Statement of

John C. Dugan

Comptroller of the Currency

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Chairman Dodd, Senator Shelby, and members of the Committee, I'm pleased to be here today to update the Committee on recent events in the financial markets and the condition of the national banking system. When I testified before this Committee in March, I reported that two powerful and related forces were exerting real stress on banks of all sizes and in many different parts of the country. One was the unprecedented series of credit market disruptions precipitated by declining house prices and severe problems with subprime mortgages. The other was the slowdown in the economy, which had begun to generate a noticeable decline in credit quality in a number of asset classes. As we assess the impact of these forces today, I would say this: credit markets are somewhat better, while credit quality — meaning the performance of loans and other credit extensions to which banks are exposed — is worse.

On the first point, we are beginning to see improvement in several key segments of the credit markets. In particular, there is significantly more liquidity in money markets, and spreads on credit default swaps have narrowed. Financial institutions have raised unprecedented amounts of capital since October 1 of last year — over $100 billion by national banking organizations alone — and this shoring up of their balance sheets has helped restore confidence and liquidity in the interbank market. In addition, the pipeline of hung leveraged loan deals has slowly begun the clearing process.

While these are all good signs of progress, we clearly are not out of the woods. There continues to be considerable uncertainty among market participants about the underlying strength of the economy and the ongoing effects the recent market disruption and economic downturn are having on financial counterparties, consumers, and commercial borrowers. This uncertainty may lead to continued volatility in the financial markets that we and the institutions that we supervise will need to monitor carefully.

Moreover, securitization channels for residential mortgages remain largely closed except for conforming mortgages sold to the GSEs and FHA. Although banks and other portfolio lenders have taken up some of this slack, they cannot provide the same level of credit to this important part of the mortgage market as was previously provided by securitization markets. In addition, the number of homes in foreclosure continues to rise. In this regard, we support the significant new options provided in this Committee's recent legislation that would help borrowers refinance their homes rather than face foreclosure.

On the second point – credit quality – the downturn in housing and the broader economy is indeed continuing to have an adverse effect on national banks' loan portfolios. The levels of nonperforming and past due loans is increasing. Not surprisingly, housing related credit is of particular concern, including home equity loans, lower quality first mortgages, and commercial real estate related to residential construction. But credit quality is also declining in credit card loans, auto loans, small business loans, and to a lesser extent, C&I loans and commercial real estate unrelated to housing.

There are two important caveats, however. First, this upward trend in losses starts from a very low base of exceptionally benign credit conditions. Second, banks in some parts of the country where regional economies are stronger have simply not experienced the same increases in problem loans.

Nevertheless, given the clear trend lines in most banks, responding to deteriorating credit quality will continue to be a major focal point for supervisors and bankers in the months ahead. In light of these conditions, we believe the substantial increases that banks have made both to loan loss reserves and to capital in recent quarters are both prudent and warranted. Indeed, should credit performance continue to worsen, as we expect, additional loan loss reserves will be needed, and in some cases, additional capital. As always, we support maintaining strong, conservative reserves, and we will continue to underscore this message to bankers, the accounting standard setters, and bank auditors.

Likewise, both on our own and in cooperation with other supervisors, we continue to identify and implement lessons learned from the recent market turmoil, especially for our larger institutions. These efforts focus on improvements to risk management, including addressing new types of liquidity risk; appropriately identifying and managing off-balance sheet exposures; managing concentrations; and significantly enhanced metrics for aggregating risks to particular counterparties.

Each of these areas is described in more detail in my written statement, and I would be pleased to address questions about any of them.