing operations and loss of critical expertise.

This past year, the OCC completely re-engineered its recruitment processes by hiring a professional recruiter as a permanent member of our staff and placing greater emphasis on a centralized approach to college recruitment. These changes have resulted in the hiring of a diverse cross-section of top quality candidates. To ensure that these candidates will be able to carry on the OCC's tradition of excellence for years to come, we have improved our training for pre-commission examiners and renewed our emphasis on employee retention. Retention efforts are particularly focused on new hires, who are especially susceptible to turnover during their first four years with the OCC.

For more than twenty years, the OCC has operated as a performance-based organization with a strong emphasis placed on aligning individual performance expectations with organizational priorities. Annual pay increases granted to employees are based on the extent to which their performance objectives are met rather than on cost of living changes or longevity. We offer compensation and benefit programs that are tailored to achieving several goals, including matching the diverse needs of our workforce, supporting the several components of our mission, and controlling costs so that we can continue to operate within a balanced budget.

Because our ability to fulfill our mission depends on the skill, dedication, and good judgment of our people, we strive to maintain an environment that promotes creative and thoughtful contributions and encourages diversity of viewpoints. It is a measure of our success that the OCC was recently recognized as one of the "Best Places to Work in the Federal Government" in a report released by the Institute for Study of Public Policy Implementation.

IV. Keeping Pace with Change in the National Banking System

Change is a consistent theme in the operation—and the supervision—of the national banking system today. National banks must evolve their businesses if they are to remain competitive in today's financial services markets. At the same time, the OCC must adjust its supervisory and regulatory approaches in order to ensure that national banks can avail themselves of all of the attributes of their charter safely and soundly. Among the most important strategies we have developed to maximize the effectiveness of our examination and supervisory program is our risk-focused approach to supervision.

The OCC's Risk-Focused Approach to National Bank Supervision

OCC's supervision by risk approach dates back more than 10 years and involves supervisory policies and processes that tailor our oversight to the key characteristics of each bank, including asset size, products offered, markets in which it competes, and the board's and management's tolerance for risk. This process provides an effective means for the OCC to allocate our supervisory resources and to better communicate to senior bank management the areas where they may need to correct problems before they become entrenched.

Risk-based supervision begins with an assessment of a banking organization's existing and emerging risks, and management's efforts to manage and control those risks, in nine specified risk areas: credit, liquidity, interest rate, price, foreign exchange, transaction, compliance, strategic, and reputation. Based on that assessment, the OCC examiner-in-charge or portfolio manager will develop and implement a detailed, supervisory strategy for the bank, based on its risk profile and the complexity of its lines of businesses. Examiners identify areas of highest risk, understand exactly what management is doing to address those risks, and communicate regularly with management to indicate where additional management actions are needed. In performing this evaluation, OCC examiners consider not only the activities of the bank and its operating subsidiaries, but also how the bank's risk profile is affected by the activities of other subsidiaries and affiliates.

Our assessment of the integrity and effectiveness of a bank's risk management systems includes appropriate validation through transaction testing. If this produces concerns, we will "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. The examination procedures implementing OCC's supervision by risk program are documented in the *Comptroller's Handbook.*

Supervision by risk provides an effective way to supervise banks in the current rapidly changing environment. It also allows us to apply a consistent supervisory methodology across an increasingly diverse group of banks and bank activities. Because the design of this approach requires that we customize an examination based on a bank's underlying risk characteristics, it allows us to more effectively direct OCC resources to the banks or activities within banks exhibiting the greatest risk.

In response to the growing divergence in the complexity and scope of operations between large and small banks, we have divided our day-to-day supervisory operations into two lines of businesses—our Community and Midsize Bank program and our Large Bank program.

Our Community/Midsize Bank line of business oversees over 2,000 national banks and federal branches and agencies through our network of district, field, and satellite offices. When examining this population of banks, examiners use a core set of examination procedures to draw conclusions about the magnitude of risk and the adequacy of the risk management system for each of the nine areas of risk. Even in low-risk banks, we sample, verify, and test the bank's policies, procedures, and systems. When risks are elevated; when activities, products and services are more complex or present greater financial or compliance risks; or when issues or problems emerge, examiners will expand the scope of their supervisory activities using more detailed guidance found in topical booklets of the *Comptroller's Handbook* series. Periodic monitoring of community banks, another key element of the supervisory process, is also designed to identify changes in the bank's condition and risk profile, including new products or services, and to assess bank corrective action on outstanding supervisory concerns between formal on-site examinations. This quarterly monitoring process allows examiners to identify significant changes in the risk profile of the banks they supervise on a timely basis.

Our Large Bank program focuses on the 24 largest national banks. The supervision of each large bank, overseen out of our headquarters office, is staffed by a resident examiner-in-charge and a team of examiners and specialists in areas such as commercial and retail credit, capital markets, bank technology, asset management, and compliance. These examiners and specialists track the quantity and quality of risk management in real time so that our assessments are forward-looking as well as historical. This program allows the OCC to develop a more thorough knowledge of the bank than is possible through the traditional regime of periodic, discrete examinations. Over the years, we have also developed, tested, and refined this supervisory approach expressly to address the special financial and compliance challenges posed by bigger, more complex, and globally positioned banks. We are confident that this approach will be effective to supervise the "mega-banks," those with assets of a trillion dollars or more, that are forming as a result of recent acquisition activity in the industry.

Today's national banking system operates not just nationally, but globally. Our large banks all have operations or a presence overseas. Our London office provides us with examiner expertise to interact with foreign supervisors and provides a platform to examine national bank branches

overseas. Our London examiner staff provides a critical network to deal with home/host country issues, information-sharing issues, and outsourcing issues. We also participate in the Foreign Banking Organization program (along with the Federal Reserve Board) to examine and supervise federal branches and agencies in the United States.

We also are deeply involved in the development of international bank supervision policy through our participation in the Basel Committee on Banking Supervision and in the Joint Forum, which is an international group of banking, securities, and insurance supervisors; through our regular dialogue with foreign banking regulators; and through our international and technical assistance programs that provide training and internship opportunities to bank supervisors. In fact, not long ago we detailed to the Treasury Department four experienced examiners who are now working in Iraq.

To help meet the challenges of an ever more complex banking industry, our resident and field examiners and specialists are supported by a team of policy specialists, analysts, accountants, and economists in our headquarters office who monitor industry, market, and economic trends; provide technical expertise; and develop analytical tools and models to support our examination functions. For example, our Canary monitoring system monitors and identifies banks that may have high or increasing levels of credit, liquidity, or interest rate risks. Our credit risk and economics staffs have developed various analytical tools that assist examiners to identify portfolio or industry concentrations where risk may be increasing for more in-depth investigation. Our Risk Analysis unit—staffed by Ph.D. economists—provides on-site technical assistance to our resident staff in evaluating banks' quantitative risk models and measurement systems. Our National Risk Committee serves as a coordinating body to gather and disseminate information from throughout the OCC and the financial markets on emerging risk issues and advises me and the OCC's Executive Committee on a quarterly basis of emerging issues and potential policy and supervisory responses.

Our combination of continuous on-site supervision, with the "ground level" intelligence it provides on each individual bank's activities and strategies, coupled with our broader, systemic risk analyses, allows us quickly to adjust our supervisory strategies to emerging risks and issues that may arise at individual institutions, within business segments or across the industry as a whole. It also allows us to leverage the diverse skill sets that are needed to supervise our most complex institutions effectively.

Regulatory Coordination

We also work closely with other federal regulators in carrying out our supervisory responsibilities through a variety of formal and informal mechanisms. Primarily through the Federal Financial Institutions Examination Council (FFIEC), the OCC works with the other federal financial regulators (Board of Governors of the Federal Reserve System, FDIC, Office of Thrift Supervision (OTS), and National Credit Union Administration) to coordinate supervisory policies, regulations and regulatory reporting requirements, and examiner training on issues that cut across the banking

system. Indeed, such coordination is the norm, not the exception among the federal banking agencies. This coordination reduces regulatory burden by promoting greater uniformity, consistency, and efficiency in the supervision of insured depository institutions.

For example, during the past year the OCC worked together with the other federal banking agencies on a variety of policy initiatives in areas such as bank technology, identity theft and consumer privacy and disclosure issues, and implementation of the USA PATRIOT Act.

In the area of bank technology, the banking agencies are undertaking a complete revision and update of the 1996 FFIEC *Information Systems Examination Handbook.* A series of 12, topical booklets addressing issues such as business continuity planning, information security, outsourcing (including off-shore outsourcing), and electronic banking will replace the 1996 handbook. The OCC also continues to coordinate with the Treasury Department's Financial and Banking Information Infrastructure Committee (FBIIC) and other agencies on issues related to improving the reliability and security of the U.S. financial system. These efforts have included sponsoring critical financial institutions' access to the Telecommunications Service Priority Program that provides priority treatment for the restoration or provisioning of telecommunications services in emergencies, and joint publication by the OCC, Federal Reserve Board, and Securities and Exchange Commission, of an Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System. The paper identifies sound practices and steps necessary to protect the U.S. financial systems from the systemic effects of a wide-scale disruption.

We also are working closely with other regulators in the important areas of identity theft and consumer privacy. Last August, we and the other federal banking agencies issued for comment proposed guidance that would require financial institutions to develop programs to respond to incidents of unauthorized access to customer information, including procedures for notifying customers under certain circumstances. The proposed guidance interprets the agencies' customer information security guidelines that require financial institutions to implement information security programs designed to protect their customers' information. We also are working closely with the Federal Reserve, the Federal Trade Commission (FTC), and other agencies on implementation of the various provisions of the Fair and Accurate Credit Transactions (FACT) Act.

Recognizing the importance of informing consumers about financial institutions' privacy policies and how consumers may affect information-sharing practices, the OCC, the other federal banking agencies, and the FTC issued in December 2003 an advance notice of proposed rulemaking (ANPR) to seek public comment on how to simplify privacy notices required under the Graham–Leach–Bliley Act (GLBA). With the other regulators, we have been meeting with consumer groups, as well as the Internal Revenue Service and Food and Drug Administration, to get insights on how the banking agencies could use consumer testing to enhance the effectiveness of privacy notices.

To help alert consumers to potential pitfalls associated with certain high-cost mortgage and home equity loans, the agencies in conjunction with the Department of Housing and Urban Develop-

ment (HUD), the Department of Justice, the Federal Housing Finance Board, the Federal Trade Commission, the National Credit Union Administration, and the Office of Federal Housing Enterprise Oversight, issued in October 2003 a consumer brochure on predatory lending. The brochure, *Putting Your Home on the Loan Line is Risky Business,* cautions consumers about various predatory lending practices and advises consumers on steps they can take to protect themselves against such practices.

The OCC also works closely with law enforcement, the Treasury Department, and other federal agencies to disseminate information and take appropriate actions to help facilitate the prevention, detection, and prosecution of international money laundering and terrorist financing. For example, in May 2003, the FFIEC agencies, in cooperation with Treasury, the SEC and the Commodity Futures Trading Commission, issued implementing regulations for the Customer Identification Program requirements of section 326 of the USA PATRIOT Act. These and other USA PATRIOT Act requirements will be subject to examination reviews conducted in accordance with standards coordinated among the FFIEC agencies.

In addition to coordinating efforts on broad policy issues, we work closely with other regulators in our on-going bank examination programs. To the extent possible, we and the other banking agencies build upon each other's supervisory reviews and databases to minimize regulatory burden. We routinely share reports of examination, inspection reports, and other agency–institution communications and provide each other with access to our organizations' structure, financial, and supervisory information. To help facilitate and coordinate our supervision of large, complex institutions, we share information on proposed examination and supervisory activities for the coming year and coordinate the planning and execution of those activities in such a way as to minimize or eliminate any overlap or duplication. When appropriate, we hold joint meetings with institutions involving matters of mutual interest and may conduct coordinated reviews or examinations where a business activity is conducted across legal entities. For example, the OCC worked closely with the Federal Reserve throughout 2003 to investigate and respond to questions about potential illegal tying activities at large, insured depository institutions. Similarly, the Federal Reserve, the OCC, and the SEC worked together closely throughout 2002 and 2003 to examine and respond to questions relating to structured finance transactions of the Enron Corporation. The OCC participates annually on an interagency basis in the Shared National Credit Program established to provide a periodic credit risk assessment of supervised institutions' largest and most complex credit facilities.

Our information-sharing and coordination efforts extend beyond the other federal banking agencies and include state insurance departments and foreign bank regulators. For example, consistent with GLBA, the OCC has entered into information-sharing agreements with 49 state insurance departments and we meet regularly with the National Association of Insurance Commissioners to

discuss topics of mutual interest. We have also entered into 11 information-sharing agreements with foreign bank regulators to promote more efficient supervision of institutions with foreign operations.[3]

Basel II Developments

Because national banks have international as well as domestic operations, the OCC must—and we do—become involved in the development of approaches to bank supervision at the international level. Currently, the most significant of these approaches is the ongoing effort to revise the 1988 Basel Capital Accord. Let me briefly provide you a status report on this effort.

There have been a number of articles in the press in recent weeks about positions that U.S. regulators, and the OCC in particular, may be taking that I believe warrant some clarification and amplification.

First, let me stress that my U.S. colleagues and I share the overarching goal that Chairman Oxley expressed in his opening statement at this committee's March 4, 2003, oversight hearing: that Basel II be implemented in a manner that is entirely consistent with the safety and soundness and continued competitive strength of the U.S. banking system.

As I have said, banks' current financial and capital positions are strong, but as the industry continues to evolve, so does its risk profile. Recognizing and adapting to changing risk profiles and changing risk management practices is critical to maintaining those strengths. These observations inform our approach to negotiations in the Basel Committee on Banking Supervision regarding Basel II. However, while we recognize that we can and should improve capital regulation to take into account changes in banking and risk management, a basic tenet in our negotiations over reform of the international capital standards is to *do no harm.* U.S. banks are world leaders in many aspects of banking—credit cards and securitizations, for example—and we must assure that these important markets are not disrupted or impaired in the name of achieving international conformity in capital rules. In view of the fundamental strength and resilience of the U.S. financial system, we believe that reforms to our regulatory and supervisory structure must be adopted in a prudent, reflective fashion.

Thus we are fully committed to three things: first, an open rule-making process in which comments are invited and considered, good suggestions are heeded, and legitimate concerns are addressed; second, a reliable quantitative analysis in which we can assess the likely impact of Basel

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[3] The U.S. federal banking supervisors have concluded memoranda of understanding or statements of cooperation with supervisors in the following jurisdictions: the European Union, Argentina, Brazil, Canada, Chile, Germany, Hong Kong, Mexico, the Netherlands, Panama, and the United Kingdom. A number of others are in process. The OCC also has entered into some less formal information-sharing arrangements with several other countries, including the Republic of China.

II on the capital of our banks *prior* to its adoption; and third, a prudent implementation in which we make well-reasoned and well-understood changes to bank capital requirements and incorporate in those changes appropriate conservatism. In this regard, I welcome the questions and issues that members of this committee and its staff have raised about this important project and I have repeatedly stressed to the Basel committee the important role that congressional oversight plays in our deliberative process.

The U.S. agencies' insistence on a thorough and rigorous deliberative process already has resulted in important modifications to the Basel II proposals. One of the most significant of these issues—and one that U.S. banks were virtually unanimous in criticizing in response to the Basel Committee's third consultative paper (CP–3)—involved the fundamental question of what losses capital requirements should be designed to cover. CP–3 would have calibrated capital to ensure coverage of both expected losses (EL) plus unexpected losses (UL). However, banks in the United States today generally measure and manage their internal economic capital allocations by reference to UL only, and most banks consider EL to be covered by a combination of reserves and credit pricing. As we examined this issue, we became convinced not only that the banks were conceptually correct in their arguments, but that retaining the EL plus UL calibration would have severe ramifications—not the least of which might be to seriously jeopardize the industry's acceptance of Basel II framework as being a conceptually sound framework. While many on the Basel Committee resisted this initially, the committee ultimately put forth a new proposal in October to modify the calibration of Basel II to UL only. This modification was strongly endorsed by industry participants and has now been agreed to by the committee.

The committee announced several other important modifications to CP–3 in January that are responsive to numerous comments we received on CP–3 and the U.S. agencies' advanced notice of proposed rulemaking that was issued last August. These modifications include simplifying the proposed treatment for securitizations and aligning it more closely to industry practice and an agreement to find a prudentially sound solution that better recognizes credit mitigation techniques used by the industry. Other issues are still under discussion by the committee's various technical working groups and are scheduled to be considered by the committee at its meeting in May.

Probably the most difficult policy issue remaining involves the appropriate risk-based capital treatment of certain retail credit products—unused credit card lines in particular. This issue is critically important for national banks and for the cost and availability of consumer credit. It is also an area in which consensus has been hard to come by, not least because of the extent to which American credit card products are marketed and administered differently than in other parts of the world. Given the prominence of this issue for U.S. banks, and for national banks in particular, there is little room for substantive compromise, and the OCC will not accept provisions that are likely to unduly disrupt or disadvantage established, well-functioning business practices for the sake of global conformity.

Notwithstanding the difficulty of these issues, the committee's goal is to be in a position by mid-

ear to release a text that will provide the basis for each country's national implementation process. Let me reiterate that point: the release of the next round of Basel II proposal does *not* represent a final agreement or accord; rather, it is the platform from which we will launch our more in-depth domestic deliberative process. In the United States, that process will have several key steps.

First, the U.S. agencies will conduct a fourth quantitative impact study (QIS–4) in the third and fourth quarters of this year. This study will be based on the committee's mid-year release and will differ in some important aspects from the Basel Committee's earlier quantitative studies. QIS-4 will not only be conducted against the background of a more fully articulated proposal, but will include a more prominent supervisory role to ensure greater reliability and consistency in survey results than has occurred in the past. We continue to believe that we cannot responsibly adopt final rules implementing Basel II until we have both determined with a high degree of reliability what the impact will be on the capital of our banks, and we have made the judgment that the impact is acceptable and conducive to the maintenance of a safe and sound banking system in the United States. We believe the results of QI–4 will be more useful than any data we currently have in determining the magnitude of Basel II on bank capital and potential competitive inequities, as well as determining ultimately what to do about them.

Second, in another effort to increase our practical understanding of the effects of Basel, the U.S. agencies have commenced an operational risk benchmarking review at a number of institutions. Information obtained through this effort will enhance agency understanding of current qualitative and quantitative operational risk practices and will assist agency efforts to develop additional supervisory guidance and training materials for banks and examiners on the operational risk component of Basel II. Throughout this period we will continue our dialogue with banks and other interested stakeholders on various issues that Basel II may raise.

These projects and discussions will help us in the third key step in Basel implementation, developing a joint notice of proposed rulemaking (NPR) that will set forth the proposed regulatory text for Basel II in the United States. Currently we anticipate that such an NPR will be released for public comment in late 2005 or early 2006. At the OCC, we have made a preliminary determination that this rulemaking will be a "significant regulatory action" for purposes of Executive Order 12866. Consequently, we will prepare and submit to the Office of Management and Budget's Office of Information and Regulatory Affairs (OIRA) an economic analysis that includes—

- A description of the need for the rules and an explanation of how they will meet the need;
- An assessment of the benefits anticipated from the rules together with, to the extent feasible, a quantification of those benefits;
- An assessment of the costs anticipated from the rules together with, to the extent feasible, a quantification of those costs; and

- An assessment of potentially effective and reasonably feasible alternatives to the planned regulation and an explanation why the planned regulatory action is preferable to the identified potential alternatives.

We have begun discussions with the OMB's OIRA regarding the how these analyses will be designed and conducted. Our analysis will be published as part of our notice and comment process.

Finally, as the rulemaking process for the domestic implementation of Basel II moves forward, we and the other U.S. agencies are exploring the implications that Basel II may have on non-mandatory banks and what, if any, changes we should make to our capital regulations for those banks. Any such changes will, of course, be subject to public notice and comment.

As my testimony conveys, while we have made important strides in trying to develop a more risk-sensitive capital framework for internationally active banks, there is still a long way to go before Basel II is completed and adopted. As I have repeatedly stated before Congress and in the Basel Committee, a new accord cannot be completely finalized until national implementation procedures have been completed and I am committed to a notice and comment process that is open and fair and responsive to public comments. The OCC and other U.S. agencies have recognized the possibility that, even in the late stages, public comments might reveal flaws in the proposal that will need to be addressed before we can issue final implementing regulations. The OCC's ultimate willingness to sign onto Basel II is going to depend on whether we are satisfied with the final product.

The Applicability of State Law to National Banks

National banks today compete in a financial services marketplace that is profoundly different from the one they confronted 20, even 10, years ago. Legal barriers to banks' geographic expansion have been eroded by market developments and, in some cases, eliminated by Congress. At the same time, technology has enabled ways of doing business that have vastly expanded their markets. Consumers can comparison shop for financial products and services on-line and can initiate financial transactions over the Internet. Banks use technology to make available a wider array of products and services and to deliver those products and services more quickly. Credit decisions—like approving a mortgage loan—that used to take weeks can now be made in a matter of hours, for a customer located across the desk or across the country. In our highly mobile society, consumers expect that, when they move, they can take with them the financial relationships they have worked to establish with their banks. All these factors have combined to produce a market for credit, deposits, and many other financial products and services that is now national, and for some banks, international, in scope. In other words, through advances in data analysis and communications and changes in customer demographics, banking markets have expanded beyond the locality in which a given customer may be resident.

These developments highlight the significance of being able to conduct a banking business pursuant to consistent, national standards, regardless of the location of a customer when he or she first becomes a bank customer or the location to which the customer may move *after* becoming a bank customer. Yet the trend at the state—and sometimes the local—level has been the enactment of an increasingly diverse and potentially conflicting assortment of laws that localize bank regulation and threaten the ability of national banks to operate under the powers granted by their federal charter, pursuant to uniform national standards, and subject to federal oversight and supervision. In addition to conflicting with federal authorities, these state and local laws have resulted in greater uncertainty about the standards applicable to national banks' operations, costly litigation to resolve that uncertainty, and in some respects, constriction of the availability of legitimate credit.

In January of this year, the OCC issued two final rules—our preemption rule and amendments to our existing visitorial powers rule—intended to provide national banks with the guidance they need to operate under uniform, predictable federal standards—plus rigorous standards of consumer protection. In the latter respect, our second and equally important goal was to ensure that the federal standards under which national banks operate directly address and prevent abusive or predatory lending practices.

The preemption rule adds provisions to our regulations expressly addressing the applicability of certain types of state laws to national banks' lending and deposit-taking activities. The rule is *not* a dramatic expansion of preemption. The regulation only preempts the types of laws that are *listed* in the regulation. The listed types of laws are ones that already are preempted under longstanding, preexisting OCC regulations, have been found to be preempted in OCC preemption opinions, have been found to be preempted by the courts, or have been determined to be preempted for federal thrifts by the OTS. Thus, they are types of laws for which substantial precedent exists recognizing the interference they pose to the ability of federally chartered institutions to operate under uniform federal standards. We will continue to evaluate other types of laws, not listed in the regulations, under the pre-existing, judicially established standards for federal preemption that are encapsulated by the "obstruct, impair, or condition" phrasing contained in the rule. It is important to stress that this phrase does not itself preempt any state law; rather it distills the standard that we believe the courts would apply in deciding questions of preemption for the types of laws *not listed* in the regulation.

Our second action involved amendments to our existing regulation concerning the OCC's exclusive "visitorial powers" with respect to national banks.[4] Existing, longstanding OCC regulations implement the visitorial powers statute by providing that state officials are not authorized to

[4] "Visitorial powers" is a term used to refer to the authority to examine, supervise, and regulate the affairs of a corporate entity. Under federal law, the OCC has exclusive visitorial powers over national banks—except where federal law provides otherwise. Specifically, 12 USC 484 provides that "no national bank shall be subject to any visitorial powers except as authorized by federal law, vested in the courts of justice" or exercised by Congress or a committee of Congress. This provision, originally enacted in 1863, is integral to the overall design of the system and the ability of national banks to conduct the business of banking subject to uniform, consistent standards and supervision, wherever in the nation they operate.

inspect, examine, or regulate national banks, except where another federal law authorizes them to do so. One amendment to our visitorial powers rule clarified that the scope of the OCC's exclusive visitorial authority applies to the content and conduct of national bank activities authorized under federal law. In other words, the OCC is exclusive supervisor of a national bank's banking activities. Another amendment clarifies that the *preservation* of visitorial powers "vested in the courts of justice" does not *grant* state regulatory or law enforcement officials *new* authority, in addition to whatever they may otherwise have, to exercise visitorial powers over national banks. State attorneys general do not dispute that federal law prohibits them from examining or taking actions directly against national banks, such as through cease-and-desist proceedings.[5] What we have said is simply that they may not use the courts to accomplish indirectly what they acknowledge federal law clearly prohibits them from accomplishing directly.

These rules were the subject of thorough examination by this committee's Subcommittee on Oversight and Investigations at a hearing held earlier this year. The written statement we submitted for that hearing contains a comprehensive description of the rules, the legal principles that support them, and our reasons for adopting them, and I would refer the members of the committee to that earlier statement for detailed discussion of those matters.[6]

Today, I want to correct the record on three points that have been the subject of a great deal of confusion, misunderstanding, and mischaracterization in recent weeks:

- The OCC's preemption and visitorial powers rules do not leave consumers vulnerable to predatory or abusive lending practices.
- The OCC employs a comprehensive, integrated approach to compliance supervision, staffed with resources ample to ensure that national bank consumers are protected.
- The OCC welcomes new opportunities to cooperate with state authorities on issues of mutual concern pertaining to consumer protection.

1. The OCC's rules do not leave consumers vulnerable to abusive lending practices.

It is simply not the case that national bank customers are left exposed to abusive practices as a result of our rules. First, national banks and their operating subsidiaries are not where predatory and abusive lending practices are festering. Second, national banks and their operating subsidiaries are governed by strong federal standards designed to prevent these practices. Finally, the OCC

[5] See footnote 28 in Brief of Amici Curiae of 41 State Attorneys General in support of Defendant, in *Wachovia Bank, N.A. v. Watters,* Civil Action No. 5:03CV0105, U.S. District Court for the Western District of Michigan, January 29, 2004.

[6] *See* "Testimony of Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, Office of the Comptroller of the Currency, Before the Subcommittee on Oversight and Investigations of the Committee on Financial Services of the U.S. House of Representatives," January 28, 2004 (Williams Testimony).

has a strong track record of taking vigorous enforcement action to remedy any such practices that do occur and require restitution to customers.

Clearly, there is a real problem with abusive lending practices in this country, but national banks are not the breeding ground.[7] Whatever our differences of opinion with the state attorneys general, they have stated unambiguously in various filings that there is scant evidence that national banks, or their operating subsidiaries, are engaged in abusive lending practices.[8] Indeed, these state officials have recognized the extent to which banks (and thrifts) are highly regulated and closely supervised, and have credited that regulatory presence for the scarcity of evidence of abusive or predatory practices.

Our preemption rule contains two new provisions that expressly prohibit abusive or predatory lending practices by national banks or their operating subsidiaries. First, the rule prohibits national banks from making any consumer loan based predominantly on the foreclosure or liquidation value of a borrower's collateral, rather than on the borrower's ability to repay the loan according to its terms. This anti-predatory lending standard applies uniformly to all consumer lending activities of national banks and their operating subsidiaries, regardless of the location from which those activities are conducted or where customers reside. This standard strikes at the heart of predatory lending, namely lending practices that effectively swindle a homeowner out of his or her property.[9]

Second, our preemption rule provides that, in connection with *any* type of lending, national banks and their operating subsidiaries shall not engage in unfair and deceptive practices within the meaning of section 5 of the Federal Trade Commission Act (FTC Act), which prohibits "unfair or deceptive acts or practices" in interstate commerce. Although we do not have the statutory

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[7] This conclusion is borne out not only by our own supervisory experience, but also by an extensive study of predatory lending conducted by the Department of Housing and Urban Development and the Treasury Department. A Treasury-HUD joint report issued in 2000 found that predatory lending practices in the subprime market are less likely to occur in lending by banks, thrifts, and credit unions that are subject to extensive oversight and regulation. . . . The subprime mortgage and finance companies that dominate mortgage lending in many low-income and minority communities, while subject to the same consumer protection laws, are not subject to as much federal oversight as their prime market counterparts—who are largely federally-supervised banks, thrifts, and credit unions. The absence of such accountability may create an environment where predatory practices flourish because they are unlikely to be detected.

Departments of Housing and Urban Development and the Treasury, "Curbing Predatory Home Mortgage Lending: A Joint Report" 17-18 (June 2000), available at http://www.treas.gov/press/releases/report3076.htm.

In addition, the report found that a significant source of abusive lending practices is non-regulated mortgage brokers and similar intermediaries who, because they "do not actually take on the credit risk of making the loan, . . . may be less concerned about the loan's ultimate repayment, and more concerned with the fee income they earn from the transaction." *Id.* at 40.

[8] Brief for Amicus Curiae State Attorneys General, *Nat'l Home Equity Mortgage Ass'n v. OTS,* Civil Action No. 02—2506 (GK) (U.S. District Court for the District of Columbia) at 10–11 (emphasis added). See also National Association of Attorneys General, Comment Letter Re: Docket No. 03–16 (dated Oct. 6, 2003) at 10.

[9] See also OCC Advisory Letter 2002–3, "Guidance on Unfair or Deceptive Acts or Practices," March 22, 2002.

authority to define particular acts or practices as "unfair" or "deceptive" under the FTC Act, we added an express reference to section 5 to our rule in response to commenters who urged us to affirm that the principles of the act apply to national banks. We viewed this addition as particularly appropriate in light of the fact that the OCC pioneered the use of section 5 as a basis for enforcement actions against banks that have engaged in such conduct, and have obtained substantial restitution for customers as a result.

These new standards are comprehensive and they apply nationwide, to all national banks and their operating subsidiaries. They apply strong protections for national bank customers in every state—including the many states that do not have their own anti-predatory lending standards.

The addition of these provisions to our lending rules reinforces the obligation of national banks and their operating subsidiaries to treat their customers fairly and operate pursuant to high standards of integrity. The provisions supplement prior OCC predatory lending guidance[10] and a host of federal consumer protection laws that apply to national banks and their operating subsidiaries.[11]

If, as a result of our examination or supervisory processes, or upon investigation of referrals or complaints, we find abusive practices in a particular institution, our track record compellingly hows that we take action to stop them. Section 8 of the Federal Deposit Insurance Act gives the OCC broad powers to require compliance with any "law, rule, or regulation." This includes the ability to issue cease-and-desist orders when the OCC determines that a national bank or its operating subsidiary has violated any applicable federal law or regulation or any applicable state law or regulation.[12] In an appropriate case, the cease-and-desist order may include restitution or a

[10] The OCC was the first federal banking agency to issue anti-predatory lending guidance. Two advisory letters issued a year ago provide comprehensive supervisory guidance directed at ensuring that national banks and their operating subsidiaries do not become involved in abusive or predatory mortgage lending practices. See OCC Advisory Letter 2003–2, "Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices," February 18, 2003; OCC Advisory Letter 2003–3,"Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans," February 18, 2003.

[11] Federal consumer protection laws and regulations that apply to national banks and to national bank operating subsidiaries include: the Federal Trade Commission Act; Truth in Lending Act; Home Ownership and Equity Protection Act; Fair Housing Act; Equal Credit Opportunity Act; Real Estate Settlement Procedures Act; Community Reinvestment Act; Truth in Savings Act; Electronic Fund Transfer Act; Expedited Funds Availability Act; Flood Disaster Protection Act; Home Mortgage Disclosure Act; Fair Housing Home Loan Data System; Credit Practices Rule; Fair Credit Reporting Act; federal privacy laws; Fair Debt Collection Practices Act; the new OCC anti-predatory lending rules in 12 CFR parts 7 and 34; OCC rules imposing consumer protections in connection with the sales of debt cancellation and suspension agreements; OCC standards on unfair and deceptive practices (http://www.occ.treas.gov/ftp/advisory/2002–3.doc); and OCC standards on preventing predatory and abusive practices in direct lending and brokered and purchased loan transactions (http://www.occ.treas.gov/ftp/advisory/2003-2.doc. and http://www.occ.treas.gov/ftp/advisory/2003–3.doc).

[12] USC 1818(b)(1). See *National State Bank of Elizabeth, N.J. v. Long,* 630 F.2d 981, 988-89 (3d Circuit Court of Appeals 1980) (confirming the OCC's authority under 12 USC 484 to enforce an applicable state redlining statute).

requirement for such other affirmative action as the OCC determines is appropriate.[13] Our record shows that we have been willing and able to use these remedies to protect customers and to address unfair, deceptive, or abusive practices when such situations occur.[14]

2. The OCC has ample resources to ensure that national bank customers are protected.

The central feature of the OCC's consumer compliance supervision is our on-site presence in the institutions we supervise. National banks and national bank operating subsidiaries are subject to a comprehensive, regular—in the case of large banks, continuous—program of supervision that is, as I have described, risk-focused and rigorous.

Federal law requires that the OCC examine national banks at least once every 12 or 18 months, depending on the size of the bank.[15] However, the largest national banks have on-site examination teams conducting continuous examinations of all aspects of the bank's operations. In addition, the OCC may at any time conduct targeted safety and soundness and compliance examinations.

Our system of supervision applies to national banks and their operating subsidiaries. The OCC supervises national banks by business line, not according to corporate form, so the standards applied in the course of that supervision are the same for national banks and their operating subsidiaries. The book figures of a parent national bank and its operating subsidiaries are combined for purposes of applying statutory or regulatory limits, such as lending limits or dividend restrictions. The OCC reviews the institution's policies and procedures in an effort to assess whether they adequately identify and address the risks the institution may face, given the nature and scope of

[13] 12 USC 1818(b)(6)

[14] See the following actions taken by the OCC under the FTC Act to address unfair or deceptive practices: *In the Matter of Clear Lake National Bank, San Antonio, Texas,* Enforcement Action 2003-135 (required restitution of fees and interest for home equity loans); In the Matter of First Consumers National Bank, Beaverton, Oregon, Enforcement Action 2003–100 (required restitution of annual fees and overlimit fees for credit cards); *In the Matter of Household Bank (SB), N.A., Las Vegas, Nevada,* Enforcement Action 2003–17 (required restitution regarding private label credit cards); *In the Matter of First National Bank in Brookings, Brookings, South Dakota,* Enforcement Action 2003–1 (required restitution regarding credit cards); *In the Matter of First National Bank of Marin, Las Vegas, Nevada,* Enforcement Action 2001–97 (restitution regarding credit cards); and *In the Matter of Direct Merchants Credit Card Bank, N.A., Scottsdale, Arizona,* Enforcement Action 2001–24 (restitution regarding credit cards). See also the following actions taken by the OCC regarding payday lending activities of national banks: *In the Matter of Peoples National Bank, Paris, Texas,* Enforcement Action 2003–2; *In the Matter of First National Bank in Brookings, Brookings, South Dakota,* Enforcement Action 2003–1; *In the Matter of Goleta National Bank, Goleta, California,* Enforcement Action 2002–93; and *In the Matter of Eagle National Bank, Upper Darby, Pennsylvania,* Enforcement Action 2001–104. These orders can be found on the OCC's Web site within the "Popular FOIA Requests" section at http://www.occ.treas.gov/foia/foiadocs.htm.

[15] 12 USC 1820(d)(1). The general rule requires examinations every 12 months. However, if a bank has less than $250 million in assets and is in good condition, the OCC need only examine it at least once every 18 months. *Id.* section 1820(d)(4).

its business. Finally, the OCC evaluates the adequacy of all elements of the institution's business, including capital, earnings, assets, management, liquidity, sensitivity to market risk, and information systems.

Through our safety and soundness and compliance examinations, the OCC reviews the adequacy of the bank's policies, systems, and controls, relative to the character and complexity of the bank's business and assesses whether the bank's activities are being carried out in compliance with applicable laws and regulations. As part of these reviews, examiners typically sample transactions to assess the adequacy of the bank's systems and controls. For example, as part of an asset quality review, the sample of loans will be reviewed to determine the quality of the loans, the adequacy and completeness of the information concerning the loan and the borrower, and whether the lending function is being carried out in compliance with applicable laws.

Depending on the bank's risk profile and other supervisory information, examiners may target their reviews to a particular loan product, business line, or operating unit. For example, if the bank is engaging in significant new or expanded mortgage lending activities through an operating subsidiary, examiners normally would select a sample of those loans for review. Similarly, as part of our compliance reviews, examiners may select a sample of consumer loan or deposit products to verify that the bank's systems and controls are adequate and that the bank is complying with applicable consumer protection laws and regulations. If the sampling process indicates potential issues, we will expand our reviews. The examination process is intended to provide a high level of assurance that each aspect of an institution's business is conducted in compliance with applicable laws and on a safe and sound basis. Through this process, we are able to examine national banks and their operating subsidiaries for potentially abusive lending practices as well as compliance with the host of specific federal consumer protection requirements to which they are subject. Our compliance supervision is an integral part of our comprehensive, ongoing oversight of the national banking system.

Today, the OCC supervises approximately 2100 national banks, together with their operating subsidiaries. Compliance and enforcement at the OCC are carried out through our corps of bank examiners and attorneys. We have nearly 1700 examiners in the field, hundreds of whom are involved in both safety and soundness and compliance supervision. Over 100 examiners throughout the country work exclusively on compliance supervision. We have over 300 examiners on site at our largest national banks, engaged in continuous supervision of all aspects of their operations. These resources are supplemented by dozens of attorneys in our district offices and Washington, D.C., who work on compliance matters.

The employees in our Customer Assistance Group (CAG) located in Houston, Texas, further supplement these functions. The CAG provides direct assistance to customers of national banks and their subsidiaries to resolve individual complaints. It also collates and disseminates complaint

data that help point our examiners toward banks, activities, and products that require further investigation or transaction testing through product sampling. While the CAG is an important supplement to our compliance supervision functions, it is by no means all there is to it.

It is important to note, by way of comparison, based on data published by the Conference of State Bank Supervisors, state banking departments collectively supervise approximately 113,000 entities, of which approximately 6,000 are commercial banks.[16] For all these entities, the states report that they have 2,308 examiners.[17] Thus, if one were to look only at commercial banks and assume all state examiners were dedicated to commercial bank supervision, OCC's resources exceed those of the states on a per-supervised bank basis. But, in fact, state banking departments are responsible for many entities in addition to commercial banks. These include, depending on the state, savings banks, thrifts, credit unions, bank holding companies, mortgage bankers and brokers, industrial loan companies, nonbank trust companies, money transmitters, consumer finance companies, other licensed lenders, payday lenders, title lenders, check cashers, pawnshops, bankers' banks, securities brokers and dealers, and funeral parlors. Thus, on a per-supervised entity basis, the OCC has significantly more resources than do the states.[18] This is exactly the opposite of what some critics of our regulations have suggested. These suggestions—that our resources are inadequate to enable the OCC to supervise compliance effectively or to fulfill the consumer protection aspect of our mission—are simply without foundation.

3. The OCC welcomes opportunities to cooperate with states on issues pertaining to consumer protection.

The OCC and the states have a long history of coordination and cooperation, which we wish to continue. Neither the preemption rule nor the revised visitorial powers rule results in the OCC taking over a vast domain of supervisory and enforcement activity currently being conducted by state authorities with respect to national banks. The rules do not effect the ability of states to engage in those activities, where authorized by federal law, e.g., securities, insurance, telemarketing, nor do the rules prevent state officials from applying and enforcing generally applicable state laws that do not attempt to control the content or conduct of national banks' banking activities. Our jurisdiction over national banks and their subsidiaries does not deprive state regulators of a role in protecting consumers in their states. We welcome the opportunity to work cooperatively with them to further that goal. We have invited state authorities to refer consumer complaints concerning national banks to the OCC and to bring to our attention concerns that any national bank is engaged in unfair, deceptive, abusive or predatory practices. We have set up special procedures to handle and track referrals from state authorities. Unfortunately, we have received very little response to the overtures.

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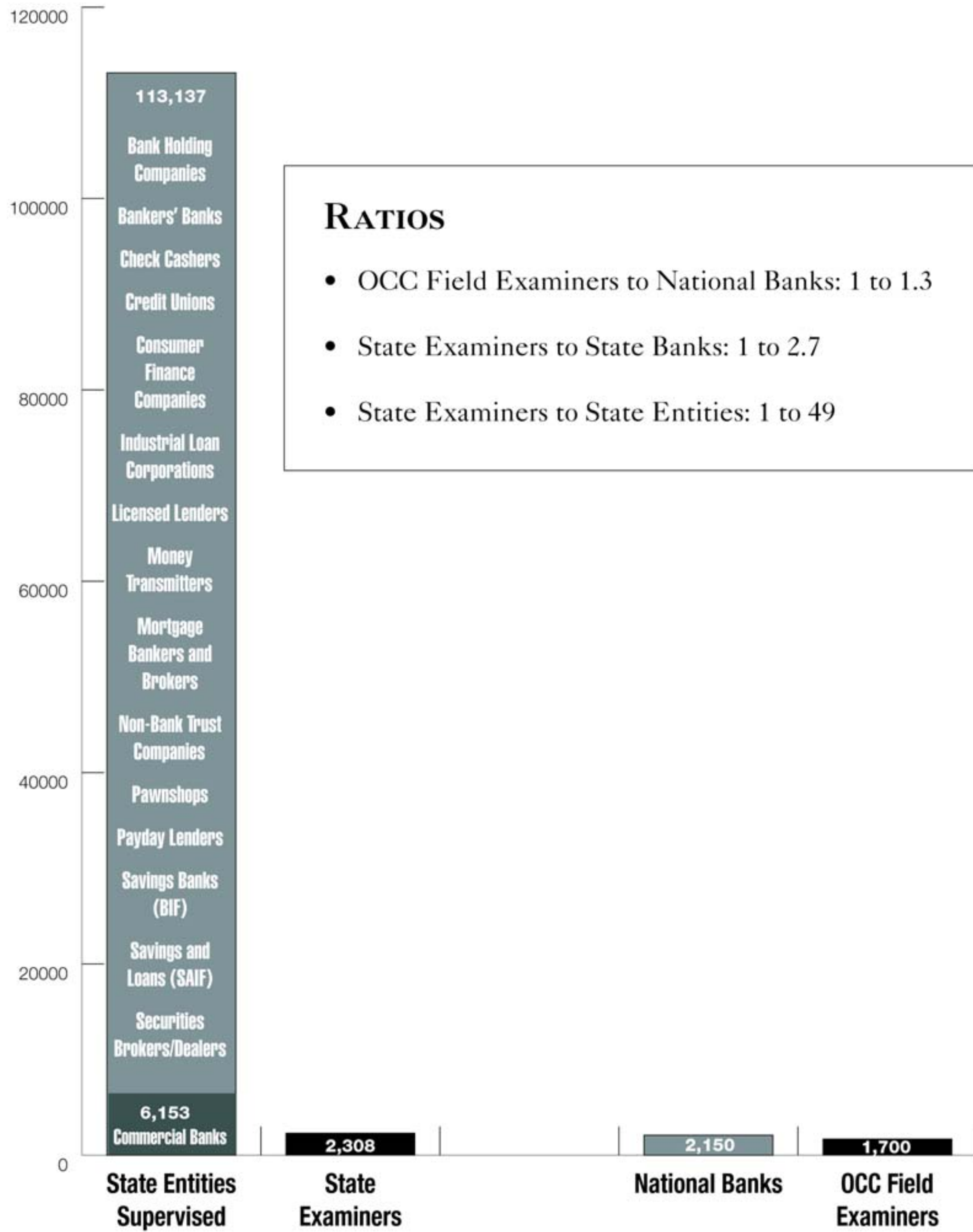
[16] *A Profile of State Chartered Banking,* Nineteenth Edition, 2002–2003, Conference of State Bank Supervisors.

[17] *Id.*

[18] See attached chart.


Comparison of OCC and
State Examiner Resources
120000
100000
80000
60000
40000
20000
0
113,137
Bank Holding Companies
Bankers' Banks
Check Cashers
Credit Unions
Consumer Finance Companies
Industrial Loan Corporations
Licensed Lenders
Money Transmitters
Mortgage Bankers and Brokers
Non-Bank Trust Companies
Pawnshops
Payday Lenders
Savings Banks (BIF)
Savings and Loans (SAIF)
Securities Brokers/Dealers
6,153
Commercial Banks
2,308
2,150
1,700
State Entities Supervised
State Examiners
National Banks
OCC Field Examiners
RATIOS
• OCC Field Examiners to National Banks: 1 to 1.3
• State Examiners to State Banks: 1 to 2.7
• State Examiners to State Entities: 1 to 49

The OCC and the states already cooperate extensively in many respects, referring consumer complaints to the appropriate regulator of the entity generating the complaint, and we welcome additional opportunities to collaborate. Recently, the OCC issued a new advisory letter to national banks clarifying our expectations about how they should handle customer complaints that are forwarded to them from state agencies and departments.[19] We took that opportunity to emphasize the importance of resolving consumer complaints fairly and expeditiously, regardless of the source of the complaint, and to remind banks that their complaint resolution processes are subject to review as part of our regular supervision of their compliance management programs.

There may ultimately be some areas where we will have to agree to disagree, but I am confident that there are many more where we can agree that there are improvements that all of us can make in how consumer concerns are identified and resolved. We welcome the opportunity to have further dialogue to achieve those goals.

V. CONCLUSION

In conclusion, Mr. Chairman, the national banking system is sound, and its recent performance has been strong. It has successfully weathered the recent recession, and it is responding in dynamic fashion to the changes in the financial services marketplace. The OCC, too, is keenly focused on keeping pace with change—by refining our own management practices, by improving the approaches we use to supervise the industry, and by striving to ensure that national banks remain the safe and sound, competitive, and high integrity engines of our economy that they were designed to be. We look forward to working productively with you, with the members of this committee, and with state officials as we pursue our efforts to achieve that goal.

[19] OCC Advisory Letter 2004–2, "Consumer Complaints Referred to National Banks from State Officials," February 26, 2004.

Statement of John D. Hawke, Jr., Comptroller of the Currency, before the U.S. Senate Committee on Banking, Housing and Urban Affairs, on federal preemption of state laws, Washington, D.C., April 7, 2004

Statement required by 12 USC, section 470: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

I. Introduction

Chairman Shelby, Ranking Member Sarbanes, and members of the committee, I appreciate this opportunity to address the Office of the Comptroller of the Currency's (OCC's) recent rulemakings pertaining to the applicability of state laws to national banks. federal preemption of state law is a subject that touches on fundamental characteristics of the national bank charter, fundamental responsibilities of the OCC, the essential attributes of this country's dual banking system, and how the interests of customers are served by the national banking system and protected by the OCC.

I welcome the opportunity to explain how our rules further the longstanding purposes of the national banking laws to ensure that national banks operate pursuant to a uniform set of nationwide standards; how they reinforce and reaffirm the high standards of integrity and fair treatment of customers that we expect of national banks; and how they preserve the distinct roles of federal and state regulators that define our dual banking system. I should emphasize that these rules resulted from a process the OCC began in 2002, by discussing with consumer groups, members of Congress and their staffs, and industry groups, the need for regulations to codify well-established preemption precedents and clarify the regulations implementing the statute governing the OCC's exclusive visitorial powers. The actions that we ultimately determined to take are grounded in the existing law, are not dramatic departures from existing preemption precedents and principles recognized for federally chartered institutions, and were taken in accordance with established, formal rulemaking processes.

In reviewing these rules, particularly as they affect state anti-predatory lending laws, it is important not to lose sight of three fundamental points:

- National banks are highly regulated and closely supervised. There is no evidence that they are the source of predatory lending practices.
- The OCC is committed to protecting customers of national banks; where problems have arisen, our track record shows that we will act to fix them.
- We welcome opportunities to enhance information sharing and collaboration with the states to address customer complaints and consumer protection issues.

My written statement, which addresses these points in greater detail, covers four areas. I will begin by describing briefly what our new rules do, and, in order to address some confusion that exists, what they do *not* do. Second, I will describe the actions the OCC has taken to ensure that customers of national banks are not subject to unfair, deceptive, abusive or predatory practices. Next, I will explain the reasons why we issued these new regulations. Finally, my testimony will address the principal arguments that have been advanced by those who question these new rules.

II. The OCC's Regulations

In January of this year, the OCC issued two final rules that address the applicability of state law to national banks. The first regulation, which follows the approach taken by the Office of Thrift Supervision (OTS) in its preemption regulations for federal savings associations, clarifies the extent to which the operations of national banks are subject to certain state laws by codifying the principles announced in a number of judicial decisions and OCC interpretations, as well as in OTS regulations (the preemption rule). The second rule amended aspects of the OCC's existing regulation concerning the OCC's exclusive "visitorial powers" with respect to national banks (the visitorial powers rule).

Increasingly in recent years, states—and even cities and counties—have enacted laws that attempt to constrain powers national banks are authorized to exercise under federal law. In addition to conflicting with federal authorities, these efforts have resulted in greater uncertainty about the standards applicable to national banks' operations, costly litigation to resolve that uncertainty, and in some respects, constriction of the availability of legitimate credit. One purpose of our regulations is to provide the clear guidance needed to ensure that national banks operate under uniform, predictable federal standards. A second—and equally important—goal was to ensure that the federal standards under which national banks operate directly address and prevent abusive or predatory lending practices. I next describe each rule in turn.

The Preemption Rule

The preemption rule adds provisions to our regulations expressly addressing the applicability of certain types of state laws to national banks' lending and deposit-taking activities. With regard to these activities, the preemption rule states the general principle that, except where made applicable by federal law, state laws do not apply to national banks if they "obstruct, impair, or condition" the bank's exercise of powers granted under federal law. The rules' preamble makes very clear that these words are not designed to create a new standard of preemption, but rather to distill the various phrases the Supreme Court has used in its preemption decisions.1 In the lending and deposit-taking areas, the preemption rule then lists certain types of state laws that are preempted by federal law and therefore are not applicable to national banks. In other words, the rule preempts the types of laws listed in the rule; other types of laws remain subject to case-by-case evaluation under established judicial standards.

For lending, examples of preempted laws include laws that restrict or prescribe the terms of credit, amortization schedules, permissible security property, escrow accounts, disclosure and advertising, and laws that require a state license as a condition of national banks' ability to make loans. For deposit-taking (in addition to laws dealing with disclosure requirements and licensing and registration requirements), the laws listed include laws that address abandoned and dormant accounts, checking accounts, and funds availability. In both areas, the listed types of laws either are preempted under longstanding, pre-existing OCC regulations, have been addressed in OCC preemption opinions, have been found to be preempted by the courts, or have been determined to be preempted by the OTS with respect to federal thrifts. Thus, they are the types of laws for which substantial precedent exists recognizing the interference they pose to the ability of federally chartered institutions to operate under uniform federal standards.

The preemption rule also contains two new provisions that expressly prohibit abusive or predatory lending practices. First, the rule prohibits national banks from making any consumer loan based predominantly on the foreclosure or liquidation value of a borrower's collateral, rather than on the borrower's ability to repay the loan according to its terms. This anti-predatory lending standard applies uniformly to all consumer lending activities of national banks,[1] regardless of the location from which the bank conducts those activities or where its customers live. This standard strikes at the heart of predatory lending, namely lending practices that effectively swindle a homeowner out of his or her property.

Second, the preemption rule provides that, in connection with any type of lending, national banks shall not engage in unfair and deceptive practices within the meaning of section 5 of the Federal Trade Commission Act (FTC Act), which prohibits "unfair or deceptive acts or practices" in interstate commerce. We added an express reference to section 5 to our rule in response to commenters who urged us to affirm that this federal standard applies to national banks. We viewed this addition as particularly appropriate in light of the fact that the OCC pioneered the use of section 5 as a basis for enforcement actions against banks that have engaged in such conduct.

It is important to emphasize that these new standards are comprehensive and they apply nationwide, to all national banks. The rules apply strong protections for national bank customers in every state—including the majority of states that do not have their own anti-predatory lending standards.

It also is important to emphasize several things that the preemption rule does not do. The final rule does not immunize national banks from all state laws, and it does not preempt undiscriminating laws of general applicability that form the legal infrastructure for conducting a banking or other business. Examples of laws that are not preempted are also identified in the preemption rule and include state laws on contracts, rights to collect debts, acquisition and transfer of prop-

[1] 69 *Federal Register* 1904, 1910 (Jan. 13, 2004).

erty, taxation, zoning, crimes, and torts. The rule also does not disturb the status quo concerning preemption of state escheat and unclaimed property laws; rather, it reaffirms that preemption does not occur for those types of laws that the Supreme Court has found not to be preempted. [2]In addition, any other law that only incidentally affects national banks' exercise of their federally authorized powers to lend, take deposits, and engage in other federally authorized activities would not be preempted under the final rule. This distinction is solidly founded in decisions of the U.S. Supreme Court.

The rule *does not preempt anti-discrimination laws.* There appears to have been some misunderstanding on this point, perhaps because some state predatory lending laws that actually seek to regulate loan terms have "fair lending" in their titles.[3] The preemption rule, consistent with federal judicial precedents,[4] does not preempt laws prohibiting discrimination in lending.

The rule *has absolutely no effect on real estate brokerage.* The rule neither enhances the ability of national banks to engage in real estate brokerage nor preempts state laws pertaining to real estate brokerage. National banks and their operating subsidiaries are not authorized to engage in the real estate brokerage business. The rule addresses certain types of state laws concerning real estate lending, not brokerage. Suggestions that the rule affects real estate brokerage activities are based on speculation about a combination of circumstances neither of which exists: (1) authorization of national banks and their operating subsidiaries to conduct real estate brokerage (they are not so authorized); and (2) an OCC rule preempting state real estate broker laws (there is no such rule).[5]

In fact, the preemption rule does not authorize any new national bank activities or powers. The rule does not address or affect activities authorized for financial subsidiaries. Nor does it impinge on the functional regulation framework for insurance and securities regulation established by Congress in the Gramm–Leach–Bliley Act.

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[2] *Anderson National Bank* v. *Luckett,* 321 U.S. 233 (1944).

[3] See, e.g., the Georgia Fair Lending Act, GA Code. Ann. §§ 7-6A-1 et seq., which does not address lending discrimination.

[4] See, e.g., *National State Bank* v. *Long,* 630 F.2d 981 (U.S. Court of Appeals for the Third Circuit 1980) (New Jersey anti-redlining statute applicable to national banks); see also *Peatros* v. *Bank of America NT&SA et al.,* 22 Cal 4th 147 (2000) (where federal law otherwise provides in employment discrimination context, state anti-discrimination statute not necessarily preempted).

[5] Concerns about preemption of state real estate brokerage laws appear to be prompted not by the regulation the OCC has issued, but by the possibility that national banks could, in the future, be permitted to engage in real estate brokerage activities. Several years ago, the Board of Governors of the Federal Reserve System (Board) and the Department of the Treasury (Treasury) issued a proposal addressing whether real estate brokerage should be considered an activity that is "financial in nature" and thus permissible for financial holding companies and bank financial subsidiaries. See 66 *Federal Register* 307 (January 3, 2001). The OCC's preemption rule would not apply to real estate brokerage activities even if the joint proposal were ever to be finalized. The rule does not apply to national bank financial subsidiaries. Thus its provisions do not preempt any state laws—including state real estate brokerage laws—or financial subsidiaries. Moreover, the preemption rule could not apply even if the Board-Treasury proposal were finalized because the applicability of state law to financial subsidiaries is determined under a different standard, that is, the standard that Congress expressly established in Section 104 of the Gramm–Leach–Bliley Act. 12 USC 6701(d)(1).

Finally, the preemption rule makes no changes to the OCC's rules governing the activities of operating subsidiaries. The OCC already has rules on the books imposing the same terms and conditions on national banks' activities whether they are conducted directly or through an operating subsidiary, except where federal law or regulation otherwise provide. By virtue of these pre-existing regulations,[6] the preemption rule has the same effect on national bank operating subsidiaries as it has on national banks.

The Visitorial Powers Rule

"Visitorial powers" is a term used to refer to the authority to examine, supervise, and regulate the affairs of a corporate entity. Under the National Bank Act, the OCC has exclusive visitorial powers over national banks. Specifically, 12 USC 484 provides that "no national bank shall be subject to any visitorial powers except as authorized by federal law, vested in the courts of justice" or exercised by Congress or a committee of Congress.[7] This provision dates from the earliest days of the national banking system and is integral to the overall scheme of the national banking system and the ability of national banks to conduct the business of banking subject to uniform, consistent standards and supervision, wherever in the nation they operate.

Existing OCC regulations implement the visitorial powers statute by providing that state officials are not authorized to inspect, examine, or regulate national banks, except where another federal law authorizes them to do so.[8] The amendment to the visitorial powers rule clarifies that the scope of the OCC's exclusive visitorial authority applies to the content and conduct of national bank activities authorized under federal law.[9] In other words, the OCC is the exclusive supervisor of a national bank's banking activities. The rule does not prevent state officials from enforcing state laws that do not pertain to a national bank's banking activities, such as health and safety standards or criminal laws of general applicability.[10]

Another amendment to the existing rule also clarifies that the preservation of visitorial powers "vested in the courts of justice" does not grant state officials new authority, in addition to whatever they may otherwise have, to use the court system to exercise visitorial powers over national banks. State attorneys general do not dispute that federal law prevents them from examining or

[6] *See* 12 CFR sections 5.34 (operating subsidiaries subject to same "terms and conditions" as apply to the parent bank) and 7.4006 (applicability of state law to national banks). *See also id.* at section 34.1(b) (real estate lending rule applies to national bank operating subsidiaries).

[7] 12 USC 484.

[8] 12 CFR 7.4000.

[9] 69 *Federal Register* 1895 (January 13, 2004).

[10] Moreover, the rule is fully consistent with the Riegle-Neal Act, which specifically provided that the provisions of any state law to which a branch of a national bank is subject under the Act *"shall be enforced, with respect to such branch, by the Comptroller of the Currency."* 12 USC 36(f)(1)(B). Thus, when state law is applicable to interstate branches of national banks, the OCC is required to enforce such laws.

taking actions directly against national banks, such as through cease-and-desist proceedings. What our revised rule says is that they may not use the courts to accomplish indirectly what they acknowledge the federal statute prohibits them from accomplishing directly.[11] The visitorial powers rule does not preclude states from seeking a declaratory judgment from a court as to whether a particular state law applies to the federally authorized business of a national bank.

Finally, like the preemption rule, the amendments to the visitorial powers rule make no change to the treatment of operating subsidiaries. Thus, in accordance with previously adopted OCC regulations, states generally can exercise visitorial powers over operating subsidiaries only to the extent that they could exercise visitorial powers over a national bank.

Some of the comments we received during the rulemaking process and some reactions to the final rules characterize them as "radical" or "dramatic" departures from the status quo. That characterization is simply incorrect.

The standard used in the preemption rule encapsulates the standards that the U. S. Supreme Court has applied in preemption cases for well over 130 years. It is phrased in words—"obstruct, impair, or condition"—that are taken from those cases. We have emphasized that we are not creating a new test for the threshold of preemption. The types of state laws identified as preempted in the rule include types of laws that a federal court has previously held, or that the OCC has previously opined, are preempted, or that are already preempted under existing OCC regulations. The other types of laws listed as preempted are virtually the same as those listed in OTS regulations that have been on the books since 1996. The clarifications we have added to our existing visitorial powers rule reinforce the point that the statutory prohibition on the exercise of visitorial powers by authorities other than the OCC means what the text clearly says. No one other than the OCC is empowered to regulate or supervise the banking business of national banks unless federal law provides that authority, and the statutory prohibition cannot be defeated by resort to the courts to impose regulatory standards or sanctions that the statute forbids state authorities from imposing directly.

What, then, has changed? What is different is that the legal conclusions that we have reached—and that have been reached in the context of comparable federally chartered institutions—in preexisting rules, in legal opinions, orders, and sometimes briefs in litigation, are now collected together in one place and codified in rules. Now, all national banks can look to one source to identify specific and predictable standards to define their compliance responsibilities with regard to specified types of state laws. This is critically important if national banks are to be able to operate efficiently and exercise fully the powers that federal law gives them.

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[11] *See* footnote 28 in Brief of Amici Curiae of 41 State Attorneys General in Support of Defendant, in *Wachovia Bank, N.A. v. Watters,* Civil Action No. 5:03CV0105, U.S. District Court for the Western District of Michigan, January 29, 2004.

III. The OCC's Commitment to Consumer Protection

The OCC's preemption rule both contains an anti-predatory lending standard and reaffirms the applicability to national banks of the prohibition on unfair and deceptive practices that is contained in the FTC Act. The addition of these provisions to our lending rules reinforces the obligations of national banks and their operating subsidiaries to treat their customers fairly and operate pursuant to high standards of integrity. Moreover, it is a consistent outgrowth of a series of actions we have taken to deter abusive lending practices and insure fair treatment of national bank customers.

It bears repeating that there is scant evidence that national banks and their operating subsidiaries are engaged in predatory practices. This conclusion is borne out not only by our own supervisory experience, but also by an extensive study of predatory lending conducted by the Department of Housing and Urban Development (HUD) and the Treasury Department.[12]

Moreover, in a brief submitted in support of an OTS rulemaking concerning preemption of state lending standards, 46 state attorneys general said that

> predatory lending abuses are largely confined to the subprime mortgage lending market and to non-depository institutions. *Almost all of the leading subprime lenders are mortgage companies and finance companies, not banks or direct bank subsidiaries.* * * *
>
> Recent major state Attorneys General and Federal Trade Commission enforcement actions and settlements targeting predatory lending activities have all involved state housing creditors—namely, non-bank finance companies—and not supervised depository institutions * * *

The attorneys general are not aware of any similar actions relating to predatory mortgage lending directed against federal thrifts or national banks.[13]

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[12] A Treasury–HUD joint report issued in 2000 found that predatory lending practices in the subprime market are less likely to occur in lending by banks, thrifts, and credit unions that are subject to extensive oversight and regulation. . . . The subprime mortgage and finance companies that dominate mortgage lending in many low-income and minority communities, while subject to the same consumer protection laws, are not subject to as much federal oversight as their prime market counterparts—who are largely federally supervised banks, thrifts, and credit unions. The absence of such accountability may create an environment where predatory practices flourish because they are unlikely to be detected.

Departments of Housing and Urban Development and the Treasury, "Curbing Predatory Home Mortgage Lending: A Joint Report" 17-18 (June 2000), available at http://www.treas.gov/press/releases/report3076.htm.

In addition, the report found that a significant source of abusive lending practices is non-regulated mortgage brokers and similar intermediaries who, because they "do not actually take on the credit risk of making the loan, . . . may be less concerned about the loan's ultimate repayment, and more concerned with the fee income they earn from the transaction." Id. at 40.

[13] Brief for Amicus Curiae State Attorneys General, *Nat'l Home Equity Mortgage Ass'n v. OTS,* Civil Action No. 02-2506 (GK) (U.S. District Court for the District of Columbia) at 10-11, 12 (emphasis added).

All *50* state attorneys general reiterated this point in their comment letter to the OCC on the proposal that preceded our final preemption rule, saying:

> It is true that most complaints and state enforcement actions involving mortgage lending practices have not been directed at banks. However, most major subprime mortgage lenders are now subsidiaries of bank holding companies, *(although not direct bank operating subsidiaries).*[14]

It is important, in our view, that the attorneys general, who have been clear about their disagreement with our preemption rule, have not found national banks and their operating subsidiaries to be engaged in predatory lending to any discernible degree. I mention the point here, by way of preface, in order to emphasize that the approach the OCC has taken to combating predatory and abusive lending practices is tailored, appropriately, to the extent that the issue exists in the national banking system.

The OCC's Anti-Predatory Lending Standards

The OCC is the first, and thus far the only, federal banking agency to issue anti-predatory lending guidance. Two advisory letters issued a year ago provide comprehensive supervisory guidance directed at ensuring that national banks and their operating subsidiaries do not become involved in abusive or predatory mortgage lending practices.[15]

The OCC's supervisory guidance details steps for national banks to take to ensure that they do not engage in such practices. The guidance makes clear that national banks should adopt policies and procedures to prevent predatory lending practices in direct lending and in transactions involving brokers and purchased loans. Each of the advisory letters expressly covers national banks as well as their operating subsidiaries.

Significantly, AL 2003–2 provides that bank policies and procedures on direct lending should reflect the degree of care that is appropriate to the risk of a particular transaction. In some cases, this will entail making the determination that a loan is reasonably likely to meet the borrower's individual financial circumstances and needs. We also emphasize that if the OCC has evidence that a national bank or its operating subsidiary has engaged in abusive lending practices, we will review those practices, not only to determine whether they violate specific provisions of law such as the Home Ownership and Equity Protection Act of 1994 (HOEPA), the Fair Housing Act, or the Equal Credit Opportunity Act, but also to determine whether they involve unfair or decep-

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[14] National Association of Attorneys General, Comment Letter Re: Docket No. 03-16 (dated Oct. 6, 2003) at 10 (emphasis added).

[15] *See* OCC Advisory Letter 2003-2, "Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices," February 18, 2003; OCC Advisory Letter 2003-3, "Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans," February 18, 2003.

tive practices that violate the FTC Act. Indeed, several practices that we identify as abusive in our standards—such as equity stripping, loan flipping, and the refinancing of special subsidized mortgage loans that originally contained terms favorable to the borrower—could well be found to be unfair practices that violate the FTC Act.

We issued our second advisory, AL 2003–3, to address concerns that have been raised about the all-too-common link between predatory lending and nonregulated lending intermediaries and to address the risk that a national bank could indirectly facilitate predatory lending through the purchase of loans and mortgage-backed securities and in connection with broker transactions. Our guidance stresses that national banks need to perform adequate due diligence prior to entering into any relationships with loan brokers, third-party loan originators, and the issuers of mortgage-backed securities, to ensure that the bank does not do business with companies that fail to employ appropriate safeguards against predatory lending in connection with loans they arrange, sell, or pool for securitization. We also advise national banks to take specific steps to address the risk of fraud and deception in brokered loan transactions relating to broker-imposed fees and other broker compensation vehicles.

The OCC's Examination and Supervisory Processes

The OCC conducts comprehensive examinations of a national bank's business, including its adherence to safe and sound banking practices and its compliance with several dozen federal consumer protection laws. Through a network of examiners located throughout the United States, we monitor conditions and trends, both in individual banks and in the national banking system as a whole. Our supervisory activities focus on the risks as identified by our supervisory monitoring tools and subject matter experts. Federal law requires that the OCC examine national banks at least once every 12 or 18 months, depending on the size and condition of the bank.[16] However, the largest national banks have on-site examination teams conducting continuous examinations of all aspects of the bank's operations. In addition, the OCC may at any time conduct targeted safety and soundness and compliance examinations.

This system of supervision applies to national banks and their operating subsidiaries. The OCC supervises national banks by business line, not according to corporate form, so the standards applied in the course of that supervision are the same for national banks and their operating subsidiaries. The book figures of a parent national bank and its operating subsidiaries are combined for purposes of applying statutory or regulatory limits, such as lending limits or dividend restrictions. The OCC reviews the institution's policies and procedures in an effort to assess whether they adequately identify and address the risks the institution may face, given the nature and scope of

[16] 12 USC 1820(d)(1). The general rule requires examinations every 12 months. However, if a bank has less than $250 million in assets and is in good condition, the OCC need only examine it at least once every 18 months. *Id.* section 1820(d)(4).

its business. Finally, the OCC evaluates the adequacy of all elements of the institution's business, including capital, earnings, assets, management, liquidity, sensitivity to market risk, and information systems.

Through our safety and soundness and compliance examinations, the OCC reviews the adequacy of the bank's policies, systems, and controls, relative to the character and complexity of the bank's business and assesses whether the bank's activities are being carried out in compliance with applicable laws and regulations. As part of these reviews, examiners typically sample transactions to assess the adequacy of the bank's systems and controls. For example, as part of an asset quality review, the sample of loans will be reviewed to determine the quality of the loans, the adequacy and completeness of the information concerning the loan and the borrower, and whether the lending function is being carried out in compliance with applicable laws.

Depending on the bank's risk profile and other supervisory information, examiners may target their reviews to a particular loan product, business line, or operating unit. For example, if the bank is engaging in significant new or expanded mortgage lending activities through an operating subsidiary, examiners normally would select a sample of those loans for review. Similarly, as part of our compliance reviews, examiners may select a sample of consumer loan or deposit products to verify that the bank's systems and controls are adequate and that the bank is complying with applicable consumer protection laws and regulations. If the sampling process indicates potential issues, we will expand our reviews as appropriate. The examination process is intended to provide a high level of assurance that each aspect of an institution's business is conducted in compliance with applicable laws and on a safe and sound basis. Through this process, we are able to examine national banks and their operating subsidiaries for potentially abusive lending practices as well as compliance with the host of specific federal consumer protection requirements to which they are subject. [17] Our compliance supervision is an integral part of our comprehensive, ongoing oversight of the national banking system.

Today, the OCC supervises approximately 2100 national banks, together with their operating subsidiaries. Compliance and enforcement at the OCC are carried out through our corps of bank examiners and attorneys. We have nearly 1700 examiners in the field, hundreds of whom are

[17] Federal consumer protection laws and regulations that apply to national banks and to national bank operating subsidiaries include: the Federal Trade Commission Act; Truth in Lending Act; Home Ownership and Equity Protection Act; Fair Housing Act; Equal Credit Opportunity Act; Real Estate Settlement Procedures Act; Community Reinvestment Act; Truth in Savings Act; Electronic Fund Transfer Act; Expedited Funds Availability Act; Flood Disaster Protection Act; Home Mortgage Disclosure Act; Fair Housing Home Loan Data System; Credit Practices Rule; Fair Credit Reporting Act; federal privacy laws; Fair Debt Collection Practices Act; the new OCC anti-predatory lending rules in 12 CFR parts 7 and 34; OCC rules imposing consumer protections in connection with the sales of debt cancellation and suspension agreements; OCC standards on unfair and deceptive practices (http://www.occ.treas.gov/ftp/advisory/2002-3.doc); and OCC standards on preventing predatory and abusive practices in direct lending and brokered and purchased loan transactions (http://www.occ.treas.gov/ftp/advisory/2003-2.doc and http://www.occ.treas.gov/ftp/advisory/2003-3.doc).

involved in both safety and soundness and compliance supervision. Over 100 examiners throughout the country work exclusively on compliance supervision. We have over 300 examiners on site at our largest national banks, engaged in continuous supervision of all aspects of their operations. These resources are supplemented by dozens of attorneys in our district offices and Washington, D.C., who work on compliance matters.

The 40 employees in our Customer Assistance Group (CAG) located in Houston, Texas, further supplement these functions. The CAG provides direct assistance to customers of national banks and their subsidiaries to resolve individual complaints. It also collates and disseminates complaint data that help point our examiners toward banks, activities, and products that require further investigation or transaction testing through product sampling. While the CAG is an important supplement to our compliance supervision functions, it is by no means all there is to it.

By way of comparison, based on data published by the Conference of State Bank Supervisors, state banking departments collectively supervise approximately 113,000 entities, of which approximately 6,000 are commercial banks.[18] For all these entities, the states report that they have 2,308 examiners.[19] Thus, if one were to look only at commercial banks and assume all state examiners were dedicated to commercial bank supervision, OCC's resources exceed those of the states on a per-supervised bank basis. But, in fact, state banking departments are responsible for many entities in addition to commercial banks. These include, depending on the state, savings banks, thrifts, bank holding companies, mortgage bankers and brokers, industrial loan companies, nonbank trust companies, money transmitters, consumer finance companies, other licensed lenders, payday lenders, title lenders, check cashers, pawnshops, bankers' banks, securities brokers and dealers, and funeral parlors. Thus, on a per-supervised entity basis, the OCC has significantly more resources than do the states. This is exactly the opposite of what some critics of our regulations have suggested. These suggestions—that our resources are inadequate to enable the OCC to supervise compliance effectively or to fulfill the consumer protection aspect of our mission—are without foundation.

Moreover, we continue to act on our strong commitment to preventing abusive or predatory lending practices in the national banking system and ensuring that the institutions we supervise adhere to high standards of customer service, integrity. Recently, for example, the OCC issued a new advisory letter to national banks clarifying our expectations about how they should handle customer complaints that are forwarded to them from state agencies and departments.[20] We took that opportunity to emphasize the importance of resolving consumer complaints fairly and

[18] "A Profile of State Chartered Banking, Nineteenth Edition, 2002-2003," Conference of State Bank Supervisors.

[19] *Id.* See attached chart.

[20] OCC Advisory Letter 2004-2, "Consumer Complaints Referred to National Banks from State Officials," February 26, 2004.

expeditiously, regardless of the source of the complaint, and to remind banks that their complaint resolution processes are subject to review as part of our regular supervision of their compliance management programs.

If, as a result of our examination or supervisory processes, or upon investigation of referrals or complaints, we find abusive practices in a particular institution, we take action to stop them. As I next describe, the OCC has a wide array of effective enforcement tools that we can use to do so.

The OCC's Enforcement Program

Section 8 of the Federal Deposit Insurance Act gives the OCC broad powers to compel compliance with any "law, rule, or regulation." This includes the ability to issue cease-and-desist orders when the OCC determines that a national bank or its operating subsidiary has violated any applicable federal law or regulation or any applicable state law or regulation.[21] In an appropriate case, the cease and desist order may include restitution or a requirement for such other affirmative action as the OCC determines is appropriate.[22] Our record shows that we have been willing and able to use these remedies to protect customers and to address unfair, deceptive, or abusive practices when such situations occur.

The OCC was the first federal banking agency to take enforcement action against an institution it supervises for violations of section 5 of the FTC Act. In a groundbreaking case, the OCC asserted section 5 of the FTC Act as a basis for seeking a cease-and-desist order, as well as affirmative remedies, against Providian National Bank.[23] The bank's settlement of that matter with the OCC required that it pay over $300 million in restitution to customers who had been the victims of unscrupulous marketing practices in connection with its "credit protection" program. Restitution through this single action was available to thousands of the bank's customers, nationwide.

- We have continued to bring actions based on violations of section 5 of the FTC Act where practices warrant. We have obtained millions of dollars in restitution for national bank customers in cases including:

    In the Matter of Clear Lake National Bank, San Antonio, Texas, Enforcement Action 2003-135 (required restitution of fees, finance charges, and interest re so-called "tax lien loans").

[21] 12 USC 1818(b)(1). *See National State Bank of Elizabeth, N.J. v. Long,* 630 F.2d 981, 988-89 (U.S. Court of Appeals for the 3rd Circuit 1980) (confirming the OCC's authority under 12 USC 484 to enforce an applicable state redlining statute).

[22] 12 USC 1818(b)(6).

[23] *In the Matter of Providian National Bank,* Tilton, New Hampshire (June 28, 2000). See also Agreement By and Between First National Bank, Ft. Pierre, South Dakota and the OCC (July 18, 2002) (formal agreement requiring national bank to cease violations of section 5 of the FTC Act in connection with the solicitation of credit cards).

In the Matter of First Consumers National Bank, Beaverton, Oregon, Enforcement Action 2003-100 (required restitution of annual fees and overlimit fees for credit cards).

In the Matter of Household Bank (SB), National Association, Las Vegas, NV, Enforcement Action 2003-17 (required restitution re private label credit cards).[24]

In the Matter of First National Bank in Brookings, Brookings, South Dakota, Enforcement Action 2003-1 (restitution re: credit cards).

In the Matter of First National Bank of Marin, Las Vegas NV, Enforcement Action 2001-97 (restitution re: credit cards).

In the Matter of Direct Merchants National Bank, Scottsdale, AZ, Enforcement Action 2001-24 (restitution re: credit cards).

- We have moved aggressively against national banks engaged in payday lending programs that involved consumer abuses as well as practices inconsistent with safety and soundness. Specifically, we concluded the following four enforcement actions against national banks that had entered into contracts with payday lenders for loan originations, in each case ordering the bank to terminate the relationship with the payday lender:

  In the Matter of Peoples National Bank, Paris, Texas, Enforcement Action 2003-2. We also assessed civil money penalties against Peoples National Bank in this matter for violating federal consumer protection statutes.

  In the Matter of First National Bank in Brookings, Brookings, South Dakota, Enforcement Action 2003-1 (as noted previously, we also ordered restitution in this action).

  In the Matter of Goleta National Bank, Goleta, California, Enforcement Action 200-93. We also assessed civil money penalties against Goleta National Bank in this matter for violating federal consumer protection statutes.

  In the Matter of Eagle National Bank, Upper Darby, Pennsylvania, Enforcement Action 2001-104.

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[24] In an action brought by the State of Arizona against this bank, among others, a state court recently observed that the restitution and remedial action that had been ordered by the OCC against the bank was "comprehensive and significantly broader in scope that that available through [the] State court proceedings." *State of Arizona* v. *Hispanic Air Conditioning and Heating, Inc.,* CV 2000-003625, Ruling at 27 (Aug. 25, 2003) (Superior Court of Arizona, Maricopa County).

The OCC is authorized to take the same enforcement actions and order the same remedies against national bank operating subsidiaries as we can against national banks.

The following are examples of enforcement actions we have taken where the basis for the action or the remedy ordered, or both, involved a national bank operating subsidiary:

- NationsBank, N.A., Charlotte, NC (now known as Bank of America, N.A.) The OCC assessed a $750,000 civil money penalty against NationsBank for unsafe or unsound practices at NationsSecurities, Inc., an operating subsidiary, relating to the sale of nondeposit products to customers. The OCC determined that NationsSecurities violated a condition of the OCC's approval of NationsBank's operating subsidiary notice. The condition related to providing appropriate disclosure to customers concerning the uninsured nature of the nondeposit products being sold and the relationship of the involved entities to the products.

- Advanta National Bank, Philadelphia, PA. The OCC issued a consent cease- and-desist action and two formal agreements to address numerous violations of law and unsafe and unsound banking practices conducted through the bank's mortgage lending subsidiary, and to require the disposition of the bank's mortgage lending operation.

- Household Bank (SB), N.A., Las Vegas, NV. The OCC issued a formal agreement against the bank requiring restitution to be paid to customers for unsafe or unsound practices and violations of consumer laws by the bank's retail services operating subsidiary in connection with solicitation and remediation of customers' complaints concerning the bank's credit cards.

- First Consumers National Bank, Beaverton, Oregon. The OCC issued a consent order in May 2002 against the bank requiring it to review all transactions with its affiliates and subsidiaries and to obtain any restitution owed to the bank from such entities, including a securitization operating subsidiary, resulting from violations of affiliate transaction laws and unsafe/unsound contracts. The OCC also required the bank (and, consequently, its subsidiary) to liquidate.

The national banking system today is safe and sound, and the operations of national banks reflect high standards. We are committed to assuring that this is always the case. In those exceptional cases where those standards are not met, we have the legal authority, the resources, and the commitment necessary to pursue appropriate sanctions and remedies.

Finally, as I noted early on in this statement, the preemption regulation that we adopted is substantially identical to the preemption regulations of the OTS that have been applicable to federal thrifts for a number of years. It does not appear from public commentary—nor have state officials indicated—that OTS preemption regulations have undermined the protection of customers of federal thrifts. There is no reason to expect that the results will be different for the customers of national banks.

IV. The OCC's Reasons for Adopting the Regulations

Precedents of the Supreme Court dating back to 1869 have addressed preemption in the context of national banks and have consistently and repeatedly recognized that national banks were designed by Congress to operate, throughout the nation, under uniform, federally set standards of banking operations. As a result, there is an extensive body of federal court precedents that reiterate and apply preemption principles to a variety of different types of state laws.[25] Yet, banks increasingly have been forced to litigate—sometimes repeatedly on the same issue—to clarify the applicability of specific types of state laws, and the OCC has issued separate legal opinions that address the applicability of state law. As national banks operate in an increasingly complex and multi-state environment, the shortcomings of this expensive and time-consuming case-by-case approach have become increasingly apparent. In addition, the financial and opportunity costs to banks of a case-by-case approach may be significant—especially where litigation becomes necessary to establish clear standards.

Rather than continuing to address preemption issues on a piecemeal basis, the preemption rules address them collectively—by clarifying and codifying prior judicial and OCC interpretations based on long-established constitutional principles—to provide clear ground rules for national banks concerning the applicability of specified types of state laws.

The changing financial services marketplace

As explained in the preamble to the preemption rule, markets for credit, deposits, and many other financial products and services are now national, if not international, in scope, as a result of significant changes in the financial services marketplace, particularly in the last 20 years. Now, more than ever before, the imposition of an overlay of 50 state and an indeterminate number of local standards and requirements on top of the federal requirements and OCC supervisory standards to which national banks already are subject has costly consequences that can materially affect a national bank's ability to serve its customers.

The changes we see in the market for financial services are the result of a combination of factors, including technological innovations, the erosion of legal barriers, and an increasingly mobile society.

[25] *See, e.g., Bank of America v. City & County of San Francisco,* 309 F.3d 551 (U.S. Court of Appeals for the Ninth Circuit 2002), cert. denied, 123 S. Ct. 2220, 2003 U.S. LEXIS 4253 (May 27, 2003) (the National Bank Act and OCC regulations together preempt conflicting state limitations on the authority of national banks to collect fees for the provision of electronic services through ATMs; municipal ordinances prohibiting such fees are invalid under the Supremacy Clause); *Wells Fargo Bank, Texas, N.A. v. James,* 321 F.3d 488 (U.S. Court of Appeals for the Fifth Circuit 2003) (Texas statute prohibiting certain check cashing fees is preempted by the National Bank Act); *Metrobank* v. *Foster,* 193 F. Supp. 2d 1156 (U.S. District Court for the Southern District of Iowa 2002) (national bank authority to charge fees for ATM use preempted Iowa prohibition on such fees). *See also Bank One, Utah v. Guttau,* 190 F.3d 844 (U.S. Court of Appeals for the Eighth Circuit 1999), *cert. denied sub nom Foster v. Bank One, Utah,* 529 U.S. 1087 (2000) (holding that federal law preempted Iowa restrictions on ATM operation, location, and advertising).

Technology has expanded the potential availability of credit and made possible virtually instantaneous credit decisions. Mortgage financing that once took weeks, for example, now can take only hours, with customers located throughout the nation obtaining mortgages based on sophisticated credit-scoring derived from centralized credit underwriting facilities. Consumer credit can be obtained at the point of sale at retailers and even when buying a major item such as a car. Consumers can shop for investment products and deposits on-line, from providers whose location may well be irrelevant. With respect to deposits, consumers can compare rates and duration of a variety of deposit products offered by financial institutions located far from where the consumer resides.

Changes in applicable law also have contributed to the expansion of markets for national banks and their operating subsidiaries. These changes have affected both the type of products that may be offered and the geographic region in which banks—large and small—may conduct business. As a result of these changes, banks may branch across state lines and offer a broader array of products than ever before. An even wider range of customers can be reached through the use of technology, including the Internet. Community national banks, as well as the largest national banks, reach customers across state lines and use new technologies to expand their reach and service to customers.

Our modern society is also highly mobile. Forty million Americans move annually, according to a recent congressional report issued in connection with enactment of the Fair and Accurate Credit Transactions Act of 2003.[26] And when they move, they often have the desire, if not the expectation, that the financial relationships and status they have established will be portable and will remain consistent.

These developments highlight the significance of being able to conduct a banking business pursuant to consistent, national standards, regardless of the location of a customer when he or she first becomes a bank customer or the location to which the customer may move *after* becoming a bank customer. They also accentuate the costs and interference that diverse and potentially conflicting state and local laws have on the ability of national banks to operate under the powers granted by their federal charter.

When national banks are unable to operate under uniform, consistent, and predictable standards, their business suffers, and their customers may face higher costs or more limited product offerings—or both—as a result. The application of multiple, often unpredictable, different state or local restrictions and requirements prevents them from operating in the manner authorized under federal law, is costly and burdensome, interferes with their ability to plan their business and manage their risks, and subjects them to uncertain liabilities and potential financial exposure. In some cases, this deters them from making certain products available in certain jurisdictions. As

[26] *See* S. Rep. No. 108-166, at 10 (2003) (quoting the hearing testimony of Secretary of the Treasury Snow).

was recently observed by Federal Reserve Board Chairman Alan Greenspan, "increased costs resulting from restrictions that differ based on geography, may lead to an increase in the price or a reduction in the availability of credit, as well as a reduction in the optimal sharing of risk and reward."[27]

It has been suggested that the ability to do business in multiple states, under uniform, consistent and predictable standards, primarily benefits the largest banks. In fact, for community and intermediate-sized banks with customers in multiple jurisdictions, this attribute of the national bank charter may have even more practical significance than for a "megabank." Take, for example, a community bank with customers in a multi-state metropolitan area like New York or Philadelphia or Washington, D.C.; or a community bank with customers in a compact multi-state region, such as New England; or any state-based bank in a state in which cities or municipalities enact unique local requirements for bank operations. Community and intermediate-sized regional banks have a smaller base of operations, e.g., a smaller number of loans, over which they are able to spread the overhead costs of legal staff, compliance staff, technology, and printing costs necessary to comply with multiple state (and potentially local) requirements. This drives up their costs and detracts from their ability to compete effectively with larger banks that have a bigger base of operations over which to apply overhead costs. This, in turn, serves as a disincentive for those banks to incur still more costs by expanding service to customers in a new state. Ultimately, the inability to compete on a cost-effective basis can be a factor that contributes to management decisions to merge or be acquired by a larger institution.

As we have learned from our experience supervising national banks, from the inquiries we have received, by the extent of litigation in recent years over these state efforts, and by the comments we received during our rulemakings, national banks' ability to conduct operations to the full extent authorized by federal law has been impaired as a result of increasing efforts by states and localities to apply state and local laws to national banks. For example, commenters on our proposal to adopt the preemption rule noted that the variety of state and local laws that have been enacted in recent years—including laws regulating fees, disclosures, conditions on lending, and licensing—have created higher costs, increased risks, and operational impediments.[28] Other commenters noted the proliferation of state and local predatory lending laws and the impact that those laws are having on lending in the affected jurisdictions. As a result, national banks must absorb the costs, pass the costs on to consumers, or simply curtail lending in jurisdictions where the costs

[27] Letter of February 28, 2003, from Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, to The Honorable Ruben Hinojosa (cited by Congressman Hinojosa on November 21, 2003, during House debate on the Conference Report to accompany H.R. 2622 (Conference Report 108-396)).

[28] Illustrative of comments along these lines were those of banks who noted that various state laws would result in the following costs: (a) approximately $44 million in start-up costs incurred by six banks as a result of a recently enacted California law mandating a minimum payment warning; (b) 250 programming days required to change one of several computer systems that needed to be changed to comply with anti-predatory lending laws enacted in three states and the District of Columbia; and (c) $7.1 million in costs a bank would incur as a result of complying with mandated annual statements to credit card customers.

are prohibitive or risks are imprudent. Commenters noted that this result occurs even in situations where a bank concludes that a law is preempted, simply so that the bank may avoid litigation costs or anticipated reputational injury.

Even the efforts of a single state to regulate the operations of a national bank operating only within that state can have a detrimental effect on that bank's operations and consumers. For example, the impact of particular state laws on the mortgage market and credit availability is discussed in detail below.

Access to the secondary mortgage markets

The continuing uncertainty about the applicability of state laws has already affected national banks' ability to lend in certain markets and to access the secondary market, a curtailment of their business that is inconsistent with their federally authorized powers and that has the potential to adversely affect credit availability as well as detract from the banks' financial position.

The trend at the state and local levels toward enacting legislation that seeks to impose costly and inconsistent compliance burdens on national banks has accelerated in recent years. These laws are well-intentioned but nonetheless curtail national banks' ability to conduct operations to the full extent authorized by federal law and can disrupt credit delivery systems.

For example, in recent years, various states and localities have enacted predatory lending laws, each employing a combination of standards that differs in some respects from the others, but each typically singling out loan product features and either barring loans with those features or imposing requirements that make it very costly for lenders to offer them. The goals of these laws—to eliminate predatory and abusive mortgage lending practices—are laudable and we strongly support their objectives. As I have repeatedly said, predatory and abusive practices have no place in the national banking system, and, as I have shown, we will take vigorous action to assure that this is the case.

However, these state and local law approaches can have the effect of banning subprime loans based on certain loan terms. They generally prohibit certain mortgage loan terms and impose extra compliance obligations when certain other loan terms or conditions are present. They introduce new standards for subprime lending that are untested, sometimes vague, often complex, and different from established federal requirements. They also create new potential liabilities and penalties for any lender who missteps in its efforts to comply with those new standards and restrictions. These laws materially increase a bank's costs and compliance and reputation risks, especially in connection with risk-based pricing to the subprime market.

It is important to understand that this approach, while intended to stop abusive practices, also can work to constrain legitimate risk-priced lending to credit-worthy subprime borrowers. [29] Like any state regulator, the OCC is dedicated to ensuring that the institutions we supervise are not engaged in abusive or predatory lending practices. However, our approach is to focus on preventing

those *practices,* not on banning or restricting specified loan products or terms in the absence of evidence of abusive, predatory, unfair, or deceptive practices.

Often, state and local predatory lending laws that have such a *product*- rather than *practice*-focus have created uncertainties that adversely affect banks ability to access the secondary market for legitimate, risk-priced mortgage loans. When a bank is able to sell a loan on a cost-effective basis to Fannie Mae or Freddie Mac, or obtains a rating for a pool of loans that it "securitizes" and sells to investors, the bank is able to liquify its loans and redeploy capital to make additional loans available. If Fannie or Freddie are unwilling to purchase loans made in jurisdictions with specialized predatory lending restrictions and potential liabilities, the funds banks have available to make additional credit available are diminished. Similarly, if a bank is unable to obtain a rating from Standard and Poors' (S&P), Moody's Investors Services, or Fitch Ratings, it will not be able to securitize its loans on a cost-effective basis and redeploy capital to make additional credit available. In other words, localized and state-based restrictions on loan terms substantially affect the marketability of such loans, and that, in turn, affects overall credit availability.

Fannie Mae and Freddie Mac have both issued policies concerning their willingness to purchase residential mortgage loans subject to various state predatory lending laws. Fannie Mae and Freddie Mac will not purchase high-cost home loans from **Arkansas, Georgia, Kentucky, Illinois, Maine, Nevada, New Jersey, New Mexico, New York, and Oklahoma.**

S&P, Moody's, and Fitch have also issued policies concerning the inclusion of high-cost loans from jurisdictions with predatory lending laws in structured finance transactions.[30] Under these policies, the rating agencies generally will not rate residential mortgage-backed securities (RMBS) structured finance transactions containing loans that carry unquantifiable assignee liability. Therefore, high-cost loans originated in states with anti-predatory lending laws providing for uncapped or unascertainable assignee liability must generally be excluded from a securitization in order for the transaction to be rated.[31]

[29] It is important to note that many legitimate, risk-priced mortgage loans would be considered "high cost home loans" under some state anti-predatory lending laws. For example, a "high cost" home loan under Georgia's anti-predatory lending law includes mortgages that have total points and fees exceeding 5 percent of the loan amount if the mortgage is $20,000 or more. On a $30,000 mortgage, this would mean any loan with origination fees of more than $1,500 would be considered "high cost." According to the Mortgage Bankers Association's 2002 Cost Study, the average cost to originate a mortgage in 2001 was $1,744.

[30] *See* Standard & Poor's, "Evaluating Predatory Lending Laws: Standard & Poors Explains its Approach" (April 15, 2003); Moody's Investor Services, "Impact of Predatory Lending Laws on RMBS Securitizations" (May 6, 2003); and Fitch Press Release, "Fitch Revises its Rating Criteria in the Wake of Predatory Lending Legislation" (May 1, 2003).

[31] *See, e.g.,* "Standard & Poor's Permits Additional New Jersey Mortgage Loans Into Rated SF Transactions" (November 25, 2003) ("Standard & Poor's will continue to exclude High-Cost Home Loans because of the potential for uncapped statutory and punitive damages."); and Mortgage Bankers Association Industry News, "Fitch Ratings Addresses New Mexico Predatory Lending Legislation" (January 15, 2004)("Since a lender or assignee of any 'high-cost home loan' may be subject to unlimited liability under the Act, Fitch will not rate RMBS transactions containing high-cost home loans originated in New Mexico as of Jan.1, 2004.") .

S&P and Fitch will rate securitizations containing loans originated in states with anti-predatory lending laws that provide for limited, or quantifiable, assignee liability, but only subject to additional credit enhancements and additional representations and warranties. Lenders doing business in the states discussed below face the following additional secondary market constraints:

- **Arkansas, Georgia, Illinois, Maine, Nevada, New York, Oklahoma, North Carolina, and South Carolina.** In these states, S&P generally requires that sellers provide representations and warranties that the loans were originated in compliance with all applicable laws and that their compliance procedures effectively identify high-cost home loans and determine that the loans do not violate predatory lending laws. Further, S&P requires that the provider of these representations and warranties be sufficiently creditworthy to purchase any loans that are in violation and cover any contingent liability associated with securitizing high-cost home loans.[32] Fitch will generally rate securitizations with loans from these jurisdictions (except North Carolina and South Carolina), but it will require additional representations and warranties and may require additional credit enhancements.[33] Fitch has not yet issued a statement with regard to loans originated in North Carolina or South Carolina.

- **Kentucky.** S&P requires sellers to conduct a loan-by-loan review of all high-cost home loans and provide the representations and warranties noted above before it will allow high-cost home loans from Kentucky in rated transactions. [34] Fitch will not allow any high-cost loans from Kentucky in rated transactions. In order to rate a transaction including any loans from Kentucky, Fitch requires receipt of a certification from a third party unaffiliated with the originators of the relevant loans that such third party conducted due diligence on a random sample of the greater of five loans or 10 percent of the loans from Kentucky and that no high-cost home loans were uncovered in the sample. If the review of the sample of loans uncov-

[32] *See* "S&P Addresses Arkansas Home Loan Protection Law" (July 11, 2003); Standard & Poor's, "Evaluating Predatory Lending Laws: Standard & Poors Explains its Approach" (April 15, 2003) (Georgia and New York); "S&P Addresses Illinois High Risk Home Loans Act" (November 17, 2003); "S&P Addresses Amendment to Maine Truth in Lending Act" (September 12, 2003); "S&P Addresses Nevada Anti-Predatory Lending Law"; "S&P Addresses Oklahoma Anti-Predatory Lending Law" (November 18, 2003); and "S&P Addresses North Carolina Anti-Predatory Lending Law" (February 12, 2004).

[33] *See* "Fitch Ratings Responds to Arkansas Predatory Lending Legislation" (June 20, 2003); Mortgage Bankers Association Industry News, "Fitch to Rate RMBS After Amendment to Georgia Predatory Lending Statute, GFLA" (March 14, 2003); Mortgage Bankers Association Industry News, "Fitch Ratings Addresses Illinois Predatory Lending Legislation" (December 15, 2003); "Fitch Ratings Responds to Maine Predatory Lending Legislation" (September 29, 2003); "Fitch Ratings Responds to Nevada Predatory Lending Legislation" (October 3, 2003); Mortgage Bankers Association Industry News, "Fitch: New York State Anti-Predatory Lending Legislation" (March 26, 2003); and "Fitch Ratings Addresses Predatory Lending Legislation of Oklahoma" (October 30, 2003).

[34] *See* "S&P Addresses Kentucky High-Cost Law" (Jun. 20, 2003).

ers any high-cost home loans, Fitch requires a review of every loan in the pool originated in Kentucky.[35]

- **New Jersey.** S&P and Fitch will not rate securitizations with certain high cost home loans from New Jersey.[36] In order to rate a transaction including any loans from New Jersey, Fitch requires, as it does in Kentucky, receipt of a certification from a third party unaffiliated with the originators of the relevant loans that such third party conducted due diligence on a random sample of the greater of five loans or 10 percent of the loans from New Jersey and that no high-cost home loans were uncovered in the sample. If the review of the sample of loans uncovers any high-cost home loans, Fitch requires a review of every loan in the pool originated in New Jersey.[37]

- **New Mexico.** S&P will rate securitizations containing high cost home loans subject to the additional representations and warranties it requires in Arkansas, Georgia, Illinois, Maine, Nevada, New York, North Carolina, and Oklahoma.[38] Fitch, however, will not rate any transaction containing high-cost home loans subject to New Mexico's anti-predatory lending law. Fitch notes that assignee liability may be unlimited in the case of punitive damages, which may be imposed for acts found to be reckless or malicious. Fitch further requires that the seller of any New Mexico loan provide adequate evidence that the transaction will enjoy the benefits of the new law's safe harbor from the law's unlimited liability for assignees and purchasers. In order to be protected by this safe harbor, a purchaser/securitizer must conduct due diligence and provide certain representations and warranties. Because it is unclear what constitutes sufficient "due diligence" under the New Mexico statute, Fitch requires the third-party certificate and random sampling it requires in Kentucky and New Jersey.[39]

These constraints translate into cost burdens at each stage of the lending process. For example, a rating agency that is willing to rate a RMBS securitization containing high-cost loans at all may, as we have seen, require representations, warranties, sampling, and certifications that go beyond the industry standard. Satisfying these extra conditions may require a bank to increase its compliance staff, provide additional training to both existing and new staff, and pay fees to obtain third-party sampling and certification. If the rating agency requires additional credit enhancement, providing that will generally add to the financial cost of the transaction. Finally, if the bank can-

[35] *See* Mortgage Bankers Association Industry News, "Fitch Ratings Responds to Kentucky Predatory Lending Legislation" (June 30, 2003); and Mortgage Bankers Association Industry News, "Fitch Ratings Updates Criteria Regarding Predatory Loans" (January 15, 2004).

[36] *See* "S&P Permits Additional New Jersey Mortgage Loans Into Related SF Transactions" (November 25, 2003).

[37] *See* "Fitch Ratings Responds to New Jersey Predatory Lending Legislation" (June 5, 2003); and Mortgage Bankers Association Industry News: "Fitch Ratings Updates Criteria Regarding Predatory Loans" (January 15, 2004).

[38] *See* "S&P Addresses New Mexico's Home Loan Protection Act" (November 25, 2003).

[39] *See* Mortgage Bankers Association Industry News: "Fitch Ratings Addresses New Mexico Predatory Lending Legislation" (January 15, 2004).

not securitize the loans and must therefore retain them on book, the bank does not realize funds that it could use to make additional loans and the bank will incur carrying costs.

These costs either will be passed back to the bank's customers or, if the bank concludes they are unacceptably high, will compel the bank to stop making loans covered by state anti-predatory lending laws.

The rating agencies have, however, responded favorably to preemption decisions by the federal banking agencies. Shortly after Fitch announced that it would not rate residential mortgage-backed securitizations containing high-cost home loans originated in New Mexico, Fitch also announced that, beginning the day the OCC's preemption rule becomes effective (February 12, 2004), it *will* rate residential mortgage-backed securitizations containing loans subject to any state or local anti-predatory lending laws that were originated by OCC-regulated national banks or their operating subsidiaries without additional credit enhancements.[40] This follows Fitch's August 22, 2003, decisions to rate securitizations without additional credit enhancement by OCC-regulated lenders in Georgia in light of the OCC's preemption order and determination concerning the GFLA,[41] and by OTS-regulated lenders in all jurisdictions in light of the OTS's preemption regulations and various preemption opinions.[42]

On October 3, 2003, S&P made the same decision concerning the GFLA determination and order.[43] On March 3, 2004, S&P announced that it had completed its review of the real estate lending provisions in the OCC's preemption rule[44] and that, as a result, it will rate securitizations containing loans originated by national banks or their operating subsidiaries in Georgia, Illinois, Kentucky, Maine, Nevada, New Jersey, New Mexico, New York, North Carolina, Oklahoma, and South Carolina. For loans originated in these jurisdictions, S&P will continue to rely on the seller's representation and warranty that the loans included in the pool were originated in compliance with all applicable laws, including anti-predatory lending laws. In addition, S&P will require legal comfort in the form of an officer's certificate indicating that the originator of the loan is a national bank or a national bank operating subsidiary.[45]

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[40] *See* "Fitch Ratings Addresses Preemption Statement from the OCC" (January 16, 2004).

[41] *See* 68 Federal Register 46264 (August 5, 2003).

[42] *See* "Fitch Ratings Addresses Preemption Statements from the OTS and OCC" (August 22, 2003).

[43] *See* "S&P Announces Position on OCC's Preemption Order for the GFLA" (October 3, 2003).

[44] On November 25, 2003, having reviewed the OTS's preemption opinions concerning the anti-predatory lending laws in Georgia, New Jersey, New Mexico, and New York, S&P announced that it would no longer apply its published criteria to federal thrifts and their operating subsidiaries operating in those states. See "S&P Announces Position on OTS Preemption Pronouncements" (November 25, 2003).

[45] *See* "S&P Addresses OCC Rule Regarding Preemption of State Anti-Predatory Lending Laws" (March 3, 2004). S&P said it was unable to conclude with certainty that assignees and purchasers of loans originated by national banks in Arkansas are not subject to liability. Therefore, S&P said, it will continue to apply its previously announced criteria with respect to such loans.

These decisions are critical because, without a certain secondary market for these loans, banks making risk-priced loans covered by this type of state law will be required to hold more of these loans to maturity. This, in turn, ties up more of a bank's capital as it carries the mortgage assets on its books, and adversely affects the ability of the bank to originate or acquire new loans.

As a result of these higher costs and operational challenges, lenders must absorb the costs, pass the costs on to consumers, or discontinue offering various products in jurisdictions where the costs or exposure to uncertain liabilities are prohibitive. It has been reported that three major lenders have announced they will no longer do business in New Jersey because of the state's predatory lending law, and at least 18 have significantly limited their lending activities there.[46] As lenders react like this, legitimate credit availability is reduced and consumers will have fewer options for home loans.

V. Correcting Misperceptions about the Preemption and Visitorial Powers Rules

Some of the comments and reaction we have received in response to our rules seem to reflect fundamental misconceptions about the law on which the rules are based, or the effect of the regulations. I welcome the opportunity to address these misconceptions.

1. The OCC's rules do not leave consumers vulnerable to abusive lending practices.

It is simply not the case that national bank customers will become vulnerable to abusive lending practices as a result of our rules. First, national banks and their operating subsidiaries are not where predatory and abusive lending practices are festering. Second, national banks and their operating subsidiaries are governed by strong federal standards designed to prevent these practices. Third, the OCC deploys substantial resources, nationwide, to ensure that these practices do not gain a foothold in the national banking system. Our examiners and supervisors have available a wide array of supervisory and enforcement tools to identify and remedy any such practices that do occur. Finally, the ability of state authorities to take aggressive action to protect vulnerable consumers from predatory practices by other types of institutions-the very institutions that have been identified as the source of abusive practices—is unaffected by our regulations.

Clearly, there is a real problem with abusive lending practices in this country, but national banks are not the breeding ground. Whatever differences of opinion may exist with the state attorneys general, they have stated unambiguously in various filings, as I have described, that there is scant evidence that national banks, or their subsidiaries, are engaged in abusive lending practices. Indeed, these state officials have recognized the extent to which banks (and thrifts) are highly regulated and closely supervised, and have credited that regulatory presence for the scarcity of evidence of abusive or predatory practices.

[46] *See* Paul Muolo and Brad Finkelstein, "Lenders Leaving New Jersey," December 2003, American Banker-Bond Buyer, Vol. 13, No. 3 at 41.

National banks and national bank operating subsidiaries are subject to comprehensive, regular-in the case of large banks, continuous—supervision, and an extensive array of federal consumer protection laws and regulations—including the anti-predatory lending standard in our new regulation and section 5 of the FTC Act—administered and enforced by the OCC.[47] As I have described, the OCC's consumer compliance program is fully and effectively staffed by examiners and compliance specialists whose work is supported by attorneys and consumer complaint specialists. OCC examinations of national banks and national bank operating subsidiaries are conducted to ensure and enforce compliance with federal laws and regulations and with supplemental OCC supervisory standards. On those limited occasions where we have found national banks to be engaged in unacceptable practices, we have taken vigorous enforcement action.[48] We will continue to use the supervisory measures and enforcement tools available to us to keep such practices out of the national banking system.

Neither the preemption rule nor the revised visitorial powers rule prevents state officials from applying and enforcing generally applicable state laws that do not attempt to control the content or conduct of national banks' banking activities. Our jurisdiction over national banks and their subsidiaries also does not deprive state regulators of a role in protecting consumers in their states, and we welcome the opportunity to work cooperatively with them to further that goal. We have invited state authorities to refer consumer complaints concerning national banks to the OCC and to bring to our attention concerns that any national bank is engaged in unfair, deceptive, abusive or predatory practices. We have set up special procedures to handle and track referrals from state authorities.

The OCC and the states already cooperate extensively in many respects, referring consumer complaints to the appropriate regulator of the entity generating the complaint, and we welcome additional opportunities to collaborate.[49] Our new advisory letter clarifies how national banks should handle consumer complaints that are forwarded to them from state agencies and departments. I firmly believe that we and state authorities share common goals, and we have invited state officials to enter into cooperative, information sharing agreements regarding consumer complaints. I am confident there are ways we can improve how complaints are handled and consumer concerns are identified and resolved, and we welcome further dialogue with state officials to further those goals.

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[47] *See supra* note 17.

[48] For examples of our enforcement actions, see supra pages 20-25.

[49] *See* attached chart.

2. The OCC is not taking on a "new role" or assuming a "longstanding responsibility" of the states to enforce state consumer protection laws.

The statutory authority for the OCC's exclusive visitorial powers does not distinguish between visitorial powers for safety and soundness, consumer compliance, operational risk, or any other type of risk faced by a national bank.[50] Given the importance of preventing abusive lending practices, some have nonetheless asserted that state and local laws should apply in addition to the federal standards to which national banks are subject. They believe that state and local regulators should also involve themselves in supervising the activities of national banks. These critics are asking, in effect, "Isn't it better to have more regulation and more regulators?"

The answer is "Not necessarily." More regulation and more regulators can have their own consequences and are not the answer unless there has been a failure of the existing regulatory regime. That is simply not the case with national banks and their respective subsidiaries.

Adding layers of regulation brings added costs, which may lead to higher prices for customers. It may also have other undesirable collateral consequences, such as diminished product availability. For example, state and local laws that increase a bank's costs and its potential liabilities in connection with subprime loans, which are already high risk, inevitably will cause some legitimate lenders to conclude that the cost and risks are not worth it. The result is diminished credit availability, and legitimate credit options that may otherwise be available to a segment of potentially credit-worthy subprime borrowers will be reduced. We believe our approach to combating abusive lending practices does not diminish credit access but does effectively target credit abuses.

Adding additional *regulators* also has implications. The typical responsibilities of a state attorney general include prosecuting Medicaid fraud, investigating and prosecuting organized crime, enforcing the state's environmental protection laws, overseeing the integrity of charitable organizations, investigating and litigating civil rights complaints, advocating for consumers stymied by health maintenance organizations (HMOs), enforcing the state's securities laws to combat fraud-the list could literally go on for pages. I have already described the many types of businesses, in addition to banks, that are the responsibility of state banking departments.

Given state budget constraints, state authorities' insistence on trying to add national banks to their already substantial roster of responsibilities is likely to have unfortunate consequences. The allocation of state resources to supervisory and enforcement functions that are already being performed at the federal level means that those resources will not be used to protect the state's consumers in connection with all the other potential sources of problems those consumers face. The net result is to diminish the availability of state resources to protect consumers in *other*

[50] The Riegle-Neal Act bolsters this conclusion, specifically providing that if state community reinvestment, consumer protection, and fair lending laws are not preempted and are applicable to interstate branches of a national bank, those laws are enforced by the OCC. 12 USC 36(f)(1).

areas—other areas where there *is* evidence of abusive lending—other areas that are not as highly regulated as the banking business.

The OCC's approach to shared responsibilities actually maximizes regulatory oversight to protect consumers. More resources would be deployed to protect more consumers if states apply their resources to the conduct of state supervised entities, the OCC applies its resources to national banks, and state officials refer problems involving national banks that come to their attention to the OCC.

3. The preemption and visitorial powers rules will not demolish the dual banking system.

Some critics have suggested that by codifying in regulations the exclusivity of the OCC's supervision of national banks and the types of state laws that are, or are not, preempted as applied to national banks, the OCC "will demolish" the dual banking system, or "deprive bankers of a choice of charters." We even heard recently that a state legislator was told that our regulation would lead to dismantling of his state's banking department because it would prevent that department from regulating *state banks.*

Some of this rhetoric is, obviously, fanciful. Other comments in the same vein profoundly shortchange the qualities of the state banking systems. More fundamentally, the argument being advanced is simply backwards. Distinctions between state and federal bank charters, powers, supervision, and regulation are not contrary to the dual banking system; they are the essence of it. Clarification of how the federal powers of national banks preempt inconsistent state laws is entirely consistent with the distinctions that make the dual banking system dual.

The national and state charters each have their own distinct advantages. Indeed, today state banking regulators vigorously assert that the state charter is superior. But many national banks engage in multi-state businesses that may particularly benefit from the efficiency of a uniform, nationwide system of laws and regulations. Customers of national banks enjoy protections that are as strong as—and in some cases stronger than—those available to customers of state banks. But they also benefit from the efficiencies of the national banking system, and predictable, uniform, consistent regulation. It is important to remember that the dual banking system offers American consumers a choice—those who believe the state system offers greater protections, or desirable variety, are free to make that choice.

4. The preemption rule is not a dramatic departure from established, recognized preemption standards and case law.

Some critics of the regulation have claimed that we are using incorrect preemption standards in our preemption rule. They argue that preemption should only occur when state law significantly impairs a national bank's *express* rights under federal law. These critics also argue that the OCC contends that national banks are immune from state law. These assertions misunderstand the final

rule and incorrectly characterize both the OCC's position and the relevant judicial standards for preemption.

First, it is useful to recap how the preemption provisions of the new rule work. The rule addresses the applicability of certain types of state laws to national banks' lending, deposit-taking, and other federally authorized activities. With regard to all three categories, the rule states the general principle that, except where made applicable by federal law, state laws do not apply to national banks if they "obstruct, impair, or condition" the bank's exercise of powers granted under federal law. The rule's preamble makes very clear that these words are not designed to create a new standard of preemption, but rather to distill the various phrases the Supreme Court has used in its preemption decisions.[51] As stated, the phrase does not refer to any particular type of state law and, thus, obviously does not preempt any particular law. By contrast, in the lending and deposit-taking areas, the preemption rule lists certain specific types of state laws that are preempted. In other words, the rule preempts the types of laws described in the rule; other types of laws remain subject to case-by-case evaluation under judicially developed standards, which the rule distills with the phrase hose listed as preempted with respect to federal thrifts in existing regulation "obstruct, impair, or condition." Collectively, the laws listed are virtually identical to those listed as preempted with respect to federal thrifts in existing regulations of the OTS; many of those listed are *already preempted by virtue of existing OCC regulations,* or have been addressed by OCC preemption opinions or judicial decisions.

The OCC is *not* arguing that national banks are immune from state law. The preemption principles referenced in our new regulation are firmly grounded on standards announced by the Supreme Court and other federal courts in cases as recent as last year, going back over 130 years, and our authority to adopt the rule is solidly based on our statutes. The final regulation specifically-and meticulously-explains the sources of our authority to issue the regulation and the standards we reference. In a nutshell, the preemption standards derive from Supreme Court and lower federal court precedents that provide that federal law can preempt state laws that obstruct (stand as an obstacle), *Hines v. Davidowitz (1941);* impair the efficiency of, *National Bank v. Commonwealth (1869), Davis v. Elmira Savings Bank (1896), McClellan v. Chipman (1896);* or condition the ability of national banks to exercise powers granted under federal law, *Barnett Bank of Marion County v. Nelson (1996); Franklin National Bank (1954);* and that state "legal infrastructure" laws—such as contract, torts, and real property laws—that do not restrict the content or extent of powers granted under federal law are **not** preempted. *National Bank v. Commonwealth (1869); McClellan v. Chipman (1896); Bank of America v. City and County of San Francisco. (U.S. Court of Appeals for the Ninth Circuit 2002).*

[51] 69 *Federal Register* at 1910.

5. There is no presumption against preemption in the case of the national banking laws, as confirmed by federal case law and the Riegle—Neal Act.

Critics of both the preemption and visitorial powers rules contend that the rules are inconsistent with the presumptive application of state law to national banks, which is embodied in the Riegle–Neal Act. This is incorrect.

As an initial matter, case law, whether decided before or after Riegle–Neal was enacted, is consistent in holding that there is no presumption against preemption in the national bank context. The Supreme Court has said that a presumption against preemption "is not triggered when the state regulates in an area where there has been a history of significant federal presence."[52] Courts have consistently held that the regulation of national banks is an area where there has been an extensive history of significant federal presence. As recently observed by the U.S. Court of Appeals for the Ninth Circuit, "since the passage of the National Bank Act in 1864, the federal presence in banking has been significant." The court thus specifically concluded that "the presumption against the preemption of State law is inapplicable."[53] Indeed, when analyzing national bank powers, the Supreme Court has interpreted "grants of both enumerated and incidental 'powers' to national banks as grants of authority not normally limited by, but rather ordinarily pre-empting, contrary State law."[54]

The relevant text of the Riegle–Neal Act is fully consistent with these conclusions. As explained in the preamble to the visitorial powers rule, the Riegle–Neal Act sorted out which state's laws—host state or home state—regarding community reinvestment, consumer protection, fair lending, and establishment of intrastate branches, would apply to interstate branches of national banks, and provided that the host state's laws in those areas would apply to national banks "except when Federal law preempts the application of such state laws to a national bank." The potential preemption of state laws thus was expressly recognized as possible in the Riegle–Neal legislation itself.

Moreover, the legislative history of the Riegle–Neal Act indicates that Congress expected the OCC to apply traditional, recognized preemption standards in deciding preemption issues, which is exactly what the OCC is doing.

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[52] U.S. v. Locke, 529 U.S. 89, 108 (2000) (explaining Rice v. Santa Fe Elevator Corp., 331 U.S. 218 (1947).

[53] *Bank of America,* 309 F.3d at 558-59 (citations omitted).

[54] *Barnett,* 517 U.S. at 32. The Barnett Court went on to elaborate:

[W]here Congress has not expressly conditioned the grant of "power" upon a grant of State permission, the Court has ordinarily found that no such condition applies. In Franklin Nat. Bank, the Court made this point explicit. It held that Congress did not intend to subject national banks' power to local restrictions, because the federal power-granting statute there in question contained "no indication that Congress [so] intended . . . as it has done by express language in several other instances."

Id. at 34 (emphasis in original) (citations omitted).

Finally, as I mentioned at the outset, the Riegle–Neal Act also specifically provided that the provisions of any state law to which a branch of a national bank is subject under the Act *"shall be enforced, with respect to such branch, by the Comptroller of the Currency."* Thus, the Riegle–Neal Act is entirely consistent with the visitorial powers rule in providing that when state law is applicable to interstate branches of national banks, the OCC is to enforce such laws (in other words, the OCC retains exclusive visitorial authority).

6. The OCC has ample authority to adopt the preemption rule.

As mentioned previously, the OCC's authority to issue the preemption regulation comes from both 12 USC 371 (regarding real estate lending) and section 93a (for all other activities). This statutory authority was recognized by the D.C. Circuit two decades ago in *CSBS v. Conover.*[55] In that case, the court expressly held that the Comptroller has the power under section 371 to issue a regulation that preempts aspects of state laws regarding real estate lending and has authority under section 93a more generally to issue regulations preempting state laws that are inconsistent with the activities permissible under federal law for national banks. In the words of the court:

> It bears repeating that the entire legislative scheme is one that contemplates the operation of state law only in the absence of federal law and where such state law does not conflict with the policies of the National Banking Act. *So long as he does not authorize activities that run afoul of federal laws governing the activities of the national banks, therefore, the Comptroller has the power to preempt inconsistent state laws.*[56]

The authority under sections 93a and 371 described by the court in *CSBS* v. *Conover* amply supports the adoption of regulations providing that specified types of state laws purporting to govern and curtail national banks' lending and deposit-taking activities are preempted.

7. State law applies to national bank operating subsidiaries to the same extent as their parent banks; therefore, the preemption and visitorial powers rules apply to national banks and their operating subsidiaries equally.

As explained previously, the preemption and visitorial powers rules make no changes to the OCC's rules governing the activities of operating subsidiaries. As already set out in 12 CFR 5.34, 7.4006, and 34.1(b), national bank operating subsidiaries conduct their activities subject to the same terms and conditions as apply to the parent banks, except where federal law provides otherwise, e.g, functional regulation of insurance and securities subsidiaries. Therefore, *by virtue of regulations already in place,* the rules apply equally to national banks and their operating subsidiaries.

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[55] 710 F.2d 878 (U.S. Court of Appeals for the First Circuit 1983).

[56] *Id.* at 878 (emphasis added).

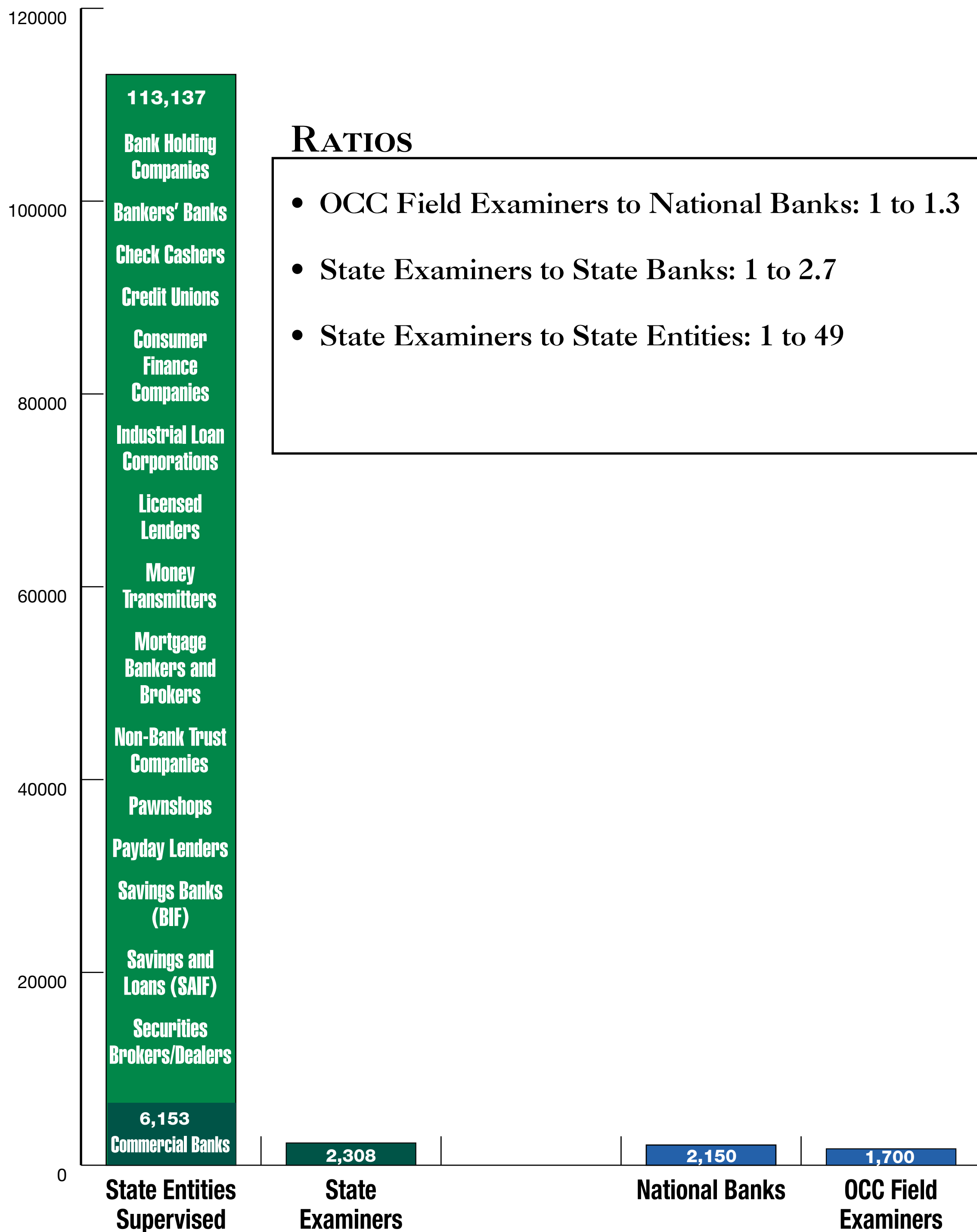
It is important to note that the OCC's position does not implicate the corporate existence or governance rules of state corporations; it concerns the ability of national banks to conduct activities through those entities subject to federal supervision and regulation. National banks conduct authorized activities through operating subsidiaries pursuant to a federal license under OCC regulations and federal law, and do not need a state license to conduct activities they are authorized to conduct under a federal permit. Operating subsidiaries are thus a federally authorized means by which national banks may conduct activities authorized under federal law; as reflected in the OCC's rules; state laws in conflict with that authority must give way.

V. Conclusion

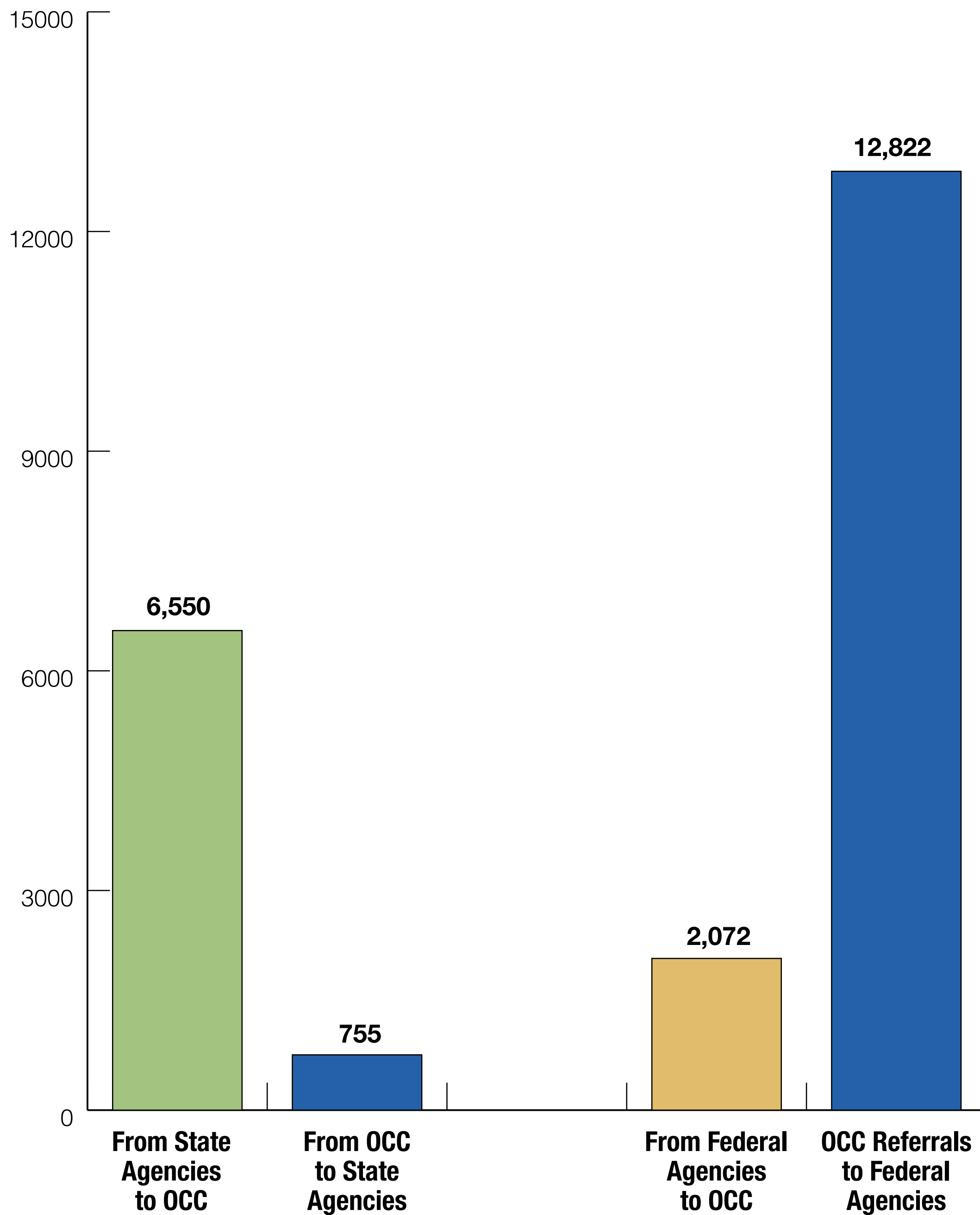
In conclusion, Mr. Chairman, we believe our new regulations provide benefits for national banks and protections for national bank customers and are entirely consistent with the fundamentals of the dual banking system. Our actions also are entirely consistent with Congress's design of the national banking system, the powers and authority Congress has vested in national banks, with legal precedent dating from the earliest years of the national banking system up to current times, and with the OCC's responsibilities to ensure not only the safety and soundness of national banks but also fair treatment of their customers.

Once again, thank you, Mr. Chairman, for this opportunity to present the OCC's views.

Comparison of OCC and State Examiner Resources



2003 Referrals of Consumer Complaints



Statement of John D. Hawke, Jr., Comptroller of the Currency, before the U.S. Senate Committee on Banking, Housing and Urban Affairs, on the condition of the national bank system and the state of the Office of the Comptroller of the Currency, Washington, D.C., April 20, 2004

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.

I. Introduction

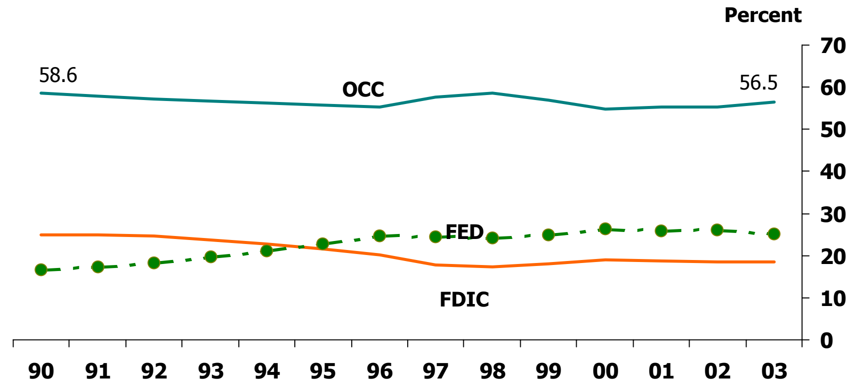
Chairman Shelby, Senator Sarbanes, and members of the committee, I appreciate this opportunity to review the condition of the national banking system. My written statement covers two principal areas.

First is the continued strong performance and condition of the national banking system in the face of a changing banking environment. National banks continue to display strong earnings, improving credit quality following the recent recession, and sound capital positions. That continued strong performance reflects, in general, past good lending and investment decisions. In addition, to some extent, that performance reflects changes in business strategies and risk management practices. Banks have adopted better risk management techniques and have benefited from greater geographic diversification. Nonetheless, risks remain, including the growing importance of operating, strategic, and reputation risk as banking companies adapt to change by using technology, different products or strategies, or more complicated business structures.

Second, we continue to adapt supervision to the changes in banking. Among the most important strategies we employ to maximize the effectiveness of our examination and supervision program is our risk-focused approach to supervision, which is designed to address change. That risk-based approach has enabled us to turn increasing attention to operating, strategic, and reputation risk.

The approach that the U.S bank regulators have taken to the effort to reform international bank capital standards, known as Basel II, provides a distinct example of how we are adapting to change. While we recognize that we can improve capital regulation to take into account changes in banking and risk management, we have advocated proceeding with appropriate caution. In my statement today, I will discuss the proposed capital reform and the commitment that I have made that any reforms of the regulatory capital rules will be adopted in a prudent, deliberate fashion.

II. The Condition of the National Banking System



Source: Integrated Banking Information System (OCC).

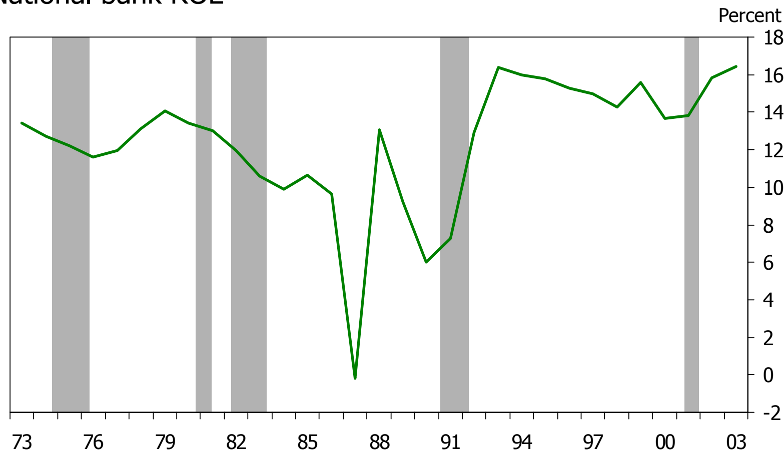
The OCC supervises federally chartered national banks and federally licensed branches of foreign banks. As of year-end 2003, the national banking system consisted of approximately 2100 banks (26 percent of all commercial banks). Of these, 2001 were Federal Deposit Insurance Corporation (FDIC)-insured banks, holding total assets of $4.3 trillion. The rest were uninsured bank and trust companies. The OCC also supervises 53 federal branches of foreign banks. While the number of national banks has declined for nearly two decades, and the assets of the system have steadily increased over the same period, the national bank share of total system assets has remained roughly constant, and now stands at 56.5 percent. The national banking system includes many of the largest banks by asset size, but community national banks are by far the most numerous in the system.

Financial Performance

The financial performance and condition of the banking system is strong. Earnings have remained at historically high levels for a decade. Until 2002, aggregate net income for national banks had never exceeded $12.5 billion in a quarter, and the industry's average return on assets had never exceeded 1.5 percent, at least not since the quarterly reporting began in 1984. But since the beginning of 2002, national banks have exceeded both earnings milestones in every quarter but one. In 2003, national banks set new records for both return on equity and return on assets. Although the slow economy led to weakness in some areas, including business lending, the contractions in these areas were more than offset by growth elsewhere.

National bank ROE at record high

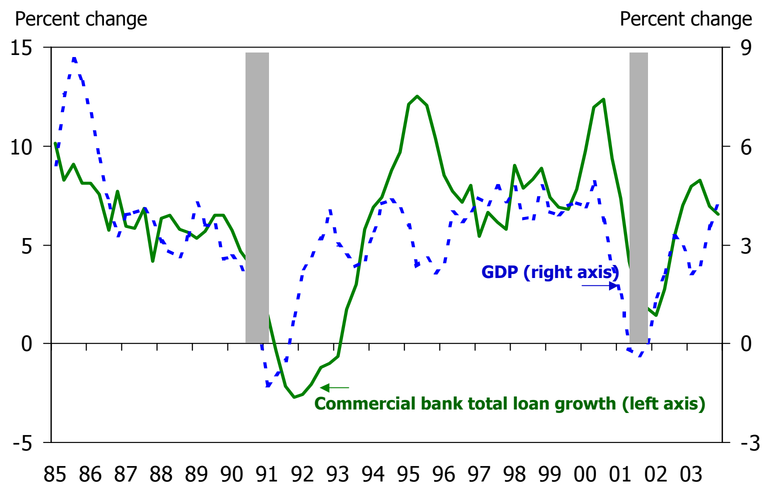
National bank ROE



Source: Integrated Banking Information System (OCC)

Data as of year-end. Shaded areas represent periods of recession.

Loan growth continued throughout this recession



Source: Integrated Banking Information System (OCC); BEA/Haver Analytics

Quarterly data through Q2-2003. Shaded areas represent periods of recession.

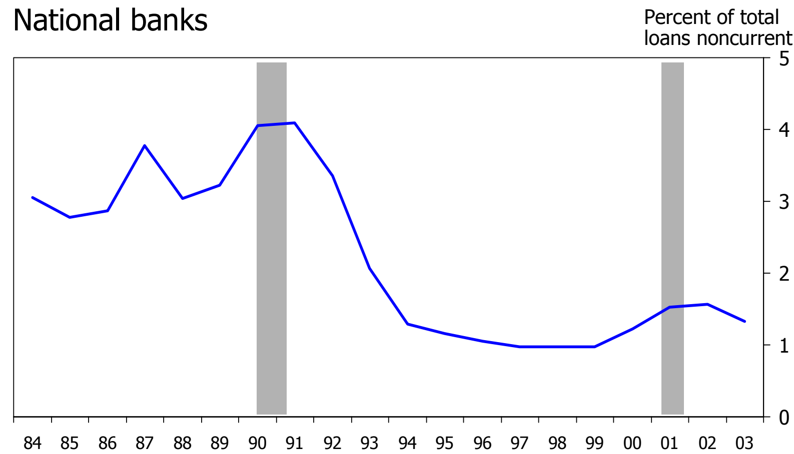
Total loans held by banks continued to expand throughout the recent economic cycle, growing by 7.8 percent in 2002 and 7.6 percent in 2003. In contrast, starting with the recession of 1990-91, total loans held by national banks fell for 10 consecutive quarters. Where the earlier recession affected all sectors of the economy, the recent recession was concentrated more extensively in the business sector, in part due to the fallout from the tech/telecomm bubble in the late 1990s. This caused a sharp fall in the demand for business loans, particularly at large banks.

The reduction in corporate lending by banks also was due to the competitiveness of corporate bond issuance due to low interest rates. Many large and even medium-size firms have been able to access the bond market at very low rates throughout this economic slowdown, which has further reduced the demand for larger commercial loans. This has affected especially the lending activity at the largest banks, because they tend to have potential business customers who have greater access to other financial options. Community banks, in contrast, taking advantage of their knowledge of local markets and business needs, have maintained their business lending throughout this cycle, with increases reported in their commercial and industrial (C&I) and commercial real estate loan books.

The mortgage and consumer sectors have been a strong source of loan growth for national banks. Residential real estate loans held by national banks rose at an annual rate of about 20 percent in both 2002 and 2003. Within this broad category, home equity lending has grown particularly fast, rising by 21 percent in 2001, 38 percent in 2002, and 37 percent in 2003. Throughout this cycle, consumers have taken advantage of declining mortgage rates to extract funds from the increased value of their homes. Some of these funds from the refinancing and home equity loan activity have been used, however, to pay off higher interest credit card and installment debt.

The low interest rate environment has been a plus and a minus for banks. Smaller banks with their greater reliance on retail funding have seen steady erosion in their net interest margins. By contrast, the largest banks, which rely more on wholesale funding, until recently experienced relatively high net interest margins. As of December 2003, the net interest margin for banks in all asset size groups has fallen below their historic averages. Despite the decline in margins, banks have reported continued growth in net interest income due to the strong expansion in household lending. As long as margins remain compressed, however, this growth in income is vulnerable if the volume of activity in the consumer markets falls.

The low interest rate environment also raises concerns about the extent to which banks may be taking on interest rate risk in an effort to maintain their interest income. Effective management of this risk will be important for banks in all asset size groups as the economy recovers, which is often accompanied by an increase in interest rates. We have alerted national banks to our concerns on this score and provided advice on approaches on how best to address this “low rate set-up.”



Source: Integrated Banking Information System (OCC) Data as of year-end. Shaded areas represent periods of recession.

Deposits have continued to flow into banks, especially large banks, as might be expected when low interest rates hold down returns on alternative money market instruments. Deposits at national banks grew at 6.0 percent in 2001, 7.6 percent in 2002, and 8.6 percent (year-over-year) in 2003. The increase in deposits has fueled growth in bank assets. The assets of national banks grew 9.8 percent in 2003 (year-over-year), as compared to a 0.1 percent decline reported at this point of the recovery from the last recession. Nevertheless, we believe banks must be vigilant in their assessment of the potential sensitivity of their sources of funds to changes in the economic environment or, in some cases, the bank's own performance. The high level of liquidity in the banking system could be reduced rapidly if the relative yield on alternative investments increased sharply or if banks failed to maintain certain performance levels required to retain some sources of funds.

While credit quality deterioration is typically an issue during recessions, the most recent experience for national banks was much better than during the previous recession. This may well reflect national banks' response to cautions issued by the OCC to bankers in the late 1990s to be vigilant about their underwriting standards. The noncurrent loan ratio for national banks (loans at least 90 days past due plus nonaccruals) reached a peak of 4.4 percent in 1991Q2; in contrast, at the peak in this economic cycle, reported in 2002Q2, the noncurrent ratio was 1.6 percent. For large banks (over $1 billion in assets), the noncurrent loan ratio has now declined to 1.3 percent, near pre-

recession levels. Smaller banks (under $1 billion in assets) were not as affected by the stresses in the nonfinancial corporate markets and thus experienced only a modest decline in credit quality during the recession. While credit quality appears to be improving for the banking industry, the OCC continues to watch developments in areas that remain vulnerable, such as small business lending and certain real estate markets and property types.

The data on bank failures and new entrants to the commercial banking system also reflects a dynamic and healthy banking system. In 2003, two banks failed—one national and one state bank. By contrast, 100 commercial banks—including 33 national banks and 67 state banks—failed in 1992, the first year of recovery after the 1990–91 recession. The commercial banking system also had 111 new entrants in 2003; this compares to 40 new banks in 1992.

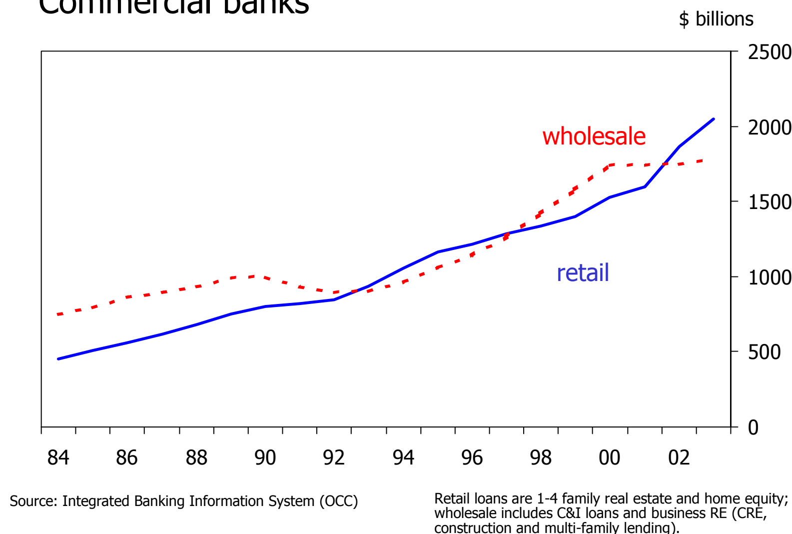
While the national banking system has displayed strong performance, even during the recent recession, history teaches us that we cannot know for certain what lies ahead, and banks' capital provides important protection against that uncertainty. National banks remain well capitalized and rest on a much firmer capital base than they did more than a decade ago. In 1990, for example, 6.3 percent of banks had risk-based capital ratios below 8 percent, which we would now consider undercapitalized, and 18.3 percent were below 10 percent. Today, all national banks, with the exception of a few small banks under special supervision, have risk-based capital ratios above 8 percent, and more than 90 percent of national banks have risk-based capital ratios above 10 percent.

Continued, Gradual Change in Bank Strategies

Like other businesses, banks adjust their strategies in response to the lasting changes in their business environments. Over past decades, bank business strategies in the United States have evolved in response to changes in household financial practices, advances in financial knowledge and information and communication technology, and the relaxation of constraints against interstate banking and allowable bank activities. Since such changes are gradual, they are sometimes hard to recognize. Nonetheless, they result in real changes in the nature of the business.

For example, one change is an increase in the relative emphasis on lending to households, especially among the large banks. Over the last 20 years, large banks have moved increasingly into retail lending to take advantage of cost-saving technologies and geographic diversification in a period of strong growth in the demand for retail products. In 1984, 30 percent of aggregate commercial bank loans were to households—residential mortgages, and loans to individuals. By 2003, that ratio had risen to 46 percent. The increased emphasis on retail lending has been particularly pronounced in the largest banks. Among the largest 10 banks, the retail portion of bank loan portfolios has increased from 22 percent to 55 percent over the last two decades.

Another strategic change in banking is the improvement in financial risk management-the tools, products and processes. Since the last business cycle, banks have made substantial investments in this area. A fundamental shift in approach is occurring, from viewing risk on a transaction-by-transaction basis to a more holistic, portfolio view. Advances in technology have enabled banks



to harness information to manage more proactively the risks in their portfolios. These include more sophisticated models to help banks underwrite and manage their credit risks and to conduct scenario analyses of their interest rate and liquidity risks.

Concurrent with the adoption of these enhanced tools has been the development of independent risk management units with responsibility for enterprise-wide risks. These units, which typically reside at the highest level of the corporation, oversee portfolio risk, balance the risks and rewards of new business strategies and initiatives, and ensure that business units and the bank as a whole comply with established risk tolerances and limits.

Risk management also has benefited from the broader array of products and tools that banks can use to adjust and manage their risk profiles. These tools help to foster deeper and broader financial markets and ultimately help to allocate risks to participants in accordance with their risk appetite and performance objectives. For example, banks have been particularly successful in reducing their exposures to credit concentrations. The growth of the syndicated loan market has enabled banks to more broadly distribute credit exposures within the U.S. banking system, as well as to foreign banking organizations and nonbanks. Similarly, the expanding asset securitization market has provided banks with another avenue to manage concentration risks and to diversify their funding sources and to provide greater access to underserved markets.

The growth in the derivatives markets has provided banks with additional tools to manage their credit and interest rate risk exposures. Derivatives are also a valuable risk management product to

help banks' institutional customers manage a broad array of risks arising from common business activities such as securing long-term funding or protecting the value of importing or exporting commercial goods. Banks' increased participation in residential real estate lending is one example of how derivatives have enabled banks to expand their product offerings while managing their risk profiles. Although residential real estate lending is typically associated with low credit risk as a consequence of diversification, solid collateral, and the borrower's vested interest, it can represent high exposure to interest rate risk. With the advent of products to hedge interest rate risk, such as interest rate swaps and options, banks have been able to expand their lending in this area while managing the risk of potential shifts in interest rates. In the absence of effective mechanisms to hedge such risks, it is unlikely banks would have been able to participate as actively in the growth of this sector.

Growing Importance of Operating, Strategic, and Reputation Risk

Notwithstanding the strong financial performance and condition of the banking industry, and improvements in the management of key financial risks, critical challenges remain. Chief among these is the need for banks to avoid missteps, abuses, or perceptions that could undermine the confidence and trust of their customers or financial markets. Recent events have demonstrated that bank soundness is much more than just a function of financial strength and that the risks facing the banking industry extend beyond the financial risks—credit, liquidity, and interest rate risks—that have traditionally been the focus of bankers and regulators. Increasingly, bankers must be cognizant of and control the operational, strategic, and reputation risks posed by their activities and how their activities will be perceived by the markets and their customers. A thorough evaluation of those risks and their potential impact on a bank's longer-term strategic direction and its relations with its customers is paramount and must override pressures from management, analysts, or shareholders to increase short-term earnings at the expense of fundamental controls and safeguards.

Many of the recently publicized problems facing the industry have stemmed from breakdowns in key governance and control areas: insufficient oversight and due diligence in reviewing or considering complex financial transactions or new product lines; lapses in security controls and the safeguarding of customer information; overreliance on third parties for critical services or product generation; and failure to adhere to sound internal audit and control procedures and processes. These breakdowns are not limited to banks of a specific size, market, or product niche. Community banks have suffered losses stemming from overreliance on loans, investments, and services purchased from third-party vendors—often in an effort to augment otherwise lackluster loan demand. Several large banks have faced significant questions about their dealing with customers and alleged improper oversight and management of key product lines.

III. Keeping Pace with Change in the National Banking System

Change is a consistent theme in the operation—and the supervision—of the national banking system today. National banks must evolve their businesses if they are to remain competitive in today's financial services markets. At the same time, the OCC must adjust its supervisory and regulatory approaches in order to ensure that national banks can avail themselves of all of the attributes of their charter safely and soundly. Among the most important strategies we have developed to maximize the effectiveness of our examination and supervisory program is our risk-focused approach to supervision.

The OCC's Risk-Focused Approach to National Bank Supervision

OCC's supervision-by-risk approach dates back more than 10 years and involves supervisory policies and processes that tailor our oversight to the key characteristics of each bank, including asset size, products offered, markets in which it competes, and the board's and management's tolerance for risk. This process provides an effective means for the OCC to allocate our supervisory resources and to better communicate to senior bank management the areas where they may need to correct problems before they become entrenched.

Risk-based supervision begins with an assessment of a banking organization's existing and emerging risks, and management's efforts to manage and control those risks, in nine specified risk areas: credit, liquidity, interest rate, price, foreign exchange, transaction, compliance, strategic, and reputation. Based on that assessment, the OCC examiner-in-charge or portfolio manager will develop and implement a detailed, supervisory strategy for the bank, based on its risk profile and the complexity of its lines of businesses. Examiners identify areas of highest risk, assess what management is doing to address those risks, and communicate regularly with management to indicate where additional management actions are needed. In performing this evaluation, OCC examiners consider not only the activities of the bank and its operating subsidiaries, but also how the bank's risk profile is affected by the activities of other subsidiaries and affiliates.

Our assessment of the integrity and effectiveness of a bank's risk management systems includes appropriate validation through transaction testing. If this produces concerns, we will "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. The examination procedures implementing OCC's supervision by risk program are documented in the *Comptroller's Handbook.*

Supervision by risk provides an effective way to supervise banks in the current rapidly changing environment. It also allows us to apply a consistent supervisory methodology across an increasingly diverse group of banks and bank activities. Because the design of this approach requires that we customize an examination based on a bank's underlying risk characteristics, it allows us

to more effectively direct OCC resources to the banks or activities within banks exhibiting the greatest risk.

In response to the growing divergence in the complexity and scope of operations between large and small banks, we have divided our day-to-day supervisory operations into two lines of businesses—our Community and Midsize Bank program and our Large Bank program.

Our Community/Midsize Bank line of business oversees over 2,000 national banks and federal branches and agencies through our network of district, field and satellite offices. When examining this population of banks, examiners use a core set of examination procedures to draw conclusions about the magnitude of risk and the adequacy of the risk management system for each of the nine areas of risk. Even in low-risk banks, we sample, verify, and test the bank's policies, procedures, and systems. When risks are elevated; when activities, products, and services are more complex or present greater financial or compliance risks; or when issues or problems emerge, examiners will expand the scope of their supervisory activities using more detailed guidance found in topical booklets of the *Comptroller's Handbook* series. Periodic monitoring of community banks, another key element of the supervisory process, is also designed to identify changes in the bank's condition and risk profile, including new products or services, and to assess bank corrective action on outstanding supervisory concerns between formal on-site examinations. This quarterly monitoring process allows examiners to identify significant changes in the risk profile of the banks they supervise on a timely basis.

Our Large Bank program focuses on the 24 largest national banks. The supervision of each large bank, overseen out of our headquarters office, is staffed by a resident examiner-in-charge and a team of examiners and specialists in areas such as commercial and retail credit, capital markets, bank technology, asset management, and compliance. These examiners and specialists track the quantity and quality of risk management in real time so that our assessments are forward-looking as well as historical. This program allows the OCC to develop a more thorough knowledge of the bank than is possible through the traditional regime of periodic, discrete examinations. Over the years, we have also developed, tested, and refined this supervisory approach expressly to address the special financial and compliance challenges posed by bigger, more complex, and globally positioned banks. We are confident that this approach will be effective to supervise the "megabanks," those with assets of a trillion dollars or more, which are forming as a result of recent acquisition activity in the industry.

Today's national banking system operates not just nationally, but globally. Our large banks all have operations or a presence overseas. The expansion of our large banks' operations across various legal entities and geographic boundaries puts an increased premium on coordinating our supervisory responsibilities with other domestic and foreign regulators. Domestically, we and the other banking agencies build upon each other's supervisory reviews and databases. We routinely share reports of examination and other agency-institution communications and provide each other with access to our organizations' structure, financial, and supervisory information. To help

facilitate and coordinate our supervision of large, complex institutions, we share information on proposed examination and supervisory activities for the coming year and coordinate the planning and execution of those activities. When appropriate, we hold joint meetings with institutions involving matters of mutual interest and may conduct coordinated reviews or examinations where a business activity is conducted across legal entities. Our London office provides us with examiner expertise to interact with foreign supervisors and provides a platform to examine national bank branches overseas. Our London examiner staff provides a critical network to deal with home/host country issues, information-sharing issues, and outsourcing issues. We also participate in the Foreign Banking Organization program (along with the Federal Reserve Board) to examine and supervise federal branches and agencies in the United States.

We also are deeply involved in the development of international bank supervision policy through our participation in the Basel Committee on Banking Supervision and in the Joint Forum, which is an international group of banking, securities, and insurance supervisors; through our regular dialogue with foreign banking regulators; and through our international and technical assistance programs that provide training and internship opportunities to bank supervisors. In fact, not long ago we detailed to the Treasury Department four experienced examiners who are now working in Iraq.

To help meet the challenges of an ever more complex banking industry, our resident and field examiners and specialists are supported by a team of policy specialists, analysts, accountants, and economists in our headquarters office who monitor industry, market and economic trends, provide technical expertise, and develop analytical tools and models to support our examination functions. For example, our "Canary" system monitors and identifies banks that may have high or increasing levels of credit, liquidity, or interest rate risks. Our credit risk and economics staffs have developed various analytical tools that assist examiners to identify portfolio or industry concentrations where risk may be increasing for more in-depth investigation. Our Risk Analysis unit—staffed by Ph.D. economists—provides on-site technical assistance to our resident staff in evaluating banks' quantitative risk models and measurement systems. Our National Risk Committee serves as a coordinating body to gather and disseminate information from throughout the OCC and the financial markets on emerging risk issues and advises me and the OCC's Executive Committee on a quarterly basis of emerging issues and potential policy and supervisory responses.

Our combination of continuous on-site supervision, with the "ground level" intelligence it provides on each individual bank's activities and strategies, coupled with our broader, systemic risk analyses, allows us to quickly adjust our supervisory strategies to emerging risks and issues that may arise at individual institutions, within business segments or across the industry as a whole. It also allows us to leverage the diverse skill sets that are needed to supervise our most complex institutions effectively.

Response to the Growing Importance of Operating, Strategic, and Reputation Risk

To address the growing importance of these nonfinancial risks, we have taken a number of steps to strengthen our supervision and oversight in the critical areas of audit and corporate governance. In April 2003, we issued an updated examination booklet on internal and external audits. This booklet sets forth our expectations that well-planned, properly structured, and independent auditing programs are essential to effective risk management and internal control systems. The revised booklet incorporates issues related to recent events related to audit programs, including the independence provisions of the Sarbanes–Oxley Act and the implementing rules and regulations of the Securities and Exchange Commission (SEC).

We have also updated our booklet, "Detecting Red Flags in Board Reports—Guide for Directors." This guide provides a bank's board of directors with an overview of information generally found in board reports and highlights various "red flags"—ratios or trends—that may signal existing or potential problems.

In response to the continued evolution of banking products and structures, the OCC's Committee on Bank Supervision has recently directed the formation of an internal group within the OCC to oversee and evaluate how new banking products and structures may affect our supervisory activities. This review committee will function similar to the new product review committees found at some of our larger institutions. The committee will have membership from our various supervisory operations, risk, legal, and information technology units.

We have also taken steps with the other U.S. banking agencies in the areas of audit and corporate governance. For example, in August 2003, the agencies issued final joint rules that strengthen their authorities to take disciplinary actions against independent public accountants and accounting firms that perform audit and attestation services required by section 36 of the Federal Deposit Insurance Act. The rules establish procedures under which the agencies can, for good cause, remove, suspend, or bar an accountant or firm from performing audit and attestation services for insured depository institutions with assets of $500 million or more. In March 2003, the agencies issued an updated "Interagency Policy Statement on the Internal Audit Function and Its Outsourcing" to reflect provisions of the Sarbanes-Oxley Act and SEC rules regarding auditor independence. The revised policy statement also provides enhanced discussion of the responsibilities of a bank's board of directors and senior management with respect to internal audit and reiterates the need for banks to maintain strong systems of internal controls and high quality internal audit programs.

More recently, the OCC has worked with the Federal Reserve Board and the Securities and Exchange Commission to develop an interagency statement on sound practices for conducting complex structured finance activities. These activities generally involve the structuring of cash flows and the allocation of risk among borrowers and investors to meet the specific objectives of the customer in more efficient ways. They often involve professionals from multiple disci-

plines within a financial institution and may be associated with the creation or use of one or more special-purpose entities designed to address the economic, legal, tax, or accounting objectives of the customer. In the vast majority of cases, structured finance products and the roles played by financial institutions with respect to these products have served the legitimate business purposes of customers, and these products have become an essential part of U.S. and international capital markets. A limited number of complex transactions, however, appear to have been used to alter the appearance of a customer's public financial statements in ways that are not consistent with the economic reality of the transaction or to inappropriately reduce a customer's tax liability.

The interagency statement, which we expect to soon publish in the *Federal Register* for comment, describes the types of internal controls and risk management procedures that can assist financial institutions to identify and address the reputation, legal, and other risks associated with complex structured transactions. The statement, among other things, provides that financial institutions should have effective policies and procedures in place to identify those complex structured finance transactions that may involve heightened reputation and legal risk, to ensure that these transactions receive enhanced scrutiny by the institution, and to ensure that the institution does not participate in illegal or inappropriate transactions. The statement also emphasizes the critical role of an institution's board of directors and senior management in establishing a corporate-wide culture that fosters integrity, compliance with the law, and overall good business ethics.

While regulatory and supervisory initiatives such as these are important to help banks manage operational, strategic, and reputation risks, it is incumbent on the banking industry to assume primary responsibility for its own conduct in these areas. In a speech last year before the American Bankers Association, where I discussed the issues of fair dealing and treatment of customers, I stressed that the ultimate protection for banks is to instill in all employees a dedication to the highest standards of fairness and ethical dealing; to make clear to employees that no loan, no customer, no profit opportunity is worth compromising those standards; and to take swift and decisive action where those standards are violated. The OCC is committed to be vigilant in this area and has and will continue to take responsive action when we discover abuses or weaknesses. I expect bankers to do the same.

Basel II Developments

Because national banks have international as well as domestic operations, the OCC must—and we do—become involved in the development of approaches to bank supervision at the international level. Currently, the most significant of these approaches is the ongoing effort to revise the 1988 Basel Capital Accord. Let me briefly provide you a status report on this effort.

There have been a number of articles in the press in recent weeks about positions that U.S. regulators, and the OCC in particular, may be taking that I believe warrant some clarification and amplification.

First, let me stress that my U.S. colleagues and I share an overarching goal that Basel II be implemented in a manner that is entirely consistent with the safety and soundness and continued competitive strength of the U.S. banking system.

As I have said, banks' current financial and capital positions are strong, but as the industry continues to evolve, so does its risk profile. Recognizing and adapting to changing risk profiles and changing risk management practices is critical to maintaining those strengths. These observations inform our approach to negotiations in the Basel Committee on Banking Supervision regarding Basel II. However, while we recognize that we can and should improve capital regulation to take into account changes in banking and risk management, a basic tenet in our negotiations over reform of the international capital standards is to *do no harm.* U.S. banks are world leaders in many aspects of banking-credit cards and securitizations, for example-and we must assure that these important markets are not disrupted or impaired in the name of achieving international conformity in capital rules. In view of the fundamental strength and resilience of the U.S. financial system, we believe that reforms to our regulatory and supervisory structure must be adopted in a prudent, reflective fashion.

Thus we are fully committed to three things: first, an open rule-making process in which comments are invited and considered, good suggestions are heeded, and legitimate concerns are addressed; second, a reliable quantitative analysis in which we can assess the likely impact of Basel II on the capital of our banks *prior* to its adoption; and third, a prudent implementation in which we make well-reasoned and well-understood changes to bank capital requirements and incorporate in those changes appropriate conservatism. In this regard, I welcome the questions and issues that members of this committee and its staff have raised about this important project and I have repeatedly stressed to the Basel Committee the important role that congressional oversight plays in our deliberative process.

The U.S. agencies' insistence on a thorough and rigorous deliberative process already has resulted in important modifications to the Basel II proposals. One of the most significant of these issues—and one that U.S. banks were virtually unanimous in criticizing in response to the Basel Committee's third consultative paper (CP–3)—involved the fundamental question of what losses capital requirements should be designed to cover. CP–3 would have calibrated capital to ensure coverage of both expected losses (EL) plus unexpected losses (UL). However, banks in the United States today generally measure and manage their internal economic capital allocations by reference to UL only, and most banks consider EL to be covered by a combination of reserves and credit pricing. As we examined this issue, we became convinced not only that the banks were conceptually correct in their arguments, but that retaining the EL plus UL calibration would have severe ramifications—not the least of which might be to seriously jeopardize the industry's acceptance of Basel II framework as being a conceptually sound framework. While many on the Basel Committee resisted this initially, the committee ultimately put forth a new proposal in October to modify the calibration of Basel II to UL only. This modification was strongly endorsed by industry participants and has now been agreed to by the committee.

The committee announced several other important modifications to CP–3 in January that are responsive to numerous comments we received on CP–3 and the U.S. agencies' advanced notice of proposed rulemaking (ANPR) that was issued last August. These modifications include simplifying the proposed treatment for securitizations and aligning it more closely to industry practice and an agreement to find a prudentially sound solution that better recognizes credit mitigation techniques used by the industry. Other issues are still under discussion by the committee's various technical working groups and are scheduled to be considered by the committee at its meeting in May.

Probably the most difficult policy issue remaining involves the appropriate risk-based capital treatment of certain retail credit products—unused credit card lines in particular. This issue is critically important for national banks and for the cost and availability of consumer credit. It is also an area in which consensus has been hard to come by. Given the prominence of the retail lending business for U.S. banks, and for national banks in particular, there is little room for substantive compromise, and the OCC will not accept provisions that are likely to unduly disrupt or disadvantage established, well-functioning business practices. We believe that this issue will be resolved in a manner that appropriately addresses safety and soundness objectives without altering legitimate business practices.

Notwithstanding the difficulty of these issues, the committee's goal is to be in a position by mid-year to release a text that will provide the basis for each country's national implementation process. Let me reiterate that point: the release of the next round of proposals does *not* represent a final agreement or accord; rather, it is the platform from which we will launch our more in-depth domestic deliberative process. In the United States, that process will have several key steps.

First, the U.S. agencies will conduct a fourth quantitative impact study (QIS–4) in the third and fourth quarters of this year. This study will be based on the committee's mid-year release and will differ in some important aspects from the Basel Committee's earlier quantitative studies. QIS–4 will not only be conducted against the background of a more fully articulated proposal but will include a more prominent supervisory role to ensure greater reliability and consistency in survey results than has occurred in the past. We continue to believe that we cannot responsibly adopt final rules implementing Basel II until we have both determined with a high degree of reliability what the impact will be on the capital of our banks, and we have made the judgment that the impact is acceptable and conducive to the maintenance of a safe and sound banking system in the United States. We believe the results of QIS–4 will be more useful than any data we currently have in determining the magnitude of the impact of Basel II on bank capital and potential competitive inequities, as well as determining ultimately what to do about them.

Second, in another effort to increase our practical understanding of the effects of Basel, the U.S. agencies have commenced an operational risk benchmarking review at a number of the largest institutions. Information obtained through this effort will enhance agency understanding of current qualitative and quantitative operational risk practices and will assist agency efforts to develop

additional supervisory guidance and training materials for banks and examiners on the operational risk component of Basel II. Throughout this period we will continue our dialogue with banks and other interested stakeholders on various issues that Basel II may raise.

Those projects and discussions will help us in the third key step in Basel implementation, developing a joint notice of proposed rulemaking (NPR) that will set forth the proposed regulatory text for Basel II in the United States. Currently we anticipate that such an NPR will be released for public comment in late 2005 or early 2006. At the OCC, we have made a preliminary determination that this rule making will be a "significant regulatory action" for purposes of Executive Order 12866. Consequently, we will prepare and submit to the Office of Management and Budget's (OMB) Office of Information and Regulatory Affairs (OIRA) an economic analysis that includes

- A description of the need for the rules and an explanation of how they will meet the need;
- An assessment of the benefits anticipated from the rules together with, to the extent feasible, a quantification of those benefits;
- An assessment of the costs anticipated from the rules together with, to the extent feasible, a quantification of those costs; and
- An assessment of potentially effective and reasonably feasible alternatives to the planned regulation and an explanation why the planned regulatory action is preferable to the identified potential alternatives.

We have begun discussions with the OMB's OIRA regarding how these analyses will be designed and conducted. Our analysis will be published as part of our notice and comment process.

Finally, as the rulemaking process for the domestic implementation of Basel II moves forward, we and the other U.S. agencies are exploring the implications that Basel II may have on non-mandatory banks and what, if any changes we should make to our capital regulations for those banks. Any such changes will, of course, be subject to public notice and comment.

As my testimony conveys, while we have made important strides in trying to develop a more risk-sensitive capital framework for internationally active banks, there is still a long way to go before Basel II is completed and adopted. As I have repeatedly stated before Congress and in the Basel Committee, a new accord cannot be completely finalized until national implementation procedures have been completed and I am committed to a notice and comment process that is open and fair and responsive to public comments. The OCC and other U.S. agencies have recognized the possibility that, even in the late stages, public comments might reveal flaws in the proposal that will need to be addressed before we can issue final implementing regulations. The OCC's ultimate willingness to sign onto Basel II is going to depend on whether we are satisfied with the final product.

IV. Conclusion

In conclusion, Mr. Chairman, the national banking system is sound, and its recent performance has been strong. It has successfully weathered the recent recession, and it is responding in dynamic fashion to the changes in the financial services marketplace. The OCC, too, is keenly focused on keeping pace with change—by improving the approaches we use to supervise the industry, and by striving to ensure that national banks remain the safe, and sound, competitive, and high-integrity engines of our economy that they were designed to be. We look forward to working productively with you, with the members of this committee, and with state officials as we pursue our efforts to achieve that goal.

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before a Conference on Credit Rating and Scoring Models, on quantitative methods in bank supervision, Alexandria, Virginia, May 17, 2004

Let me extend a warm personal welcome to all of you, and a special note of appreciation to those who have traveled great distances to join us. Anyone who doubted that this is the Era of the Modeler in risk management need only look at the response to the announcement of this conference and the great outpouring of interest we have here today. Your participation not only furthers the discussion on how to develop and implement methods for validating, tracking, and testing the performance of rating and scoring models, it also furthers the public interest in a stable and healthy global financial system.

But, it occurred to me that as leading practitioners in this relatively young and exciting field, some of you may be more familiar with the specialized work of your OCC colleagues—work that I'm delighted to say will be on prominent display over the next couple of days—than with the core mission of the OCC itself: the crucial mission of ensuring the safety and soundness of the national banking system of the United States.

The OCC was entrusted with this mission more than 140 years ago, back in the days of Lincoln. And, for most of the period since then, it was a mission we pursued with a singular constancy of technique and purpose.

As recently as a long generation ago, the OCC was an organization of traditional bank examiners, a scattering of attorneys, along with clerks and a few others. It reflected the one-dimensional nature of the industry we supervised. But, over the past four decades, bank supervision has been changing at a breathtaking pace—mirroring the evolution of the financial services industry itself. This conference, bringing together experts with specialties that fall far outside the mainstream of traditional bank supervision, is a further sign of how far this change has come.

In light of all this, I thought it would be useful to talk about how this change came about—how it happened, in other words, that we and other financial regulators now depend so heavily on the unique skills of quantitative analysts, modelers, and a host of other specialists, as members of a diverse team that works together to ensure the safety and soundness of our financial system.

We can start this little historical excursion about a century ago. Before going on to become one of the greatest American men of letters, William Sydney Porter, better known as O. Henry, spent several years toiling as a clerk at a national bank—experience he put to good use as the setting for a tale—called "Friends in San Rosario"—in which an OCC national bank examiner is one of the chief protagonists. At the OCC, we've been cringing at O. Henry's characterization ever since. His examiner went by the name of Nettlewick, and he just oozed brusque bureaucratic officiousness. In the story, and without so much as a nod of greeting, he storms into the bank, counts the

cash, adds up the deposits, looks at a sampling of the loans, and pronounces the work done. O. Henry wrote short stories, of course, but short shrift is what most examiners of those early days made of the typical national bank.

I would like to tell you that O. Henry took vast liberties with his facts, but alas, he knew whereof he spoke. An experienced examiner in those days could wrap up the exam at a fair-sized national bank in half a day or less and move on to the next, not to be seen nor heard from again for a year or two—or even longer. In those days, examiners were paid a fee for each bank they reviewed, so they had a material incentive to hasten things along, perhaps subordinating their governmental interest to their own pecuniary one, even if the result was a superficial exam. Nettlewick did just what examiners in those days did: examined banks, one after the other, without pause, and collected a fee from each.

Contrast this, however, with the account of an actual OCC examiner, reflecting on his 40-year career, which ended in the 1970s, and it turns out that there's not as much contrast as one might expect—or hope:

> "We tried to take charge of all the records and inspect them. Cash was counted, ledgers were balanced, loans were balanced, then appraised, and bonds were verified and priced. Invoices on bonds purchased since the preceding examination were verified. Correspondent bank accounts were reconciled. Time certificates, cashiers checks, and certified checks were balanced, and a numerical list made for the next examination."

It sounded much the same.

One thing did change much for the better over the years. Once examiners were placed on salary in 1914, examiners stopped fixating on railroad timetables and started taking the time they needed to get to know—really know—their banks and the bankers who managed them. Good examiners develop a sixth sense about a troubled bank—something they can almost sniff out before they sit down and start reviewing the records.

But, examiners don't have mystical powers. Their effectiveness comes from training and experience—in classrooms, through on-the-job analysis and interaction with more seasoned colleagues. Not until the 1960s did the OCC require that new examiners have college degrees, although most did anyway. Of course, bankers of the World War II era were not always college-trained, either. It was one more way that bank supervision mirrored the industry.

Until fairly recently, the mechanics of bank examination remained almost as simple and straightforward as they were in O. Henry's time, and so was the psychology of the banker-examiner relationship. Sometimes, it seemed as though terrorizing bankers was almost a requirement of the examiner's job. When O. Henry's Nettlewick showed up and demanded that the chief teller turn over the cash, that conscientious bank official did so with a trembling hand, even though he knew that it was "right to a cent, and he had nothing to fear." Even so, the banker "was nervous and

flustered. So was every one in the bank. There was something so icy and swift, so impersonal and uncompromising about this [examiner] that his very presence seemed an accusation. He looked to be a man who would never make nor overlook an error."

And, more than half a century later, in the official instructions issued to national bank examiners, it was thus stated flatly: "The examination of a bank is always begun without prior notice and in a manner that will preserve the element of surprise. Hotel or other accommodations should be arranged so that advance notice of the examination will be avoided. Personal mail should not be directed to the bank. The element of surprise is an important factor contributing to a successful and effective examination. The examination staff should assemble near the bank briefly and as inconspicuously as possible. Greetings [to bank personnel] should be courteous but brief in order that assets and records may be taken under control as soon as possible."

One could almost see our friend Nettlewick writing these instructions himself.

But, beginning in the 1970s, the OCC's whole approach to examination—the mechanics of the process as well as the relationships that a good bank examination entails—began to change. It had become clear that the by-the-numbers, one-size-fits-all approach left a lot to be desired, especially as the risks banks faced became more esoteric and sophisticated. Interest rate risk, liquidity risk, risks associated with off-balance-sheet transactions, and risks arising from bad strategic decisions required more imagination on the part of bank supervisors. They required examiners who could think and act critically, who knew how to ask the right questions, and who had the patience and good manners to listen to the answers, and who were as sophisticated and knowledgeable when it came to modern methods as the bankers themselves.

By the 1970s, it was also becoming increasingly clear to the OCC that the old approach—with its repetitive, labor-intensive emphasis on checking individual loans and validating routine transactions, and guns-blazing skepticism—was becoming increasingly untenable, from both a methodological and resource standpoint.

In the 1970s it was also becoming more apparent that the banking business was undergoing major change. Those changes reflected the combined impact of changes in demand for banking services and the supply of those services. On the demand side, the primary driver of change has been increased competition. While banks once operated in a somewhat segmented market, providing transactions and savings services to households and lending to businesses, nonbanks were beginning to compete in virtually all dimensions. Of course, laws against the combination of commercial and investment banking and against interstate branching reinforced the segmentation of the U.S. banking business against the growing competition. But, when those legal constraints eventually fell, the resulting increase in competition merely confirmed the trend, apparent decades earlier, toward a more vibrant and competitive banking system.

The upshot of growing competition is that banks have found that they must be responsive to customer demands for services or risk losing those customers. Of course, this change in competi-

tiveness in banking has happened against a backdrop of changing customer appetites for financial services products. Both household and business customers have responded to the advances in financial technology and have profoundly changed the way they use financial assets. The post–World War II advances in financial economics that gave us Markowitz portfolio theory, options pricing, and derivatives trading have touched all bank customers. For example, while they may not realize it, even relatively less-sophisticated U.S. households use "structured finance." If you need to be convinced of that point, consider the impressive array of mortgage products available today, reflecting different combinations of cash flow structures and options, to accomplish what is basically the same secured borrowing transaction.

The factors affecting banking from the supply side are, if anything, more dramatic than the drivers of changing demand. The same advances in financial economics that touched businesses and households have swept over banking. Derivatives trading, hedging, securitization, credit scoring, and structured finance, which are all routine parts of banking today, were exotic or nonexistent 30 years ago. Credit risk management, on a portfolio basis, was conducted implicitly 30 years ago through crude limit-setting devices that attempted to avoid concentrations to single borrowers, single industries, or geographic regions. And, interest rate risk was only beginning to be addressed systematically with the wider recognition of concepts such as "duration."

The advances in, and dissemination of, financial technology cannot be separated from advances in computer and telecommunications technology used by banks. The advances in the technology are well known to the people in this audience. That these advances have had profound impacts on every aspect of banking is, perhaps, taken for granted.

In the fourth quarter of 2003, the notional values of derivatives contracts traded by U.S. commercial banks was $71.1 trillion; 30 years ago, it was virtually zero. With today's vast ATM network, it's easy to lose sight of the fact that it was only 35 years ago that the first ATM was installed in a bank lobby. And, while lending is now conducted over vast distances, it was once a local activity. Mortgage lending provides an obvious example of the role of nonlocal lenders. But, even small business lending, which was once the province of the local community bank, is being influenced by the wider availability of credit scoring and easier telecommunications. Preliminary research by economists at the OCC, collaborating with economists from outside the agency, demonstrates that trend. Using data from the Small Business Administration, they have shown that the average physical distance between SBA borrowers and their lenders has increased fivefold over a decade, from 5 miles to 25 miles. There is little doubt that the way in which banking is conducted has changed.

The results of the changes I have highlighted were industry upheaval and phenomenal industry growth. In 1960, there were nearly 13,000 commercial banking organizations in the U.S., and 91 percent of them had real assets—in terms of 1996 dollars—of under $100 million. By the year 2000, there were fewer than 7,000 commercial banking organizations, and 60 percent of them had real assets under $100 million. While those numbers give the general impression of a consolidat-

ing industry, they do not reveal the true extent of the change. In 1960, there were only three banks with real assets of $25 billion or more; in 2000, that number had risen to 34.

But, even those numbers do not give an adequate sense of the magnitude of the change. After the most recent mergers, the United States now has three banking companies with over one trillion in assets. There is little doubt that today's banking industry is much different—and more complex—than it was decades ago.

Those changes in business activities, size, and complexity have required U.S. regulators to adopt an entirely different approach to supervision. I would like to claim that we made these changes in a perfectly anticipatory fashion, recognizing the changing risks and market pressures. However, we all know such proactive change is rare. Instead, a succession of highly public bank failures in the 1970s and the systemic threats of the 1980s demonstrated to us that we had to change the way that we conducted bank supervision.

From these needs emerged the OCC's risk-based approach to supervision—an approach predicated on spending more time analyzing the quality of bank systems and controls and leaving the business of bean-counting to the auditors. This shift has literally transformed bank supervision—not only in the United States, but in large part because the OCC, with its reputation for pioneering excellence, has adopted it—also around the world. It has, furthermore, transformed the OCC and its people: today our examiners hold advanced degrees and certifications, are encouraged to continue their professional educations throughout their careers, and are recognized as some of the leading experts in the most esoteric financial fields. And, the generalist examiner ranks are augmented with specialists who also participate in bank supervision. Most relevant for this conference are the specialists in risk modeling who are housed in our Economics department, and who are the organizers of this conference.

The basic premise of risk-based supervision is that supervisory resources should be brought to bear where they are needed—and preferably, before they're needed—based on the bank's condition and on the potential systemic consequences should its condition deteriorate. This approach seeks to determine whether banks have identified and controlled the risks they have assumed; it seeks to validate the quality of a bank's internal risk management systems. And, it rejects the logic of a purely calendar-driven, episodic examination regime of what seems like long ago, in which a bank may be forgotten until it shows up again on the examination calendar 18 months after the last. Instead, we now conceive of supervision as an ongoing process, in which examiners are responsible for both on- and off-site monitoring the condition of the institutions within their portfolios, on a continuous basis.

It was in the early 1990s that quantitative economists began participating more directly in the examination process itself. At first, their role in examinations was mostly limited to interpreting for examiners who found themselves baffled by the quantitative methods increasingly in vogue in the banking industry. Over time, however, many of our quantitative economists have become full-fledged members of the examination team, integrated not only into our Large Bank program, but

in our Midsize and Community Bank examinations as well.

Increasingly, our quantitative economists are joining examiners on the scene to offer crucial assessments on whether banks, having chosen to rely on advanced models to manage their various risk exposures, understand the limitations of those models.

If industry developments over the past decade have elevated the importance within bank supervision of the ability to evaluate quantitative models, the immediate future portends even heavier burdens as Basel II nears completion. As many of you know, the updated rule will place tremendous emphasis on banks' own internal risk models to determine how much capital they will have to hold, and, in both the rule-making process and once the rule goes into operation, U.S. bank supervisors will face an enormous challenge in validating models, especially during the period when the rules are being phased in. Examiners will need to be trained in the new methodologies, and we will be relying heavily on the men and women who already possess that expertise. The challenges will be enormous.

Yet, while the role that quantitative economists play in the examination process is large and growing, we have not by any means abandoned the fundamental set of skills that has distinguished OCC supervision for nearly all of our organizational life. Banking is still a business involving people as well as numbers; and as long as it remains so, judgment and expertise-the so-called "soft skills"—will weigh preponderantly in the assessments that examiners are called upon to make. We have found over time that the key to effective supervision is being open to new tools and methodologies and integrating those that work into our established processes. Over the years, our goals and objectives have not changed, but our approaches have constantly evolved. That flexibility has made it possible for the OCC to stay current with a rapidly changing financial services environment and to continue to be effective as we carry out the mission entrusted to us back in the days of Lincoln.

Statement of John D. Hawke, Jr., Comptroller of the Currency, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, on combating money laundering, Washington, D.C., June 3, 2004

Statement required by 12 U.S.C. 250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

I. Introduction

Chairman Shelby, Ranking Member Sarbanes, members of the committee, I appreciate the opportunity to appear before you today to discuss the challenges we at the Office of the Comptroller of the Currency (OCC)—and other financial institution regulators—face in combating money laundering in the U.S. financial system, and how we are meeting those challenges. I will also address the enforcement actions in this area we have recently taken against Riggs Bank, N.A.

As the regulator of national banks, the OCC has long been committed to the fight against money laundering. For more than 30 years, the OCC has been responsible for ensuring that the banks under its supervision have the necessary controls in place and provide requisite notices to law enforcement to assure that those banks are not used as vehicles to launder money for drug traffickers or other criminal organizations. The tragic events of 9/11 have brought into sharper focus the related concern of terrorist financing. Together with the other federal banking agencies, the banking industry, and the law enforcement community, the OCC shares the committee's goal of preventing and detecting money laundering, terrorist financing, and other criminal acts and the misuse of our nation's financial institutions.

The cornerstone of the federal government's anti-money laundering (AML) efforts is the Bank Secrecy Act (BSA). Enacted in 1970, the BSA is primarily a record-keeping and reporting statute that is designed to ensure that banks and other financial institutions provide relevant information to law enforcement in a timely fashion. The BSA has been amended several times, most recently through passage of the USA PATRIOT Act in the wake of the 9/11 tragedy. Both the Secretary of the Treasury, through the Financial Crimes Enforcement Network (FinCEN), and the federal banking agencies, have issued regulations implementing the BSA, including regulations requiring all banks to have a BSA compliance program, and to file reports such as suspicious activity reports (SARs) and currency transaction reports (CTRs).

Due to the sheer volume of financial transactions processed through the U.S. financial system, primary responsibility for compliance with the BSA and the AML statutes rests with the nation's financial institutions themselves. The OCC and the other federal banking agencies are charged with ensuring that the institutions we supervise have strong AML programs in place to identify and report suspicious transactions to law enforcement, and that such reports are, in fact, made.

Thus, our supervisory processes seek to ensure that banks have systems and controls in place to prevent their involvement in money laundering, and that they provide the types of reports to law enforcement that the law enforcement agencies, in turn, need in order to investigate suspicious transactions that are reported.

To accomplish our supervisory responsibilities, the OCC conducts regular examinations of national banks and federal branches and agencies of foreign banks in the United States. These examinations cover all aspects of the institution's operations, including compliance with the BSA. Our resources are concentrated on those institutions, and areas within institutions, of highest risk. In cases of noncompliance, the OCC has broad investigative and enforcement authority to address the problem.

Unlike other financial institutions, which have only recently become subject to compliance program and SAR filing requirements, banks have been under such requirements for years. For example, banks have been required to have a BSA compliance program since 1987, and have been required to file suspicious activity reports (SARs) (or their predecessors) since the 1970s. Not surprisingly, most banks today have strong AML programs in place, and many of the largest institutions have programs that are among the best in the world. There are now approximately 1.3 million SARs in the centralized database that is maintained by FinCEN. While the PATRIOT Act further augmented the due diligence and reporting requirements for banks in several key areas, one of its primary objectives was to impose requirements on nonbanking institutions that had long been applicable to banks.

The OCC's efforts in this area do not exist in a vacuum. We have long been active participants in a variety of interagency working groups that include representatives of the Treasury Department, law enforcement, and the other federal banking agencies. We also work closely with the FBI and other criminal investigative agencies, providing them with documents, information, and expertise on a case-specific basis. In addition, when we are provided with lead information from a law enforcement agency, we use that information to investigate further to ensure that BSA compliance systems are adequate.

We continue to work to improve our supervision in this area and we are constantly revising and adjusting our procedures to keep pace with technological developments and the increasing sophistication of money launderers and terrorist financers. For example, along with the other federal banking agencies, the OCC recently developed examination procedures to implement several key sections of the PATRIOT Act, and we expect to be issuing a revised version of our BSA *Handbook* booklet by year-end. We have also recently initiated two programs that will provide stronger and more complete analytical information to assist our examiners in identifying banks that may have high money-laundering risk. Specifically, we are developing a database of national-bank-filed SARs with enhanced search and reporting capabilities, and we also are developing and will implement nationwide a new risk assessment process to better identify high-risk banks. Addi-

tionally, we are exploring with FinCEN and the other banking agencies better ways to use BSA information in our examination process to better identify risks and vulnerabilities in the banking system.

Recent events surrounding Riggs Bank, N.A., have heightened interest in how the banking agencies, and the OCC in particular, conduct supervision for BSA/AML compliance. Together with FinCEN, the OCC recently assessed a record $25 million civil money penalty (CMP) against Riggs Bank, N.A. The OCC also imposed a supplemental cease-and-desist (C&D) order on the bank, requiring the institution to strengthen its controls and improve its processes in the BSA/AML area. Along with the C&D order we issued against the bank in July 2003, these and other actions we have taken have greatly reduced the bank's current risk profile.

However, with the benefit of hindsight, it is clear that the supervisory actions that we previously took against the bank were not sufficient to achieve satisfactory and timely compliance with the BSA, that more probing inquiry should have been made into the bank's high-risk accounts, and that stronger, more forceful enforcement action should have been taken sooner. While we do not believe that Riggs is representative of the OCC's supervision in the BSA/AML area, we are nonetheless taking a number of steps to guard against a repeat of this type of situation. In this regard, I have directed that our Quality Management Division commence a review and evaluation of our BSA/AML supervision of Riggs and make recommendations to me on several issues concerning our approach to and the adequacy of our BSA/AML supervision programs generally and particularly with respect to Riggs.

II. Background and Legal Framework

In 1970 Congress passed the Currency and Foreign Transactions Reporting Act otherwise known as the Bank Secrecy Act (BSA), which established requirements for record keeping and reporting by private individuals, banks, and other financial institutions. The BSA was designed to help identify the source, volume, and movement of currency and other monetary instruments into or out of the United States or being deposited in financial institutions. The statute sought to achieve that objective by requiring individuals, banks, and other financial institutions to create a paper trail by keeping records and filing reports of certain financial transactions and of unusual currency transfers. This information then enables law enforcement and regulatory agencies to pursue investigations of criminal, tax and regulatory violations.

The BSA regulations require all financial institutions to submit various reports to the government. The most common of these reports are: (1) FinCEN Form 104 (formerly IRS Form 4789)-Currency Transaction Report (CTR) for each payment or transfer, by, through, or to a financial institution, which involves a transaction in currency of more than $10,000; and (2) FinCEN Form 105 (formerly Customs Form 4790)-Report of International Transportation of Currency or Monetary Instruments (CMIR) for each person who physically transports monetary instruments in an aggregate amount exceeding $10,000 into or out of the United States. Bank supervisors are

not responsible for investigating or prosecuting violations of criminal law that may be indicated by the information contained in these reports; they are, however, charged with assuring that the requisite reports are filed timely and accurately.

The Money Laundering Control Act of 1986 precludes circumvention of the BSA requirements by imposing criminal liability for a person or institution that knowingly assists in the laundering of money, or who structures transactions to avoid reporting. It also directed banks to establish and maintain procedures reasonably designed to assure and monitor compliance with the reporting and record keeping requirements of the BSA. As a result, on January 27, 1987, all federal bank regulatory agencies issued essentially similar regulations requiring banks to develop procedures for BSA compliance. The OCC's regulation requiring that every national bank maintain an effective BSA compliance program is set forth at 12 CFR 21.21 and is described in more detail below.

Together, the BSA and the Money Laundering Control Act charge the bank regulatory agencies with

- Overseeing banks' compliance with the regulations described, which direct banks to establish and maintain a BSA compliance program;
- Requiring that each examination includes a review of this program and describes any problems detected in the agencies' report of examination; and
- Taking C&D actions if the agency determines that the bank has either failed to establish the required procedures or has failed to correct any problem with the procedures that was previously cited by the agency.

The Annunzio–Wylie Anti-Money-Laundering Act, which was enacted in 1992, strengthened the sanctions for BSA violations and the role of the Treasury Department. It contained the following provisions:

- A so-called "death penalty" sanction, which authorized the revocation of the charter of a bank convicted of money laundering or of a criminal violation of the BSA;
- An authorization for Treasury to require the filing of suspicious-transaction reports by financial institutions;
- The grant of a "safe harbor" against civil liability to persons who report suspicious activity; and
- An authorization for Treasury to issue regulations requiring all financial institutions, as defined in BSA regulations, to maintain "minimum standards" of an AML program.

Two years later, Congress passed the Money Laundering Suppression Act, which primarily ad-

dressed Treasury's role in combating money laundering. This statute

- Directed Treasury to attempt to reduce the number of CTR filings by 30 percent and, to assist in this effort, it established a system of mandatory and discretionary exemptions for banks;
- Required Treasury to designate a single agency to receive SARs;
- Required Treasury to delegate CMP powers for BSA violations to the federal bank regulatory agencies subject to such terms and conditions as Treasury may require;
- Required nonbank financial institutions to register with Treasury; and
- Created a safe harbor from penalties for banks that use mandatory and discretionary exemptions in accordance with Treasury directives.

Finally, in 2001, as a result of the 9/11 terror attacks, Congress passed the USA PATRIOT Act. The PATRIOT Act is arguably the single most significant AML law that has been enacted since the BSA itself. Among other things, the PATRIOT Act augmented the existing BSA framework by prohibiting banks from engaging in business with foreign shell banks, requiring banks to enhance their due diligence procedures concerning foreign correspondent and private banking accounts, and strengthening their customer identification procedures. The PATRIOT Act also

- Provides the Secretary of the Treasury with the authority to impose special measures on jurisdictions, institutions, or transactions that are of "primary money-laundering concern";
- Facilitates records access and requires banks to respond to regulatory requests for information within 120 hours;
- Requires regulatory agencies to evaluate an institution's AML record when considering bank mergers, acquisitions, and other applications for business combinations;
- Expands the AML program requirements to all financial institutions; and
- Increases the civil and criminal penalties for money laundering.

The OCC and the other federal banking agencies have issued two virtually identical regulations designed to ensure compliance with the BSA. The OCC's BSA compliance regulation, 12 CFR 21.21, requires every national bank to have a written program, approved by the board of directors, and reflected in the minutes of the bank. The program must be reasonably designed to assure and monitor compliance with the BSA and must, at a minimum, (1) provide for a system of internal controls to assure ongoing compliance, (2) provide for independent testing for compliance, (3) designate an individual responsible for coordinating and monitoring day-to-day compliance, and (4) provide training for appropriate personnel. In addition, the implementing regulation for section 326 of the PATRIOT Act requires that every bank adopt a customer identification program as

part of its BSA compliance program.

The OCC's SAR regulation, 12 CFR 21.11, requires every national bank to file a SAR when they detect certain known or suspected violations of federal law or suspicious transactions related to a money-laundering activity or a violation of the BSA. This regulation mandates a SAR filing for any potential crimes (1) involving insider abuse regardless of the dollar amount, (2) where there is an identifiable suspect and the transaction involves $5,000 or more, and (3) where there is no identifiable suspect and the transaction involves $25,000 or more. Additionally, the regulation requires a SAR filing in the case of suspicious activity that is indicative of potential money laundering or BSA violations and the transaction involves $5,000 or more.

III. OCC's BSA/AML Supervision

The OCC and the other federal banking agencies are charged with ensuring that banks maintain effective AML programs. The OCC,s AML responsibilities are coextensive with our regulatory mandate of ensuring the safety and soundness of the national banking system. Our supervisory processes seek to ensure that institutions have compliance programs in place that include systems and controls to satisfy applicable CTR and SAR filing requirements, as well as other reporting and record-keeping requirements to which banks are subject under the BSA.

The OCC devotes significant resources to BSA/AML supervision. The OCC has nearly 1700 examiners in the field, many of whom are involved in both safety and soundness and compliance with applicable laws including the BSA. We have over 300 examiners on-site at our largest national banks, engaged in continuous supervision of all aspects of their operations. In 2003, the equivalent of approximately 40 full-time employees were dedicated to BSA/AML supervision. The OCC also has three full time BSA/AML compliance specialists in our Washington, D.C., headquarters office dedicated to developing policy, training, and assisting on complex examinations. In addition, the OCC has a full-time fraud expert in Washington, D.C., who is responsible for tracking the activities of offshore shell banks and other vehicles for defrauding banks and the public. These resources are supplemented by dozens of attorneys in our district offices and Washington, D.C., headquarters office who work on compliance matters. In 2003 alone, not including our continuous large bank supervision, the OCC conducted approximately 1,340 BSA examinations of 1,100 institutions and, since 1998, we have completed nearly 5,700 BSA examinations of 5,300 institutions.

The OCC monitors compliance with the BSA and money laundering laws through its BSA compliance and money-laundering prevention examination procedures. The OCC's examination procedures were developed by the OCC, in conjunction with the other federal banking agencies, based on our extensive experience in supervising and examining national banks in the area of BSA/AML compliance. The procedures are risk-based, focusing our examination resources on high-risk banks and high-risk areas within banks. During an examination, examiners use the pro-

cedures to review the bank's policies, systems, and controls. Examiners test the bank's systems by reviewing certain individual transactions when they note control weaknesses, have concerns about high-risk products or services in a bank, or receive information from a law enforcement or other external source.

In 1997, the OCC formed the National Anti-Money-Laundering Group (NAMLG), an internal task force that serves as the focal point for all BSA/AML matters. Through the NAMLG, the OCC has undertaken a number of projects designed to improve the agency's supervision of the BSA/AML activities of national banks. These projects include the development of a program to identify high-risk banks for expanded scope BSA examinations and the examination of those banks using agency experts and expanded procedures; examiner training; the development of revised examination procedures; and the issuance of policy guidance on various BSA/AML topics.

Over the years, the NAMLG has had many significant accomplishments including

- Publishing and updating numerous guidance documents, including the Comptroller's BSA *Handbook* booklet, extensive examination procedures, numerous OCC advisories, bulletins, and alerts, and a comprehensive reference guide for bankers and examiners;
- Providing expertise to the Treasury Department and the Department of Justice in drafting the annual U.S. National Money Laundering Strategy;
- Providing expertise to the Treasury Department, FinCEN, and the other federal banking agencies in drafting the regulations to implement the PATRIOT Act; and
- Developing state-of-the-art training programs for OCC and other federal and foreign regulatory authorities in training their examiners in BSA/AML supervision.

To deploy its resources most effectively, the OCC uses criteria developed by NAMLG that targets banks for expanded scope AML examinations. Experienced examiners and other OCC experts who specialize in BSA compliance, AML, and fraud are assigned to the targeted examinations. The examinations focus on areas of identified risk and include comprehensive transactional testing procedures. The following factors are considered in selecting banks for targeted examinations:

- Locations in high-intensity drug trafficking areas (HIDTA) or high-intensity money-laundering and related financial crime areas (HIFCA);
- Excessive currency flows;
- Significant international, private banking, fiduciary, or other high-risk activities;
- Unusual suspicious activity reporting patterns;
- Unusual large currency transaction reporting patterns; and

- Fund transfers or account relationships with drug source countries or countries with stringent financial secrecy laws.

The program may focus on a particular area of risk in a given year. For example, our 2005 targeting program will focus on banks that have significant business activity involving foreign money services businesses. In prior years, our targeting focus has been on banks that have significant business activity in private banking, offshore banking, and lines of business subject to a high risk of terrorist financing.

Other responsibilities of the NAMLG include sharing information about money laundering issues with the OCC's district offices; analyzing money-laundering trends and emerging issues; and promoting cooperation and information sharing with national and local AML groups, the law enforcement community, bank regulatory agencies, and the banking industry.

NAMLG has also worked with law enforcement agencies and other regulatory agencies to develop an interagency examiner training curriculum that includes instruction on common money-laundering schemes. In addition, the OCC has conducted AML training for foreign bank supervisors and examiners two to three times per year for the past four years. Over 250 foreign bank supervisors have participated in this training program. Recently, the World Bank contracted with the OCC to tape our international BSA school for worldwide broadcast. The OCC has also partnered with the State Department to provide AML training to high-risk jurisdictions, including selected Middle Eastern countries. And we consistently provide instructors for the Federal Financial Institutions Examination Council schools, which are now patterned after the OCC's school. In total, the OCC's AML schools have trained approximately 550 OCC examiners over the past five years.

OCC's Enforcement Authority

Effective bank supervision requires clear communications between the OCC and the bank's senior management and board of directors. In most cases, problems in the BSA/AML area, as well as in other areas, are corrected by bringing the problem to the attention of bank management and obtaining management's commitment to take corrective action. An OCC report of examination documents the OCC's findings and conclusions with respect to its supervisory review of a bank. Once problems or weaknesses are identified and communicated to the bank, the bank's senior management and board of directors are expected to promptly correct them. The actions that a bank takes, or agrees to take, to correct deficiencies documented in its report are important factors in determining whether more forceful action is needed.

OCC enforcement actions fall into two broad categories: informal and formal. In general, informal actions are used when the identified problems are of limited scope and magnitude and bank management is regarded as committed and capable of correcting them. Informal actions include commitment letters, memoranda of understanding and matters requiring board attention in examination reports. These generally are not public actions.

The OCC also may use a variety of formal enforcement actions to support its supervisory objectives. Unlike most informal actions, formal enforcement actions are authorized by statute, are generally more severe, and are disclosed to the public. Formal actions against a bank include C&D orders, formal written agreements and CMPs. C&D orders and formal agreements are generally entered into consensually by the OCC and the bank and require the bank to take certain actions to correct identified deficiencies. The OCC may also take formal action against officers, directors, and other individuals associated with an institution (institution-affiliated parties). Possible actions against institution-affiliated parties include removal and prohibition from participation in the banking industry, CMPs, and C&D orders.

In the BSA area, the OCC's CMP authority is concurrent with that of FinCEN. In cases involving systemic noncompliance with the BSA, in addition to taking our own actions, the OCC refers the matter to FinCEN. In the case of Riggs Bank, the OCC and FinCEN worked together on the CMP against the bank.

In recent years, the OCC has taken numerous formal actions against national banks to bring them into compliance with the BSA. These actions are typically C&D orders and formal agreements. The OCC has also taken formal actions against institution-affiliated parties who participated in BSA violations. From 1998 to 2003, the OCC has issued a total of 78 formal enforcement actions based in whole, or in part, on BSA/AML violations. During this same time period, the OCC has also taken countless informal enforcement actions to correct compliance program deficiencies that did not rise to the level of a violation of law.

Significant BSA/AML Enforcement Actions

The OCC has been involved in a number of cases involving serious BSA violations and, in some cases, actual money laundering. Some of the more significant cases involved the Bank of China (New York federal branch), Broadway National Bank, Banco do Estado de Parana (New York federal branch), and Jefferson National Bank. There are also dozens of other examples where the OCC identified significant money-laundering or BSA non-compliance, took effective action to stop the activity, and ensured that accurate and timely referrals were made to law enforcement.

Bank of China, New York Federal Branch

In May 2000, OCC examiners conducting a safety and soundness examination discovered serious misconduct on the part of the branch and its former officials, including the facilitation of a fraudulent letter of credit scheme and other suspicious activity and potential fraud and money laundering. The misconduct, which resulted in significant losses to the branch, was subsequently referred to law enforcement. In January 2002, the OCC and the Peoples Bank of China entered into companion actions against the Bank of China and its U.S.-based federal branches. The bank's New York branch agreed to pay a $10 million penalty assessed by the OCC and the parent bank, which is based in Beijing, agreed to pay an equivalent amount in local currency to the People's Bank of China, for a total of $20 million. The OCC also required that the branch execute a C&D

order which, among other things, required it to establish account opening and monitoring procedures, a system for identifying high risk customers, and procedures for regular, ongoing review of account activity of high-risk customers to monitor and report suspicious activity. The OCC also took actions against six institution-affiliated parties.

Broadway National Bank, New York, New York

In March of 1998, the OCC received a tip from two separate law enforcement agencies that this bank may be involved in money laundering. The OCC immediately opened an examination which identified a number of accounts at the bank that were either being used to structure transactions, or were receiving large amounts of cash with wire transfers to countries known as money-laundering and drug havens. Shortly thereafter, the OCC issued a C&D order that shut down the money laundering and required the bank to adopt more stringent controls. The OCC also initiated prohibition and CMP cases against bank insiders. In referring the matter to law enforcement, we provided relevant information including the timing of deposits that enabled law enforcement to seize approximately $4 million and arrest a dozen individuals involved in this scheme. The subsequent OCC investigation resulted in the filing of additional SARs, the seizure of approximately $2.6 million in additional funds, more arrests by law enforcement, and a referral by the OCC to FinCEN. In November 2002, the bank pled guilty to a three count felony information that charged it with failing to maintain an AML program, failing to report approximately $123 million in suspicious bulk cash and structured cash deposits, and aiding and assisting customers to structure approximately $76 million in transactions to avoid the CTR requirements. The bank was required to pay a $4 million criminal fine.

Banco do Estado de Parana, Federal Branch, New York, N.Y (Banestado).

In the summer of 1997, the OCC received information from Brazilian government officials concerning unusual deposits leaving Brazil via overnight courier. The OCC immediately dispatched examiners to the branch that was receiving the majority of the funds. OCC examiners discovered significant and unusually large numbers of monetary instruments being shipped via courier into the federal branch from Brazil and other countries in South America, as well as suspicious wire transfer activity that suggested the layering of the shipped deposits through various accounts with no business justification for the transfers. The OCC entered into a C&D order with the federal branch and its head office in Brazil in January 1998 that required controls over the courier and wire transfer activities and the filing of SARs with law enforcement. The OCC also hosted several meetings with various law enforcement agencies discussing these activities and filed a referral with FinCEN. Shortly thereafter, the Brazilian bank liquidated the branch. In May of 2000, the OCC assessed a CMP against the branch for $75,000.

Jefferson National Bank, Watertown, New York

During the 1993 examination of this bank, the OCC learned from the Federal Reserve Bank of New York that the bank was engaging in cash transactions that were not commensurate with

its size. OCC examiners subsequently discovered that several bank customers were depositing large amounts of cash that did not appear to be supported by the purported underlying business, with the funds being wired offshore. The OCC filed four criminal referral forms (predecessor to the SAR) with law enforcement pertaining to this cash activity and several additional criminal referral forms pertaining to insider abuse and fraud at the bank. The OCC also briefed several domestic and Canadian law enforcement agencies alerting them to the significant sums of money flowing through these accounts at the bank. Based upon this information, law enforcement commenced an investigation of these large deposits. The investigation resulted in one of the most successful money-laundering prosecutions in U.S. government history. The significant sums of money flowing through the bank were derived from cigarette and liquor smuggling through the Akwesasne Indian Reservation in northern New York. The ring smuggled $687 million worth of tobacco and alcohol into Canada between 1991 and 1997. The case resulted in 21 indictments that also sought the recovery of assets totaling $557 million. It also resulted in the December 1999 guilty plea by a subsidiary of R.J. Reynolds Tobacco Company and the payment of a $15 million criminal fine. The four criminal referral forms filed by the OCC in the early stages of this investigation were directly on point and pertained to the ultimate ringleaders in the overall scheme. These money-laundering cases were in addition to the C&D order entered into with the bank, the prohibition and CMP cases that were brought by the OCC, and the insider abuse bank fraud cases that were brought by law enforcement against some of the bank's officers and directors. Seven bank officers and directors were ultimately convicted of crimes.

OCC Cooperation with Law Enforcement and Other Agencies

As the above cases illustrate, combating money laundering depends on the cooperation of law enforcement, the bank regulatory agencies, and the banks themselves. The OCC participates in a number of interagency working groups aimed at money laundering prevention and enforcement, and meets on a regular basis with law enforcement agencies to discuss money laundering issues and share information that is relevant to money laundering schemes. For example, the OCC is an original member of both the National Interagency Bank Fraud Working Group and the Bank Secrecy Act Advisory Group. Both of these groups include representatives of the Department of Justice, the FBI, the Treasury Department, and other law enforcement agencies, as well as the federal banking agencies. Through our interagency contacts, we sometimes receive leads as to possible money laundering in banks that we supervise. Using these leads, we can target compliance efforts in areas where we are most likely to uncover problems. For example, if the OCC receives information that a particular account is being used to launder money, our examiners would then review transactions in that account for suspicious funds movements, and direct the bank to file a SAR if suspicious transactions are detected. The OCC also provides information, documents, and expertise to law enforcement for use in criminal investigations on a case-specific basis.

The OCC has also played an important role in improving the AML and terrorist financing controls in banking throughout the world. For the past several years, the OCC has provided examiners to assist with numerous U.S. government-sponsored international AML and terrorist financ-

ing assessments. We have a cadre of specially trained examiners that has provided assistance to the Treasury Department and the State Department on these assessments in various parts of the world, including South and Central America, the Caribbean, the Pacific Rim nations, the Middle East, Russia, and the former Eastern Bloc nations. In this regard, the cadre has participated in terrorist financing investigations, assessed local money laundering laws and regulatory infrastructure, and provided training to bank supervisors.

The OCC is also providing direct assistance to the Coalition Provisional Authority (CPA) of Iraq. Four OCC examiners are currently working in Iraq as technical assistance advisers to the CPA's Ministry of Finance and helping their counterparts at the Central Bank of Iraq develop a risk-based supervisory system tailored to the Iraqi banking system. The OCC examiners are assisting in the development of a law addressing money laundering and terrorist financing that is close to enactment by the CPA, the drafting of new policy and examination manuals to implement this law, and they are providing extensive AML training to Iraqi bank regulators.

IV. Post–9/11 Activities and the Implementation of the USA PATRIOT Act

In the immediate aftermath of the 9/11 terror attacks, the OCC participated in a series of interagency meetings with bankers sponsored by the New York Clearinghouse to discuss the attacks and their impact on the U.S. economy and banking system and provided guidance to the industry concerning the various requests from law enforcement for account and other information. The OCC was also instrumental in working with the other banking agencies to establish an electronic e-mail system for law enforcement to request information about suspected terrorists and money launderers from every financial institution in the country. This FBI Control List system was in place five weeks after 9/11 and was the precursor to the current system established under section 314(a) of the PATRIOT Act, which is now administered by FinCEN. At the same time, the OCC established a secure emergency communications e-mail system for all national banks through the OCC's BankNet technology.

In October 2001, Congress passed the USA PATRIOT Act. The OCC has been heavily involved in the many interagency work groups tasked with writing regulations to implement the PATRIOT Act over the past few years. To date, these work groups have issued final rules implementing sections 313 (foreign shell bank prohibition); 319(b) (foreign correspondent bank account records), 314 (information sharing), and 326 (customer identification). The OCC was also involved in drafting the interim final rule implementing section 312 (foreign private banking and correspondent banking).

The OCC took the lead in developing the current 314(a) process for disseminating information between law enforcement and the banks. The OCC worked with the interested regulatory and law enforcement agencies, and drafted detailed instructions to banks concerning the 314(a) process and the extent to which banks are required to conduct record and transactions searches on behalf

of law enforcement. The OCC also took the lead in drafting a frequently asked questions (FAQs) document to provide further guidance as to the types of accounts and transactions required to be searched, when manual searches for this information would be required, and the timeframes for providing responses back to law enforcement. Under the new procedures, 314(a) requests from FinCEN are batched and issued every two weeks, unless otherwise indicated, and financial institutions have two weeks to complete their searches and respond with any matches.

Throughout this process, the OCC continually assisted FinCEN in maintaining an accurate electronic database of 314(a) contacts for every national bank and federal branch, provided effective communications to the industry through agency alerts concerning the 314(a) system, and participated in quarterly interagency meetings with fellow regulators and law enforcement agencies to ensure that the process was working effectively and efficiently.

The OCC also took the lead in drafting the interagency Customer Identification Program (CIP) regulation mandated by section 326 of the PATRIOT Act, which mandates the promulgation of regulations that, at a minimum, require financial institutions to implement reasonable procedures for (1) verifying the identity of any person seeking to open an account, to the extent reasonable and practicable; (2) maintaining records of the information used to verify the person's identity, including name, address, and other identifying information; and (3) determining whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided to the financial institution by any government agency. The OCC is also the primary drafter of interagency FAQs concerning the implementation of the CIP rules. A second set of interagency FAQs will be issued shortly.

In order to assess PATRIOT Act implementation by the industry, in the summer of 2002, the OCC conducted reviews of all of its large banks to assess their compliance with the regulations issued under the PATRIOT Act up to that time and to evaluate the industry response to terrorist financing risk. Although, at that time, many of the PATRIOT Act regulations had not yet been finalized, we felt it was important to ascertain the level of bank compliance with and understanding of the new requirements. The purpose of these reviews was to discern the types of systems and controls banks had in place to deter terrorist financing and follow up with full-scope AML exams in institutions that had weaknesses. As a result of these reviews, the OCC was able to obtain practical first-hand knowledge concerning how banks were interpreting the new law, whether banks were having problems implementing the regulations or controlling terrorist financing risk, and which banks needed further supervision in this area.

On October 20, 2003, the OCC issued interagency examination procedures to evaluate national bank compliance with the requirements of sections 313 and 319(b) and section 314 of the PATRIOT Act. The procedures were designed to assess how well banks are complying with the new regulations and to facilitate a consistent supervisory approach among the banking agencies. OCC examiners are now using the procedures during BSA/AML examinations of the institutions under our supervision. The procedures allow examiners to tailor the examination scope according to the

reliability of the bank's compliance management system and the level of risk assumed by the institution. An interagency working group is currently drafting examination procedures concerning Section 326 of the PATRIOT Act. The OCC is also the primary drafter of these procedures and we expect that they will be issued shortly.

OCC Outreach and Industry Education

As previously stated, the primary responsibility for ensuring that banks are in compliance with the BSA lies with the bank's management and its directors. To aid them in meeting this responsibility, the OCC devotes extensive time and resources to educating the banking industry about its obligations under the BSA. This has typically included active participation in conferences and training sessions across the country. For example, in 2002 the OCC sponsored a nationwide teleconference to inform the banking industry about the PATRIOT Act. This teleconference was broadcast to 774 sites with approximately 5,400 listeners.

The OCC also provides guidance to national banks through (1) industry outreach efforts that include roundtabl discussions with bankers and industry-wide conference calls sponsored by the OCC; (2) periodic bulletins that inform and remind banks of their responsibilities under the law, applicable regulations, and administrative rulings dealing with BSA reporting requirements and money laundering; (3) publications, including the distribution of a comprehensive guide in this area entitled *Money Laundering: A Banker's Guide to Avoiding Problems;* (4) publication and distribution of the Comptroller's BSA *Handbook* booklet which contains the OCC's BSA examination procedures, and the Comptroller's *Handbook for Community Bank Supervision* which provides guidance on BSA/AML risk assessment; and (5) periodic alerts and advisories of potential frauds or questionable activities, such as alerts on unauthorized banks and FinCEN reporting processes. In addition, senior OCC officials are regular participants in industry seminars and forums on the BSA, the PATRIOT Act, and related topics.

Current Supervisory Initiatives

The OCC uses somewhat different examination approaches depending largely on the size of the institution and its risk profile. In large banks (generally, total assets of $25 billion) and midsize banks (generally, total assets of $5 billion), OCC examiners focus first on the bank's BSA compliance program. These banks are subject to our general BSA/AML examination procedures that include, at a minimum, a review of the bank's internal controls, policies, procedures, customer due diligence, SAR/CTR information, training programs, and compliance audits. We also evaluate BSA officer competence, the BSA program structure, and the bank's audit program, including the independence and competence of the audit staff. While examining for overall BSA compliance, examiners typically focus on suspicious activity monitoring and reporting systems and the effectiveness of the bank's customer due diligence program.

Additional and more detailed procedures are conducted if control weaknesses or concerns are encountered during the general procedures phase of the examination. These supplemental procedures include

- Transaction testing to ascertain the level of risk in the particular business area (e.g., private banking, payable upon proper identification programs (PUPID), nonresident alien accounts, international brokered deposits, foreign correspondent banking, and pouch activity) and to determine whether the bank is complying with its policies and procedures, including SAR and CTR filing requirements;
- Evaluation of the risks in a particular business line or in specific accounts and a determination as to whether the bank is adequately managing the risks;
- A selection of bank records to determine that its record-keeping processes are in compliance with the BSA.

For community banks (generally, total assets under $5 billion), examiners determine the examination scope based on the risks facing the institution. For low-risk banks, examiners evaluate changes to the bank's operations and review the bank's BSA/AML compliance program. For banks with higher-risk characteristics and weak controls, additional procedures are performed, including review of a sample of high-risk accounts and additional procedures set forth above. Examiners also perform periodic monitoring procedures between examinations and conduct follow-up activities when significant issues are identified.

Use of CTR and SAR Data in the Examination Process

All banks are required by regulation to report suspected crimes and suspicious transactions that involve potential money laundering or violate the BSA. In April 1996, the OCC, together with the other federal banking agencies, and FinCEN, unveiled the SAR system, SAR form, and database. This system provides law enforcement and regulatory agencies online access to the entire SAR database. Based upon the information in the SARs, law enforcement agencies may then, in turn, initiate investigations and, if appropriate, take action against violators. By using a universal SAR form, consolidating filings in a single location, and permitting electronic filing, the system greatly improves the reporting process and makes it more useful to law enforcement and to the regulatory agencies. As of December 2003, banks and regulatory agencies had filed over 1.3 million SARs, with national banks by far the biggest filers. Nearly 50 percent of these SARs were for suspected BSA/money-laundering violations.

The OCC also uses the SAR database as a means of identifying high-risk banks and high-risk areas within banks. Year-to-year trend information on the number of SARs and CTRs filed is used to identify banks with unusually low or high filing activity. This is one factor used by the OCC to identify high-risk banks. Examiners also review SARs and CTRs to identify accounts to include in the examination sample. Accounts where there have been repetitive SAR filings or accounts with significant cash activity in a high-risk business or inconsistent with the type of business might be accounts selected for the sample.

V. Riggs Bank Enforcement Actions

As previously mentioned, the OCC and FinCEN recently assessed a $25 million CMP against Riggs Bank, N.A., for violations of the BSA and its implementing regulations, and for failing to comply with the requirements of an OCC C&D order that was signed by the bank in July 2003. Also, in a separate C&D action dated May 13, 2004 to supplement the C&D we had issued in July 2003, the OCC directed the bank to take a number of steps to correct deficiencies in its internal controls, particularly in the BSA/AML area. Among other requirements in this separate action, the OCC directed the bank to

- Ensure competent management. Within 30 days, the board of directors must determine whether management or staff changes are needed and whether management skills require improvement.

- Develop a plan to evaluate the accuracy and completeness of the bank's books and records, and develop a methodology for determining that information required by the BSA is appropriately documented, filed, and maintained.

- Adopt and implement comprehensive written policies for internal controls applicable to the bank's account relationships and related staffing, including the Embassy and International Private Banking Group. Among other requirements, the policies must mandate background checks of all relationship managers at least every three years and must prohibit any employee from having signature authority, ownership or custodial powers for any customer account.

- Develop and implement a policy that permits dividend payments only when the bank is in compliance with applicable law and upon written notice to the OCC.

- Adopt and implement an internal audit program sufficient to detect irregularities in the bank's operation, determine its level of compliance with applicable laws and regulations and provide for testing to support audit findings, among other requirements.

These actions were based on a finding that the bank had failed to implement an effective AML program. As a result, the bank did not detect or investigate suspicious transactions and had not filed SARs as required under the law. The bank also did not collect or maintain sufficient information about its foreign bank customers. In particular, the OCC found a number of problems with the bank's account relationship with foreign governments, including Saudi Arabia and Equatorial Guinea. Riggs failed to properly monitor, and report as suspicious, transactions involving tens of million of dollars in cash withdrawals, international drafts that were returned to the bank, and numerous sequentially numbered cashier's checks. The OCC will continue to closely monitor the corrective action that the bank takes in response to the order and we are prepared to take additional actions if necessary.

These actions are the most recent of a series of escalating supervisory and enforcement reactions to ongoing deficiencies in Riggs' BSA/AML compliance program. Since this matter involves an open bank and open investigations, there are limitations on what can be said without disclosing confidential supervisory information and potentially compromising future criminal, civil, and administrative actions. With that caveat, we have tried to set out below a summary of our supervision of this institution in the BSA/AML area, dating back to 1997.

The OCC first identified deficiencies in Riggs' procedures several years ago. Beginning in the late 1990s we recognized the need for improved processes at Riggs and for improvements in the training in, and awareness of, the BSA's requirements and in the controls over their BSA processes. Prior to 9/11, the OCC visited the bank at least once a year and sometimes more often to either examine or review the Bank's BSA/AML compliance program.

Over this timeframe OCC examiners consistently found that Riggs' BSA compliance program was either "satisfactory" or "generally adequate," meaning that it met the minimum requirements of the BSA, but we nonetheless continued to identify weaknesses and areas of its program that needed improvement in light of the business conducted by the bank. We addressed these weaknesses using various informal, supervisory actions. Generally, this involved bringing the problems to the attention of bank management and the board and securing their commitment to take corrective action.

During this period, it was clear that the bank's compliance program needed improvement but we determined that the program weaknesses did not rise to the level of a violation of our regulation or pervasive supervisory concern. The OCC identified problems with the bank's internal audit coverage in this area, its internal monitoring processes, and its staff training on the BSA and customer due diligence requirements. Repeatedly, management took actions to address specific OCC concerns but, as is now clear, the corrective actions being taken often were not sufficient to achieve the intended results. The bank was continually taking steps to respond to OCC criticisms but failed to take action on its own to improve its overall compliance program, especially with regard to high-risk areas. Due to the lack of an effective and proactive management team, additional weaknesses and deficiencies were continually identified by the OCC over this time period, but bank follow-up on these weaknesses ultimately proved to be ineffective and the problems continued longer than they should have.

As various changes occurred in the regulatory expectations for banks relative to BSA compliance and related issues over this period of time, our scrutiny of the bank was adjusted accordingly. For example, when the Financial Action Task Force and FinCEN identified "uncooperative" countries, we conducted an examination at Riggs that specifically focused on account relationships with those countries and determined that the bank did not have extensive transaction activity with any of the countries on the list. In addition, Treasury issued its guidance on "politically exposed persons" in January 2001, and, as a result, the OCC's focus on the risks associated with the Riggs' embassy banking business began to increase and our supervisory activities were heightened ac-

cordingly. However, at that time, the Kingdom of Saudi Arabia was not viewed as a country that posed heightened risk of money laundering or terrorist financing, and Equatorial Guinea had just begun to reap the financial benefits of the discovery of large oil reserves in the mid-1990s.

After 9/11, the OCC escalated its supervisory efforts to bring Riggs' compliance program to a level commensurate with the risks that were undertaken by the bank and we believed that we were beginning to see some progress in this regard. In fact, the bank was beginning the process of a major computer system conversion that would address many of the shortcomings in the existing information systems that the bank was relying on. Unfortunately, bank management had to adjust the timeline repeatedly. This caused significant delays in the implementation date, pushing it from the original target of year-end 2002 to September 2003. Thus, the bank was not able to fulfill many of the commitments that it made to the OCC to correct our concerns pertaining to their BSA compliance program. Also, as previously mentioned, the OCC conducted a series of anti-terrorist financing reviews at our large or high-risk banks, including Riggs, in 2002. As a result of these reviews and other internal assessments, plus published accounts of suspicious money transfers involving Saudi Embassy accounts, our concerns regarding Riggs BSA/AML compliance were heightened. Thus, we commenced another examination of Riggs in January of 2003.

The focus of the January 2003 examination was on Riggs' embassy banking business, and, in particular, the accounts related to the Embassy of Saudi Arabia. Due to its Washington, D.C., location, its extensive retail branch network, and its expertise in private banking, Riggs found embassy banking to be particularly attractive and had developed a market niche. In fact, at one time, 95 percent of all foreign embassies in the United States., and 50 percent of the embassies in London conducted their banking business with Riggs. The OCC's examination lasted for approximately five months and involved experts in the BSA/AML area. The findings from the January 2003 examination formed the basis for the July 2003 C&D order entered into with the bank. The OCC also identified violations of the BSA that were referred to FinCEN.

During the course of the 2003 examination, the OCC cooperated extensively with investigations by law enforcement into certain suspicious transactions involving the Saudi Embassy relationship. These transactions involved tens of millions of dollars in cash withdrawals from accounts related to the Embassy of Saudi Arabia; dozens of sequentially numbered international drafts that totaled millions of dollars that were drawn from accounts related to officials of Saudi Arabia, and that were returned to the bank; and dozens of sequentially numbered cashier's checks that were drawn from accounts related to officials of Saudi Arabia made payable to the account holder. There was regular contact with the FBI investigators throughout this examination. We provided the FBI with voluminous amounts of documents and information on the suspicious transactions, including information concerning transactions at the bank that the FBI previously was not aware of. The OCC also hosted a meeting with the FBI to discuss these documents and findings. Throughout this process we provided the FBI with important expertise on both general banking matters and on some of the complex financial transactions and products that were identified.

The July 2003 C&D order directed the bank to take a number of steps to correct deficiencies in its internal controls in the BSA/AML area and to strongly consider staffing changes. Among other requirements in this action, the OCC directed the bank to

- Hire an independent, external management consultant to conduct a study of the bank's compliance with the BSA, including, training, SAR monitoring, and correcting deficiencies and conduct a risk assessment for compliance with the BSA throughout the bank.
- Evaluate the responsibilities and competence of management. In particular, the consultant's report to the board of directors must address, among other things, the responsibilities and competence of the bank's BSA officer and the capabilities and competence of the supporting staff in this area. Within 90 days, the board of directors must determine whether any changes are needed regarding the bank's BSA officer and staff;
- Adopt and implement detailed policies and procedures (including account opening and monitoring procedures) to provide for BSA compliance and for the appropriate identification and monitoring of high-risk transactions;
- Ensure effective BSA audit procedures and expansion of these procedures. Within 90 days the board of directors must review and evaluate the level of service and ability of the audit function for BSA matters provided by any auditor; and
- Ensure bank adherence to a comprehensive training program for all appropriate operational and supervisory personnel to ensure their awareness and their responsibility for compliance with the BSA.

The OCC began its next examination of the bank's BSA compliance in October 2003. The purpose of this examination was to assess compliance with the C&D order and the PATRIOT Act and to review accounts related to the embassy of Equatorial Guinea. It was clear from this examination that the bank had made progress in complying with the order and in improving its AML program. Another notable accomplishment was the successful implementation of the long-planned system upgrade that significantly improved the information available to bank staff and management to monitor account activity and identify suspicious activity. Notwithstanding, there were significant areas of noncompliance noted by our examination. The examiners found that, as with the Saudi Embassy accounts, the bank lacked sufficient policies, procedures and controls to identify suspicious transactions concerning the bank's relationship with Equatorial Guinea. These transactions involved millions of dollars deposited in a private investment company owned by an official of the country of Equatorial Guinea; hundreds of thousands of dollars transferred from an account of the country of Equatorial Guinea to the personal account of a government official of the country; and over a million dollars transferred from an account of the country of Equatorial Guinea to a private investment company owned by the bank's relationship manager. The findings from this examination, as well as previous examination findings, formed the basis for the OCC's recent CMP and C&D actions.

In retrospect, as we review our BSA/AML compliance supervision of Riggs during this period, we should have been more aggressive in our insistence on remedial steps at an earlier time. We also should have done more extensive probing and transaction testing of accounts. Our own BSA examination procedures called for transactional reviews in the case of high-risk accounts, such as those at issue here, yet until recently, that was not done at Riggs in the Saudi embassy and the Equatorial Guinea accounts. Clearly, the types of strong formal enforcement action that we ultimately took should have been taken sooner. This is not a case where the deficiencies in the bank's systems and controls were not recognized, nor was there an absence of OCC supervisory attention to those deficiencies. But we failed to sufficiently probe the transactions occurring in the bank's high-risk accounts and we gave the bank too much time, based on its apparent efforts to fix its own problems, before we demanded specific solutions, by specific dates, pursuant to formal enforcement actions. As described below, we have reevaluated our BSA/AML supervision processes in light of this experience and we will be implementing changes to improve how we conduct supervision in this area. I have also directed that our Quality Management Division undertake an internal review of our supervision of Riggs. These steps are outlined more fully below.

Improvements Undertaken to Improve BSA/AML Supervision

While we believe our overall supervisory approach to BSA/AML compliance has been rigorous and is working well, we are committed to ongoing evaluation of our approaches to BSA/AML compliance and to appropriate revisions to our approach in light of technological developments and the increasing sophistication of money launderers and terrorist financers, as well as to address aspects of the process where shortcomings were evidenced in the Riggs situation. Recent and current initiatives include the following:

- As previously mentioned, together with the other federal banking agencies, we recently developed revised examination procedures for several key sections of the PATRIOT Act and we expect to be issuing a revised version of our BSA *Handbook* booklet by the end of the year.

- We plan to develop our own database of national bank-filed SARs with enhanced search and reporting capabilities for use in spotting operational risk including in the BSA/AML area. This database will be compatible with the OCC's supervisory databases and will enable us to: (1) generate specialized reports merging SAR data with our existing supervisory data, (2) sort SAR information by bank asset size and line of business, and (3) provide enhanced word and other search capabilities.

- We are developing and will implement nationwide, a new risk assessment process to better identify high-risk banks. This system uses standardized data on products, services, customers, and geographies to generate reports that we will use to identify potential outliers, assist in the allocation of examiner resources, and target our examination scopes (e.g., particular products or business lines).

- We are exploring with FinCEN and the other agencies better ways to use BSA information in our examination process, so that we can better pinpoint risks and secure corrective action. Upon completion of FinCEN's BSA Direct initiative (currently under development), the OCC will have direct access, as opposed to dial-in access, to the SAR database. We expect that this direct access system will allow us to make better and more effective use of FinCEN's SAR database.

- We are also exploring how we can systematically capture BSA/AML criticisms in examination reports so that we can track situations where no follow-up formal action has been taken.

- Our Committee on Bank Supervision also has sent an alert to remind and reinforce for OCC examination staff the need to recognize accounts and transactions that appear to be anomalous or suspicious or that have other characteristics that should cause them to be considered high-risk in nature, and to conduct additional transaction testing and investigation in such situations.

In addition, specifically with regard to Riggs, I have directed our Quality Management Division to immediately commence a review and evaluation of our BSA/AML supervision of Riggs. This review will include an assessment of whether we took appropriate and timely actions to address any shortcomings found in the bank's processes and in its responses to matters noted by the examiners, and the extent and effectiveness of our coordination and interaction with other regulators and with law enforcement. I have also asked for recommendations for improvements to our BSA/AML supervision and our enforcement policy with regard to BSA/AML violations.

VI. Conclusion

The OCC is committed to preventing national banks from being used, wittingly or unwittingly, to engage in money laundering, terrorist financing or other illicit activities. We stand ready to work with Congress, the other financial institution regulatory agencies, the law enforcement agencies, and the banking industry to continue to develop and implement a coordinated and comprehensive response to the threat posed to the nation's financial system by money laundering and terrorist financing.

Remarks by Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, before the annual meeting of the Cleveland Neighborhood Housing Services, on banks and subprime mortgages, Cleveland, Ohio, June 15, 2004

All across America, when people talk about cities on the move, Cleveland, the "Comeback City," is among those mentioned. So when I get to come back, as I wish I could more often, it's not only a pleasure—it's an inspiration. My family traces to Ohio roots, and I spent many summers of my youth with my grandmother and other relatives who lived not far from Cleveland. I can still remember listening to Indians' games—and the heroics of Rocky Colavito-on the radio at night. It's always great to be back.

But it's really great to be back to see what Cleveland is today. The Cleveland renaissance serves as a reminder of what it takes to make such a turnaround happen. I was not surprised, looking over Mayor Campbell's latest "Cleveland 500,000-plus" quarterly report, to see the emphasis on two key requirements: partnerships and leadership. Cleveland has taken this one better. Here, civic, nonprofit, and business leaders have united with their colleagues from government to advocate for the city and its goals.

It's particularly gratifying as a representative of my agency, the Office of Comptroller of the Currency (OCC), which is the administrator of our country's system of nationally chartered banks, to see the names of so many national bankers among the city's partners in leadership. For bankers, as for all responsible business people, fostering a vibrant city is not only commendable, it's enlightened self-interest.

When it comes to delivering a vision that moves citizens from all walks of life, economic stations, and political persuasions, and brings them together in this great campaign of mutual uplift and municipal renewal, Cleveland has learned that many voices speak louder than one. With those many voices speaking as one in support of common goals, this is one city that's already a demonstrably "safer, smarter, and stronger" place than it was when Cleveland started on the long road back.

Leadership and partnerships also combine to make the Cleveland Neighborhood Housing Services (NHS) the outstanding organization it is today. We know what a crucial part the Neighborhood Reinvestment Corporation and its network of more than 200 community-based NeighborWorks affiliates, of which this is one, have played in the stabilization and rehabilitation of literally thousands of the nation's neighborhoods. We know what can be achieved when you bring together a broad array of residents, nonprofits, and public and private sector representatives in a multi-faceted program that targets the whole range of a community's problems.

I have the privilege of serving as the OCC's designate on the board of the Neighborhood Reinvestment Corporation's board of directors. And the OCC's Community Affairs Department also

reports to me in my capacity as the agency's chief counsel and first senior deputy comptroller. I take great personal satisfaction in the work of our Community Affairs Department and the support the OCC continues to provide to the NeighborWorks agenda in many ways.

As a further expression of that support, it gives me great pleasure today to introduce Norma Polanco, the OCC's newest Community Affairs officer. For the first time, the OCC will station one of our district community affairs officers right here in Cleveland, beginning on July 1. Norma joins Paul Ginger, who is based in Chicago, as our second Community Affairs officer in our Central District. Norma comes to the OCC after serving for six years as the founding executive director of the Humboldt Park Economic Development Corporation on Chicago's northwest side, where she specialized in developing financial literacy workshops and commercial revitalization initiatives. When you get to know her, I know you'll find Norma to be an enormous asset to the greater Cleveland community and region, our national bankers doing business here—and to the Cleveland NHS.

I mention the city and the city's NHS together, because, in a very real sense, your fortunes are inextricably linked. That should give everyone in this room an enormous sense of optimism. Under executive director Emily Lipovan Holan and her dedicated board of directors, the Cleveland NHS has developed a full and impressive range of services for low- and moderate-income home owners and prospective homeowners—pre-purchase education, counseling programs, home repair loans, down payment and closing cost loans, and more. I know that some of you here today would not be homeowners if this organization were not in the business of caring and helping. And Cleveland would be a less promising, less vibrant city than it is today.

But there's much work to be done—here and all across America.

The more than four million Americans who are direct beneficiaries of the productive partnerships between banks and NeighborWorks organizations and other housing community development corporations certainly represent a great accomplishment. Home ownership records are being set, and the gap in the homeownership rate between African Americans and Hispanics and the rest of our population is narrowing. Last year, nearly half of all minority households achieved the goal of home ownership. This promising achievement is the result of many factors, some of which I'll discuss a bit more fully in a moment.

And yet these gains are both incomplete and precarious. Incomplete, because while we have narrowed the minority home ownership gap, we have not erased it: minority home ownership still trails the national average by as much as 28 percentage points. Incomplete, because while national home ownership rates are at all time highs, for nearly a third of all Americans households, home ownership remains an elusive dream. And precarious, because predatory lending remains a cancer in many communities, and its terminal byproduct—epidemic foreclosure rates—can unravel all the good work and progress made to revitalize a neighborhood.

The frustrating part is that this unraveling is taking place in the face of determined eradication efforts on the part of community-based organizations, like this one, and their private-sector partners, including national banks and other regulated financial institutions, elected officials, and state and federal agencies.

And that leads to the challenging part—understanding why the problem is so tenacious and recognizing that we need to evolve our partnerships to bring to bear new tools and new approaches to beat it.

I think it's useful to step back and appreciate how the structure of the U.S. mortgage market has changed in recent decades and how profoundly that change affects the challenge we face.

People who haven't shopped for a mortgage in a while are sometimes startled to discover just how much the process has changed. Some of those changes-the ability to easily comparison shop rates and terms, to submit applications electronically via fax and the Internet, and to obtain commitments in days that might once have taken weeks or even months-are very visible. For most consumers, they're also most appreciated.

Other changes have been more of a mixed blessing from the customer's standpoint. Most mortgages today do not come from a locally headquartered bank or thrift, and securitization has overtaken deposit gathering as the source of funding for mortgage lending. The mortgage industry has become increasingly consolidated and increasingly dominated by large, high-volume, automated producers operating nationwide. None of these characteristics is bad. Indeed, size, speed and geographic diversity can translate in more product offerings, more competitive pricing, greater customer convenience, and better credit risk diversification.

But, it can also translate into a different—and transitory—relationship between the borrower and the originator of the borrower's mortgage. In fact, the originator may neither fund, nor hold, nor service a borrower's mortgage. Notably, according to a recent mortgage industry publication, over 62 percent of the subprime mortgage loans originated in 2002 were securitized, that is, they were not held in the lender's portfolio, but were sold to third parties to make up pools of loans, with securities representing interests in the pool sold to investors.

With the growth of secondary mortgage markets, and a declining share of all mortgage loans sourced by depository institutions and mortgage companies, loan originators themselves are less likely to be banks than correspondents or brokers. Indeed, the ranks of mortgage brokers and correspondents have increased dramatically. Based on one recent accounting, there were 44,000 mortgage brokers in 2002, compared to 7,000 in 1987. This should mean more competition and better rates and service for consumers. And if you're a prime customer, it usually does.

But in the subprime market, where the largest share of loans is originated by brokers, the story can be quite different. Indeed, some observers have described a dual mortgage delivery system, where some individuals—mostly poorer, older, or less sophisticated, and disproportionately

minority—often pay more for mortgages than their actual credit profile would warrant, do not so much "shop" for loans as they are "sold" loans, and who are therefore inordinately vulnerable to a range of abusive practices.

Don't get me wrong. I'm not suggesting there's anything inherently more abusive about broker-originated loans than any other kind. Indeed, as I've already mentioned, the rise of the subprime segment, in which brokers are key players, can be credited for much of what we've achieved of late in advancing home ownership, especially for minority Americans.

But, we need to recognize that there are a combination of ingredients at work here that can make for a toxic brew: subprime borrowers who may have limited credit options available and less sophistication about how to pursue those options and a dominant distribution network where mortgage originators are compensated, up front, through a share of fees charged the borrower, and where those originators have little or no expectation of any ongoing relationship with the borrower, such as by holding or servicing the loan. Recent studies do indicate that brokers have competing interests in getting loans funded and on collecting fees for their services, on the one hand, and in matching borrowers with the best available mortgage, with the best prospects for long term performance, on the other. And, as I noted earlier, as of recent years over 60 percent of subprime mortgage loans are securitized.

These structural shifts in the U.S. mortgage market have surely contributed to the challenge of eradicating predatory and abusive lending in our communities—challenges that NeighborWorks organizations all across the country are stepping up to meet. It's impossible to estimate how many new homeowners might have had no alternatives other than to obtain loans on unfair terms—or who might never have become homeowners at all—but for the success of NeighborWorks' Full-Cycle Lending approach, with its emphasis on financial counseling and financial literacy. Under the NeighborWorks Campaign for Home Ownership, thousands of homeowners are receiving help in managing their property and their finances, making it significantly less likely that they'll wind up as victims of predatory lending. But if they do, NeighborWorks organizations like the NHS right here in Cleveland, are providing workout and refinancing alternatives for borrowers through delinquency intervention programs.

But more needs to be done.

What can bankers do? Simply put: Don't be part of the problem, be part of the solution. On the first point, we expect national bankers to be following the formal guidance the OCC issued last year on the steps they should take and the factors they should consider to avoid becoming involved in abusive, predatory, unfair, or deceptive lending practices. With respect to purchased and brokered loans in particular, we emphasized that banks should have criteria for entering into and continuing relationships with intermediaries and originators, including due diligence requirements, and standards related to total compensation, including compensation of intermediaries,

such as maximum rates, points and other charges. We also emphasized the importance of management information systems and quality control reviews to verify conformity with the standards a bank has set.

There are opportunities here for us to work together to build on this guidance and enhance productive partnerships—as well as a whole range of new possibilities for organizations like the Cleveland NHS to increase its contribution to the fight against predatory lending.

One area in which you can help is in monitoring the behavior of mortgage originators and exposing those few who are responsible for soiling the reputation of many. You who work with victims of abusive lending know who these lenders are. And no one is in a better position than you to get that information out, to the state and federal agencies that regulate mortgage brokers and lenders, to mortgage industry data exchanges, and to regulated financial institutions, which need that information to ensure that they don't become unwitting accomplices of the abusive lenders by purchasing loans they have originated. And should a national bank ever be involved, you bet we want to hear about it.

And there is still more to do.

I talked about the changing structure of the mortgage market earlier in my remarks to provide a framework for the challenge we face, but that structure and the forces that led to it also may be a blueprint for approaches to some solutions. The dynamics and incentives inherent in today's mortgage market contribute to the problem we have, but they may also reflect techniques we should use to solve it.

For example, let's assume that there will always be some mortgage originators driven, not by the interests of their customers, but by the size of their fee, and let's assume also that there will be prospective borrowers with subprime credit qualifications, that seek out, or are sought out by those originators. I described this as a "toxic brew." Today, we try to regulate it. Consider also how to *compete with it.*

For example, thoughtful commentators have described, and community-based groups are pioneering, the concept of the "buyer's broker," to help potential borrowers shop for the right loan for them. This means reaching out—like the brokers do—to identify prospective borrowers, giving them a realistic reading of their credit risk profile, and helping to locate the best available loan for them. This requires community organizations to have accurate, dependable information on prospective borrowers, access to the automated tools used to evaluate their risk profile, and loan pricing information similar to the information that mortgage brokers receive. It means *competing* effectively to reach potential borrowers and get them the best deal available-which may be a subprime loan that reflects subprime rates, but which will *not* be a predatory loan.

It strikes me that this type of initiative is a natural for constructive collaboration between community organizations and banking institutions.

Community organizations also can *learn from* the structure of the mortgage banking business today. Ask yourself—are there opportunities for scale, scope, and automation in making available responsible subprime credit in your communities? How can subprime—nonpredatory—loan programs be designed and made available on a regional, or even national basis? Are there functions that you perform—but not in any unique way—that could be outsourced, so that your resources could be focused on the activities that you do uniquely well? Are there things you do well that you could do for others, such as smaller scale community organizations?

For example, some organizations have outsourced the origination and servicing operations of their community-based loan programs to third parties—thus saving overhead expenses—while a few others, with a more entrepreneurial touch, have chosen to create in-house state-of-the-art servicing operations of their own. Some of those now offer loan processing and servicing to other community loan programs, resembling the correspondent banking services relationships that exist in the banking industry among large institutions and smaller banks that they service.

Indeed, I am struck—and very encouraged—by how these initiatives resemble one of the most important and far-reaching trends that we have seen in the banking industry over the past decade. In a speech several years ago I called it "deconstruction" of the functions of the banking business. What I described was the separation or segmentation of banking products, services and operations into their component parts or processes so that they can be provided or obtained separately.

For example, a bank with a capacity for a particular function, such as loan servicing, may "export" that capacity by marketing it to other banks, while another bank might determine that it does not want to develop that capacity and would look for a bank from which it can "import" the function. Similarly, a bank may decide that it is important for its customers to have access to a broad range of products, but rather than producing those products itself, it will import the choices and give its customers access to products from other providers. This perspective enables a firm to play to its strengths; to commit resources to the particular processes it does best, and to gain access to skills, expertise, and products that it needs to be most effective and efficient.

Community organizations can learn from this experience—indeed, I would argue that they must—lest they use precious resources inefficiently, and try to combat modern market forces and modern techniques with strategies that worked in a previous era. Here again, bankers who know the modern mortgage marketplace and have utilized new techniques to contribute to the quality and efficiency of their operations would make natural partners for community organizations as they explore how to apply these perspectives to enhance their own organizations' operations.

So if I leave you with any one message, let it be a message of partnership. Community organizations, bankers, and bank regulators, don't always see eye-to-eye. But when the task is to restore and reinvigorate America's communities, we are shoulder to shoulder. We may bring different perspectives and different approaches to the mission, but partnerships built on that diversity lend strength to our efforts and can illuminate new paths to achieve our common goal.

The OCC is proud to be a participant in the revival of this great organization and the great city of Cleveland. It has been a real honor and personal pleasure to be here with you today, and I am deeply grateful to you for both.

Statement of Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, on regulatory burden relief, Washington, D.C., June 22, 2004

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 Shelby, Ranking Member Sarbanes, and members of the committee, I appreciate this opportunity to appear before you to discuss the challenge of reducing unnecessary regulatory burden on America's banking system. The Office of the Comptroller of the Currency (OCC) welcomes the opportunity to discuss this challenge and to offer suggestions for reforms, including some suggestions particularly affecting the national banking system. We also want to express appreciation to Senator Crapo for his commitment and dedication to this issue.

Imposition of unnecessary regulatory burdens is not simply an issue of bank costs. When unnecessary regulatory burdens drive up the cost of doing business for banks, bank customers feel the impact in the form of higher prices and, in some cases, diminished product choice. Unnecessary regulatory burden also can become an issue of competitive viability, particularly for our nation's community banks, where bankers face competitors that offer comparable products and services but are not subject to comparable regulatory requirements.

This is a challenge that we must confront on several levels. First, at the level of bank regulation, when regulators adopt regulations, and as we review the regulations we already have on the books, we have a responsibility to ensure that regulations are effective to protect safety and soundness, foster the integrity of bank operations, and safeguard the interests of consumers. We also have a responsibility to regulate efficiently, so that we do not impose regulatory burdens that are unnecessary to achieve those goals, and which then act as a drag on banks' efficiency and competitiveness. In the first portion of my testimony, I summarize initiatives the OCC has undertaken in the past decade, and the efforts in which we are currently involved on an interagency basis, to review and revise regulations to reduce unnecessary regulatory burdens stemming from our rules.

Second, there are regulatory burden reduction initiatives that must come from Congress in the form of federal *legislation*—adding provisions to law to provide new flexibilities, modifying requirements to be less burdensome, and in some cases, eliminating certain requirements currently in the law altogether. This hearing today is a crucial stage in that process, and we and the other witnesses you will hear from have a number of suggestions to offer. My testimony will highlight

several of the OCC's priority recommendations, and an appendix to my testimony contains a more extensive set of suggestions.

Finally, it is important to recognize that many of the areas that are often identified as prospects for regulatory burden reduction involve requirements put in place by Congress for the protection of consumers. Over the years, those requirements have accreted, and in the disclosure area, in particular, consumers receive disclosures so voluminous and so technical that many simply don't read them-or when they do, don't understand them. At some point as we continue our efforts to address regulatory burdens, we are going to run out of discrete fixes to make and face more fundamental questions about basic approaches. If we were to undertake that task, and do it responsibly, we need much better data on the costs resulting from particular regulatory requirements, and the benefits of that requirement—particularly relative to other approaches that might be used to achieve Congress' goals—than we have now. I would urge the committee to consider what sort of information and analysis would need to be assembled as a foundation for such an undertaking.

Regulatory Initiatives to Address Regulatory Burden

The OCC constantly reviews its regulations to identify opportunities to streamline regulations or regulatory processes, while still ensuring that the goals of protecting safety and soundness, ensuring the integrity of bank operations, and safeguarding the interests of consumers are met. In the mid 1990s, pursuant to our "Regulation Review" project, we went through every regulation in our rulebook with that goal in mind. We have since conducted several supplemental reviews focused on particular areas where we thought further improvements could be made.

With respect to regulatory processes, the OCC recently adopted a final rule that allows national banks to file licensing applications electronically, utilizing the agency's new electronic filing system, called e-Corp. This ruling materially reduces the paperwork burden on national banks and achieves greater efficiency in the OCC's regulatory processes.

The OCC, together with the banking agencies, the Federal Trade Commission, Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission also have undertaken an effort to simplify the privacy notices to consumers required under the Gramm–Leach–Bliley Act (GLBA). The agencies asked for comments on whether to consider amending their privacy regulations to allow, or require, financial institutions to provide alternative types of privacy notices, such as a short-form privacy notice, that would be more consumer friendly and easier for consumers to understand and banks to implement. The agencies also asked commenters to provide sample privacy notices that they believe work well for consumers, and to provide the results of any consumer testing that has been conducted in this area. We also will be conducting a series of focus groups with consumers to find out—from them—what sort of information they find most meaningful, and the most effective way to disclose it to them. This project has the potential to be a win-win for consumers and financial institutions—more effective and meaningful disclosures for consumers, and reduced burden on institutions to produce and distribute privacy notices.

We are also active participants and supporters of the regulatory burden reduction initiative being led by Vice Chairman Reich of the Federal Deposit Insurance Corporation (FDIC). Under Vice Chairman Reich's capable and dedicated leadership, the federal banking agencies currently are conducting the 10-year regulatory review required under section 2222 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA). Section 2222 requires the Federal Financial Institutions Examination Council and each federal banking agency to conduct a review of all regulations every 10 years to identify outdated, unnecessary regulatory requirements. The current review period ends in September 2006.

As part of the EGRPRA process, the banking agencies have broken out their regulations into twelve categories. The agencies have agreed to ask for public comments every six months on the regulations in one or more of these categories throughout the review period. To date, the agencies have issued two joint notices for public comment and are about to put out a third. Each of the comments received is being carefully reviewed and will be considered in formulating the agencies' recommendations for specific regulatory changes that also will be published for public comment.

Moreover, in addition to soliciting written comments, the federal banking agencies, in conjunction with the Conference of State Bank Supervisors and state regulatory agencies, held five banker outreach meetings last year in different cities so that the regulators could hear first-hand the bankers' concerns and suggestions to reduce burden.[1] These meetings were so well attended and successful that at least three more are being held this year. In addition, we held a consumer and community groups outreach meeting earlier this year in the Washington, D.C., area and we have tentative plans to hold two more meetings in other locations.

The agencies are making every effort to ensure that there is ample opportunity for consumers and the industry to participate in this process. I would like to thank Vice Chairman Reich for his work on this important project and his efforts to make sure that our review is as comprehensive and encompassing of as many different viewpoints as possible.

Moreover, as you know, section 2222 of EGRPRA recognizes that some of the changes suggested by the public comments may require legislative changes and cannot be appropriately addressed through a regulatory amendment. Thus, the banking agencies have been discussing jointly recommending certain legislative changes to reduce burden that have been raised by commenters as part of the EGRPRA process and we welcome the opportunity to make further suggestions.

[1] During the EGRPRA outreach sessions held by the interagency working group, some bankers also identified the requirements under the current privacy regulations as a significant burden.

OCC Support for Regulatory Burden Relief Legislation

The results that Congress can achieve by removing or reducing regulatory burden imposed by federal statutes can be broader and more far-reaching than regulatory changes that we can make under the current law. My testimony will highlight some of the important items that the OCC believes will reduce regulatory burden on our banking system and will benefit consumers. We have highlighted other changes that the OCC believes will significantly enhance safety and soundness. These and other suggestions are discussed in more detail in an appendix to my testimony.[2]

National Banks

Repealing State Opt-In Requirements for De Novo Branching. As both national and state banks seek to establish branch facilities to enhance service to customers, a change that would reduce burden would be to repeal the state opt-in requirement that applies to banks that choose to expand interstate by establishing branches de novo. Under the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994, interstate expansion through bank mergers generally is subject to a state “opt-out” that had to be in place by June 1, 1997. Under the time frames in the statute, interstate bank *mergers* are now permissible in all 50 states. De novo branching, however, is permissible only in those approximately 17 states that have affirmatively opted-in to allow the establishment of new branches in the state. In many cases in order to serve customers in multistate metropolitan areas or regional markets, banks must, under current law, structure artificial and unnecessarily expensive transactions in order to establish a new branch across a state border. Enactment of this recommended amendment would relieve these unnecessary and costly burdens on the industry.

Providing Relief for Subchapter S National Banks. Another priority item supported by the OCC is an amendment that would allow directors of national banks that are organized as Subchapter S corporations to purchase subordinated debt instead of capital stock to satisfy the directors’ qualifying shares requirements in national banking law. As a result, the directors purchasing such debt would not be counted as shareholders for purposes of the 75-shareholder limit that applies to Subchapter S corporations. This relief would make it possible for more community banks with national bank charters to organize in Subchapter S form while still requiring that such national bank directors retain their personal stake in the financial soundness of these banks.

Simplifying Dividend Calculations for National Banks. Under current law, the formula for calculating the amount that a national bank may pay in dividends is both complex and antiquated and unnecessary for purposes of safety and soundness. The amendment supported by the OCC

[2] Many of the suggested changes that we discuss are included in H.R. 1375, the Financial Services Regulatory Relief Act of 2004, as passed by the House on March 18, 2004. However, we also are recommending some new amendments that were not part of the House-passed bill and have identified these new provisions in the appendix.

would make it easier for national banks to perform this calculation, while retaining safeguards in the current law that provide that national banks (and state member banks)[3] need the approval of the Comptroller (or the Federal Reserve Board (FRB) in the case of state member banks) to pay a dividend that exceeds the current year's net income combined with any retained net income for the preceding two years. The amendment would ensure that the OCC (and the FRB for state member banks) would continue to have the opportunity to deny any dividend request that may deplete the net income of a bank that may be moving towards troubled condition. Other safeguards, such as Prompt Corrective Action, which prohibit any insured depository institution from paying any dividend if, after that payment, the institution would be undercapitalized (see 12 USC 1831o(d)(1)) would remain in place.

Resolving Ambiguities About Federal Court Diversity Jurisdiction. Also among our priority items is an amendment that would provide a single-state citizenship rule for national banks and other federally chartered depository institutions for purposes of determining federal court diversity jurisdiction. Under this uniform rule, a federally chartered depository institution, *i.e.,* a national bank or a federal savings association, would be a citizen only of the state in which it has its main office. Our suggested amendment would apply comparable treatment to national banks and federal thrifts. Both national banks and federal thrifts are federally chartered and neither is incorporated under the laws of any state. Providing more certainty on this issue would reduce burden and costs on national banks and federal thrifts.

Modernizing Corporate Governance. The OCC also supports an amendment that would eliminate a requirement in current law that precludes a national bank from prescribing, in its articles of association, the method for election of directors that best suits its business goals and needs. Unlike most other companies and state banks, national banks cannot choose whether or not to permit cumulative voting in the election of their directors. Instead, current law *requires* a national bank to permit its shareholders to vote their shares cumulatively. Providing a national bank with the authority to decide for itself whether to permit cumulative voting in its articles of association would conform the National Bank Act to modern corporate codes and provide a national bank with the same corporate flexibility available to most corporations and state banks.

Modernizing Corporate Structure Options. Another amendment that is strongly supported by the OCC is an amendment to national banking law clarifying that the OCC may permit a national bank to organize in any business form, in addition to a "body corporate." An example of an alternative form of organization that may be permissible would be a limited liability national association, comparable to a limited liability company. The provision also would clarify that the OCC by regulation may provide the organizational characteristics of a national bank operating in

[3] *See* 12 USC 324 and 12 CFR 208.5 generally applying the national bank dividend approval requirements to state member banks.

an alternative form, consistent with safety and soundness. Except as provided by these organizational characteristics, all national banks, notwithstanding their form of organization, would have the same rights and privileges and be subject to the same restrictions and enforcement authority.

Such an amendment would allow a national bank to choose the business form that is most consistent with the banks' business plans and would, thus, improve the efficiency of a national bank's operations. For example, if the OCC should permit a national bank to organize as a limited liability national association, this may be a particularly attractive option for community banks. The bank may then be able to take advantage of the pass-through tax treatment for comparable entities organized as limited liability companies (LLCs) under certain tax laws and eliminate double taxation under which the same earnings are taxed both at the corporate level as corporate income and at the shareholder level as dividends. Some states currently permit state banks to be organized as unincorporated LLCs and the FDIC adopted a rule allowing certain state bank LLCs to qualify for federal deposit insurance. This amendment would clarify that the OCC can permit national banks to organize in an alternative business form, such as an LLC, in the same manner.

Paying Interest on Demand Deposits. The OCC supports amendments to the banking laws to repeal the statutory prohibition that prevents banks from paying interest on demand deposits. The prohibition on paying interest on demand deposits was enacted approximately 70 years ago for the purpose of deterring large banks from attracting deposits away from community banks. The rationale for this provision is no longer true today and financial product innovations, such as sweep services, allow banks and their customers to avoid the statutory restrictions. Repealing this prohibition would reduce burden on consumers, including small businesses, and reduce costs associated with establishing such additional accounts to avoid the restrictions.

Federal Branches and Agencies of Foreign Banks.

The OCC also licenses and supervises federal branches and agencies of foreign banks. Federal branches and agencies generally are subject to the same rights and privileges, as well as the same duties, restrictions, penalties, liabilities, conditions and limitations and laws that apply to national banks. Thus, federal branches and agencies will benefit equally from legislation that would reduce burden on national banks. Branches and agencies of foreign banks, however, also are subject to other requirements under the International Banking Act of 1978 (IBA) that are unique to their organizational structure and operations in the U.S. as an office of a foreign bank. In this regard, the OCC is recommending amendments to reduce certain unnecessary burdens on federal branches and agencies while preserving national treatment with national banks.

Implementing Risk-Based Requirements for Federal Branches and Agencies. A priority item for the OCC is an amendment to the International Banking Act of 1978 to allow the OCC to set the capital equivalency deposit (CED) for federal branches and agencies to reflect their risk profile. We support an amendment that would allow the OCC, after consultation with the Federal Financial Institutions Examination Council, to adopt regulations setting the CED on a risk-based

institution-by-institution basis. This approach would closely resemble the risk-based capital framework that applies to both national and state banks.

Agency Operations

Improving Ability to Obtain Information from Regulated Entities. Another item that we recommend be adopted is an amendment that would permit all of the federal banking agencies-the OCC, FDIC, Office of Thrift Supervision (OTS), and the Federal Reserve Board-to establish and use advisory committees in the same manner. Under current law, only the Board is exempt from the disclosure requirements under the Federal Advisory Committee Act (FACA). The OCC, FDIC, and OTS, however, also supervise insured depository institutions and these institutions and their regulators have the same need to share information and to be able to conduct open and frank discussions about important supervisory and policy issues without fear of information being withheld because it must be publicly disclosed. Because of the potentially sensitive nature of this type of information, the public meeting and disclosure requirements under FACA could inhibit the supervised institutions from providing the OCC, FDIC, or OTS with their candid views. Our amendment would enhance the free exchange of information between all depository institutions and their federal bank regulators with resulting safety and soundness benefits.

Safety and Soundness

The OCC also supports a number of amendments that would promote and maintain the safety and soundness and facilitate the ability of regulators to address and resolve problem situations.

Enforcing Written Agreements and Commitments. The OCC supports an amendment that would expressly authorize the federal banking agencies to enforce written agreements and conditions imposed in writing in connection with an application or when the agency imposes conditions as part of its decision not to disapprove a notice, e.g., a Change in Bank Control Act (CBCA) notice.

Such a provision would overturn recent federal court decisions that conditioned the agencies' authority to enforce such conditions or agreements with respect to a nonbank party to the agreement on a showing that the nonbank party was "unjustly enriched." This change will enhance the safety and soundness of depository institutions and protect the deposit insurance funds from unnecessary losses.

Barring Convicted Felons From Participating in the Affairs of Depository Institutions. The OCC also supports an amendment to the banking laws that would give the federal banking agencies the authority to prohibit a person convicted of a crime involving dishonesty, breach of trust, or money laundering from participating in the affairs of an uninsured national or state bank or uninsured branch or agency of a foreign bank without the consent of the agency. Under current law, the ability to keep these "bad actors" out of depository institutions applies only to insured depository institutions.

Ensuring That Accountants of Insured Depository Institutions Are Held to the Same Standard as Any Other Institution-Affiliated Party. Under current law, independent contractors for insured depository institutions are treated more leniently under the enforcement provisions in the banking laws than are directors, officers, employees, controlling shareholders, or even agents for the institution or shareholders, consultants, and joint venture partners who participate in the affairs of the institution (institution-affiliated parties (IAP)). To establish that an independent contractor, such as an accountant, has the type of relationship with the insured depository institution that would allow a federal banking agency to take action against the accountant for a violation of law, breach of fiduciary duty, or an unsafe or unsound banking practice, the banking agency must show that the accountant "knowingly and recklessly" participated in such a violation. This standard is so high that it is extremely difficult for the banking agencies to take enforcement actions against accountants and other contractors who engage in wrongful conduct. The OCC supports removing the "knowing and reckless" requirement to hold independent contractors to a standard that is more like the standard that applies to other IAPs.

Strengthening the Supervision of Stripped-Charter Institutions. The OCC supports an amendment to the CBCA to address issues that have arisen for the banking regulators when a stripped-charter institution (i.e., an insured bank that has no ongoing business operations because, for example, all of the business operations have been transferred to another institution) is the subject of a change-in-control notice. The agencies' primary concern with such CBCA notices is that the CBCA is sometimes used as a way to acquire a bank with deposit insurance without submitting an application for a *de novo* charter and an application for deposit insurance even though the risks presented by the two transactions may be substantively identical. In general, the scope of review of a *de novo* charter application or deposit insurance application is more comprehensive than the statutory grounds for denial of a notice under the CBCA. There also are significant differences between the application and notice procedures. In the case of an application, the banking agency must affirmatively approve the request before a transaction can be consummated. Under the CBCA, if the federal banking agency does not act to disapprove a notice within certain time frames, the acquiring person may consummate the transaction. To address these concerns, the OCC supports an amendment that (1) would expand the criteria in the CBCA that allow a federal banking agency to extend the time period to consider a CBCA notice so that the agency may consider business plan information, and (2) would allow the agency to use that information in determining whether to disapprove the notice.

Conclusion

Mr. Chairman, on behalf of the OCC, I thank you for your leadership in holding these hearings. As I have indicated, the OCC supports initiatives that will reduce unnecessary burden on the industry in a responsible manner. We believe that the changes outlined in my testimony today will further these objectives. We would be pleased to work with you and your staff on these issues.

Appendix

Summary of the Regulatory Burden Relief Legislation Supported by the Office of the Comptroller of the Currency

National Banks

Repealing State Opt-In Requirements for De Novo Branching. The OCC supports amending section 5155(g) of the Revised Statutes of the United States (12 USC 36(g)), section 18(d)(4) of the Federal Deposit Insurance Act (FDIA) (12 USC 1828(d)(4)), section 9 of the Federal Reserve Act (FRA) (12 USC 321), and section 3(d)(1) of the Bank Holding Company Act (BHCA) (12 USC 1842(d)(1)) to ease certain restrictions on banks' interstate banking and branching. Under the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle–Neal Act), an out-of-state national or state bank may establish a de novo branch in a state only if that state has adopted legislation affirmatively "opting in" to de novo branching. This amendment would repeal the requirement that a state expressly must adopt an "opt-in" statute to permit the de novo branching form of interstate expansion. The amendment also would repeal the state age requirement for interstate mergers. The Riegle-Neal Act permits a state to prohibit an out-of-state bank or bank holding company from acquiring an in-state bank unless the state bank has been in existence for a minimum period of time (which may be as long as five years).

Under the Riegle–Neal Act, interstate expansion through bank mergers generally is subject to a state "opt-out" that had to be in place by June 1, 1997. While two states "opted out" at the time, interstate bank mergers are now permissible in all 50 states. By contrast, de novo *branching* by banks requires states to pass legislation to affirmatively "opt-in" to permit out-of-state banks to establish new branches in the state. This requires banks in many cases to structure artificial and unnecessarily expensive transactions in order for a bank to simply establish a new branch across a state border. However, federal thrifts are not similarly restricted and generally may branch interstate without the state law "opt-in" requirements that are imposed on banks. Also, repeal of the state age requirement would remove a limitation on bank acquisitions by out-of-state banking organizations that is no longer necessary if interstate de novo branching is permitted.

Enactment of this amendment should enhance competition in banking services with resulting benefits for bank customers. Moreover, it will ease burdens on banks that are planning interstate expansion through branches and would give banks greater flexibility in formulating their business plans and in making choices about the form of their interstate operations.

Providing Relief for Subchapter S National Banks. The OCC supports amending section 5146 of the Revised Statutes of the United States (12 USC72) to provide more flexible requirements regarding director qualifying shares for national banks operating, or seeking to operate, as Subchapter S corporations. The National Banking Act currently requires all directors of a national bank to own "shares of the capital stock" of the bank having an aggregate par value of at least $1,000, or an equivalent interest, as determined by the Comptroller, in a bank holding company that controls

the bank. This amendment would permit the Comptroller to allow the use of a debt instrument that is subordinated to the interests of depositors, the Federal Deposit Insurance Corporation (FDIC), and other general creditors to satisfy the qualifying shares requirement for directors of national banks seeking to operate in Subchapter S status.

The requirement in current law creates difficulties for some national banks that operate in Subchapter S form. It effectively requires that all directors be shareholders, thus making it difficult or impossible for some banks to comply with the 75-shareholder limit that defines eligibility for the benefit of Subchapter S tax treatment, which avoids double tax on the bank's earnings. Such a subordinated debt instrument would have features resembling an equity interest, since the directors could only be repaid if all other claims of depositors and nondeposit creditors of the bank were first paid in full, including the FDIC's claims, if any. It would thus ensure that directors retain their personal stake in the financial soundness of the bank. However, the holding of such an instrument would not cause a director to be counted as a shareholder for purposes of Subchapter S.

Resolving Ambiguities in Federal Court Jurisdiction. The OCC supports amending chapter three of title LXII of the Revised Statutes of the United States (12 USC 81, et seq.) to provide that, in determining whether a federal court has diversity jurisdiction over a case in which a national bank is a party, a national bank is considered to be a citizen only of the state in which the bank has its main office. Other versions of this proposal have provided the single-state rule only for federal savings associations. The OCC supports expanding these versions to include national banks, as well as federal thrifts. National banks, like federal thrifts, are chartered by the federal government and not by any state. As a result, national banks also have been subject to differing court rulings on their citizenship status for purposes of diversity jurisdiction. There is no reason to have this unique, special citizenship rule only for federally chartered thrift institutions. It makes sense to treat all federally chartered depository institutions the same and end the confusion.

National banks' diversity jurisdiction is governed by 28 USC 1348. This statute provides that generally national banks are "citizens" of the states in which they are "located." The term "located" is not defined in section 1348 and the federal courts have not defined the term consistently. For example, in 2001, a U.S. Circuit Court concluded that a national bank is "located" in and a citizen of the state of its principal place of business and the state listed in its organization certificate. *See Firstar Bank, N.A. v. Faul,* 253 F.3d 982 (U.S. Court of Appeals for the 7th Circuit 2001) *(Firstar).* This circuit court opinion has created some confusing issues for national banks. The state listed in a national bank's organization certificate may not necessarily be the state in which the national bank currently has its main office. Under federal law, a national bank can relocate its main office to a state other than that designated in its organization certificate.[4] However, no new organization certificate would need to be issued. After such a relocation, it is possible that

[4] 12 USC 30.

the national bank may no longer have any offices in the state listed in its organization certificate. Under Firstar, however, the bank would continue to be deemed a citizen of that state for diversity purposes because it is the state listed in its organization certificate.

Courts generally have followed the *Firstar* decision since it was issued. However, more recently other courts have held that a national bank is "located" in the state where it has its principal place of business *and* in the state specified in its *articles of association. See RDC Funding Corp. v. Wachovia Bank, N.A.,* No. 3:03cv1360 (JBA), 2004 U.S. Dist. LEXIS 5524 (U.S. District Court for the District of Connecticut, March 31, 2004); *Evergreen Forest Products of Georgia v. Bank of America,* 262 F. Supp. 2d 1297, 1306-07 (U.S. District Court for the Middle District of Alabama 2003). Under these cases, because a national bank's articles of association must be updated to reflect the bank's current main office, the articles of association and *not* the bank's organization certificate should be used to determine citizenship status in diversity cases. However, even under this interpretation, a national bank also could potentially be a citizen of two states but a different criterion is used to identify one of the two states.

The OCC's suggested amendment would resolve these ambiguities and provide relief to national banks, as well as federal thrifts. It would provide a clear uniform rule for determining the citizenship of all federally chartered depository institutions and put into place a simple, single-state rule.

The amendment recommended by the OCC is a new provision and was not included in the House-passed version of H.R. 1375, the Financial Services Regulatory Relief Act of 2004 (FSRRA).

Modernizing Corporate Governance. The OCC supports amending section 5144 of the Revised Statutes of the United States (12 USC 61). Section 5144 imposes mandatory cumulative voting requirements on all national banks. This law currently requires that, in all elections of national bank directors, each shareholder has the right to (1) vote for as many candidates as there are directors to be elected and to cast the number of votes for each candidate that is equal to the number of shares owned, or (2) cumulate his or her votes by multiplying the number of shares owned by the number of directors to be elected and casting the total number of these votes for only one candidate or allocating them in any manner among a number of candidates. The OCC support an amendment that would permit a national bank to provide in its articles of association the method of electing its directors that best suits its business goals and needs and would provide the OCC with authority to issue regulations to carry out the purposes of this section.

The Model Business Corporation Act and most states' corporate codes provide that cumulative voting is optional. The amendment recommended by the OCC would conform this provision of the National Bank Act to modern corporate codes and would provide national banks with the same corporate flexibility available to most state corporations and state banks.

Modernizing Corporate Structure Options. The OCC supports amending the *Revised Statutes of the United States* (12 USC 21 et seq.) to clarify the Comptroller's authority to adopt regulations

allowing national banks to be organized in different business forms. Notwithstanding the form of organization, however, generally all national banks would continue to have the same rights and be subject to the same restrictions and requirements except to the extent that different treatment may be appropriate based on the different forms of organization. Many of the requirements in the National Bank Act are based on a national bank having stock and shareholders. It is expected that the Comptroller will apply these requirements in a comparable manner to other authorized organizational forms except as warranted by the differences in form.

The OCC's suggested amendment would reduce burden on national banks and allow them to choose among different business organizational forms, as permitted by the Comptroller, and to select the form that is most consistent with the their business plans and operations so that they may operate in the most efficient manner. Certain alternative business structures may be particularly attractive for community banks. For example, if the Comptroller should permit a national bank to be organized as a limited liability national association and establish the characteristics of such a national bank, the bank then may be able to take advantage of the pass-through tax treatment for comparable limited liability entities under certain tax laws and eliminate double taxation under which the same earnings are taxed both at the corporate level as corporate income and at the shareholder level as dividends.

Some states currently permit state banks to be organized as unincorporated limited liability companies (LLCs) and the FDIC recently adopted a rule that will result in certain state bank LLCs being eligible for federal deposit insurance. Clarifying that national banks also may be organized in alternative business forms would provide a level playing field.

Paying Interest on Demand Deposits. The OCC supports repealing section 19(i) of the FRA (12 USC 371a), section 5(b)(1)(B) of the Home Owners' Loan Act (HOLA) (12 USC 1464(b)(1)(B)) and section 18 of the FDIA (12 USC 1828) to permit member banks, thrifts, and nonmember banks, respectively, to pay interest on demand deposits. In a joint report submitted to Congress in September 1996, the OCC, along with the other federal banking agencies, concluded that the statutory prohibition against the payment of interest on demand deposits no longer serves a useful public purpose. *See Joint Report: Streamlining of Regulatory Requirements* (September 23, 1996). Because banks can pay interest on NOW accounts held by individuals, it is primarily business checking accounts that are subject to prohibition on paying interest on demand deposits. Banks, however, find ways around this prohibition for their business customers through such financial products as sweep accounts that sweep excess demand deposits into money market investments. These programs are costly for the banks to maintain, an inefficient use of the banks' resources, and an unnecessary burden on business customers to establish such accounts.

Simplifying Dividend Calculations for National Banks. The OCC supports amending section 5199 of the *Revised Statutes of the United States* (12 USC 60) to simplify the formula for calculating the amount that a national bank may pay in dividends. The current law requires banks to follow a complex formula that is unduly burdensome and unnecessary for safety and soundness. The

proposed amendment would retain certain safeguards in the current law that provide that national banks (and state member banks)[5] need the approval of the Comptroller (or the FRB in the case of state member banks) to pay a dividend that exceeds the current year's net income combined with any retained net income for the preceding two years. For purposes of the approval requirement, these federal regulators would retain the authority to reduce the amount of a bank's "net income" by any required transfers to funds, such as a sinking fund for retirement of preferred stock.

The amendment would reduce burden on banks in a manner that is consistent with safety and soundness. Among other things, the amendment would ensure that the OCC (and the FRB for state member banks) would continue to have the opportunity to deny any dividend request that may deplete the net income of a bank that may be moving towards troubled condition. Importantly, the amendment would not affect other safeguards in the National Bank Act (12 USC 56). These provisions generally prohibit national banks from withdrawing any part of their permanent capital or paying dividends in excess of undivided profits except in certain circumstances.

Moreover, other safeguards, such as Prompt Corrective Action, have been enacted in the last ten years that provide additional safety and soundness protections for all insured depository institutions. The proposed amendment would not affect the applicability of these safeguards. These additional safeguards prohibit any insured depository institution from paying any dividend if, after that payment, the institution would be undercapitalized (see 12 USC 1831o(d)(1)).

Repealing Obsolete Limitations on the OCC's Removal Authority. The OCC supports amending section 8(e)(4) of the FDIA (12 USC 1818(e)(4)) relating to the procedures for the removal of an institution-affiliated party from office or participation in the affairs of an insured depository institution. With respect to national banks, current law requires the OCC to certify the findings and conclusions of an administrative law judge to the FRB for the FRB's determination as to whether any removal order will be issued. This amendment would repeal this certification and FRB approval process and allow the OCC directly to issue the removal order with respect to national banks.

The present system stems from historical decisions made by Congress on circumstances that are no longer applicable. Originally, the role of the OCC in removal cases was to certify the facts of the case to the FRB. The FRB then made the decision to pursue the case and made the final agency decision. At that time, the Comptroller was a member of the FRB and, therefore, participated in the FRB's final removal decision. However, Congress later removed the Comptroller from the FRB and gave the OCC the authority directly to issue suspensions and notices of intention to remove.

All of the federal banking agencies, except the OCC, may remove a person who engages in certain improper conduct from the banking business. This amendment would give the Comptrol-

[5] *See* 12 USC 324 and 12 CFR 208.5 generally applying the national bank dividend approval requirements to state member banks.

ler the same removal authority as the other banking agencies to issue orders to remove persons who have been determined under the statute to have, for example, violated the law or engaged in unsafe or unsound practices in connection with an insured depository institution. Like the other banking agencies, the Comptroller should make these decisions about persons who engage in improper conduct in connection with the institutions for which the Comptroller is the primary supervisor. This is a technical change to streamline and expedite these actions and has no effect on a person's right to seek judicial review of any removal order. The FRB also supports this amendment.

Repealing Obsolete Intrastate Branch Capital Requirements. The OCC supports amending section 5155(c) of the Revised Statutes of the United States (12 USC 36(c)) to repeal the requirement that a national bank, in order to establish an intrastate branch office in a state, must meet the capital requirements imposed by the state on state banks seeking to establish intrastate branches.

This technical amendment would repeal the obsolete capital requirement for the establishment of intrastate branches by national banks. This requirement is not necessary for safety and soundness. Branching restrictions are already imposed under other provisions of law to limit the operations of a bank if it is in troubled condition. See 12 USC 1831o(e) (prompt corrective action).

Clarifying the Waiver of Publication Requirements for Bank Merger Notices. The OCC supports amending sections 2(a) and 3(a)(2) of the National Bank Consolidation and Merger Act (12 USC 215(a) and 215a(a)(2), respectively) concerning the newspaper publication requirement of a shareholder meeting to vote on a consolidation or merger of a national bank with another bank located within the same state. This change would clarify that the publication requirement may be waived by the Comptroller in the case of an emergency situation or by unanimous vote of the shareholders of the national or state banks involved in the transaction.

This amendment does not affect other requirements in the law. The current law also requires that the consolidation or merger must be approved by at least a 2/3 vote of the shareholders of each bank involved in the transaction. In addition, the shareholders of the banks generally must receive notice of the meeting by certified or registered mail at least ten days prior to the meeting. These provisions are not changed.

Repealing Obsolete References to the Main Place of Business of a National Bank. The OCC supports amending two sections of the *Revised Statutes of the United States* (12 USC 22 and 81) to replace obsolete language that is used in these two sections with the modern term "main office."

The change to 12 USC 22 would clarify that the information required to be included in a national bank's organization certificate is the location of its *main office*. The change of 12 USC 81 would clarify that the general business of a national bank shall be transacted in its *main office* and in its branch or branches. Both statutes currently use obsolete terms to describe a main office of a national bank.

Deleting Obsolete Language in the National Bank Act. The OCC supports amending section 5143 of the Revised Statues of the United States (12 USC 59) to delete obsolete language. Generally, 12 USC 59 permits a national bank to reduce its capital and distribute cash or other assets to its shareholders that become available as a result of the reduction if approved by a vote of two-thirds of its shareholders and by the OCC. The current statute, however, also references two obsolete provisions. The first provision limits the amount of the capital reduction to a "sum not below the amount required by this chapter to authorize the formation of associations." This limitation refers to the obsolete minimum capital requirement for a de novo institution that was provided under 12 USC 51; however, 12 USC 51 was repealed in 2000 by the American Homeownership and Economic Opportunity Act of 2000, Pub. L. No. 106-569, Title XII, 1233(c). The second obsolete provision limits the amount of a bank's capital that can be reduced to the "amount required for its outstanding circulation." The reference to "outstanding circulation" relates to the obsolete practice by national banks of issuing circulating notes to serve as currency.

This amendment would delete the obsolete language in the statute but would maintain the current relevant requirement that a national bank cannot reduce its capital and distribute assets to its shareholders unless approved by two-thirds of its shareholders and by the OCC.

This amendment is a new provision and was not included in the House-passed version of the FSSRA.

Safety and Soundness

Enforcing Written Agreements and Commitments. The OCC supports amending the FDIA (12 USC 1811, et seq.) to add a new section that provides that the federal banking agencies may enforce the terms of (1) conditions imposed in writing in connection with an application, notice, or other request, and (2) written agreements.

This amendment would enhance the safety and soundness of depository institutions and protect the deposit insurance funds from unnecessary losses. This amendment is intended to reverse some court decisions that question the authority of the agencies to enforce such conditions or agreements against institution-affiliated parties (IAP) without first establishing that the IAP was unjustly enriched. In addition, the amendment would clarify that a condition imposed by a banking agency in connection with the nondisapproval of a notice, e.g., a notice under the Change in Bank Act (CBCA), can be enforced under the FDIA.

Barring Convicted Felons From Participating in the Affairs of Depository Institutions. The OCC supports amending section 19 of the FDIA (12 USC 1829) to give the federal banking agencies the authority to prohibit a person convicted of a crime involving dishonesty, breach of trust, or money laundering from participating in the affairs of an uninsured national or state bank or uninsured branch or agency of a foreign bank without the consent of the agency. Under current law, the ability to keep these bad actors out of depository institutions applies only to insured deposito-

ry institutions. The OCC believes that this amendment would help to enhance the safe and sound operations of uninsured, as well as insured, institutions.

Ensuring That Accountants of Insured Depository Institutions Are Held to the Same Standard as Other IAPs. The OCC supports amending section 3(u)(4) of the FDIA (12 USC 1813(u)(4)) to remove the "knowing and reckless" requirement. This change would hold independent contractors to a standard that is more like the standard that applies to other IAPs. Under current law, independent contractor IAPs are treated more leniently under the enforcement provisions in the banking laws than are directors, officers, employees, controlling shareholders, or even agents for the institution or shareholders, consultants, and joint venture partners who participate in the affairs of the institution. To establish that an independent contractor, such as an accountant, has the type of relationship with the insured depository institution that would allow a federal banking agency to take action against the accountant as an IAP for a violation of law, breach of fiduciary duty, or an unsafe or unsound banking practice, the banking agency must show that the accountant "knowingly and recklessly" participated in such a violation. This amendment would strike the "knowing and reckless" requirement.

The knowing and reckless standard in the current law is so high that it is extremely difficult for the banking agencies to take enforcement actions against accountants and other contractors who engage in wrongful conduct. The amendment will strengthen the agencies' enforcement tools with respect to accountants and other independent contractors.

This amendment is a new provision and is not included in the House-passed version of the FSSRA.

Strengthening the Supervision of Stripped-Charter Institutions. The OCC supports amending the CBCA in section 7(j) of the FDIA (12 USC 1817(j)) to expand the criteria to allow a federal banking agency to extend the time period to consider a CBCA notice. Under the CBCA, a federal banking agency must disapprove a CBCA notice within certain time frames or the transaction may be consummated. Initially, the agency has up to 90 days to issue a notice of disapproval. The agency may extend that period for up to an additional 90 more days if certain criteria are satisfied and this amendment provides for new criteria that would allow an agency to extend the time period under this additional up to 90-day period. The new criteria that an agency could use to extend the time period can provide the agency more time to analyze the future prospects of the institution or the safety and soundness of the acquiring party's plans to sell the institution or make changes in its business operations, corporate structure, or management. Moreover, the amendment would permit the agencies to use that information as a basis to issue a notice of disapproval.

The OCC believes that this amendment will address issues that have arisen for the banking regulators when a stripped-charter institution (i.e., an insured bank that has no ongoing business operations because, for example, all of the business operations have been merged into another institution) is the subject of a CBCA notice. The agencies' primary concern with such CBCA

notices is that the CBCA is sometimes used as a way to acquire a bank with deposit insurance without submitting an application for a de novo charter and an application for deposit insurance.

In general, the scope of review of a de novo charter application or deposit insurance application is more comprehensive than the statutory grounds for the denial of a notice under the CBCA. There are also significant differences between the application and notice procedures. In the case of an application, the banking agency must affirmatively approve the request before a transaction can be consummated. Under the CBCA, if the federal banking agency does not act to disapprove a notice within certain time frames, the acquiring person may consummate the transaction. In the case of a CBCA notice to acquire a stripped-charter institution, acquirers are effectively buying a bank charter without the requirement for prior approval and without the scope of review that the law imposes when applicants seek a new charter, even though the risks presented by the two sets of circumstances may be substantively identical. The recommended amendment would expand the criteria in the CBCA that allows a federal banking agency to extend the time period to consider a CBCA notice so that the agency may consider the acquiring party's business plans and the future prospects of the institution and use that information in determining whether to disapprove the notice.

Providing a Statute of Limitations for Judicial Review of Appointment of a Receiver for a National Bank. The OCC supports amending section 2 of the National Bank Receivership Act (12 USC 191) to provide for a 30-day period to judicially challenge a determination by the OCC to appoint a receiver for a national bank. Current law generally provides that challenges to a decision by the OTS to appoint a receiver or conservator for an insured savings association or the FDIC to appoint itself as receiver or conservator for an insured state depository institution must be raised within 30 days of the appointment. 12 USC 1464(d)(2)(B), 1821(c)(7). There is, however, no statutory limit on a national bank's ability to challenge a decision by the OCC to appoint a receiver of an insured or uninsured national bank.[6] As a result, the general six-year statute of limitations for actions against the United States applies to the OCC's receiver appointments. *See James Madison, Ltd. v. Ludwig,* 82 F.3d 1085 (U.S. Court of Appeals for the 1st Circuit. 1996).

The six-year protracted time period under current law severely limits the OCC's authority to manage insolvent national banks that are placed in receivership by the agency and the ability of the FDIC to wind up the affairs of an insured national bank in a timely manner with legal certainty. (In the case of an insured national bank that is placed in receivership by the OCC, the FDIC must be appointed the receiver.) The recommended amendment would make the statute of limitations governing the appointment of receivers of national banks consistent with the time period that generally applies to other depository institutions. The amendment would not affect a national bank's ability to challenge a decision by the OCC to appoint a receiver, but simply require that these

[6] Under current law, there is a 20-day statute of limitations for challenges to the OCC's decision to appoint a *conservator* of a national bank. 12 USC 203(b)(1).

challenges must be brought in a timely manner and during the same time frame that generally applies to other depository institutions.

Allocating Examiner Resources More Efficiently. The OCC supports amending section 10(d) of the FDIA (12 USC 1820(d)) to provide that an appropriate federal banking agency may make adjustments in the examination cycle for an insured depository institution if necessary for safety and soundness and the effective examination and supervision of insured depository institutions. Under current law, insured depository institutions must be examined by their appropriate federal banking agencies at least once during a 12-month period in a full-scope, on-site examination unless an institution qualifies for the 18-month rule. Small insured depository institutions with total assets of less than $250 million and that satisfy certain other requirements may be examined on an 18-month basis rather than a 12-month cycle. The amendment would permit the banking agencies to make adjustments in the scheduled examination cycle as necessary for safety and soundness.

Such an amendment would give the appropriate federal banking agencies the discretion to adjust the examination cycle of insured depository institutions to ensure that examiner resources are allocated in a manner that provides for the safety and soundness of insured depository institutions. For example, as deemed appropriate by a federal banking agency, a well-capitalized and well-managed bank's examination requirement for an annual or 18-month examination could be extended if the agency's examiners were needed to immediately examine troubled or higher-risk institutions. This amendment would permit the agencies to use their resources in the more efficient manner.

Enhancing the Ability of Banking Agencies to Suspend or Remove Bad Actors From Depository Institutions. The OCC supports amending section 8(g) of the FDIA (12 USC 1818(g)) to clarify that the appropriate federal banking agency may suspend or prohibit IAPs charged or convicted with certain crimes (including those involving dishonesty, breach of trust, or money laundering) from participating in the affairs of any depository institution and not only the institution with which the party is or was last affiliated. The amendment also would clarify that the section 8(g) authority applies even if the IAP is no longer associated with the depository institution at which the offense allegedly occurred or if the depository institution with which the IAP was associated is no longer is existence. Moreover, the amendment would allow the banking agency to suspend or remove an individual who attempts to become involved in the affairs of an insured depository institution after being charged with a covered crime. It makes little sense to allow the agencies to suspend or remove a person who is charged with such a crime while serving at an insured depository institution, but deny the agencies the ability to remove a person that becomes affiliated with an insured depository institution while under indictment for the same type of crime.

Under current law, if an IAP is charged with such a crime, the suspension or prohibition will remain in effect until the charge is finally disposed of or until terminated by the agency. If the individual is convicted of such a crime, the party may be served with a notice removing the party from office and prohibiting the party for further participating in the affairs of a depository in-

stitution without the consent of the appropriate federal banking agency.[7] Before an appropriate federal banking agency may take any of these actions under section 8(g), the agency must find that service by the party may pose a threat to interests of depositors or impair public confidence in a depository institution. The statute further provides that an IAP that is suspended or removed under section 8(g) may request a hearing before the agency to rebut the agency's findings. Unless otherwise terminated by the agency, the suspension or order of removal remains in effect until the hearing or appeal is completed. Current law, however, applies only to the depository institution with which the IAP is then associated. This amendment will help to ensure that, if a federal banking agency makes the required findings, the agency has adequate authority to suspend or prohibit an IAP charged with such crimes from participating in the affairs of any depository institution if any of the various circumstances described above should occur.

The amendment that the OCC supports is more comprehensive and covers more circumstances under which an IAP who is charged with such a crime may be suspended or removed than the amendment to section 8(g) that is included in the House-passed version of the FSSRA.

Federal Branches and Agencies of Foreign Banks

Implementing Risk-Based Requirements for Federal Branches and Agencies. The OCC supports an amending section 4(g) of the International Banking Act of 1978 (12 USC 3102(g)) concerning the Comptroller's authority to set the amount of the capital equivalency deposit (CED) for a federal branch or agency. The CED is intended to ensure that assets will be available in the U.S. for creditors in the event of liquidation of a U.S. branch or agency. The current CED statute that applies to foreign banks operating in the U.S. through a federal license may impose undue regulatory burdens without commensurate safety and soundness benefits. These burdens include obsolete requirements about where the deposit must be held and the amount of assets that must be held on deposit. As a practical matter, the IBA sets the CED at 5percent of total liabilities of the federal branch or agency and provides that the CED must be maintained in such amount as determined by the Comptroller. As a result, federal branches and agencies often must establish a CED that is larger than the capital that would be required for a bank of corresponding size or for a similar size state-chartered foreign branch or agency in major key states.

The OCC recommends that section 4(g) be amended to allow the OCC, after consultation with the federal Financial Institutions Examination Council (FFIEC), to adopt regulations allowing the CED to be set on a risk-based institution-by-institution basis. Such an approach would more closely parallel the risk-based capital framework that applies to national and state banks. The Federal Reserve Board has no objections to the OCC's amendment.

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[7] Under another provision of the FDIA, any person convicted of any crime involving dishonesty, breach of trust, or money laundering may not, among other things, become or continue as an IAP with respect to any insured depository institution without the prior consent of the FDIC. 12 USC 1829. As discussed above, the OCC also supports amending section 1829 to apply to uninsured, as well as insured, depository institutions and to give the OCC the authority to keep these convicted felons out of uninsured national banks or federal branches or agencies.

This amendment is a new provision and was not included in the House-passed version of the FSSRA.

Allowing the Option for a Federal Representative Office License. The OCC supports amending section 4 of the IBA (12 USC 3102) to permit the OCC to license federal representative offices. Representative offices of foreign banks generally engage in representational functions. They do not engage in core banking activities, such as accepting deposits or lending money. Although the IBA sought to provide foreign banks with a federal option for their U.S. offices by giving the OCC the authority to license federal branches and agencies, it did not provide the OCC with the authority to establish federal representative offices. In this respect, the IBA does not fully implement the dual banking option, nor does it advance the goal of national treatment for foreign banks seeking to establish a representative office in the United States.

The absence of a federal representative office option has in some cases resulted in additional regulatory burden for those foreign banks that would want to have their entire U.S. operations under a federal license. If foreign banks with an existing federal branch or agency want to have a representative office, they are required to establish them under state law provisions, and thus gain another U.S. regulator (the state).

The amendment supported by the OCC would provide foreign banks with the option of establishing federal representative offices with OCC approval and under the OCC's supervision. Specifically, it would authorize the OCC to approve the establishment of a representative office, provided that state law does not prohibit this establishment. In acting on an application to establish a federal representative office, the OCC generally would apply the same criteria that it applies when it acts on federal branch or agency applications.

The amendment also would provide that the OCC would have the authority to regulate, supervise, and examine representative offices that it licenses. Finally, to ensure that the OCC has adequate authority to enforce this provision, the proposal would amend section 3(q) of the FDI Act to include a federal representative office as an entity for which the Comptroller serves as the appropriate federal banking agency and, would further amend the FDI Act to clarify that representative offices are subject to the enforcement authority of the Federal Reserve and OCC under 12 USC 1818.

This amendment would not affect or in any way diminish the Federal Reserve's authority under current law to approve (in addition to the primary, or licensing, authority) the establishment of foreign banks' U.S. offices (federal- or state-licensed branches, agencies, or representative offices) and to examine any of these entities under the IBA. Moreover, the Federal Reserve would have the same ability to recommend to the OCC that the license of a federal representative office be terminated that it has under current law to recommend that the license of a federal branch or agency be terminated.

This amendment is a new provision and was not included in the House-passed version of the FSSRA.

Providing Equal Treatment for Federal Agencies of Foreign Banks. The OCC supports amending section 4(d) of the IBA (12 USC 3102(d)) to provide that the prohibition on uninsured deposit-taking by federal agencies of foreign banks applies only to deposits from U.S. citizens or residents. As a result, a federal agency would be able to accept uninsured foreign source deposits from non-U.S. citizens. State agencies of foreign banks may accept uninsured deposits from parties who are neither residents nor citizens of the United States, if so authorized under state law. However, due to slight language differences in the IBA, the D.C. Circuit Court of Appeals has held that federal agencies cannot accept any deposits, including those from noncitizens who reside outside of the United States. *Conference of State Bank Supervisors v. Conover,* 715 F.2d 604, 623 (U.S. Court of Appeals for the First Circuit 1983).

The amendment supported by the OCC would allow federal agencies to accept the limited uninsured foreign source deposits that state agencies may accept under the IBA. As a result, the amendment would repeal an unnecessary regulatory burden that has competitively disadvantaged federal agencies and prevented them from offering the same services to foreign customers that may be offered by state agencies. Because these deposits are not insured, this amendment does not pose any risks to the deposit insurance fund.

Maintaining a Federal Branch and a Federal Agency in the Same State. The OCC supports an amendment to section 4(e) of the IBA (12 USC 3102(e)) to provide that a foreign bank is prohibited from maintaining both a federal agency and a federal branch in the same state only if state law prohibits maintaining both an agency and a branch in the state. Current law prohibits a foreign bank from operating both a federal branch and a federal agency in the same state notwithstanding that state law may allow a foreign bank to operate both types of offices.

According to the legislative history of the current provision, this prohibition was included in the IBA to maintain parity with state operations. However, today some states permit foreign banks to maintain both a branch and agency in the same state. Florida law permits a foreign bank to operate more than one agency, branch, or representative office in Florida (see Fla. Stat. Ann. 663.06). Other states, such as Connecticut, also may permit a foreign bank to have both a state branch and a state agency (see Conn. Gen. Stat. Ann. 36a-428). This amendment would repeal an outdated regulatory burden in current law and permit a foreign bank to maintain both a federal branch and a federal agency in those states that do not prohibit a foreign bank from maintaining both of these offices. This change would enhance national treatment and give foreign banks more flexibility in structuring their U.S. operations.

Information Sharing

Improving Information Sharing With Foreign Supervisors. The OCC supports amending section 15 of the IBA (12 USC 3109) to add a provision that ensures that the FRB, OCC, and FDIC cannot be compelled to disclose information obtained from a foreign supervisor if public disclosure of this information would be a violation of foreign law and the U.S. banking agency obtained the information pursuant to an information-sharing arrangement with the foreign supervisor or other procedure established to administer and enforce the banking laws. The banking agency, however, cannot use this provision as a basis to withhold information from Congress or to refuse to comply with a valid court order in an action brought by the United States or the agency.

This amendment would provide assurances to foreign supervisors that the banking agencies cannot be compelled to disclose publicly confidential supervisory information that the agency has committed to keep confidential, except under the limited circumstances described in the amendment. This authority is similar to the authority provided to the Securities and Exchange Commission under the securities laws (15 USC 78q(h)(5)). Some foreign supervisors have been reluctant to enter into information-sharing agreements with U.S. banking agencies because of concerns that the U.S. agency may not be able to keep the information confidential and public disclosure of the confidential information provided could subject the supervisor to a violation of its home country law. This amendment will be helpful to ease those concerns and will facilitate information-sharing agreements that enable U.S. and foreign supervisors to obtain necessary information to supervise institutions operating internationally.

Improving Ability to Obtain Information from Regulated Entities. The OCC supports amending the FDIA (12 USC 1811, et seq.) to permit the OCC, FDIC, Fed, and OTS to establish and use advisory committees in the same manner. All of these agencies have the same need to be able to conduct open and frank discussions with the banking industry and other members of the public about a variety of supervisory, policy, and consumer issues. Moreover, frequently, the banking agencies are discussing the same issues with industry and public officials.

In particular, given the significant changes occurring in the structure of the banking system and the way banks deliver products and services, the agencies need the ability to efficiently-and quickly-keep abreast of these changes and how they will impact the continuing ability of banks to be responsive to customer and community needs. Because of the potentially sensitive nature of information about these issues, any public meeting requirements could inhibit the banking agencies from obtaining frank, open, and candid advice from industry and community representatives and the customers the banks serve.

The Federal Advisory Committee Act (5 USC App.) (FACA) generally requires that the meetings of advisory committees must be open to the public, and that advance notice of a committee meeting must be published in the *Federal Register.* The minutes of the meeting and all working papers and other documents prepared for or by the advisory committee also must be publicly available. Under current law, the Federal Reserve System is exempt from FACA. However, all of the other

federal banking agencies must follow FACA's procedures and requirements when establishing or using committees to provide advice or recommendations to the agency relating to their supervisory responsibilities.

This amendment, which is recommended by the OCC and FDIC, would ensure that all of the other federal banking agencies can benefit from the same free exchange of information with the banks and others that currently only is available to the Federal Reserve System. The amendment would permit the OCC, FDIC, and OTS also to establish and use committees to provide advice and recommendations with respect to safety and soundness, product and service developments and delivery, and consumer issues affecting supervised institutions without concerns that confidential information will be publicly disclosed. Moreover, by enhancing the free exchange of information between banks and all federal bank regulators, the amendment further strengthens the safety and soundness of insured depository institutions.

This amendment is a new provision and was not included in the House-passed version of the FSSRA.

Improving Information Sharing. The OCC supports amending the FDIA (12 USC 1811, et seq.) to provide that a federal banking agency has the discretion to furnish any confidential supervisory information, including a report of examination, about a depository institution or other entity examined by the agency to another federal or state supervisory agency and to any other person deemed appropriate.

Such an amendment would give the other federal banking agencies parallel authority to share confidential information that was given to the FRB in section. 727 of the Gramm-Leach-Bliley Act (GLBA). This provision is discretionary and nothing in this provision would compel a banking agency to disclose confidential supervisory information that it has agreed to keep confidential pursuant to an information-sharing or other agreement with another supervisor.

Other Recommendations

Reducing Reporting Burdens Relating to Insider Lending Reporting. The OCC supports amending section 22(g) of the Federal Reserve Act (12 USC 375a) and section 106(b)(2) of the Bank Holding Company Act Amendments of 1970 (12 USC 1972(2)) to eliminate certain reporting requirements concerning loans made to insiders. Specifically, the reports that would be eliminated are (1) the report that must be filed with a bank's board of directors when an executive officer of the bank obtains certain types of loans from another bank that exceeds the amount the officer could have obtained from his or her own bank, (2) the supplemental report a bank must file with its quarterly call report identifying any loans made to executive officers during the previous quarter, and (3) an annual report filed with a bank's board of directors by its executive officers and principal shareholders regarding outstanding loans from correspondent banks.

Nothing in these amendments affects the insider lending restrictions that apply to national banks or the OCC's enforcement of those restrictions. Moreover, the OCC believes that it will continue to have access to sufficient information during the examination process to review a national bank's compliance with the insider lending laws. Under the OCC's regulations, national banks are required to follow the FRB's regulations regarding insider lending restrictions and reporting requirements (see 12 CFR 31.2). The FRB's regulations require member banks to maintain detailed records of all insider lending. In addition, the OCC has the authority under 12 USC 1817(k) to require any reports that it deems necessary regarding extensions of credit by a national bank to any of its executive officers or principal shareholders, or the related interests of such persons.

Providing an Inflation Adjustment for the Small Depository Institution Exception under the Depository Institution Management Interlocks Act (DIMIA). The OCC supports amending section 203(1) of DIMIA (12 USC 3202(1)). Under current law, generally a management official may not serve as a management official of any other nonaffiliated depository institution or depository institution holding company if (1) their offices are located or they have an affiliate located in the same metropolitan statistical area (MSA), or (2) the institutions are located in the same city, town, or village, or a city, town, or village that is contiguous or adjacent thereto. For institutions of less than $20 million in assets, the standard metropolitan statistical area (SMSA) restriction does not apply. The amendment would increase the current $20 million exemption to $100 million. The OCC supports this amendment. This $20 million cap has not been amended since the current law was originally enacted in 1978. However, the asset size of FDIC-insured commercial banks between 1976 and 2000 has increased over five fold. Depository institutions of all sizes will continue to be subject to the city, town, or village test.

Streamlining Depository Institution Merger Application Requirements. The OCC supports amending the Bank Merger Act (BMA) (12 USC 1828(c)) to provide that the responsible agency in a merger transaction, which is generally the federal banking agency that has the primary regulatory responsibility for the resulting bank, must request a competitive factors report only from the attorney general, with a copy to the FDIC. Under current law, this report must be requested from all of the other federal banking agencies but the other agencies are not required to file a report. This amendment would appropriately streamline the agencies' procedures in processing BMA transactions.

Shortening of the Post-Approval Antitrust Review Period. The OCC supports amending section 11(b)(1) of the BHCA (12 USC 1849(b)(1)) and section 18(c)(6) of the BMA (12 USC 1828(c)(6)) to permit the shortening of the post-approval waiting period for certain bank acquisitions and mergers. Under current law, the post-approval waiting period generally is 30 days from the date of approval by the appropriate federal banking agency. The waiting period gives the attorney general time to take action if the attorney general determines that the transaction will have a significant adverse effect on competition. The waiting period under both the BHCA and BMA, however, may be shortened to 15 days if the appropriate banking agency and the attorney general

agree that no such effect on competition will occur. The proposed amendment would shorten the mandatory 15-day waiting period to five days.

The amendment would give the banking agency and the Attorney General more flexibility to shorten the post-approval waiting period as appropriate for those transactions that do not raise competitive concerns. If such concerns exist, the 30-day waiting period will continue to apply. This change will not affect the waiting periods for transactions that involve bank failures or emergencies. In those cases, the statute already provides for other time frames.

This amendment is a new provision and was not included in the House-passed version of the FSSRA.

Statement of Daniel P. Stipano, Deputy Chief Counsel, before the U.S. House of Representatives Subcommittee on Oversight and Investigations, Committee on Financial Services, on the OCC's anti-money-laundering activities, Washington, D.C., June 2, 2004

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.

I. INTRODUCTION

Chairwoman Kelly, Ranking Member Gutierrez, members of the subcommittee, I appreciate the opportunity to appear before you today to discuss the challenges we at the Office of the Comptroller of the Currency (OCC)—and other financial institution regulators—face in combating money laundering in the U.S. financial system, and how we are meeting those challenges. I will also address the enforcement actions in this area we have recently taken against Riggs Bank, N.A.

As the regulator of national banks, the OCC has long been committed to the fight against money laundering. For more than 30 years, the OCC has been responsible for ensuring that the banks under its supervision have the necessary controls in place and provide requisite notices to law enforcement to assure that those banks are not used as vehicles to launder money for drug traffickers or other criminal organizations. The tragic events of 9/11 have brought into sharper focus the related concern of terrorist financing. Together with the other federal banking agencies, the banking industry and the law enforcement community, the OCC shares the subcommittee's goal of preventing and detecting money laundering, terrorist financing, and other criminal acts and the misuse of our nation's financial institutions.

The cornerstone of the federal government's anti-money-laundering (AML) efforts is the Bank Secrecy Act (BSA). Enacted in 1970, the BSA is primarily a record-keeping and reporting statute that is designed to ensure that banks and other financial institutions provide relevant information to law enforcement in a timely fashion. The BSA has been amended several times, most recently through passage of the USA PATRIOT Act in the wake of the 9/11 tragedy. Both the Secretary of the Treasury, through the Financial Crimes Enforcement Network (FinCEN), and the federal banking agencies have issued regulations implementing the BSA, including regulations requiring all banks to have a BSA compliance program and to file reports such as suspicious activity reports (SARs) and currency transaction reports (CTRs).

Due to the sheer volume of financial transactions processed through the U.S. financial system, primary responsibility for compliance with the BSA and the AML statutes rests with the nation's financial institutions themselves. The OCC and the other federal banking agencies are charged with ensuring that the institutions we supervise have strong AML programs in place to identify

and report suspicious transactions to law enforcement and that such reports are, in fact, made. Thus, our supervisory processes seek to ensure that banks have systems and controls in place to prevent their involvement in money laundering and that they provide the types of reports to law enforcement that the law enforcement agencies, in turn, need in order to investigate suspicious transactions that are reported.

To accomplish our supervisory responsibilities, the OCC conducts regular examinations of national banks and federal branches and agencies of foreign banks in the United States. These examinations cover all aspects of the institution's operations, including compliance with the BSA. Our resources are concentrated on those institutions, and areas within institutions, of highest risk. In cases of noncompliance, the OCC has broad investigative and enforcement authority to address the problem.

Unlike other financial institutions, which have only recently become subject to compliance program and SAR filing requirements, banks have been under such requirements for years. For example, banks have been required to have a BSA compliance program since 1987 and have been required to file SARs (or their predecessors) since the 1970s. Not surprisingly, most banks today have strong AML programs in place, and many of the largest institutions have programs that are among the best in the world. There are now approximately 1.3 million SARs in the centralized database that is maintained by FinCEN. While the PATRIOT Act further augmented the due diligence and reporting requirements for banks in several key areas, one of its primary objectives was to impose requirements on nonbanking institutions that had long been applicable to banks.

The OCC's efforts in this area do not exist in a vacuum. We have long been active participants in a variety of interagency working groups that include representatives of the Treasury Department, law enforcement, and the other federal banking agencies. We also work closely with the FBI and other criminal investigative agencies, providing them with documents, information, and expertise on a case-specific basis. In addition, when we are provided with lead information from a law enforcement agency, we use that information to investigate further to ensure that BSA compliance systems are adequate.

We continue to work to improve our supervision in this area, and we are constantly revising and adjusting our procedures to keep pace with technological developments and the increasing sophistication of money launderers and terrorist financers. For example, along with the other federal banking agencies, the OCC recently developed examination procedures to implement several key sections of the PATRIOT Act, and we expect to be issuing a revised version of our BSA *Handbook* booklet by yearend. We have also recently initiated two programs that will provide stronger and more complete analytical information to assist our examiners in identifying banks that may have high money-laundering risk. Specifically, we are developing a database of national bank-filed SARs with enhanced search and reporting capabilities, and we also are developing and will implement nationwide a new risk assessment process to better identify high-risk banks. Addi-

tionally, we are exploring with FinCEN and the other banking agencies better ways to use BSA information in our examination process to better identify risks and vulnerabilities in the banking system.

Recent events surrounding Riggs Bank, N.A., have heightened interest in how the banking agencies, and the OCC in particular, conduct supervision for BSA/AML compliance. Together with FinCEN, the OCC recently assessed a record $25 million civil money penalty (CMP) against Riggs Bank, N.A. The OCC also imposed a supplemental cease-and-desist (C&D) order on the bank, requiring the institution to strengthen its controls and improve its processes in the BSA/AML area. Along with the C&D order we issued against the bank in July 2003, these and other actions we have taken have greatly reduced the bank's current risk profile.

However, with the benefit of hindsight, it is clear that the supervisory actions that we previously took against the bank were not sufficient to achieve satisfactory and timely compliance with the BSA, that more probing inquiry should have been made into the bank's high-risk accounts, and that stronger, more forceful enforcement action should have been taken sooner. While we do not believe that Riggs is representative of the OCC's supervision in the BSA/AML area, we are nonetheless taking a number of steps to guard against a repeat of this type of situation. In this regard, the Comptroller has directed that our Quality Management Division commence a review and evaluation of our BSA/AML supervision of Riggs and make recommendations to him on several issues concerning our approach to and the adequacy of our BSA/AML supervision programs generally and particularly with respect to Riggs.

II. BACKGROUND AND LEGAL FRAMEWORK

In 1970 Congress passed the Currency and Foreign Transactions Reporting Act, otherwise known as the Bank Secrecy Act, which established requirements for record keeping and reporting by private individuals, banks, and other financial institutions. The BSA was designed to help identify the source, volume, and movement of currency and other monetary instruments into or out of the United States or being deposited in financial institutions. The statute sought to achieve that objective by requiring individuals, banks, and other financial institutions to create a paper trail by keeping records and filing reports of certain financial transactions and of unusual currency transfers. This information then enables law enforcement and regulatory agencies to pursue investigations of criminal, tax, and regulatory violations.

The BSA regulations require all financial institutions to submit various reports to the government. The most common of these reports are (1) FinCEN Form 104 (formerly IRS Form 4789)—Currency Transaction Report (CTR) for each payment or transfer by, through, or to a financial institution, which involves a transaction in currency of more than $10,000; and (2) FinCEN Form 105 (formerly Customs Form 4790)—Report of International Transportation of Currency or Monetary Instruments (CMIR) for each person who physically transports monetary instruments in an aggregate amount exceeding $10,000 into or out of the United States. Bank supervisors are not re-

sponsible for investigating or prosecuting violations of criminal law that may be indicated by the information contained in these reports; they are, however, charged with assuring that the requisite reports are filed timely and accurately.

The Money-Laundering Control Act of 1986 precludes circumvention of the BSA requirements by imposing criminal liability for a person or institution that knowingly assists in the laundering of money or who structures transactions to avoid reporting. It also directed banks to establish and maintain procedures reasonably designed to assure and monitor compliance with the reporting and record-keeping requirements of the BSA. As a result, on January 27, 1987, all federal bank regulatory agencies issued essentially similar regulations requiring banks to develop procedures for BSA compliance. The OCC's regulation requiring that every national bank maintain an effective BSA compliance program is set forth at 12 CFR 21.21 and is described in more detail below.

Together, the BSA and the Money-Laundering Control Act charge the bank regulatory agencies with

- Overseeing banks' compliance with the regulations described, which direct banks to establish and maintain a BSA compliance program;
- Requiring that each examination includes a review of this program and describes any problems detected in the agencies' report of examination; and
- Taking C&D actions if the agency determines that the bank has either failed to establish the required procedures or has failed to correct any problem with the procedures, which was previously cited by the agency.

The Annunzio–Wylie Anti-Money-Laundering Act, which was enacted in 1992, strengthened the sanctions for BSA violations and the role of the Treasury Department. It contained the following provisions:

- A so-called "death penalty" sanction, which authorized the revocation of the charter of a bank convicted of money laundering or of a criminal violation of the BSA
- An authorization for Treasury to require the filing of suspicious-transaction reports by financial institutions
- The grant of a "safe harbor" against civil liability to persons who report suspicious activity
- An authorization for Treasury to issue regulations requiring all financial institutions, as defined in BSA regulations, to maintain "minimum standards" of an AML program.

Two years later, Congress passed the Money-Laundering Suppression Act, which primarily addressed Treasury's role in combating money laundering. This statute

- Directed Treasury to attempt to reduce the number of CTR filings by 30 percent and, to assist

in this effort, it established a system of mandatory and discretionary exemptions for banks;

- Required Treasury to designate a single agency to receive SARs;
- Required Treasury to delegate CMP powers for BSA violations to the federal bank regulatory agencies subject to such terms and conditions as Treasury may require;
- Required nonbank financial institutions to register with Treasury; and
- Created a safe harbor from penalties for banks that use mandatory and discretionary exemptions in accordance with Treasury directives.

Finally, in 2001, as a result of the 9/11 terror attacks, Congress passed the USA PATRIOT Act. The PATRIOT Act is arguably the single most significant AML law that has been enacted since the BSA itself. Among other things, the PATRIOT Act augmented the existing BSA framework by prohibiting banks from engaging in business with foreign shell banks, requiring banks to enhance their due diligence procedures concerning foreign correspondent and private banking accounts, and strengthening their customer identification procedures. The PATRIOT Act also

- Provides the Secretary of the Treasury with the authority to impose special measures on jurisdictions, institutions, or transactions that are of "primary money-laundering concern";
- Facilitates records access and requires banks to respond to regulatory requests for information within 120 hours;
- Requires regulatory agencies to evaluate an institution's AML record when considering bank mergers, acquisitions, and other applications for business combinations;
- Expands the AML program requirements to all financial institutions; and
- Increases the civil and criminal penalties for money laundering.

The OCC and the other federal banking agencies have issued two virtually identical regulations designed to ensure compliance with the BSA. The OCC's BSA compliance regulation, 12 CFR 21.21, requires every national bank to have a written program, approved by the board of directors, and reflected in the minutes of the bank. The program must be reasonably designed to assure and monitor compliance with the BSA and must, at a minimum (1) provide for a system of internal controls to assure ongoing compliance, (2) provide for independent testing for compliance, (3) designate an individual responsible for coordinating and monitoring day-to-day compliance, and (4) provide training for appropriate personnel. In addition, the implementing regulation for section 326 of the PATRIOT Act requires that every bank adopt a customer identification program as part of its BSA compliance program.

The OCC's SAR regulation, 12 CFR 21.11, requires every national bank to file a SAR when they detect certain known or suspected violations of federal law or suspicious transactions related to a

money-laundering activity or a violation of the BSA. This regulation mandates a SAR filing for any potential crimes (1) involving insider abuse regardless of the dollar amount; (2) where there is an identifiable suspect and the transaction involves $5,000 or more; and (3) where there is no identifiable suspect and the transaction involves $25,000 or more. Additionally, the regulation requires a SAR filing in the case of suspicious activity that is indicative of potential money-laundering or BSA violations and the transaction involves $5,000 or more.

III. OCC'S BSA/AML SUPERVISION

The OCC and the other federal banking agencies are charged with ensuring that banks maintain effective AML programs. The OCC's AML responsibilities are coextensive with our regulatory mandate of ensuring the safety and soundness of the national banking system. Our supervisory processes seek to ensure that institutions have compliance programs in place that include systems and controls to satisfy applicable CTR and SAR filing requirements, as well as other reporting and record-keeping requirements to which banks are subject under the BSA.

The OCC devotes significant resources to BSA/AML supervision. The OCC has nearly 1700 examiners in the field, many of whom are involved in both safety and soundness and compliance with applicable laws including the BSA. We have over 300 examiners on-site at our largest national banks, engaged in continuous supervision of all aspects of their operations. In 2003, the equivalent of approximately 40 full-time employees were dedicated to BSA/AML supervision. The OCC also has three full time BSA/AML compliance specialists in our Washington, D.C., headquarters office dedicated to developing policy, training, and assisting on complex examinations. In addition, the OCC has a full-time fraud expert in Washington, D.C., who is responsible for tracking the activities of offshore shell banks and other vehicles for defrauding banks and the public. These resources are supplemented by dozens of attorneys in our district offices and Washington, D.C., headquarters office who work on compliance matters. In 2003 alone, not including our continuous large bank supervision, the OCC conducted approximately 1,340 BSA examinations of 1,100 institutions and, since 1998, we have completed nearly 5,700 BSA examinations of 5,300 institutions.

The OCC monitors compliance with the BSA and money-laundering laws through its BSA compliance and money-laundering prevention examination procedures. The OCC's examination procedures were developed by the OCC, in conjunction with the other federal banking agencies, based on our extensive experience in supervising and examining national banks in the area of BSA/AML compliance. The procedures are risk-based, focusing our examination resources on high-risk banks and high-risk areas within banks. During an examination, examiners use the procedures to review the bank's policies, systems, and controls. Examiners test the bank's systems by reviewing certain individual transactions when they note control weaknesses, have concerns about high-risk products or services in a bank, or receive information from a law enforcement or other external source.

In 1997, the OCC formed the National Anti-Money-Laundering Group (NAMLG), an internal task force that serves as the focal point for all BSA/AML matters. Through the NAMLG, the OCC has undertaken a number of projects designed to improve the agency's supervision of the BSA/AML activities of national banks. These projects include the development of a program to identify high-risk banks for expanded-scope BSA examinations and the examination of those banks using agency experts and expanded procedures, examiner training, the development of revised examination procedures, and the issuance of policy guidance on various BSA/AML topics.

Over the years, the NAMLG has had many significant accomplishments, including

- Publishing and updating numerous guidance documents, including the *Comptroller's Handbook* BSA booklet, extensive examination procedures, numerous OCC advisories, bulletins and alerts, and a comprehensive reference guide for bankers and examiners;
- Providing expertise to the Treasury Department and the Department of Justice in drafting the annual U.S. National Money-Laundering Strategy;
- Providing expertise to the Treasury Department, FinCEN, and the other federal banking agencies in drafting the regulations to implement the PATRIOT Act; and
- Developing state-of-the-art training programs for OCC and other federal and foreign regulatory authorities in training their examiners in BSA/AML supervision.

To deploy its resources most effectively, the OCC uses criteria developed by NAMLG that targets banks for expanded-scope AML examinations. Experienced examiners and other OCC experts who specialize in BSA compliance, AML, and fraud are assigned to the targeted examinations. The examinations focus on areas of identified risk and include comprehensive transactional testing procedures. The following factors are considered in selecting banks for targeted examinations:

- Locations in high-intensity drug trafficking areas (HIDTA) or high-intensity money-laundering and related financial crime areas (HIFCA)
- Excessive currency flow
- Significant international, private banking, fiduciary or other high-risk activities
- Unusual suspicious activity reporting patterns
- Unusual large currency transaction reporting patterns
- Fund transfers or account relationships with drug source countries or countries with stringent financial secrecy laws

The program may focus on a particular area of risk in a given year. For example, our 2005 targeting program will focus on banks that have significant business activity involving foreign money

services businesses. In prior years, our targeting focus has been on banks that have significant business activity in private banking, offshore banking, and lines of business subject to a high risk of terrorist financing.

Other responsibilities of the NAMLG include sharing information about money-laundering issues with the OCC's district offices; analyzing money-laundering trends and emerging issues; and promoting cooperation and information-sharing with national and local AML groups, the law enforcement community, bank regulatory agencies, and the banking industry.

NAMLG has also worked with law enforcement agencies and other regulatory agencies to develop an interagency examiner training curriculum that includes instruction on common money-laundering schemes. In addition, the OCC has conducted AML training for foreign bank supervisors and examiners two to three times per year for the past four years. Over 250 foreign bank supervisors have participated in this training program. Recently, the World Bank contracted with the OCC to tape our international BSA school for worldwide broadcast. The OCC has also partnered with the State Department to provide AML training to high-risk jurisdictions, including selected Middle Eastern countries. And we consistently provide instructors for the Federal Financial Institutions Examination Council schools, which are now patterned after the OCC's school. In total, the OCC's AML schools have trained approximately 550 OCC examiners over the past five years.

OCC's Enforcement Authority

Effective bank supervision requires clear communications between the OCC and the bank's senior management and board of directors. In most cases, problems in the BSA/AML area, as well as in other areas, are corrected by bringing the problem to the attention of bank management and obtaining management's commitment to take corrective action. An OCC report of examination documents the OCC's findings and conclusions with respect to its supervisory review of a bank. Once problems or weaknesses are identified and communicated to the bank, the bank's senior management and board of directors are expected to promptly correct them. The actions that a bank takes, or agrees to take, to correct deficiencies documented in its report are important factors in determining whether more forceful action is needed.

OCC enforcement actions fall into two broad categories: informal and formal. In general, informal actions are used when the identified problems are of limited scope and magnitude and bank management is regarded as committed and capable of correcting them. Informal actions include commitment letters, memoranda of understanding, and matters requiring board attention in examination reports. These generally are not public actions.

The OCC also may use a variety of formal enforcement actions to support its supervisory objectives. Unlike most informal actions, formal enforcement actions are authorized by statute, are generally more severe, and are disclosed to the public. Formal actions against a bank include C&D orders, formal written agreements and CMPs. C&D orders and formal agreements are

generally entered into consensually by the OCC and the bank and require the bank to take certain actions to correct identified deficiencies. The OCC may also take formal action against officers, directors and other individuals associated with an institution (institution-affiliated parties). Possible actions against institution-affiliated parties include removal and prohibition from participation in the banking industry, CMPs and C&D orders.

In the BSA area, the OCC's CMP authority is concurrent with that of FinCEN. In cases involving systemic noncompliance with the BSA, in addition to taking our own actions, the OCC refers the matter to FinCEN. In the case of Riggs Bank, the OCC and FinCEN worked together on the CMP against the bank.

In recent years, the OCC has taken numerous formal actions against national banks to bring them into compliance with the BSA. These actions are typically C&D orders and formal agreements. The OCC has also taken formal actions against institution-affiliated parties who participated in BSA violations. From 1998 to 2003, the OCC has issued a total of 78 formal enforcement actions based in whole, or in part, on BSA/AML violations. During this same time period, the OCC has also taken countless informal enforcement actions to correct compliance program deficiencies that did not rise to the level of a violation of law.

Significant BSA/AML Enforcement Actions

The OCC has been involved in a number of cases involving serious BSA violations and, in some cases, actual money laundering. Some of the more significant cases involved the Bank of China (New York federal branch), Broadway National Bank, Banco do Estado de Parana (New York federal branch), and Jefferson National Bank. There are also dozens of other examples where the OCC identified significant money laundering or BSA noncompliance, took effective action to stop the activity, and ensured that accurate and timely referrals were made to law enforcement.

Bank of China, New York Federal Branch

In May 2000, OCC examiners conducting a safety and soundness examination discovered serious misconduct on the part of the branch and its former officials, including the facilitation of a fraudulent letter of credit scheme and other suspicious activity and potential fraud and money laundering. The misconduct, which resulted in significant losses to the branch, was subsequently referred to law enforcement. In January 2002, the OCC and the Peoples Bank of China entered into companion actions against the Bank of China and its U.S.-based federal branches. The bank's New York branch agreed to pay a $10 million penalty assessed by the OCC and the parent bank, which is based in Beijing, agreed to pay an equivalent amount in local currency to the People's Bank of China, for a total of $20 million. The OCC also required that the branch execute a C&D order which, among other things, required it to establish account opening and monitoring procedures, a system for identifying high-risk customers, and procedures for regular, ongoing review of account activity of high-risk customers to monitor and report suspicious activity. The OCC also took actions against six institution-affiliated parties.

Broadway National Bank, New York, New York

In March of 1998, the OCC received a tip from two separate law enforcement agencies that this bank may be involved in money laundering. The OCC immediately opened an examination which identified a number of accounts at the bank that were either being used to structure transactions, or were receiving large amounts of cash with wire transfers to countries known as money-laundering and drug havens. Shortly thereafter, the OCC issued a C&D order, which shut down the money laundering and required the bank to adopt more stringent controls. The OCC also initiated prohibition and CMP cases against bank insiders. In referring the matter to law enforcement, we provided relevant information including the timing of deposits that enabled law enforcement to seize approximately $4 million and arrest a dozen individuals involved in this scheme. The subsequent OCC investigation resulted in the filing of additional SARs, the seizure of approximately $2.6 million in additional funds, more arrests by law enforcement, and a referral by the OCC to FinCEN. In November 2002, the bank pled guilty to a three-count felony information that charged it with failing to maintain an AML program, failing to report approximately $123 million in suspicious bulk cash and structured cash deposits, and aiding and assisting customers to structure approximately $76 million in transactions to avoid the CTR requirements. The bank was required to pay a $4 million criminal fine.

Banco do Estado do Parana, Federal Branch, New York, N.Y (Banestado).

In the summer of 1997, the OCC received information from Brazilian government officials concerning unusual deposits leaving Brazil via overnight courier. The OCC immediately dispatched examiners to the branch that was receiving the majority of the funds. OCC examiners discovered significant and unusually large numbers of monetary instruments being shipped via courier into the federal branch from Brazil and other countries in South America, as well as suspicious wire transfer activity that suggested the layering of the shipped deposits through various accounts with no business justification for the transfers. The OCC entered into a C&D order with the federal branch and its head office in Brazil in January 1998 that required controls over the courier and wire transfer activities and the filing of SARs with law enforcement. The OCC also hosted several meetings with various law enforcement agencies discussing these activities and filed a referral with FinCEN. Shortly thereafter, the Brazilian bank liquidated the branch. In May of 2000, the OCC assessed a CMP against the branch for $75,000.

Jefferson National Bank, Watertown, New York

During the 1993 examination of this bank, the OCC learned from the Federal Reserve Bank of New York that the bank was engaging in cash transactions that were not commensurate with its size. OCC examiners subsequently discovered that several bank customers were depositing large amounts of cash that did not appear to be supported by the purported underlying business, with the funds being wired offshore. The OCC filed four criminal referral forms (predecessor to the SAR) with law enforcement pertaining to this cash activity and several additional criminal referral forms pertaining to insider abuse and fraud at the bank. The OCC also briefed several

domestic and Canadian law enforcement agencies alerting them to the significant sums of money flowing through these accounts at the bank. Based upon this information, law enforcement commenced an investigation of these large deposits. The investigation resulted in one of the most successful money-laundering prosecutions in U.S. government history. The significant sums of money flowing through the bank were derived from cigarette and liquor smuggling through the Akwesasne Indian Reservation in northern New York. The ring smuggled $687 million worth of tobacco and alcohol into Canada between 1991 and 1997. The case resulted in 21 indictments that also sought the recovery of assets totaling $557 million. It also resulted in the December 1999 guilty plea by a subsidiary of the R.J. Reynolds Tobacco Company and the payment of a $15 million criminal fine. The four criminal referral forms filed by the OCC in the early stages of this investigation were directly on point and pertained to the ultimate ringleaders in the overall scheme. These money-laundering cases were in addition to the C&D order entered into with the bank, the prohibition and CMP cases that were brought by the OCC, and the insider abuse bank fraud cases that were brought by law enforcement against some of the bank's officers and directors. Seven bank officers and directors were ultimately convicted of crimes.

OCC Cooperation with Law Enforcement and Other Agencies

As the above cases illustrate, combating money laundering depends on the cooperation of law enforcement, the bank regulatory agencies, and the banks themselves. The OCC participates in a number of interagency working groups aimed at money-laundering prevention and enforcement, and meets on a regular basis with law enforcement agencies to discuss money-laundering issues and share information that is relevant to money-laundering schemes. For example, the OCC is an original member of both the National Interagency Bank Fraud Working Group and the Bank Secrecy Act Advisory Group. Both of these groups include representatives of the Department of Justice, the FBI, the Treasury Department, and other law enforcement agencies, as well as the federal banking agencies. Through our interagency contacts, we sometimes receive leads as to possible money laundering in banks that we supervise. Using these leads, we can target compliance efforts in areas where we are most likely to uncover problems. For example, if the OCC receives information that a particular account is being used to launder money, our examiners would then review transactions in that account for suspicious funds movements, and direct the bank to file a SAR if suspicious transactions are detected. The OCC also provides information, documents, and expertise to law enforcement for use in criminal investigations on a case-specific basis.

The OCC has also played an important role in improving the AML and terrorist financing controls in banking throughout the world. For the past several years, the OCC has provided examiners to assist with numerous U.S. government-sponsored international AML and terrorist financing assessments. We have a cadre of specially trained examiners that has provided assistance to the Treasury Department and the State Department on these assessments in various parts of the world, including South and Central America, the Caribbean, the Pacific Rim nations, the Middle East, Russia and the former Eastern Bloc nations. In this regard, the cadre has participated in

terrorist financing investigations, assessed local money-laundering laws and regulatory infrastructure, and provided training to bank supervisors.

The OCC is also providing direct assistance to the Coalition Provisional Authority (CPA) of Iraq. Four OCC examiners are currently working in Iraq as technical assistance advisers to the CPA's Ministry of Finance and helping their counterparts at the Central Bank of Iraq develop a risk-based supervisory system tailored to the Iraqi banking system. The OCC examiners are assisting in the development of a law addressing money laundering and terrorist financing that is close to enactment by the CPA, the drafting of new policy and examination manuals to implement this law, and they are providing extensive AML training to Iraqi bank regulators.

IV. POST–9/11 ACTIVITIES AND THE IMPLEMENTATION OF THE USA PATRIOT ACT

In the immediate aftermath of the 9/11 terror attacks, the OCC participated in a series of interagency meetings with bankers sponsored by the New York Clearinghouse to discuss the attacks and their impact on the U.S. economy and banking system and provided guidance to the industry concerning the various requests from law enforcement for account and other information. The OCC was also instrumental in working with the other banking agencies to establish an electronic e-mail system for law enforcement to request information about suspected terrorists and money launderers from every financial institution in the country. This FBI Control List system was in place five weeks after 9/11 and was the precursor to the current system established under section 314(a) of the PATRIOT Act, which is now administered by FinCEN. At the same time, the OCC established a secure emergency communications e-mail system for all national banks through the OCC's BankNet technology.

In October 2001, Congress passed the USA PATRIOT Act. The OCC has been heavily involved in the many interagency work groups tasked with writing regulations to implement the PATRIOT Act over the past few years. To date, these work groups have issued final rules implementing sections 313 (foreign shell bank prohibition); 319(b) (foreign correspondent bank account records), 314 (information sharing), and 326 (customer identification). The OCC was also involved in drafting the interim final rule implementing section 312 (foreign private banking and correspondent banking).

The OCC took the lead in developing the current 314(a) process for disseminating information between law enforcement and the banks. The OCC worked with the interested regulatory and law enforcement agencies and drafted detailed instructions to banks concerning the 314(a) process and the extent to which banks are required to conduct record and transactions searches on behalf of law enforcement. The OCC also took the lead in drafting a frequently asked questions (FAQs) document to provide further guidance as to the types of accounts and transactions required to be searched, when manual searches for this information would be required, and the timeframes for providing responses back to law enforcement. Under the new procedures, 314(a) requests from

FinCEN are batched and issued every two weeks, unless otherwise indicated, and financial institutions have two weeks to complete their searches and respond with any matches.

Throughout this process, the OCC continually assisted FinCEN in maintaining an accurate electronic database of 314(a) contacts for every national bank and federal branch, provided effective communications to the industry through agency alerts concerning the 314(a) system, and participated in quarterly interagency meetings with fellow regulators and law enforcement agencies to ensure that the process was working effectively and efficiently.

The OCC also took the lead in drafting the interagency Customer Identification Program (CIP) regulation mandated by section 326 of the PATRIOT Act, which mandates the promulgation of regulations that, at a minimum, require financial institutions to implement reasonable procedures for (1) verifying the identity of any person seeking to open an account, to the extent reasonable and practicable; (2) maintaining records of the information used to verify the person's identity, including name, address, and other identifying information; and (3) determining whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided to the financial institution by any government agency. The OCC is also the primary drafter of interagency frequently asked questions (FAQs) concerning the implementation of the CIP rules. A second set of interagency FAQs will be issued shortly.

In order to assess PATRIOT Act implementation by the industry, in the summer of 2002, the OCC conducted reviews of all of its large banks to assess their compliance with the regulations issued under the PATRIOT Act up to that time and to evaluate the industry response to terrorist financing risk. Although, at that time, many of the PATRIOT Act regulations had not yet been finalized, we felt it was important to ascertain the level of bank compliance with and understanding of the new requirements. The purpose of these reviews was to discern the types of systems and controls banks had in place to deter terrorist financing and follow up with full-scope AML exams in institutions that had weaknesses. As a result of these reviews, the OCC was able to obtain practical first-hand knowledge concerning how banks were interpreting the new law, whether banks were having problems implementing the regulations or controlling terrorist financing risk, and which banks needed further supervision in this area.

On October 20, 2003, the OCC issued interagency examination procedures to evaluate national bank compliance with the requirements of section 313 and 319(b), and section 314 of the PATRIOT Act. The procedures were designed to assess how well banks are complying with the new regulations and to facilitate a consistent supervisory approach among the banking agencies. OCC examiners are now using the procedures during BSA/AML examinations of the institutions under our supervision. The procedures allow examiners to tailor the examination scope according to the reliability of the bank's compliance management system and the level of risk assumed by the institution. An interagency working group is currently drafting examination procedures concerning section 326 of the PATRIOT Act. The OCC is also the primary drafter of these procedures and we expect that they will be issued shortly.

OCC Outreach and Industry Education

As previously stated, the primary responsibility for ensuring that banks are in compliance with the BSA lies with the bank's management and its directors. To aid them in meeting this responsibility, the OCC devotes extensive time and resources to educating the banking industry about its obligations under the BSA. This has typically included active participation in conferences and training sessions across the country. For example, in 2002 the OCC sponsored a nationwide teleconference to inform the banking industry about the PATRIOT Act. This teleconference was broadcast to 774 sites with approximately 5,400 listeners.

The OCC also provides guidance to national banks through (1) industry outreach efforts that include roundtable discussions with bankers and industry-wide conference calls sponsored by the OCC; (2) periodic bulletins that inform and remind banks of their responsibilities under the law, applicable regulations, and administrative rulings dealing with BSA reporting requirements and money laundering; (3) publications, including the distribution of a comprehensive guide in this area titled *Money Laundering: A Banker's Guide to Avoiding Problems;* (4) publication and distribution of the *Comptroller's Handbook* booklet, "Bank Secrecy Act/Anti-Money Laundering," which contains the OCC's BSA examination procedures, and the *Comptroller's Handbook* booklet, "Community Bank Supervision," which provides guidance on BSA/AML risk assessment; and (5) periodic alerts and advisories of potential frauds or questionable activities, such as alerts on unauthorized banks and FinCEN reporting processes. In addition, senior OCC officials are regular participants in industry seminars and forums on the BSA, the PATRIOT Act, and related topics.

Current Supervisory Initiatives

The OCC uses somewhat different examination approaches depending largely on the size of the institution and its risk profile. In large banks (generally, total assets of $25 billion) and mid-size banks (generally, total assets of $5 billion), OCC examiners focus first on the bank's BSA compliance program. These banks are subject to our general BSA/AML examination procedures that include, at a minimum, a review of the bank's internal controls, policies, procedures, customer due diligence, SAR/CTR information, training programs, and compliance audits. We also evaluate BSA officer competence, the BSA program structure, and the bank's audit program, including the independence and competence of the audit staff. While examining for overall BSA compliance, examiners typically focus on suspicious activity monitoring and reporting systems and the effectiveness of the bank's customer due diligence program.

Additional and more detailed procedures are conducted if control weaknesses or concerns are encountered during the general procedures phase of the examination. These supplemental procedures include

- Transaction testing to ascertain the level of risk in the particular business area (e.g., private banking, payable upon proper identification programs (PUPID), nonresident alien accounts, international brokered deposits, foreign correspondent banking, and pouch activity) and to determine whether the bank is complying with its policies and procedures, including SAR and CTR filing requirements;
- Evaluation of the risks in a particular business line or in specific accounts and a determination as to whether the bank is adequately managing the risks;
- A selection of bank records to determine that its record-keeping processes are in compliance with the BSA.

For community banks (generally, total assets under $5 billion), examiners determine the examination scope based on the risks facing the institution. For low-risk banks, examiners evaluate changes to the bank's operations and review the bank's BSA/AML compliance program. For banks with higher-risk characteristics and weak controls, additional procedures are performed, including review of a sample of high-risk accounts and additional procedures set forth above. Examiners also perform periodic monitoring procedures between examinations and conduct follow-up activities when significant issues are identified.

Use of CTR and SAR Data in the Examination Process

All banks are required by regulation to report suspected crimes and suspicious transactions that involve potential money laundering or violate the BSA. In April 1996, the OCC, together with the other federal banking agencies, and FinCEN, unveiled the SAR system, SAR form, and database. This system provides law enforcement and regulatory agencies on-line access to the entire SAR database. Based upon the information in the SARs, law enforcement agencies may then, in turn, initiate investigations and, if appropriate, take action against violators. By using a universal SAR form, consolidating filings in a single location, and permitting electronic filing, the system greatly improves the reporting process and makes it more useful to law enforcement and to the regulatory agencies. As of December 2003, banks and regulatory agencies had filed over 1.3 million SARs, with national banks by far the biggest filers. Nearly 50 percent of these SARs were for suspected BSA/money-laundering violations.

The OCC also uses the SAR database as a means of identifying high-risk banks and high-risk areas within banks. Year-to-year trend information on the number of SARs and CTRs filed is used to identify banks with unusually low or high filing activity. This is one factor used by the OCC to identify high-risk banks. Examiners also review SARs and CTRs to identify accounts to include in the examination sample. Accounts where there have been repetitive SAR filings or accounts with significant cash activity in a high-risk business or inconsistent with the type of business might be accounts selected for the sample.

V. RIGGS BANK ENFORCEMENT ACTIONS

As previously mentioned, the OCC and FinCEN recently assessed a $25 million CMP against Riggs Bank, N.A., for violations of the BSA and its implementing regulations, and for failing to comply with the requirements of an OCC C&D order that was signed by the bank in July 2003. Also, in a separate C&D action dated May 13, 2004, to supplement the C&D we had issued in July 2003, the OCC directed the bank to take a number of steps to correct deficiencies in its internal controls, particularly in the BSA/AML area. Among other requirements in this separate action, the OCC directed the bank to

- Ensure competent management. Within 30 days, the board of directors must determine whether management or staff changes are needed and whether management skills require improvement.

- Develop a plan to evaluate the accuracy and completeness of the bank's books and records, and develop a methodology for determining that information required by the BSA is appropriately documented, filed, and maintained.

- Adopt and implement comprehensive written policies for internal controls applicable to the bank's account relationships and related staffing, including the Embassy and International Private Banking Group. Among other requirements, the policies must mandate background checks of all relationship managers at least every three years and must prohibit any employee from having signature authority, ownership, or custodial powers for any customer account.

- Develop and implement a policy that permits dividend payments only when the bank is in compliance with applicable law and upon written notice to the OCC.

- Adopt and implement an internal audit program sufficient to detect irregularities in the bank's operation, determine its level of compliance with applicable laws and regulations and provide for testing to support audit findings, among other requirements.

These actions were based on a finding that the bank had failed to implement an effective AML program. As a result, the bank did not detect or investigate suspicious transactions and had not filed SARs as required under the law. The bank also did not collect or maintain sufficient information about its foreign bank customers. In particular, the OCC found a number of problems with the bank's account relationship with foreign governments, including Saudi Arabia and Equatorial Guinea. Riggs failed to properly monitor, and report as suspicious, transactions involving tens of million of dollars in cash withdrawals, international drafts that were returned to the bank, and numerous sequentially numbered cashier's checks. The OCC will continue to closely monitor the corrective action that the bank takes in response to the order and we are prepared to take additional actions if necessary.

These actions are the most recent of a series of escalating supervisory and enforcement reactions to ongoing deficiencies in Riggs' BSA/AML compliance program. Since this matter involves an open bank and open investigations, there are limitations on what can be said without disclosing confidential supervisory information and potentially compromising future criminal, civil, and administrative actions. With that caveat, we have tried to set out below a summary of our supervision of this institution in the BSA/AML area, dating back to 1997.

The OCC first identified deficiencies in Riggs' procedures several years ago. Beginning in the late 1990s we recognized the need for improved processes at Riggs and for improvements in the training in, and awareness of, the BSA's requirements and in the controls over their BSA processes. Prior to 9/11, the OCC visited the bank at least once a year and sometimes more often to either examine or review the Bank's BSA/AML compliance program.

Over this timeframe OCC examiners consistently found that Riggs' BSA compliance program was either "satisfactory" or "generally adequate," meaning that it met the minimum requirements of the BSA, but we nonetheless continued to identify weaknesses and areas of its program that needed improvement in light of the business conducted by the bank. We addressed these weaknesses using various informal supervisory actions. Generally, this involved bringing the problems to the attention of bank management and the board and securing their commitment to take corrective action.

During this period, it was clear that the bank's compliance program needed improvement but we determined that the program weaknesses did not rise to the level of a violation of our regulation or pervasive supervisory concern. The OCC identified problems with the bank's internal audit coverage in this area, its internal monitoring processes, and its staff training on the BSA and customer due diligence requirements. Repeatedly, management took actions to address specific OCC concerns but, as is now clear, the corrective actions being taken often were not sufficient to achieve the intended results. The bank was continually taking steps to respond to OCC criticisms but failed to take action on its own to improve its overall compliance program, especially with regard to high-risk areas. Due to the lack of an effective and proactive management team, additional weaknesses and deficiencies were continually identified by the OCC over this time period, but bank follow-up on these weaknesses ultimately proved to be ineffective and the problems continued longer than they should have.

As various changes occurred in the regulatory expectations for banks relative to BSA compliance and related issues over this period of time, our scrutiny of the bank was adjusted accordingly. For example, when the Financial Action Task Force and FinCEN identified "uncooperative" countries, we conducted an examination at Riggs that specifically focused on account relationships with those countries and determined that the bank did not have extensive transaction activity with any of the countries on the list. In addition, Treasury issued its guidance on "politically exposed persons" in January 2001, and, as a result, the OCC's focus on the risks associated with the Riggs embassy banking business began to increase and our supervisory activities were heightened ac-

cordingly. However, at that time, the Kingdom of Saudi Arabia was not viewed as a country that posed heightened risk of money laundering or terrorist financing, and Equatorial Guinea had just begun to reap the financial benefits of the discovery of large oil reserves in the mid-1990s.

After 9/11, the OCC escalated its supervisory efforts to bring Riggs' compliance program to a level commensurate with the risks that were undertaken by the bank and we believed that we were beginning to see some progress in this regard. In fact, the bank was beginning the process of a major computer system conversion that would address many of the shortcomings in the existing information systems that the bank was relying on. Unfortunately, bank management had to adjust the timeline repeatedly. This caused significant delays in the implementation date, pushing it from the original target of year-end 2002 to September 2003. Thus, the bank was not able to fulfill many of the commitments that it made to the OCC to correct our concerns pertaining to its BSA compliance program. Also, as previously mentioned, the OCC conducted a series of anti-terrorist financing reviews at our large or high-risk banks, including Riggs, in 2002. As a result of these reviews and other internal assessments, plus published accounts of suspicious money transfers involving Saudi Embassy accounts, our concerns regarding Riggs BSA/AML compliance were heightened. Thus, we commenced another examination of Riggs in January of 2003.

The focus of the January 2003 examination was on Riggs' embassy banking business, and, in particular, the accounts related to the Embassy of Saudi Arabia. Due to its Washington, D.C., location, its extensive retail branch network, and its expertise in private banking, Riggs found embassy banking to be particularly attractive and had developed a market niche. In fact, at one time, 95 percent of all foreign embassies in the United States, and 50 percent of the embassies in London conducted their banking business with Riggs. The OCC's examination lasted for approximately five months and involved experts in the BSA/AML area. The findings from the January 2003 examination formed the basis for the July 2003 C&D order entered into with the bank. The OCC also identified violations of the BSA that were referred to FinCEN.

During the course of the 2003 examination, the OCC cooperated extensively with investigations by law enforcement into certain suspicious transactions involving the Saudi Embassy relationship. These transactions involved tens of millions of dollars in cash withdrawals from accounts related to the Embassy of Saudi Arabia; dozens of sequentially numbered international drafts that totaled millions of dollars that were drawn from accounts related to officials of Saudi Arabia, and that were returned to the bank; and dozens of sequentially numbered cashier's checks that were drawn from accounts related to officials of Saudi Arabia made payable to the account holder. There was regular contact with the FBI investigators throughout this examination. We provided the FBI with voluminous amounts of documents and information on the suspicious transactions, including information concerning transactions at the bank that the FBI previously was not aware of. The OCC also hosted a meeting with the FBI to discuss these documents and findings. Throughout this process we provided the FBI with important expertise on both general banking matters, and on some of the complex financial transactions and products that were identified.

The July 2003 C&D order directed the bank to take a number of steps to correct deficiencies in its internal controls in the BSA/AML area and to strongly consider staffing changes. Among other requirements in this action, the OCC directed the bank to

- Hire an independent, external management consultant to conduct a study of the bank's compliance with the BSA, including training, SAR monitoring, and correcting deficiencies, and conduct a risk assessment for compliance with the BSA throughout the bank.

- Evaluate the responsibilities and competence of management. In particular, the consultant's report to the board of directors must address, among other things, the responsibilities and competence of the bank's BSA officer, and the capabilities and competence of the supporting staff in this area. Within 90 days, the board of directors must determine whether any changes are needed regarding the bank's BSA officer and staff;

- Adopt and implement detailed policies and procedures (including account opening and monitoring procedures) to provide for BSA compliance and for the appropriate identification and monitoring of high-risk transactions;

- Ensure effective BSA audit procedures and expansion of these procedures. Within 90 days the board of directors must review and evaluate the level of service and ability of the audit function for BSA matters provided by any auditor; and

- Ensure bank adherence to a comprehensive training program for all appropriate operational and supervisory personnel to ensure their awareness and their responsibility for compliance with the BSA.

The OCC began its next examination of the bank's BSA compliance in October 2003. The purpose of this examination was to assess compliance with the C&D order and the PATRIOT Act, and to review accounts related to the Embassy of Equatorial Guinea. It was clear from this examination that the bank had made progress in complying with the order and in improving its AML program. Another notable accomplishment was the successful implementation of the long-planned system upgrade that significantly improved the information available to bank staff and management to monitor account activity and identify suspicious activity. Notwithstanding, there were significant areas of noncompliance noted by our examination. The examiners found that, as with the Saudi Embassy accounts, the bank lacked sufficient policies, procedures, and controls to identify suspicious transactions concerning the bank's relationship with Equatorial Guinea. These transactions involved millions of dollars deposited in a private investment company owned by an official of the country of Equatorial Guinea; hundreds of thousands of dollars transferred from an account of the country of Equatorial Guinea to the personal account of a government official of the country; and over a million dollars transferred from an account of the country of Equatorial Guinea to a private investment company owned by the bank's relationship manager. The findings from this examination, as well as previous examination findings, formed the basis for the OCC's recent CMP and C&D actions.

In retrospect, as we review our BSA/AML compliance supervision of Riggs during this period, we should have been more aggressive in our insistence on remedial steps at an earlier time. We also should have done more extensive probing and transaction testing of accounts. Our own BSA examination procedures called for transactional reviews in the case of high-risk accounts, such as those at issue here, yet until recently, that was not done at Riggs in the Saudi Embassy and the Equatorial Guinea accounts. Clearly, the types of strong formal enforcement action that we ultimately took should have been taken sooner. This is not a case where the deficiencies in the bank's systems and controls were not recognized, nor was there an absence of OCC supervisory attention to those deficiencies. But we failed to sufficiently probe the transactions occurring in the bank's high-risk accounts and we gave the bank too much time, based on its apparent efforts to fix its own problems, before we demanded specific solutions, by specific dates, pursuant to formal enforcement actions. As described below, we have reevaluated our BSA/AML supervision processes in light of this experience and we will be implementing changes to improve how we conduct supervision in this area. The Comptroller has also directed that our Quality Management Division undertake an internal review of our supervision of Riggs. These steps are outlined more fully below.

Improvements Undertaken to Improve BSA/AML Supervision

While we believe our overall supervisory approach to BSA/AML compliance has been rigorous and is working well, we are committed to ongoing evaluation of our approaches to BSA/AML compliance and to appropriate revisions to our approach in light of technological developments, and the increasing sophistication of money launderers and terrorist financers, as well as to address aspects of the process where shortcomings were evidenced in the Riggs situation. Recent and current initiatives include the following:

- As previously mentioned, together with the other federal banking agencies, we recently developed revised examination procedures for several key sections of the PATRIOT Act and we expect to be issuing a revised version of our BSA/AML *Handbook* booklet by the end of the year.
- We plan to develop our own database of national bank-filed SARs with enhanced search and reporting capabilities for use in spotting operational risk including in the BSA/AML area. This database will be compatible with the OCC's supervisory databases and will enable us to (1) generate specialized reports merging SAR data with our existing supervisory data, (2) sort SAR information by bank asset size and line of business, and (3) provide enhanced word and other search capabilities.

- We are developing and will implement nationwide, a new risk assessment process to better identify high-risk banks. This system uses standardized data on products, services, customers, and geographies to generate reports that we will use to identify potential outliers, assist in the allocation of examiner resources, and target our examination scopes (e.g., particular products or business lines).
- We are exploring with FinCEN and the other agencies better ways to use BSA information in our examination process, so that we can better pinpoint risks and secure corrective action. Upon completion of FinCEN's BSA Direct initiative (currently under development), the OCC will have direct access, as opposed to dial-in access, to the SAR database. We expect that this direct access system will allow us to make better and more effective use of FinCEN's SAR database.
- We are also exploring how we can systematically capture BSA/AML criticisms in examination reports so that we can track situations where no follow-up formal action has been taken.
- Our Committee on Bank Supervision also has sent an alert to remind and reinforce for OCC examination staff the need to recognize accounts and transactions that appear to be anomalous or suspicious or that have other characteristics that should cause them to be considered high-risk in nature and to conduct additional transaction testing and investigation in such situations.

In addition, specifically with regard to Riggs, the Comptroller has directed our Quality Management Division to immediately commence a review and evaluation of our BSA/AML supervision of Riggs. This review will include an assessment of whether we took appropriate and timely actions to address any shortcomings found in the bank's processes and in its responses to matters noted by the examiners, and the extent and effectiveness of our coordination and interaction with other regulators and with law enforcement. The Comptroller has also asked for recommendations for improvements to our BSA/AML supervision and our enforcement policy with regard to BSA/AML violations.

CONCLUSION

The OCC is committed to preventing national banks from being used, wittingly or unwittingly, to engage in money laundering, terrorist financing or other illicit activities. We stand ready to work with Congress, the other financial institution regulatory agencies, the law enforcement agencies, and the banking industry to continue to develop and implement a coordinated and comprehensive response to the threat posed to the nation's financial system by money laundering and terrorist financing.